Corporate Law After the Eighties: Reflections on the Relationship Between Management, Shareholders, and Stakeholders

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ARTICLES

CORPORATE LAW AFTER THE EIGHTIES: REFLECTIONS ON THE RELATIONSHIP BETWEEN MANAGEMENT, SHAREHOLDERS, AND STAKEHOLDERS

PETER J. HENNING*

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I. INTRODUCTION

Every era has symbols of greed and wretched excess, and the past decade brought forth its exemplars from the world of corporate finance. Whether one chooses to focus on the individual, such as Michael Milken, the investment bank, such as Drexel Burnham Lambert, or the financial vehicle, the junk bond, all have acquired the type of pejorative meaning that has been ascribed to earlier symbols of alleged financial chicanery: the robber barons of the nineteenth century or the great trusts of the early twentieth century. Many of the alleged excesses of the 1980s revolved around the boom in corporate mergers and acquisitions, particularly the tactics developed for hostile takeovers and the defenses erected by management to ward off the threat of unwanted offers.\(^1\) Although the pace of corporate transactions, both friendly and hostile, has slowed considerably, it is likely that this is only a temporary lull rather than an end to the process of corporate restructuring.\(^2\)

The battle for corporate control has had an enormous impact on every segment of society, bringing both great wealth to shareholders and severe disruptions\(^3\) to management, investors, and the broader communi-

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1. However, deceit and fraud in the financial markets certainly did not end with the 1980s as the collapse of the fraud-ridden Bank of Credit & Commerce International (BCCI) and the Salomon Brothers government bond bidding scandal demonstrate. See Bacon & Salwen, Summer of Financial Scandals Raises Questions About the Ability of Regulators to Police Markets, Wall St. J., Aug. 28, 1991, at A10, col. 1.


ty of "stakeholders." The 1980s saw a fundamental change in the corporate control market through the expanded use of debt, including junk bonds, to finance transactions. Outside bidders had access to an enormous pool of capital to fund offers for corporations once thought unsellable. Moreover, the tactics adopted to achieve control changed through the use of two-tiered tender offers, junk bond financing, and some corporate "raiders" organized greenmail campaigns designed to wring profits out of companies through threats of a hostile offer. Corporations responded to the threat of hostile offers with an enormous array of increasingly potent defenses, including "shark repellents," poison pills, and lock-ups. In certain instances, corporate management even

4. The Business Roundtable, an organization of 200 chief executive officers of large public corporations, described stakeholders as the corporation's "employees, customers, suppliers, creditors, the communities where the corporation does business, and society as a whole." Statement of the Business Roundtable, Corporate Governance and American Competitiveness, 46 BUS. LAW. 241, 244 (1990) [hereinafter Corporate Governance]. Stakeholders have firm-specific investments in corporations that may be appropriated by shareholders through an extraordinary corporate transaction, without the consent of the stakeholders, that redistributes company's value to its shareholders. Macey, Fundamental Corporate Changes, supra note 3, at 175.

5. These are generally provisions in the corporate charter that provide for stringent conditions before approval of a merger, such as super-majority approval of extraordinary transactions and fair price provisions providing all shareholders with the same consideration for their shares. The board of directors reserves the right to waive the restrictive provisions if it approves the transaction, thereby giving the corporation a negotiating tool. See Carney, Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model, 1988 WIS. L. REV. 385, 393-95 [hereinafter Agency Cost Model].

6. Poison pills are rights granted to shareholders that vest upon the occurrence of a specified triggering event, generally the acquisition by an outside party of anywhere from 10% to 25% of the issuer's stock. This right permits the purchase of additional shares at a predetermined bargain price. Poison pills generally contain both "flip-in" rights, allowing the purchase of the target's stock, and "flip-over" rights, permitting purchase of the acquirer's stock. These rights dilute the bidder's holdings and significantly increase the cost of completing the transaction. Id. at 398-99; Note, The Defensive and Offensive Use of "Poison Pills" Within the Business Judgment Rule, 24 U. RICH. L. REV. 127, 134-36 (1989). Bidders generally condition their bid on management redeeming the rights before completing the transaction, and usually seek to enjoin operation of the poison pill. See, e.g., City Capital Associates Ltd. Partnership v. Interco, Inc., 551 A.2d 787, 798 (Del. Ch. 1988) (ordering management to redeem poison pill).

7. Lock-ups are agreements between the target and a bidder giving the bidder an advantage over other bidders (real or potential) by granting the bidder the right to purchase a large block of stock or prized assets of the target at a favorable price if a third party submits a competing bid. See Bainbridge, Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions, 75 MINN. L. REV. 239, 250-51
adopted the ultimate defense of a leveraged buyout (LBO), through which management and investors take a company private in a transaction financed by the company's own assets. By 1989, the trend of corporate restructuring culminated in the largest transaction in financial history -- with the LBO of RJR Nabisco for $24 billion, a deal punctuated by a frantic bidding war in which each participant furiously sought to top competing offers with bids built on creative financing.

The rapid developments in the market for corporate control in the 1980s challenged the courts to resolve disputes involving management's power to adopt defensive measures using the legal concept of the business judgment rule. This rule, however, could not comprehend the types of conduct being challenged. The Delaware judiciary had developed the business judgment rule to protect management's ability to act without the threat of second-guessing by the courts. The rule shields directors from liability for their good faith decisions if the decisions are based on adequate information (or an attempt to obtain the information) and are not tainted by self-interest. The Delaware Supreme Court (1990). Courts have enjoined lock-ups where the transaction unfairly favored one bidder and effectively halted a competitive auction for the target. See Hanson Trust PLC v. MLSCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989); In re Holly Farms Corp. Shareholders Litigation, 564 A.2d 342 (Del. Ch. 1989).


eroded the business judgment rule’s protections, however, in a series of cases decided in the mid-1980s. These cases signaled the Delaware Supreme Court’s unease with the protection offered by the business judgment rule in corporate control transactions where management’s defensive measures or a coercive bid may taint the decision-making process.12

The judicial trend of subjecting directorial decisions to closer review was part of a larger movement emphasizing the benefits of allowing the market for corporate control to police managerial performance and, ultimately, replace inefficient managers. In a seminal article, Professor (and now Judge) Frank Easterbrook and Professor Daniel Fischel argue that management should be passive when presented with an offer for the firm’s shares.13 The passivity thesis, which relies on the market


12. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Unocal, 493 A.2d 946 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 173 (Del. 1986). In Van Gorkom, the court held that a board of directors was grossly negligent in its failure to follow proper procedures in determining the adequacy of the offer price even though the friendly tender offer was a 50% premium over the current market price. 488 A.2d at 873; see infra text accompanying notes 89-101 (discussing Van Gorkom). Van Gorkom has been roundly criticized as “one of the worst decisions in the history of corporate law.” Fischel, The Business Judgment Rule and the Trans Union Case, 40 BUS. LAW. 1437, 1455 (1985) [hereinafter Trans Union]; see also, Herzel & Katz, Smith v. Van Gorkom: The Business of Judging Business Judgment, 41 BUS. LAW. 1187, 1188 (1986) (decision is “misguided”).

Shortly after Van Gorkom, the Delaware Supreme Court considered a board’s defensive self-tender in response to a two-tiered tender offer in Unocal. The target’s self-tender was for all shares except those held by the defendant bidder. 493 A.2d at 951. The Court noted that when a board faces a tender offer, there is an “omnipresent specter” of self-interest requiring an enhanced review of the board’s decision. Id. at 954; see infra, text accompanying notes 105-116 (discussing the Unocal decision). Although the court upheld management’s defensive response in Unocal, the decision indicated that a potentially higher level of scrutiny would be applied to determine whether defensive measures were commensurate with the threat posed by the offer. The Delaware Supreme Court extended the rationale of Unocal in Revlon by imposing a duty on the directors to conduct a fair auction to achieve the best price for shareholders when a company faces an impending break-up. 506 A.2d at 182; see infra, text accompanying notes 117-127 (discussing the Revlon decision).

13. Easterbrook & Fischel, The Proper Role of a Target’s Management in Re-
as the primary disciplinary tool for corporations, conflicts with a managerialist approach that emphasizes the need to protect management, shareholders, and other corporate constituencies from coercive tender offers. The differing approaches reflect the deeper philosophical question of on whose behalf the corporation exists and operates: shareholders or a broader group of stakeholders.

For shareholders, the 1980s proved to be quite lucrative, with gains variously estimated at $150 to $300 billion. By the end of the 1980s, however, shareholders had seen the Delaware Supreme Court erode the scope of their protection from management’s defensive tactics aimed at defeating hostile offers and preventing future unwanted advances. In

sponding to a Tender Offer, 94 HARV. L. REV. 1161 (1981) [hereinafter Proper Role]. Their thesis is that “shareholders’ welfare is maximized by an externally imposed legal rule severely limiting the ability of managers to resist a tender offer even if the purpose of resistance is to trigger a bidding contest.” Id. at 1164. The passivity thesis has been criticized for, among other things, not fully comprehending management’s potential role as the strongest negotiator on behalf of the shareholders to seek a higher price from the bidder. See, Oesterle, Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis, 71 CORNELL L. REV. 53, 55 (1985); Bebchuk, The Case for Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028 (1982).

14. The leading proponent of the managerialist approach is Martin Lipton, who argued that boards should have complete discretion to defeat hostile tender offers. Lipton, Takeover Bids in the Target’s Boardroom, 35 BUS. LAW. 101 (1979). More recently, Lipton proposed that boards be elected to a five year term, during which there can be no hostile offers for the company. At the end of each term shareholders would review the company’s performance and then decide whether to reelect the board. Lipton & Rosenblum, Quinquennial Election, supra note 2, at 225-26. For an analysis comparing the theoretical limits of the passivity thesis and managerial approach; see Brown, In Defense of Management Buyouts, 65 TUL. L. REV. 57, 85-93 (1990).

15. See, e.g., Millon, Theories of the Corporation, 1990 DUKE L.J. 201 [hereinafter Theories of the Corporation]; Johnson, The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law, 68 TEX L. REV. 865 (1990) [hereinafter The Meaning of Corporate Life]. Professors Johnson and Millon have been the leading proponents of the position that the focus of corporate law should be expanded beyond merely protecting the interests of shareholders, and must include a societal focus promoting the greater good of the communities in which corporations operate. See also Johnson & Millon, Misreading the Williams Act, 87 MICH. L. REV. 1862 (1989) [hereinafter Misreading the Williams Act]; Johnson & Millon, Missing the Point About State Takeover Statutes, 87 MICH. L. REV. 846 (1989) [hereinafter Missing the Point].

1989, the court held that a board of directors could reject a $200 per share tender offer to pursue a business combination that, according to the board, would result in even greater long-term gains for shareholders, although shareholders could not vote on the proposed transaction or otherwise reap any immediate benefits. Scarcely two years later, the company, Time Warner, saw its stock fall to $88 1/8 per share, and there appeared to be little if any hope for shareholders to achieve the propounded long-term gains within any reasonable period, if ever. The *Time* decision signalled the end to heightened scrutiny by the Delaware Supreme Court and may represent the beginning of an era of added protection for management in which the business judgment rule allows management to pursue strategies without regard to shareholder interests.

The perception of negative effects on both management and stakeholders from the wave of takeovers and resultant corporate restructurings reached beyond the rather narrow confines of financial and judicial circles to the political arena. Largely in response to pressure for relief from management of local companies subject to takeover threats and, to a lesser degree, from employees, local businesses, and community groups, a number of states enacted laws in the 1980s to limit takeovers. Some states went beyond simply enacting legislation to limit tender offers for local companies by altering the focus of the board.


19. Among the states that responded to pressure to protect a local corporation by enacting or amending takeover laws to make a pending offer more difficult to complete are: Arizona (Greyhound); Florida (Harcourt Brace Jovanovich); Massachusetts (Gillette); Minnesota (Dayton-Hudson); Missouri (TWA); New York (CBS); North Carolina (Burlington Industries); Ohio (Goodyear Tire and Rubber Co.); Pennsylvania (Armstrong World Industries); Washington (Boeing); Wisconsin (G. Heilemann Breweries). See Tyson, *The Proper Relationship Between Federal and State Law in the Regulation of Tender Offers*, 66 NOTRE DAME L. REV. 241, 346 (1990); Mahle, *Proxy Contests, Agency Costs, and Third Generation Antitakeover Statutes*, 15 J. CORP. L. 721, 730 (1990); Garfield, *State Competence to Regulate Corporate Takeovers: Lessons From State Takeover Statutes*, 17 HOFSTRA L. REV. 535, 561 (1989) [hereinafter *State Competence*]; Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 469-70 [hereinafter *State Anti-Takeover Legislation*]. Connecticut enacted its second generation antitakeover statute at the behest of Aetna, although there was no pending offer for its shares. See Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 122-23 (1987).
of directors. These states permitted (or even required) consideration of the interests of non-shareholders in determining how to conduct the business, including responding to takeovers. This legislation fundamentally changed corporate law's exclusive focus on shareholder welfare. Managers and shareholders previously constituted the closed world of corporate law, but now the public interest has been injected into the system.


21. Some commentators support the expanded focus of corporate law to protect other constituencies affected by corporate activity. See Johnson, The Meaning of Corporate Life, supra note 15, at 908 (reasserting shareholder primacy is not necessarily the proper role for corporate law; non-shareholder interests more closely aligned with management's in takeover context); Millon, Theories of the Corporation, supra note 15, at 261 (corporate law must take into account the public dimension, not just shareholders rights); Coffee, Takeover Reform, supra note 16, at 449-50 (state statutes may be a way to protect contracts of stakeholders); Johnson & Millon, Missing the Point, supra note 15, at 855 (state statutes are a "new vision of what corporations are"); Cf. Norwitz, "The Metaphysics of Time: A Radical Corporate Vision, 46 BUS. LAW. 377, 384 (1991) (Delaware Supreme Court properly recognizes the need to protect non-shareholder interests in corporation as separate from interests of shareholders).

The expansion of directorial power to consider different constituencies has been criticized as being both unworkable and a thinly disguised attempt by management to protect itself from the market for corporate control by expanding the board's power to reject offers. Ribstein, Takeover Defenses and the Corporate Contract, 78 GEO. L.J. 71, 141 (1989) (stakeholders should depend on contracts with corporation to protect interests); Garfield, Evaluating State Anti-takeover Legislation: A Broadminded New Approach to Corporation Law or "A Race to the Bottom"?, 1990 COLUM. BUS.
The recent changes in corporate law reconfigure tensions between management and shareholders by adding new constituencies who demand attention from corporations. The key issue is whether those new constituencies, the stakeholders, will be able to maintain their newfound prominence, or will fall back into the recesses of corporate law. These state statutes and judicial rules have vested the power to address both shareholder and stakeholder concerns in the board of directors, with only minimal judicial oversight. Given stakeholders' dependence on management to champion their interests, it is doubtful that, on their own, stakeholders will be able to achieve any real voice in corporate decision-making.

That prediction, however, does not necessarily mean stakeholders will suffer from management decisions. The 1980s also saw a more

L. REV. 119, 122 [hereinafter Evaluating State "Anti-Takeover" Legislation] (corporation law cannot adequately address concerns of non-shareholders); Carney, Does Defining Constituencies Matter, 59 U. CIN. L. REV. 385, 422 (1990) [hereinafter Defining Constituencies] ("altering legal rules to permit consideration of [stakeholder interests] will have little effect on corporate behavior"); Macey, Fundamental Corporate Changes, supra note 3, at 175 (negative effects on non-shareholders can best be remedied through contractual side-payments from corporation); Macey, State Anti-Takeover Legislation, supra note 19, at 476 (managerial self-interest sole reason for state statutes). See infra text accompanying notes 207-10 (discussing effect of non-shareholder statutes on shareholders).

22. In addition to stakeholders, bondholders have sought greater protection from takeovers. Bondholders are generally considered more conservative investors than shareholders, yet they saw the value of a number of their holdings eroded by LBOs that dramatically increased corporate debt while shareholders reaped the benefits from the transactions. Moreover, a number of those companies ended up in bankruptcy or teetering on the brink of insolvency, forcing even greater losses on creditors of the failing corporation. Bondholders have only minimal defenses against management's defensive actions, such as LBOs or re-capitalizations entailing assumption of large amounts of additional debt, because generally, directors do not owe creditors of the corporation a fiduciary duty. Some commentators have argued that directors should owe fiduciary duties to bondholders similar to those owed to shareholders. See Mitchell, The Fairness Rights of Corporate Bondholders, 65 N.Y.U.L. REV. 1165 (1990); McDaniel, Bondholders and Corporate Governance, 41 BUS LAW. 413 (1986). Nevertheless, courts have rejected such an extension of fiduciary duties, holding that bondholders are governed by the terms of the bond indenture. See Hartford Fire Insurance v. Federated Department Stores, 723 F. Supp. 976 (S.D.N.Y. 1989); Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989); Simons v. Cogan, 549 A.2d 300 (Del. 1988); see also, Comment, Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise, 11 HARV. J. L. & PUB. POL'Y 461, 484 (1988) (fiduciary duty principle cannot be used to regulate debtor-creditor relationship because of degree of adversity between corporation and bondholders).
subtle change in the market as institutional investors acquired a greater
stake in public corporations while individual stock ownership dimin-
ished. These institutional investors, which are primarily public and pri-
ivate pension funds, mutual funds, bank trust funds, insurance companies,
and nonprofit endowments, own approximately 44% of the total equities
in the United States. More importantly, the assets controlled by insti-
tutions are funds invested by individuals, companies, and communities
who are the stakeholders in corporations. The dynamic facing corpo-
ations is that they cannot separate the interests of equity investors, which
increasingly involve institutional owners, from stakeholder interests be-
because those two groups significantly overlap. Institutional investors may
seek greater responsiveness to shareholder interests and force manage-
ment to give more than rhetorical attention to corporate stakeholders
because the institutional investors represent both of those interests. The
potential of institutional ownership becoming a dominant influence on
the direction of corporations is at this point more a promise than a reali-
ty. There is, however, an increasing possibility of far reaching changes
in the relationship between management and shareholders, and the con-
sequent change in corporate law.

The slowing pace of the corporate acquisitions market, and fewer
legal challenges to management, allow for some reflections on how
corporate law responded to the issues raised by hostile offers and man-
agement defenses as well as how the law may develop as we enter the
next era of corporate law. Part II of this article briefly reviews where
corporate law stood before the boom in mergers and acquisitions began
to reach the courts and state legislatures in the 1980s. Part III analyzes
the judicial response, primarily that of the Delaware courts, to
management’s defensive measures, and how the Delaware Supreme
Court swung from raising the level of scrutiny of management decisions
to deferring to those decisions, at the cost of abandoning the basic prin-
ciple that shareholder welfare is the fundamental focus of corporate
decisions. Part IV examines the status of stakeholders, and explores
whether corporate law has in fact changed at all in addressing the con-
cerns of those groups beyond giving management a freer reign in run-
ing the corporation now that states permit corporate boards to consider
the interests of non-shareholders. Part V reviews the role institutional
investors may play in representing the interests of shareholders and non-
shareholder constituencies through the proxy process, and how manage-
ment may seek to limit the voting power of institutional shareholders.

23. NEW YORK STOCK EXCHANGE, INSTITUTIONAL INVESTOR FACT BOOK 1991
at 5.
The Article concludes by advocating that the Delaware Supreme Court pull back from its decision in *Time* deferring to management’s conclusions about the value of corporate plans. The Article recommends that the court reassert its role by subjecting defensive measures to a higher standard of scrutiny requiring that management disclose the basis for its strategic plans. This would ensure that institutional shareholders have sufficient information to judge the value of their investment and the effects of management’s plans.

II. CORPORATE LAW BEFORE THE TUMULT

In 1932, Adolf Berle and Gardiner Means concluded that the tension between shareholders and management in the modern corporation arises from the separation of ownership and control that insulated management from the discipline of the market. Until the pressure for change from the mergers and acquisition boom reached the courts and state legislatures, corporate law operated on the relatively straightforward relationship between management and shareholders. Management controlled corporate operations, with broad discretion to implement policies and determine the direction of the corporate enterprise. A legal regime developed to protect shareholders from the breadth of management’s discretion by creating a series of rules designed to ensure management’s accountability to the shareholders’ primary interest: wealth maximization. The bugaboo of corporate law was the unrestrained manager wasting corporate assets for personal enrichment with nary a care for the shareholders’ hard earned (yet relatively meager) investment in the company’s stock. By enshrining shareholder welfare as the governing principle, corporate law developed a closed system that did not require consideration of the interests of other corporate constituencies.

This focus on shareholder welfare has never been free of controversy. In response to the thesis that shareholders are the sole beneficiaries of the corporation, Merrick Dodd argued in the 1930s that corporations had a social, as well as, economic function, and that corporations


25. One of the basic assumptions of corporate law has been that a company’s stock is widely held by individuals, each with only an infinitesimal stake in the corporation. *Contra* Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 523 (1990) (arguing that this assumption was never true and is now obsolete). Nonetheless, the assumption does not adequately describe the current situation of large scale institutional ownership of the stock of most highly capitalized corporations. See *infra* notes 299-331 and accompanying text. (discussing effect of institutional ownership on proxy process).
must serve a greater variety of interests. 26 Four decades later, consumer activists Ralph Nader, Mark Green, and Joel Seligman proposed expanding corporate boards to include constituency representatives to make corporations more responsive to society's interests. 27 Beyond the issue of corporate governance is the question why shareholders should have primacy over other potential claimants to a corporation's value and continuing enterprise. There is no a priori legal requirement that a corporation must act to maximize the welfare of its shareholders, even if such a principle allows for the creation of a systemically consistent set of rules. 28 Moreover, "shareholder welfare" is not a precise term, and confining shareholder welfare to the immediate maximum market price for the company's stock provides no insight into how that goal is to be accomplished. 29

Regardless of how the term is understood, the philosophical issue of whom the corporation should serve did not interfere with the corpo-

26. Dodd, For Whom Are Corporate Managers Trustees?, 45 HARV. L. REV. 1145, 1148 (1932). The issue of what it means to be a "corporation" and who that corporation should serve has been evolving since the middle of the nineteenth century. The historical development of the theory of the corporation is beyond this Article's scope. For an excellent review of the development of the theory of the corporation, see Note, State Takeover Statutes and Corporate Theory: The Revival of an Old Debate, 64 N.Y.U.L. REV. 806 (1989).


28. See M. EISENBERG, THE NATURE OF THE COMMON LAW 44-47 (1988) (discussing concept of "systemic consistency" in rules of law). The economic view of the corporation as a "nexus" of contracts, or contracting relationships, views the shareholders as the residual beneficiaries of the value created by the corporation with the greatest stake in the outcome of corporate decisions. See Fama, Agency Problems and the Theory of the Firm, 88 J. POL. ECON. 288 (1980); Jensen & Meckling, Theory of the Firm, Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976). If one accepts the premise that corporate law should reflect the theory of the firm described by economists, then there is a basis for asserting that shareholder welfare should be the fundamental organizing principle of corporate law. See, e.g., Macey, Fundamental Corporate Changes, supra note 3, at 179-80. The economic analysis of corporations is not a value-neutral approach, and corporate law can encompass other social and political values. See Hazen, The Corporate Persona, Contract (And Market) Failure, and Moral Values, 69 N.C.L. REV. 273, 275 (1991) [hereinafter Corporate Persona] ("While economic analysis undoubtedly is helpful, it does not provide the complete answer to all of our problems. Furthermore, economic analysis, like any paradigm, brings with it its own biases and shortcomings.").

29. See Johnson, The Meaning of Corporate Life, supra note 15, at 881 n.66. Johnson correctly notes that "the belief that corporate managers should be held accountable does not logically lead to the conclusion that maximizing shareholder wealth is the proper focal point of corporate activity." Id. at 882.
rate law’s development around the principle of shareholder welfare. The means of constraining management’s discretion in governing the corporation fell into three broad categories: shareholder voting, the market for corporate control, and judicial review. 30

A. Shareholder Democracy and the Problem of Collective Action

Corporations are sometimes compared to democratic political institutions because each has a constituency with a right to vote for representatives who determine policy and oversee the operation of the bureaucratic entity, be it corporate or governmental. 31 Under state law, shareholders have a broader franchise than political voters, with the right to amend the corporate charter and approve major changes in the company’s structure, such as a merger, sale of substantially all assets, or liquidation, as well as the right to elect the corporation’s board of directors. 32 The corporate charter or state law may specify other areas of permissible voting. On issues in which there is no right to vote, shareholders are generally empowered to propose and vote on resolutions recommending certain actions to the board. 33 While state law governs

30. The economic approach views the market as the primary method for restraining management opportunism and enforcing accountability. That method of constraint does not strictly involve corporate law, except to the extent legal rules interfere with the proper functioning of the market.

31. See, e.g., DEL CODE ANN. tit. 8, § 211(c) (1991) (election of board of directors). The Business Roundtable asserts that comparison of corporate and political governance is erroneous, and that voting in the two systems “cannot be equated.” Corporate Governance, supra note 4, at 244. The Business Roundtable does not, however, describe the proper understanding of corporate voting, or why the different goals of corporate and political entities means that the act of voting cannot be “equated” where one of the franchise’s essential aims is to choose representatives. One may suspect that the Business Roundtable’s hidden agenda is to dissuade shareholders from thinking that they can prosper without management’s firm (even omniscient) guidance.

32. See., e.g., DEL. CODE ANN. tit. 8, §§ 242 (charter amendments), 251 (merger), 271 (sale of assets), 275 (liquidation) (1991). Certain transactions, such as mergers, may require a higher percentage of the vote for approval. See, e.g., N.Y. BUS. CORP. LAW § 903(a)(2) (McKinney 1986) (two-thirds of outstanding shares). Shark repellant charter amendments generally require a super-majority vote of outstanding shares, but those provisions can be waived by the directors. See supra note 4.

33. Shareholders generally vote by means of a proxy, although corporations must hold annual meetings open to all shareholders where voting rights can be exercised. In some states shareholders can even call a special meeting. See, e.g., DEL. CODE ANN. tit. 8, § 211(d) (1991) (special meetings may be called by the board of directors or by persons authorized by the certificate of incorporation or by the by-
the basic requirements for shareholder voting, federal law controls the content and process of voting by proxy. Any person who solicits proxies from more than ten shareholders must provide each solicitee a written proxy statement containing various disclosures pre-approved by the Securities and Exchange Commission (SEC).34

Prior to the 1960s, proxy contests were the primary means of effecting changes in corporate control. Their use, however, declined in favor of the tender offer because of the often insurmountable problems of mounting a successful proxy contest.35 Thus, while state law gives shareholders the right to vote, and the SEC proxy rules govern the content of the proxy and the solicitation process, the important issue is whether shareholder voting even matters.

The problem shareholders face is coordinating their actions to effectively discipline management when it is more likely that individual shareholders will be apathetic to a proxy solicitation. The collective action problem rests on the presumption that widely dispersed shareholders

34. Securities Exchange Act of 1934 § 14(a), 15 U.S.C. §78n(a) (1988); 17 C.F.R. § 240.14a-2 (1991). The pre-clearance requirement entails filing a preliminary proxy statement with the SEC at least 10 days before the proposed mailing date to allow for review and any objections by the SEC staff. 17 C.F.R. § 240-14a-6 (1991). “Solicitation” is broadly defined to include “[t]he furnishing of a form or proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.” 17 C.F.R. § 240.14a-1(f)(l)(iii) (1991). The breadth of the proxy solicitation definition has been held to include advertisements not specifically targeted to shareholders as well as furnishing information to the financial press. See Long Island Lighting Co. v. Barbash, 779 F.2d 793 (2d Cir. 1985); Trans World Corp. v. Odyssey Partners, 561 F. Supp. 1315 (S.D.N.Y. 1983). All proxies are subject to an antifraud prohibition barring false or misleading statements or omissions. Shareholders have a private right of action to sue for antifraud violations. J.I. Case Co. v. Borak, 377 U.S. 426, 434 (1964); 17 C.F.R. § 240.14a-9 (1991).

35. See Johnson & Millon, Misreading the Williams Act, supra note 15, at 1864 (hostile takeover has replaced proxy fight as the more potent vehicle for ousting management).
ers with small holdings in the company will not find it economically feasible to bear the costs of informing themselves about management's proposals. Shareholders face high agency costs in pursuing the necessary information while reaping only a pro rata benefit equal to their stock ownership for their expenditure. The likely shareholder response is termed "rational apathy," in which no shareholder undertakes the burden of becoming informed about management's proposals and will usually exercise the franchise, if at all, in management's favor.

Even where shareholders overcome the decision to be rationally apathetic and decide to oppose management by running an opposition slate of directors or making a shareholder proposal, they face two additional problems. First, the shareholders must deal with the "free-rider" issue. Although each shareholder may gain from opposing management, if the costs are greater than the individual benefit from the action, it is more likely that the shareholders will take a free ride on the expenditures of other shareholders by enjoying the benefit without the cost. As with the rational apathy problem, the free rider problem stems from

36. The collective action problem in the corporate context is thoroughly reviewed in R. CLARK, CORPORATE LAW § 9.5 (1986); Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & ECON. 395 (1983). Professor Rock aptly summarized the collective action problem facing shareholders: "[W]hile it is better for all if each contributes, it is better for each not to contribute, with the result that discipline, while in the collective interest of the shareholders, is not provided." Rock The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445, 456 (1991) (footnote omitted).

37. The collective action problem arises once a corporation has more than one shareholder. In a sole shareholder corporation, the owner has the greatest incentive to gather information to evaluate and discipline management because that owner will reap the entire benefit, equaling or exceeding the cost of acting. Once ownership becomes dispersed among a large group of shareholders, the problem of coordination arises, although there is no clear line past which the collective action problem effectively eliminates all shareholder oversight. See Bebchuk and Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 CALIF. L. REV. 1071, 1080 & n. 30 (1990) (discussing collective action problems from dispersed ownership); Rock, supra note 36, at 453 (discussing sole shareholder oversight of corporation).


39. Rock points out that free riding is a problem only if it interferes with the collective good either because the group is too small to act collectively without all the members or the presence of free riders will cause others to engage in free riding. Rock, supra note 36, at 461. In a corporation owned by widely dispersed shareholders with small individual holdings, it is the more likely the free rider problem in proxy contests will arise.
dispersed owners who lack a sufficient incentive to organize against management since any gain will be equally shared and may not outweigh the costs of acting.

Second, the likelihood of success is minimal for widely dispersed shareholders, and the costs of undertaking a proxy fight can be high. Management controls the agenda and the timing of when the proxy materials will be sent. Moreover, management runs the voting, and because most proxies are not secret, it can intervene in the middle of the process to pressure shareholders to vote with management or switch their votes. Finally, failing to vote has the same effect as voting with management because shareholder proposals generally must pass with the vote of a majority of the corporation’s shares, not a simple majority of the shares voted. When these problems are combined with the rational apathy of most shareholders, management usually has an overwhelming advantage.

The cost of mounting a successful proxy campaign is compounded by federal securities laws and the right of management to reimbursement for costs related to the proxy contest. In addition to complying with all the applicable proxy rules, which entail certain costs and delay, shareholders who coordinate their activity by communicating their positions or soliciting proxies may be subject to the disclosure requirements of Section 13(d) of the Securities Exchange Act of 1934 and related rules requiring groups beneficially owning more than five percent of a public company to disclose the names of the group members, its stock ownership, and its plans with regard to the company. If the shareholder group holds ten percent or more of the company’s stock, it may be subject to the short-swing trading prohibitions of Section 16. The securities laws undoubtedly increase the cost of pursuing a proxy contest regardless of whether complying with the proxy rules and other securities laws is considered an onerous burden.

40. See Black, Shareholder Passivity Reexamined, supra note 24, at 560-62 (describing a number of ways in which management can acquire “tainted” votes during an election).

41. See Rock, supra note 36, at 461 (compliance with federal proxy regulations increases costs of organizing shareholders).

42. 15 U.S.C. § 78m(d) (1988); 17 C.F.R. §§ 240.13d-1 - 240.13d-7 (1991); 17 C.F.R. § 240.13d-101 (1991). A 13D schedule must be filed within 10 days of the person or group owning 5% or more of the issuer’s stock.


44. See Gilson & Kraakman, Reinventing the Outside Director: An Agenda for
Greater costs are not problematic if the rules provide shareholders with a commensurate benefit; unfortunately, they do not. Shareholders and management must comply with the same proxy rules, but management is reimbursed for its proxy costs while challengers' must pay their own costs, except in the rare circumstance where a new board is elected and votes to pay the challengers' costs. The board can approve payment of proxy expenses if the contest involved a question of policy and the expenses are reasonable. As might be expected, those limitations are empty, and boards routinely approve management's proxy expenses, including the costs of proxy solicitation and public relations firms. Shareholders mounting a proxy fight, however, have no affirmative right to reimbursement. If the contest involves a shareholder proposal that is not somehow coupled with replacement of the board, then the possibility of reimbursement rests on management largesse, a doubtful proposition at best.

The various hurdles facing widely dispersed shareholders desiring to discipline management through the corporate franchise means that the proxy process can be largely hollow. Management can rely on a quiescent electorate to approve its proposals, which came to include the various antitakeover provisions developed in the 1980s. These provisions provided the context in which the courts and legislatures altered the focus of corporate law beyond the simple principle of protecting shareholder welfare.

Institutional Investors, 43 STAN. L. REV. 863, 894 (1991) [hereinafter Reinventing the Outside Director] (regulatory barriers exist, but their importance is exaggerated); Black, Shareholder Passivity Reexamined, supra note 25, at 533 (shareholders face many obstacles, and no single rule is a "show stopper", but the cumulative impact is large). The litigation is an additional hidden cost of a proxy contest expense likely to result from management's attack on the proxy statement as allegedly violating the antifraud prohibition and the reporting requirements of section 13(d). The corporation, however, bears management's legal expenses. See id. at 540 (antifraud proscription is "serious overkill" when used by management to challenge shareholder statements in proxy contest).

45. See Levin v. Metro-Goldwyn-Mayer, Inc., 264 F. Supp. 797 (S.D.N.Y. 1967); Hand v. Missouri-Kansas Pipe Line Co., 54 F. Supp. 649 (D. Del. 1944). 46. See Levin, 264 F. Supp. at 802-04 (use of two proxy solicitation firms and public relations consultant are reasonable expenses); Steinberg v. Adams, 90 F. Supp. 604, 607 (S.D.N.Y. 1950) (use of proxy solicitation firm reasonable expense). Professors Bebchuk and Kahan found that reimbursement of management's expenses has rarely been denied if the proxy contest did not involve a policy question or because the costs were unreasonable. Bebchuk & Kahan, supra note 37, at 1107-08.
B. A First Attempt to Corral the Market for Corporate Control: The Williams Act

In 1960, there were only eight cash tender offers for U.S. corporations, totalling less than $200 million. By the middle of the 1960s, however, hostile offers emerged as the method of choice for gaining control of a company and ousting its management. Tender offerors operated with almost complete freedom in bidding for companies, with no obligation to disclose the true identity of the bidder or the source of their funding. The offers were conditioned on quick acceptance to stampede shareholders into accepting. Management's response was sometimes equally suspect, including unsubstantiated statements concerning the offer. Although Congress heard horror stories of tender offer abuses, it also received testimony about shareholder benefits from an active market for corporate control.

After considering tender offer reform legislation for three years, Congress passed the Williams Act in 1968 to prevent some of the abuses observed in tender offers. Congress recognized that tender offers serve important purposes in disciplining management and improving its accountability to shareholders. The Williams Act advances two objectives: shareholder protection through disclosure, and regulatory neutrality between offerors and management. The disclosure provision was patterned after the proxy rules, and the SEC was given broad authority under the Act to promulgate rules to protect against fraudulent and

48. Id. at 2, reprinted in 1968 U.S. CODE CONG. & ADMIN NEWS at 2812. The offeror was not required to give any specified period for shareholders to review an offer. In hearings on tender offer reform legislation, one Senator referred to the "rape" of corporations by raiders operating under a "cloak of secrecy." Full Disclosure of Corporate Equity Ownership in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 43 [hereinafter Hearings on S. 510] (statement of Sen. Kuchel).
49. Hearings on S. 510, at 204-05.
50. Id. at 56-57 (Professor Samuel Hayes); Id. at 115 (Professor Robert Mundheim).
Section 14(d) of the Williams Act establishes basic disclosure duties in tender offers, requiring the offeror to disclose to the SEC its identity and background, the source and amount of funds used in making the purchases, the offeror's holdings in the target company, and the purpose of the purchases.\footnote{54} If an offeror increases the price during a tender offer, all shareholders will receive the higher price.\footnote{55} The SEC granted target shareholders rights to regulate the terms of the offer. This is an expansion of rights beyond those specified in the Williams Act. Rule 14d-7 allows tendering shareholders to withdraw their shares while the offer remains open. If the offer is for less than all shares, Rule 14d-8 requires the offeror to purchase the shares on a pro rata basis if the offer is oversubscribed.\footnote{56}

Section 14(e) is a two-prong antifraud provision, prohibiting false or misleading statements in connection with a tender offer, and prohibiting fraudulent, deceptive, or manipulative practices in a tender offer.\footnote{57} The 1970 amendments\footnote{58} to the Williams Act expanded the SEC's rulemaking power under Section 14(e) to proscribe fraudulent, deceptive, or manipulative practices. The Commission enacted two rules to limit abuses in tender offers: Rule 14e-1, which requires that all tender offers remain open for twenty business days; and Rule 14e-2, which requires that, within ten business days of the commencement of the tender offer, the target send its shareholders a statement explaining its position on the tender offer.\footnote{59}

The regulatory regime adopted in the Williams Act and expanded

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\footnote{53. Securities Exchange Act of \text{1934} \S 14(e), 15 U.S.C. \S 78n(e) (1988).}  
\footnote{54. 15 U.S.C. \S 78n(d)(1) (1988). The information provided to the SEC on Schedule 14D-1 and transmitted to the target is called the Tender Offer Statement. 17 C.F.R. \S 240.14d-100 (1991). Section 14(d) and Rule 14d-9 impose similar disclosure requirements when the issuer makes a tender offer for its own securities. 17 C.F.R. \S 240.14d-9 (1991).}  
\footnote{55. 15 U.S.C. \S 78n(d)(7) (1988).}  
\footnote{56. 17 C.F.R. §§ 240.14d-7, 14d-8 (1991).}  
\footnote{57. 15 U.S.C. \S 78n(e) (1988).}  
\footnote{59. 17 C.F.R. \S 240.14e-1(a), 14e-2 (1991). The Commission has also promulgated Rule 14e-3, 17 C.F.R. \S 240.14e-3, which prohibits trading or tipping information relating to a tender offer in the target's securities. The rule is designed to mitigate the effect of the Supreme Court's decision in \text{Chiarella v. United States}, 445 U.S. 222 (1980) (employee of financial printer not a fiduciary to stockholders of target company), and is not directly related to the abuses of the tender offer process by offerors or targets.}
by the SEC has been likened to a "federal corporation law." Despite the Williams Act, however, many states responded to hostile takeovers by passing what has come to be called first-generation anti-takeover legislation. The state legislation tended to follow the Williams Act disclosure model, but many of the statutes also imposed pre-bid notice requirements on bidders and allowed state officials to review the substantive terms of the offer. Moreover, the statutes often reached beyond the state's borders to regulate foreign corporations.

A key issue concerning the Williams Act has been determining whether Congress intended to preempt the states from regulating tender offers or only intended to regulate the narrow area of proper disclosure and procedures for tender offers. In its first decision considering whether the Williams Act preempted state regulation of tender offers, Edgar v. MITE Corp., the Supreme Court issued a muddled plurality opinion that was effectively overruled a few years later.

MITE effectively invalidated most first-generation antitakeover statutes. However, the Court was split on the constitutional basis for overturning the state legislation. Three Justices concluded that the appeal

60. Tyson, supra note 19, at 260.
61. See Garfield, State Competence, supra note 19, at 542 (37 states passed first-generation anti-takeover statutes).
64. Scholarly commentators have interpreted the Act and the SEC rules both ways. Compare Tyson, supra note 19, at 248 (Supreme Court has "emasculated Williams Act by faulty construction of provisions" and has "derailed tender offer regulation from the federal track Congress intended."); Garfield, State Competence, supra note 19, at 540 (legislative history "reveals a strong desire on the part of Congress that takeover battles be fought on a level playing field"), with Johnson & Millon, Misreading the Williams Act, supra note 15, at 1868 ("proper understanding of the Williams Act offers no credible support for the preemption claim").
66. MITE challenged the Illinois antitakeover law after making a cash tender offer for the shares of Chicago Rivet & Machine Co., an Illinois corporation headquartered in Chicago. Id. at 627. The Illinois law required an offeror to provide the target and the Illinois Secretary of State twenty days advanced notice of a bid. During that period only the target, not the offeror, could communicate with shareholders. ILL. REV. STAT. ch. 121 1/2, para. 137.54A, E (repealed 1983). The act applied to all target companies in which Illinois residents owned 10% or more of the outstanding
was moot after MITE withdrew its offer and did not offer an opinion on the constitutionality of the Illinois law. Five Justices concluded that the law violated the commerce clause, but only three Justices were willing to find that the Williams Act preempted the Illinois statute. The plurality opinion concluded that Congress intended to preempt state laws that effectively favored bidders or targets because of the Williams Act's policy of neutrality in tender offers. Yet, the opinion is not clear why that policy preempts state laws that regulate tender offers.

The Williams Act and SEC rules curb the most abusive tactics in tender offers by mandating disclosure by bidders and target management, a uniform price for all shareholders, withdrawal rights, and an adequate waiting period before the offer closes. Unintentionally, the Williams Act does not answer the pivotal question of what role, if any, the states had to play in regulating takeovers, and the Supreme Court did not provide a definitive answer in the first review of a state antitakeover statute in MITE.

C. Protecting Shareholders Through Fiduciary Duties

The traditional corporate model envisions a pyramid, with the directors at the top, overseeing management which acts for the good of the shareholders at the bottom. The accountability of the directors is ensured through judicial review of their decisions under the rubric of fiduciary duties imposed on the directors: the duty of care and the duty of loyalty. Shareholders may enforce these duties by bringing derivative actions
The duty of care requires that directors exercise the care of a reasonably prudent person acting under similar circumstances. The duty covers primarily the procedural aspects of the board's decision-making process, mandating that the board be adequately informed of the facts relating to the proposed act or policy, and to properly deliberate before acting. Although judicial pronouncements on the duty of care seemingly require a certain threshold of board involvement in a decision, findings of directorial violations are rare. Duty of care cases focus more on articulating a standard rather than undertaking anything more than a cursory review of the board's actions as a prelude to finding that there is no violation.

The duty of loyalty requires that directors act in the best interests of the corporation, free from their own interests. The Delaware Supreme Court announced the rationale of the duty in Guth v. Loft,
where it stated:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . .

A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty. 78

The duty of loyalty does not prohibit all transactions involving potential self-dealing, but the proponents of a transaction in which a board member or management has a financial interest must show the entire fairness of the transaction to the corporation, and that disinterested members of the board approved the transaction after complete disclosure. 79

If the directors’ decision is not tainted by a conflict that entails a breach of the duty of loyalty, and if the decision meets the minimal procedural requirements of the duty of care, then the court will apply the business judgment rule to protect the directors from liability. The business judgment rule is a presumption of the court that “in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interests of the company.” 80 Invocation of the business judgment rule means that a court will not substitute its judgment for that of the directors, thereby giving boards latitude to take risks and, perhaps more importantly, to avoid forcing the judiciary to evaluate complex business decisions that it likely could not fully comprehend. 81 As one court noted colloquially, the rule prevents “Monday-morning quarterbacking.” 82

The board’s duties of care and loyalty are equally implicated in transactions involving corporate control, when the board must follow proper procedures in reviewing an offer and confront the obvious conflict of interest presented by a transaction that will affect the positions of both management and the directors. In both friendly and hostile transactions, the directors have a stake in the outcome such that any decision

77. 5 A.2d 503 (Del. 1939).
78. Id. at 510. The case involved a director usurping a corporate opportunity.
79. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); see Palmiter, supra note 10, at 1395-1411 (reviewing development of application of duty of loyalty).
81. See Fischel, Trans Union, supra note 12, at 1439 (“judges lack competence in making business decisions”).
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may be tainted by self-interest. Courts could require that all acts by the board of directors be subjected to the entire fairness test applied to transactions implicating the duty of loyalty. In *Cheff v. Mathes*, however, the Delaware Supreme Court held that the directors' conflict of interest in a corporate control situation is qualitatively different than in other cases raising loyalty issues. If the directors could show that there was a policy conflict between the corporation and the offeror, then "the directors satisfy their burden by showing good faith and reasonable investigation; the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made." The Delaware Supreme Court opted to apply the business judgment rule to the directors' decision, rather than the stricter entire fairness standard, by positing the potential loyalty problems as somehow different, i.e. inconsequential.

*Cheff* eliminates any meaningful role for judicial review of transactions involving corporate control "[b]ecause competent counsel could always document a policy conflict between a would-be acquirer and defending management . . . ." As interpreted by the Delaware Supreme Court in the context of takeovers, the business judgment rule gives management a potent weapon to defend against hostile offers by allowing the board to reject an offer and adopt defensive measures without justifying how its decisions will benefit the shareholders. Once the implications of *Cheff*'s minimal level of scrutiny of management's antitakeover tactics became apparent, the Delaware Supreme Court reacted by imposing, at least temporarily, a higher standard of review. The path of the Delaware Supreme Court in first adopting that standard, and its recent demise, will be reviewed in Part III.

III. THE PENDULUM SWINGS: MANAGEMENT AND SHAREHOLDERS IN THE BATTLE FOR CORPORATE CONTROL

Delaware is the preeminent jurisdiction for defining the limits of corporate law because a disproportionate number of large companies are

83. 199 A.2d 548 (Del. 1964).
84. *Id.* at 554. *Cheff* involved a challenge to a stock repurchase program designed to prevent a hostile acquisition.
85. *Id.* at 555 (citation omitted).
86. Gilson & Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 249 (1989) [hereinafter *Delaware’s Intermediate Standard*]. Professors Gilson and Kraakman note that companies losing cases under the lax *Cheff* standard "were smaller companies without the benefit of advice from special counsel and investment bankers." *Id.* at n.7.
incorporated there. The state has been accused of winning the "race to the bottom" to attract corporate charters. The Delaware judiciary is widely credited with bringing a special expertise to corporate law issues, and indeed Delaware courts decided most of the major state corporate law decisions in the 1980s or other courts cited the Delaware courts as precedent to support their decision. The corporate law decisions of the Delaware courts were considered pro-management, and Cheff certainly adheres to that tradition. The business judgment rule served as a shield for management risk taking by allowing the board to rely on the judiciary's reluctance to second guess board decisions to pursue transactions that may not ultimately result in the greatest gain to shareholders.

Shareholders used to have at least the theoretical ability to discipline and, ultimately, replace inefficient managers without causing disruptions outside the corporate community. By the early 1980s, however, this basic premise of corporate law began to collapse as the power of management to protect itself grew far beyond the limited ability of the courts to use legal principles, such as the business judgment rule, to guard shareholders from corporate decisions entrenching management. Defensive measures approved by directors became increasingly troublesome for shareholders, but the rules of corporate law were ill-equipped to curtail managerial discretion. Ultimately, the principle of shareholder primacy would be questioned by both the courts and state legislatures as the effect of mergers and acquisitions reached broader constituencies. The conflict between shareholders and management took precedence because, at least initially, that was all corporate law could address at one time.


88. See Macey & Miller, Trans Union Reconsidered, 98 YALE L.J. 127, 133 (1988) (Delaware courts generally give management wide discretion); Gilson & Kraakman, Delaware's Intermediate Standard, supra note 86, at 250 (Cheff considered unduly favorable to management).

89. Some commentators argue that shareholder interference with management's decisions by pursuing legal claims can cause management to take fewer risks. Fischel & Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 CORNELL L. REV. 261, 265-74 (1986); see Fischel, Trans Union, supra note 12, at 1442 (shareholder lawsuits when management decisions turn out poorly will reinforce management's tendency to avoid risk, which is detrimental to shareholders).
A. The Van Gorkom Signal

In Smith v. Van Gorkom,\(^{90}\) the Delaware Supreme Court sent a signal that it was ready to adopt a greater role in reviewing management’s actions in corporate control transactions. The court reviewed a class action challenge to the board’s decision to approve a buyout of Trans Union Corp. at $55 per share, a fifty percent premium over the price of the company’s stock prior to the announcement.\(^{91}\) The shareholders had overwhelmingly approved the buyout.\(^{92}\) Despite the obvious increase in value received by the shareholders, and their strong approval of the transaction, the Delaware Supreme Court, in a 3-2 decision, held that the board “was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the . . . merger proposal . . . .”\(^{93}\) The corporate bar was taken aback, to say the least, by a finding that a well-respected corporate board’s decision was not protected by the business judgment rule.\(^{94}\)

The court focused on the board’s inadequate review of the $55 per share merger proposal. Jerome Van Gorkom, Trans Union’s chairman and CEO, approached Jay Pritzker, a prominent investor, and proposed the $55 price and suggested a financing structure for Pritzker to acquire the company.\(^{95}\) Shortly thereafter, Pritzker made an offer contingent on

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90. 488 A.2d 858 (Del. 1985).
91. Id. at 866.
92. Id. at 870.
93. Id. at 881.
94. The Delaware legislature subsequently limited the effect of Van Gorkom by enacting a provision permitting shareholders to amend the corporate charter to eliminate monetary liability for breach of the duty of care by directors. Del. Code Ann. tit. 8, § 102(b)(7) (1991). Section 102(b)(7), which became effective on July 1, 1986, provides:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

95. 488 A.2d at 866. Prior to approaching Pritzker, Van Gorkom considered and rejected an LBO of Trans Union at $55 per share. Id. at 865. A strong motive for selling the company was to allow it to take advantage of large investment tax credits that were not currently applicable apply due to insufficient taxable income. Id.
a decision being reached by the board in three days. The merger proposal allowed Trans Union ninety days to accept any better offer, and Pritzker had the right to purchase one million shares of Trans Union stock at a slight premium if a higher bid was accepted. At a special board meeting the day before the offer expired, Van Gorkom made a twenty minute presentation concerning the company and the merger proposal, although the agreement was not available for review. The entire meeting lasted two hours, and the board did not have any outside appraisals or fairness opinions to consider. The court determined that the board did not fully inform itself about the proposed merger before voting on it, finding that:

[Under] all of the surrounding circumstances — hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever — the directors were duty bound to make reasonable inquiry of Van Gorkom . . . , and if they had done so, the inadequacy of that upon which they now claim to have relied would have been apparent.

The majority opinion paints a picture of a board's decision that is not a model of a thoughtful deliberative process. In fact, however, no Delaware court reviewing management's conduct under the business judgment rule has reached a conclusion remotely similar to Van Gorkom. The holding that the directors were grossly negligent in not fully informing themselves is suspect. The board's five outside directors were eminently qualified, and Van Gorkom was a lawyer, an accountant, and an experienced manager with an intimate familiarity with Trans Union's business. The business judgment rule is designed to allow directors to use their experience to make decisions without judicial second guessing, including a board's decision to defer to the CEO's judgment that an offer at a fifty percent premium does not require a drawn out review process that will likely not change the final decision to accept the offer. The Van Gorkom opinion, however, reads like judicial second guessing, and serves as a signal to corporations that the Delaware Supreme Court will not acquiesce in board conduct that is at the limit

96. Id. at 866-70. Fischel notes that the majority opinion is "almost like a detective story." Fischel, Trans Union, supra note 12, at 1438. The above account is intended only as a cursory review of the dense factual analysis in the majority opinion.

97. 488 A.2d at 875.

98. See Fischel, Trans Union, supra note 12, at 1445-47.
of adequate consideration where the issue is control of the corporation.  

The court’s focus on the lack of an outside valuation is an integral part of the signal to corporations that a more rigorous decision-making process is necessary. Although the court stated that it did not “imply that an outside valuation study is essential ... [or] that fairness opinions by independent investment bankers are required as a matter of law,” there is no other way to read the opinion than as a mandate to corporate boards to adopt the very procedures broadly hinted in the opinion. Nevertheless, focusing on the board’s failure to secure outside legal and financial advice about the adequacy of the offer does not answer the ultimate question of whether the decision to accept a fifty percent premium was proper.

99. Professors Macey and Miller interpret Van Gorkom as the Delaware Supreme Court making an “example” of the Trans Union board “to send the strongest possible message to the corporate bar that rush offers need not be entertained.” Macey & Miller, Trans Union Reconsidered, supra note 88, at 138. This Article agrees with their position that the rush offer was the core problem, and makes the related point that the Van Gorkom Court intended to inform corporations of the proper procedures they should follow in future situations involving issues of corporate control by making an example of Trans Union’s board.

100. 488 A.2d at 876.

101. One of the Trans Union board’s strongest arguments was that the 50% premium over the market price validated the board’s decision to accept the merger. The argument is based on the efficient market theory that the securities markets digest information within a short period of time and adjust stock prices accordingly to reflect that information in valuing the security. See generally, Henning, Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws, 39 KAN. L. REV. 1, 11 (1990) (discussing Supreme Court use of efficient market theory in Rule 10b-5 cases). The court rejected that argument, finding that Van Gorkom and the board “knew that the market had consistently undervalued the worth of Trans Union’s stock.” 488 A.2d at 876. By rejecting the market price as the sole indicator of a company’s value, the Delaware Supreme Court created a powerful shield allowing management to point to its own “valuation” of the company as the basis for rejecting a price the market (i.e., shareholders) considered fair. See Macey & Miller, supra note 88, at 138 (“difficult to justify defensive maneuvers if the efficient capital markets hypothesis is accepted”). The full implication of this aspect of Van Gorkom would not be apparent until the court’s decision in Time, in which it blindly accepted management’s assertion that the company was worth far more than a cash tender offer.

Commentators argued that the effect of Van Gorkom may be merely to mandate unnecessary procedural steps for boards that will only serve to generate legal and underwriting fees without substantially altering the outcome of the process. See Fischel, Trans Union, supra note 12, at 1453 (outside consultants are the biggest winners after this case); Macey & Miller, Trans Union Reconsidered, supra note 88,
The essential mistrust of management and directors embodied in the duty of loyalty is implicated in corporate control decisions. Yet the Delaware Supreme Court in Cheff rejected a strict application of the entire fairness standard in reviewing the transaction. Short of reversing Cheff, the Van Gorkom court sought to require boards to use some type of independent source of information to support a decision. Effectively requiring legal and financial opinions is the most obvious method to force a board to document its decision. Van Gorkom’s message is a functional one that addresses how a board makes a decision while maintaining the basic rationale of the business judgment rule, that the substance of the directors’ decision will not be reviewed.\footnote{at 134-35 (“[f]airness opinions of investment bankers are notorious for the degree to which they can be induced to reflect the wishes of the incumbent board”).}

102. Professor Fischel bitterly criticized the Court’s implied requirement of outside legal and financial advice, noting that an attempt to obtain an opinion might have “killed” the Trans Union merger and that participation by outside consultants is “a type of insurance no matter how worthless their opinion is or how much it will cost.” Fischel, Trans Union, supra note 12, at 1446, 1453. The implicit assumption in criticizing the cost of using outside lawyers and investment bankers is that, without the court imposing that requirement, corporate boards would not hire these advisers. That assumption is highly suspect if for no other reason than those outside advisers perform the “grunt work,” for lack of a better term, of putting together the necessary documents for public filings, proxies, and closings. The “expertise” provided by independent advisers goes far beyond providing fairness opinions and valuations because an offer involves far more than a board of directors simply saying no (or yes). The costs imposed by Van Gorkom are more likely a minor addition to the legal, financial, and accounting bills the corporation receives for independent advice.

In contrast to the overwhelmingly negative reputation of lawyers and investment bankers, in Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988), the lawyer for a bidder involved in an auction terminated a telephone call from the target’s CEO after the CEO tried to improperly pass important information about the bids without informing the other bidder. Id. at 1275. The Delaware Supreme Court noted the integrity of the bidder’s counsel and that the information would not otherwise have come to light without his statement. Id. at n.23. At least in this one instance, the presence of an outside adviser advanced the cause of fairness to shareholders.

A more telling argument against the enhanced procedural requirements of Van Gorkom is that “papering” the transaction will not affect the board’s decision. Macey and Miller conclude that “the benefits of such increased deliberation are likely small, because of the ease with which corporate boards, aided by a phalanx of sophisticated lawyers and investment bankers, can cloak result-oriented decision-making in the guise of careful deliberation.” Macey & Miller, Trans Union Reconsidered, supra note 88, at 141. That criticism assumes that directors will not undertake their review of an offer in good faith, and that the decision has been made before the consideration begins. While that may be true in some instances, it is an unfair generalization when applied to all boards. There is no way to quantify the effect of the
B. Unocal and Revlon: Claiming a Seat at the Table

The rise of the corporate "raider" coercing shareholders into tendering their stock or, if they refused, making them face the prospect of receiving "junk" bonds in a forced back-end merger, received an inordinate amount of attention from corporate management (for propaganda purposes) and from courts. The idea that shareholders could be forced or "stampeded" into tendering rests largely on the assumption, noted earlier in the context of proxy contests, that stock owners are widely dispersed individuals who cannot or will not adequately review the value of an offer to determine whether it is in their best interest to tender or to hold out in the hope of a higher offer. The concomitant of this sad picture of shareholder coercion is the need for management to rescue shareholders from the corporate raider and their own blind self-interest in an immediate payoff, a scene one commentator compared to a "spaghetti western." There is, however, some question whether shareholders are ever "mistreated" by an offer that will pay them more for their stock than its current market value.

Nevertheless, in Unocal Corp. v. Mesa Petroleum Co., the Delaware Supreme Court recognized the two-tier tender offer as "a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." Mesa owned approximately thirteen percent of Unocal's stock, and commenced a partial cash tender offer for thirty-seven percent of Unocal's shares at enhanced procedures required by Van Gorkom.

103. Weiss, Emperor Has No Clothes I, supra note 71, pt. I, at 1684. Professor Weiss argues that the Supreme Court's decision in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987), upholding an Indiana anti-takeover statute as not unconstitutional or in violation of the Williams Act, does not explain the analysis used to reach its decision thereby allowing the Court to retain flexibility in deciding future cases. Professor Weiss terms this as keeping "a seat at the table." Weiss, Emperor Has No Clothes I, supra note 71, at 1684.


105. See id. at 464 ("myth of target shareholder mistreatment in takeovers is as unfounded as the myths of the tooth fairy, Santa Claus, and the Easter bunny") (footnote omitted); Coffee, Takeover Reform, supra note 15, at 439 ("In the real world, demonstrated examples of coercion remain as rare as confirmed sightings of the Loch Ness monster."); Easterbrook & Fischel, Proper Role, supra note 13, at 1164 (shareholder welfare maximized by barring management from resisting tender offer).

106. 493 A.2d 946 (Del. 1985).

107. Id. at 956 (footnote omitted).
$54 per share. Upon completion of that transaction, Mesa intended to effect a back-end merger by exchanging junk bonds ostensibly valued at $54 per share for the remaining shares. After an extended board meeting to consider Mesa’s offer, the outside directors rejected it as inadequate and considered a self-tender for the company’s shares. Shortly thereafter, the board approved an exchange offer of debt securities valued at $72 per share for the remaining forty-nine percent of Unocal’s stock if Mesa successfully completed its offer; Mesa was explicitly excluded from tendering its shares back to the company. The Delaware Chancery Court enjoined Unocal’s discriminatory exchange offer.\(^{108}\)

The Delaware Supreme Court began the analysis of the applicability of the business judgment rule to a board’s decision involving corporate control by addressing the conflict of interest problem shunted aside in Cheff. The court stated that “[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.”\(^{109}\) The “enhanced duty” examination involves a two-step analysis: first, pursuant to Cheff, the offer must pose a danger to corporate policy; second, the defensive response “must be reasonable in relation to the threat posed.”\(^{110}\) The court noted the possible concerns a board may consider in determining whether the offer posed a threat to the corporation or its shareholders: “inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.”\(^{111}\)

The court held that the discriminatory exchange offer was reasonably related to the threat posed by Mesa.\(^{112}\) The coercive nature of Mesa’s offer and the problems with receiving junk bonds in the back-end merger posed a substantial threat to the corporation. Moreover, the court noted that T. Boone Pickens, chairman of Mesa, had a “national

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\(^{108}\) Id. at 950-53. It is interesting to note that the Delaware Supreme Court’s opinion makes repeated references to the role of the board’s investment advisers in determining the value of the company and proposing various structures for the transaction. This emphasis is likely an implicit affirmation of Van Gorkom’s admonition that boards seek independent advice in considering an offer.

\(^{109}\) Id. at 954.

\(^{110}\) Id. at 955.

\(^{111}\) Unocal Corp., 493 A.2d at 955.

\(^{112}\) Id. at 956.
reputation as a ‘greenmailer’” whose actions posed a threat to the corporation. The board’s exchange offer served to protect shareholders, even short-term investors, and was reasonable in response to the threat posed by Mesa. Therefore, the court applied the business judgment rule to Unocal’s actions.

The new intermediate level of scrutiny adopted in Unocal avoids the pitfall of Van Gorkom because a court can focus on “objective” criteria, such as, the nature of the threat and the reasonableness of the response, without necessarily becoming involved in reviewing how the directors reached their decision. Unocal shows that directors will use outside legal and financial advice to erect powerful defensive measures that will always withstand the type of review the court applied to the Trans Union board’s decision, yet simply applying Cheff to the discriminatory exchange offer would be a hollow exercise. The Delaware Supreme Court adopted a compromise position that allows the business judgment rule to retain its primacy while constricting the wide berth the rule gave to management.

Unocal does not explain what types of offers constitute a sufficient threat to the corporation to permit a defensive response, and therefore it is impossible to determine from the opinion what responses will be reasonable beyond those facts described in the case. The Unocal test announces that the Delaware courts will more closely scrutinize board decisions involving corporate control while retaining maximum flexibility to first define what is a “threat” to the corporation and then decide whether the defensive response was proportionate to the threat. In that sense, the Delaware Supreme Court staked its claim to a seat at the table of corporate control contests, but did not announce whether it would be an active participant in the game.

While Unocal announced an intermediate level of scrutiny of management’s defensive tactics, it also recognized that the board is not strictly limited to considering shareholder welfare in ascertaining whether

113. Id. It is not clear how Pickens’ reputation as a greenmailer posed a threat to Unocal, especially when a company must agree to greenmail by buying out the person’s stake in order to prevent a takeover. It is anomalous to use a management defensive tactic, greenmail, as the basis for finding a threat to the corporation. The Delaware Supreme Court later upheld a board’s greenmail payment under the Unocal intermediate scrutiny standard in Polk v. Good, 507 A.2d 531, 537 (Del. 1986).
114. 493 A.2d at 958.
an offer constitutes a threat. The court stated that the directors may consider an offer's effect on other constituencies, which was the only factor in the nonexclusive list that did not relate directly to the structure of the offer or its value to shareholders. Whether the court intended to alter the basic principle of corporate law, that the directors act solely on behalf of the shareholders, is not clear from the opinion because the question of the interests of other constituencies was not at issue. The effect of acknowledging non-shareholder interests, however, gives the court even greater flexibility to shape future decisions to include those interests if they are of sufficient magnitude.

The issue of management's defensive tactics becomes more complicated when there is more than one bidder seeking control of the company, and the board is placed in the position of choosing between competing bids that may include a management sponsored proposal. The rather simple context in which the court began its enhanced scrutiny of board decisions in *Unocal*, a case with only one bidder who could easily be painted as a "raider" in a black (or green) hat, became more complex in the bidding war at issue in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* Pantry Pride indicated to Revlon that it was interested in negotiating the purchase of Revlon at approximately $43 per share, and that Pantry Pride was ready to pursue a hostile takeover. Revlon immediately took defensive measures by adopting a poison pill. Pantry Pride launched a hostile offer at $47.50 per share, which the board rejected as inadequate. Revlon then completed an offer for ten million of its shares by exchanging a debt security and cumulative preferred stock for the tendered shares. The new securities included covenants

116. 493 A.2d at 955.
117. Compare Gilson & Kraakman, *Delaware's Intermediate Standard*, supra note 86, at 267 & n. 65 (shareholder interests are primary and consideration by directors of other interests would render most of corporate law incoherent), with Johnson, *The Meaning of Corporate Life*, supra note 15, at 888 n.88 (Gilson and Kraakman are incorrect in concluding that non-shareholder interests would render corporate law incoherent).
118. 506 A.2d 173 (Del. 1986).
119. Id. at 177. In Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985), the Delaware Supreme Court held that a company decision adopting a poison pill even when there was no pending or threatened tender offer was protected by the business judgment rule under the *Unocal* proportionality analysis. 500 A.2d at 1356. The court noted rather ominously, however, that applying the business judgment rule to adoption of a poison pill does not insulate the board. "The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders." Id. at 1357 (citing *Unocal*).
limiting Revlon’s power to incur additional debt, sell assets, or pay dividends without approval from the independent directors. Pantry Pride renewed its offer at essentially the same price. The Revlon board authorized management to begin negotiations with third parties interested in acquiring the company. Pantry Pride then raised its bid three more times, reaching $56.25 per share.

Management reached an agreement with Forstmann Little & Co. (Forstmann) for an LBO of the company at $56 per share, conditioned on board waiving the poison pill and canceling the restrictive covenants on the debt securities. Upon announcement of the LBO, the value of the debt securities began to fall, and the bondholders threatened litigation against the directors for their losses. Pantry Pride continued to pursue Revlon, announcing that it would top any other bid for the company. After receiving financial information from Revlon that was not made available to Pantry Pride, Forstmann raised its bid to $57.25, conditioned on Revlon agreeing to certain actions. Forstmann agreed to an exchange of the debt securities for new securities at par to protect their value. Forstmann demanded immediate acceptance of its offer, after which Pantry Pride then raised its bid to $58 per share. Pantry Pride filed suit to enjoin any transaction between Revlon and Forstmann and require Revlon’s board to redeem the poison pill and cancel the debt security covenants.

The Delaware Supreme Court first considered whether the poison pill and exchange offer for ten million shares were protected by the business judgment rule under the Unocal standard. The court held that Pantry Pride’s initial offer was a threat because the board determined it was inadequate and was made by a company intent on a “bust-up” transaction financed by junk bonds. It then concluded that the

120. 506 A.2d at 177.
121. The Forstmann conditions were: (1) Revlon’s agreement to a lock-up option on a Revlon division at a price at least $100 million below Revlon’s valuation of the unit if another acquirer owned 40% of Revlon’s shares; (2) a no-shop provision; (3) cancellation of debt security covenants and redemption of the poison pill; (4) a $25 million cancellation fee; and (5) no Revlon management would not participate in the merger. Id. at 178.
122. Id. at 180-81.
123. Id. The court accepts the board’s conclusion as to inadequacy without subjecting it to even minimal scrutiny, using the pejorative terminology of “bust-up” and “junk bond” as if that buttresses a reasonable conclusion that an offer is inadequate. It is possible the court undertook the initial Unocal analysis of the defensive measures as an example to the lower court of how these types of defensive actions should be reviewed, knowing that upholding the board on the preliminary defensive measures under the enhanced scrutiny standard would not change the ultimate decision
poison pill and exchange offer were reasonable responses to an inadequate offer. If the perfunctory Unocal analysis of management's defensive tactics was the extent of Revlon, the case would be wholly unimportant except to show that the Delaware Supreme Court was not interested in pursuing any measure of heightened scrutiny.

The court went on to hold, however, that once Revlon became involved in a bidding war and "the break-up of the company was inevitable," the board's duties changed from "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." Revlon takes Unocal one step further by imposing an additional duty on the directors to conduct an auction for the sole purpose of maximizing the value of the company for the benefit of the shareholders. Revlon means not only that the directors' decisions will be more closely reviewed, but that the court will evaluate those actions under the single standard of shareholder wealth maximization. On that basis, the board's goal of protecting the value of the debt securities "was inconsistent with the changed concept of the directors' responsibilities." While Unocal acknowledges that non-shareholder interests may be considered by a board in responding to an offer, that concern is inappropriate when the break-up of the company is inevitable because non-shareholder interests are subject to the overriding limitation that all acts must be for the benefit of shareholders. The court held that Revlon ended the bidding contest without allowing the auction to run its course to permit the highest bid. Therefore the board's decision to enter the agreement with Forstmann could not withstand the heightened Unocal scrutiny. Revlon expands the Unocal policy of closer scrutiny of management's actions in a corporate control contest because Unocal applies to the directors' actions in direct response to a takeover, and measures their validity in proportion to the threat posed. Revlon goes a

124. Id.
125. Id. at 182. The court noted that the board "no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot." (citing Revlon at 182).
126. Id.
127. Id. at 184. The court found that "the Revlon board ended the auction in return for very little actual improvement in the final bid. The principal benefit went to the directors, who avoided personal liability to a class of creditors to whom the board owed no further duty under the circumstances." Id.
CORPORATE RESTRUCTURING AFTER THE EIGHTIES

step further by holding that when there is no longer any "threat" to the corporation, the board must take positive steps to maximize the value of the shareholders' investment. Management can no longer simply respond to a threat; it must create the greatest possible value in the short-term. While Unocal provided management with discretion to respond reasonably to an offer, Revlon forces a response that is not both defensive in nature and wealth maximizing. 128

Revlon does not, however, clarify the issue unresolved in Unocal regarding what constitutes a threat to the corporation. The Delaware Supreme Court concluded that there was no longer a threat to corporate policy or to the shareholders' interests once the break-up was inevitable, but did not identify when that line had been crossed. Describing the break-up of the company as "inevitable" is the conclusion of the Revlon analysis, not the starting point. Revlon, however, does not explain when the point of inevitability is reached or what constitutes the "break-up" of a company. The court created a new auction duty without specifying when the board must fulfill the duty, thereby maintaining its seat at the table first claimed in Unocal. By failing to provide a clear description of the scope of the test, the court created an additional level of heightened scrutiny without limiting its application.

While Revlon is an extension of Unocal's enhanced scrutiny approach, reconciling the underlying policies of the two decisions is more problematic. Unocal stated that the concerns a board may address include those of non-shareholders. The decision gives the board, not the shareholders, the power to determine the proper response to an offer threatening the corporation's policy or effectiveness. However, stating that consideration of non-shareholder interests must entail benefits to the shareholders, Revlon, disparages the board's actions favoring bondholders at the expense of shareholders, and seemingly cuts back on Unocal's shift away from the principle of shareholder primacy. The tension between the two decisions is a further reflection of the court's approach creating a new standard to scrutinize management without defining the scope of that standard. 129 The fundamental unresolved issue for the court is whether management, through consideration of non-shareholder

128. See Note, Time and Time Again the Board is Paramount: The Evolution of the Unocal Standard and the Revlon Trigger Through Paramount v. Time, 66 NOTRE DAME L. REV. 159, 173 & n.77 (1990) [hereinafter Time and Time Again] (Revlon established a bright line rule that is a subset of Unocal's analysis).

129. See Johnson, The Meaning of Corporate Life, supra note 15, at 914 (Revlon tries to contain the "potentially mutinous" policy of Unocal acknowledging non-shareholder interests).
interests, or shareholders would be the beneficiaries of the new standard.

C. Ivanhoe Partners v. Newmont Mining Corp.: Wavering on Heightened Scrutiny

In *Ivanhoe Partners v. Newmont Mining Corp.*, the Delaware Supreme Court proved that the indecision in the *Unocal* and *Revlon* decisions could lead to a questionable result. Newmont Mining faced two potential offers, both of which might be hostile, from Ivanhoe Partners (Ivanhoe), a T. Boone Pickens entity owning 9.95% of Newmont Mining, and Gold Fields, which owned 26% of Newmont Mining. After Ivanhoe failed to enlist Gold Fields in a joint undertaking, Ivanhoe made a two-tiered tender offer for 42% of Newmont at $95 per share, with a back-end cash out merger at the same price. Ivanhoe subsequently raised its offer to $105 per share, which the Newmont Mining board rejected as inadequate. Newmont Mining and Gold Fields then entered into an agreement that allowed Gold Fields to purchase up to 49.9% of Newmont Mining conditioned on the company declaring a special dividend of $33 per share. Further, Gold Fields would only be allowed 40% representation on Newmont Mining's board. With the funds from the special dividend, Gold Fields then made a "street sweep" of Newmont Mining stock, increasing its holdings to 49.7% of the shares.

Ivanhoe challenged the special dividend and Gold Fields' street sweep. The Delaware Supreme Court found that both Ivanhoe and Gold Fields posed a threat to the company. The Gold Fields threat was not overt, in that it never made an offer for Newmont Mining, but Gold Fields did "pause[] to weigh its options" with regard to Newmont Mining, and it could conceivably have undertaken a hostile offer. The court held that Newmont's response to both threats was reasonable under *Unocal* because it "enabled Newmont to maintain its independent status for the benefit of its other stockholders." More importantly,

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130. 535 A.2d 1334 (Del. 1987); see Gilson & Kraakman, Delaware's Intermediate Standard, supra note 86, at 257 n.38 (Ivanhoe "demonstrates that the road to doctrinal clarity in Delaware is neither straight nor straightforward").

131. *Id.* at 1338-40. The Court explained that a street sweep involves the rapid accumulation of a company's stock in open market transactions during (or shortly after) a tender offer for the stock. The shares are generally purchased at a small premium over the market price from arbitragers holding large blocks of stock. *Id.* at 1337 n.3.

132. *Id.* at 1342.

133. *Id.*

134. *Ivanhoe* at 1344. The court upheld the special dividend on the basis that it distributed to shareholders the "heretofore undervalued nongold assets," a position that
the court did not subject Newmont Mining to a Revlon analysis because the board never put the company up for sale and there was never a bidding contest between Ivanhoe and Gold Fields.

The focus on Newmont Mining's desire to remain independent is the key to the decision, and demonstrates the potential breadth of the threat prong of Unocal's heightened scrutiny. By recognizing that independence is a separate corporate value to be protected in the face of a hostile offer, the court sanctioned virtually any response by the board as proportionate to the threat because, by their nature, hostile offers destroy corporate independence. Moreover, the court set a high standard for applying the Revlon duty by holding that the Newmont directors did not trigger the auction duty because they never decided to sell the company. This is the flip side of the independence issue, because any board seeking to avoid being taken over will usually not put itself up for sale. The implication of Ivanhoe is that the Delaware Supreme Court could abandon the new enhanced scrutiny standard it had just adopted in favor of a return to Cheff's deferential approach to management's decisions in corporate control contests. Ivanhoe indicates that the court may adopt an expansive approach to what constitutes a threat to the corporation. That possibility, however, would have to wait for a later time.

D. Interco, Pillsbury, and Macmillan: Shareholders in Ascendancy

Management's expanding power to fight hostile offers led to the erection of increasingly formidable defensive barriers. This resulted in extensive litigation that challenged the courts, both doctrinally and procedurally, to develop a coherent set of rules, with expedited hearings and pressure to deliver reasoned judgments within a matter of days or weeks. While the courts doubtlessly sought to achieve consistency

reiterates the rejection of the efficient capital markets theory in Van Gorkom. See supra, note 100 and accompanying text. In Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772 (D. Del. 1988), the district court rejected the target's argument that its recapitalization plan was designed in part to assure continued corporate independence. The court distinguished Ivanhoe on the grounds that Newmont Mining had not undergone a change in control, whereas in Black & Decker the control of the target changed when management's voting power increased from 7% to 54%. Id. at 782-83.

135. See Gilson & Kraakman, Delaware's Intermediate Standard, supra note 86, at 257 n.38 (if any hostile offer is seen as a threat to corporate independence, and any defense is reasonably related, then Unocal analysis is reduced to rhetoric).

136. See, e.g., Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1142 (Del. 1990) (decided by Chancery Court on July 14, 1989, with oral decision delivered by Delaware Supreme Court on July 24 after argument); Ivanhoe Partners v.
and adhere to precedent, the decisions resulting from the application of Unocal and Revlon are not easily reconcilable. The cases are not a steady march forward in developing the Unocal standard for determining the types of threats to which management can respond and the reasonableness of the defensive tactics. Instead, they indicate that the Delaware courts’ first favored greater protection of shareholders by invalidating defensive tactics, and later reversed course in favor of granting management broad discretion to erect substantial barriers to hostile offers.

In City Capital Associates Ltd. Partnership v. Interco Inc., Steven and Mitchell Rales began accumulating a stake in Interco through their investment vehicle, City Capital Associates. Interco responded by adopting a poison pill with both “flip-in” and “flip-over” provisions. Interco then announced it intended to undertake a major restructuring program, after which the Rales contacted the company and offered $64 per share, later raised to $70. After receiving advice from its investment banker that the offer was inadequate the Interco board voted to reject the Rales’ private $70 offer, and authorized management to explore a restructuring plan. One week later, the Rales announced a $70 per share cash tender offer, conditioned on, among other things, redemption of the poison pill and a determination that Delaware’s antitakeover statute was unconstitutional.

The board rejected the tender offer as inadequate after reviewing a
study by its investment bankers showing a new reference range for the company of $74 - $87.1\textsuperscript{41} The Rales later increased their offer to $72 per share, which the board rejected as inadequate the board instead adopted a restructuring plan. The restructuring involved selling assets and assuming over $2 billion of debt to pay a dividend to shareholders made up of cash, debentures, and a stub equity share. An investment banker valued the restructuring package at $76 per share.1\textsuperscript{42} As part of the restructuring, Interco also announced it would sell its Ethan Allen furniture division, one of its most valuable assets. Thereafter, the board rejected the Rales' next bid of $74 per share. The Rales then brought an action in Delaware Chancery Court challenging the company's refusal to redeem its poison pill and sale of its Ethan Allen division.

The Chancery Court began its analysis by making two crucial factual determinations: first, the court found that the value of Interco's dividend was "inherently a debatable proposition" primarily because of problems in valuing the stub equity share; and second, the court determined that the all cash tender offer was not coercive.1\textsuperscript{43} The first prong of the Unocal analysis required a review of the nature of the threat. The court held that in a cash tender offer for all shares, the only threat is to shareholders and not to corporate policies.1\textsuperscript{44}

The court noted that noncoercive offers may still pose a threat because shareholders cannot bargain effectively with the offeror, while management may be able to extract a higher price or pursue more valuable alternatives.1\textsuperscript{45} Defensive tactics were reasonable, therefore, to allow the board to exercise its business judgment "to take such steps as it deems appropriate to protect and advance shareholder interests."1\textsuperscript{46} Once the directors used the time provided by the defensive tactic to seek a "value-maximizing transaction . . . the legitimate role of the

\textsuperscript{141.} The investment banker had earlier advised Interco's board that the reference range was $68-80. The court noted that the investment banker's range was based on a deliberately vague method of valuation. 551 A.2d at 792.

\textsuperscript{142.} Id. Interco's board had approved a compensation arrangement with the investment banker providing a large premium if the restructuring was successful, which the court characterized as "a rather straightforward and conventional conflict of interest" for a firm valuing a transaction in which it has a substantial stake. Id. at 793.

\textsuperscript{143.} Id. at 795-96.

\textsuperscript{144.} The court followed the method of analysis proposed by Gilson and Kraakman, see Gilson & Kraakman, Delaware's Intermediate Standard, supra note 86. The court noted that threats to shareholders from an offer come in two forms: threats to voluntariness stemming from, such as two-tiered offers, and threats from inadequate offers that are not otherwise coercive. 551 A.2d at 797.

\textsuperscript{145.} 551 A.2d at 797-98.

\textsuperscript{146.} Id.
poison pill in the context of a noncoercive offer will have been fully satisfied." In comparing the Rales offer of $74 cash with the restructuring proposal, the court found that shareholders may reasonably choose the cash payment rather than select a securities package of debatable value. The board, however, sought to preclude shareholder choice between two noncoercive alternatives by refusing to redeem the poison pill to protect the restructuring. That response was not reasonable in response to the threat posed by the tender offer. The court found that under Unocal the directors' decision could not be justified. The court upheld the sale of the Ethan Allen division as an "easy" question of reasonableness, however, finding that a board may respond to an inadequate offer through a restructuring. The offeror has no right to demand that a company not undertake actions that change the status quo and affect the offer.

Interco reflects the problems first confronted by the Delaware Supreme Court in Unocal and Revlon in balancing the demands of shareholders and management. The principle of shareholder primacy led the Chancery Court to invalidate the poison pill, while the focus on managerial discretion under the Unocal standard resulted in holding that the board acted reasonably in selling a "crown jewel," the Ethan Allen division. Nor did Interco violate its fiduciary duty in not conducting an auction. Nevertheless, Interco's analysis of what types of threats an offer poses to shareholders is an important clarification of the scope of Unocal. Where the offer is for all cash and does not involve a back-end transaction at a lower value, management's response is limited to using

147. Id. at 798.
148. Id. at 799.
149. Interco at 799. The court criticized the board by noting there may be a case justifying a decision permanently barring shareholders from accepting a noncoercive offer, but that was not presented on the facts before it. Id. at 798.
150. 551 A.2d at 801. In deciding whether the Interco board must conduct an auction for the company, the court read Revlon as applying the Unocal standard to a particular transaction requiring the board to act in an informed manner by probing the market for the best price. Revlon does not, however, require directors to follow a single course of action. An open market auction and a defensive restructuring may be acceptable responses. The court stated that Revlon was not a "sharp turn" in the law, but rather it requires the board to assess the costs and benefits of a decision and consider other alternatives. Id. at 802. The court then held that the Interco board had fulfilled its duty under Revlon to explore alternatives and had appropriately informed themselves about the company's value. Therefore the directors had not breached their fiduciary duty by failing to conduct an auction. Id. at 802-03.
151. See Johnson, The Meaning of Corporate Life, supra note 15, at 920 (Interco opinion is "at war with itself").
defensive tactics to advance shareholder interests by seeking a better deal because the only threat is to shareholders and not to the corporation. The board serves as the representative for the shareholders in the face of a noncoercive offer, and the defensive response must maximize shareholder welfare.

Interco also takes Unocal one step further by focusing on the need to preserve shareholder choice. Although Unocal allows the board to protect shareholder interests, the opinion is unclear about who decides which course (or offer) is best for shareholders. Interco integrates the principle of preservation of shareholders’ right to ultimately decide what path is best into the determination of what is a reasonable response to a threat. By finding that an all cash offer does threaten only the shareholders, responses by the board will not be allowed if they interfere with the power of shareholders to choose between competing offers. The burden then shifts to the directors to explore alternatives. Any defensive tactic must be designed to generate the maximum value while reserving to shareholders the choice of which competing offers they should accept.

The trend toward empowering shareholders to determine whether to accept a bid continued in Grand Metropolitan PLC v. Pillsbury Co. The Delaware Chancery Court again considered the threat posed by an all cash tender offer and the target’s use of a poison pill and asset spin-off to defend against the offer. Grand Met commenced a tender offer for all Pillsbury shares at $60 per share, later raised to $63 per share. The Pillsbury board declined the offer as inadequate and refused to redeem the poison pill. Pillsbury then announced a restructuring plan that included the spin-off of a large subsidiary and distribution of one share of the spin-off company for each share of Pillsbury stock, with a special dividend to be paid to holders of the new shares after the transaction.

Following the analysis applied in Interco, the Chancery Court held that a cash tender offer for all shares poses no threat to corporate poli-

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152. 558 A.2d 1049 (Del. Ch. 1988).

153. Id. at 1052 & n.4. Prior to the announcement of Grand Met’s bid, Pillsbury heard rumors of Grand Met’s interest. Pillsbury began communicating with state regulatory commissions about possible violations of “Tied-House” provisions barring manufacturers of alcoholic beverages from owning restaurants, such as those owned by Pillsbury. On the day Grand Met’s offer was announced, Pillsbury sued Grand Met in 14 states alleging violations of the “Tied-House” laws. Id. at 1051-52. Three months before Grand Met’s bid, Pillsbury’s chairman was quoted as saying, “If you want to see a hell of a cat and dog fight, just let someone make a move on us.” Id. at 1051. The facts bear out his prediction.
The court then compared Grand Met's offer and management's plan to determine whether shareholders were threatened by an inadequate bid. In analyzing Pillsbury's plan, the court noted that while the company's investment bankers valued it at $68, shareholders would not realize that value for at least four or five years even if Pillsbury's operations achieved predicted levels, which was itself a doubtful proposition. The court next determined that, if the poison pill were not redeemed and the Grand Met bid failed, shareholders would suffer immediate and substantial losses since Grand Met's outstanding bid was the sole reason for Pillsbury's high current stock price; Pillsbury's plan would take years to achieve the same or greater value.

In refusing to redeem the poison pill, the Pillsbury board was preventing shareholders from choosing between two noncoercive offers. The board argued, however, that shareholders were not the proper party to decide whether to accept a tender offer because only the directors have the duty to determine the policy of the corporation. The court flatly rejected that argument, holding that the board's refusal to redeem the pill, disenfranchising shareholders, was not a reasonable response to any threat posed by the offer. The court ordered redemption of the poison pill. Contrary to Interco, the Chancery Court also enjoined the spin-off, finding that the transaction would substantially alter Pillsbury's corporate structure and negatively affect the Grand Met offer.

Pillsbury takes the principle of shareholder primacy to its outer limit, but brings into question whether the business judgment rule can survive such an approach. In order to vindicate the shareholders' right to choose, the Chancery Court had to judge between competing offers. To support the conclusion that the shareholders should determine which offer to accept, the court had to determine that the offers were essentially equivalent in value. This determination draws the court into the very

154. Id. at 1056.
156. Id. at 1057. "In all events, expectancies over a four or five year period out into the nineties are subject to economic and competitive conditions which are beyond Pillsbury's control." Id.
157. Id. at 1058. The court calculated a loss of at least $1.5 billion to shareholders by assuming that Pillsbury's stock would recede to the price before the offer, a decline of approximately $25 per share. As evidence of strong shareholder support for the bid, the court noted that 87% of the shares were tendered. Id.
158. Grand Met at 1059. The court also noted the irony of management's restructuring plan that entailed the ultimate break-up of the company, while the offeror made a noncoercive cash bid. Id. at 1061.
159. Id.
realm supposedly protected by the business judgment rule, even as modified by *Unocal* and *Revlon*, that the directors alone have the duty to inform themselves of the alternatives available and calculate what response will best protect the shareholders and the corporation. Whether the business judgment rule should even apply in takeover situations is a separate question. However, the language of the Delaware Supreme Court’s decisions indicates adherence at least to the rhetoric of the rule. *Pillsbury* largely disposes of that rhetoric, elevating shareholders’ desires for maximum value to the level of sole guiding principle in evaluating management’s defensive response.

*Interco* and *Pillsbury* reflect the trend in tender offers away from the two-tier coercive offer that caused such consternation in management and the courts. Although management could still argue that an offer was coercive because the price did not reflect the full value of the company, that claim began to ring hollow since every bid seemed to be inadequate. Additionally, companies’ investment bankers often gave increasingly higher valuations to each new bid. The implicit reasoning behind most of management’s arguments in favor of rejecting a hostile offer is that the market has not fairly valued the company, and that given sufficient time, shareholders will reap a greater return from management’s efforts than from accepting the offer. Although the Delaware Supreme Court accepted that the market may not reflect a corporation’s full value in *Cheff*, *Interco* and *Pillsbury* look to the market as the criterion for determining the adequacy of an offer and gauging the reasonableness of management’s defensive efforts to negotiate the best deal for shareholders. Just as offerors moved away from coercive bids, so the Delaware courts seemed to move in the direction of adopting the market as the best available guide to determine a company’s value.

While *Interco* and *Pillsbury* focus on comparing the value of offers by management and the offeror, *Mills Acquisition Co. v. Macmillan* indicates that the directors’ decision-making process is also subject to scrutiny under *Unocal* and *Revlon*. *Macmillan* is a catalogue of horrors and the opinion adopts an attitude of near contempt for manage-

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160. See, e.g., *Mills Acquisition Co. v. Macmillan*, Inc., 559 A.2d 1261, 1272-73 (Del. 1988) (noting incongruity of investment banker’s maximum valuation of $80 on June 7 with its opinion on August 25 that hostile offer of $80 was inadequate).

161. 559 A.2d 1261. Macmillan was the subject of perceived or actual takeover attempts for over one year. The Chancery Court had invalidated a restructuring proposal sponsored by management. *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1247 (Del. Ch. 1988).
ment and the board's actions that had not been seen since Van Gorkom. The Chancery Court had earlier enjoined a management-sponsored restructuring in response to an all cash tender offer on grounds similar to Interco and Pillsbury; that the offer did not pose a threat to the company and the restructuring was not an adequate alternative. In Macmillan, the Delaware Supreme Court reviewed the conduct of an auction run by directors that the court characterized as "allegedly" independent. Management engaged legal and financial advisers to rubber stamp decisions designed to repel outside bidders and transfer control of the company to management.

After the Chancery Court's rejection of the management restructuring, Robert Maxwell proposed an $80 per share merger in which Macmillan's senior management would be retained. Macmillan did not respond to Maxwell's offer, but instead negotiated with Kohlberg, Kravis, Roberts & Co. (KKR), a renowned LBO firm, to reach an agreement for a management LBO. Macmillan provided KKR with confidential financial information on the company. After receiving no response to the offer for five weeks, Maxwell made a cash tender offer for the company at $80 per share. Maxwell also offered to negotiate the purchase of certain assets for $1.1 billion. Macmillan rejected the $80 offer as inadequate despite an earlier opinion by the company's investment adviser that its maximum breakup value was $80 per share. Maxwell informed Macmillan that he would prevail in an auction for the company, yet management continued to negotiate an LBO with KKR.

Without knowing the content or price of KKR's proposed LBO, Macmillan management suggested that they would support the proposal with the board. KKR indicated it would submit its final bid three days later. The day before KKR's bid was due, management informed Maxwell that it would have to submit a bid the following day, and that management intended to support KKR's bid and would not consider Maxwell's offer to top any bid. Maxwell subsequently increased his offer to $84 per share, while KKR proposed a two-tiered offer of cash and subordinated debt with a face value of $85 per share. The board accepted KKR's offer, after which Maxwell increased his offer to $86.60. The board then instituted an auction for the company to be

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162. The court subjects management's various buyout schemes and the board's inattentiveness to its duties to withering scorn lasting over 10 pages in the reported opinion. 559 A.2d at 1265-78.

163. Id. at 1271.

164. Id. at 1272-73.
conducted by Wasserstein Perella. After Maxwell and KKR submitted virtually identical bids, Macmillan’s chairman called KKR representatives to “tip” them about Maxwell’s bid. After further bidding, and actions that clearly favored KKR over Maxwell, the board accepted KKR’s bid and granted it a lock-up option on Macmillan’s most highly valued assets.

The court noted that the facts showed not only deception by Macmillan’s management about the conduct of the auction and the favoritism showed to KKR, but also “the board’s own lack of oversight in structuring and directing the auction.” The board’s failure to conduct a fair auction breached its duty of loyalty and its duty of care to fully inform itself. The transaction would be judged under the entire fairness test rather than the business judgment rule. Under that higher threshold standard, the decision of the board could not stand.

The more important part of Macmillan is the court’s dicta concerning the relationship between the Unocal and Revlon analyses. The court reviewed the asset lockup agreement to determine whether the board’s decision met the requirements of Revlon, although it need not have reached that issue, given its finding that the board repeatedly breached its fiduciary duty. Nevertheless, the court stated that the Unocal enhanced standard applies to directors’ decisions made in conducting a Revlon auction, although their responsibilities are different in responding to the offer. When a company is under a duty to conduct an auction to maximize shareholder value, a plaintiff must first show that the directors treated a party unfairly before applying the Unocal standard. If there is unequal treatment, then the court must determine whether the directors properly perceived that shareholder interests were enhanced by the auction. The board’s actions must be reasonable in response to any threat to shareholders. The actions of Macmillan’s board were tainted by the breach of the duty of loyalty and

165. 559 A.2d at 1275. KKR’s counsel terminated the discussion once he realized the impropriety of the call. Id.
166. Id. at 1276-77. Senior management and Wasserstein Perella made presentations to the board about the process for submitting the final Maxwell and KKR bids, which the Court described as “false” and “untruthful.” Id. at 1277.
167. Id. at 1279. The Court went on to state that “[t]he board was torpid, if not supine, in its efforts to establish a truly independent auction . . . .” Id. at 1280.
168. See Prentice & Langmore, supra note 8, at 55 (analysis was “presumably” dicta).
169. 559 A.2d at 1287. “Although the board’s irresponsibilities under Unocal are far different, the enhanced duties of the directors in responding to a potential shift in control, recognized in Unocal, remain unchanged.” Id. (emphasis in original).
the deceptions by management. Therefore the lockup option was invalid-
dated.\textsuperscript{170}

The litany of abuses described by the court makes \textit{Macmillan} an
easy case. However, the close scrutiny of management and the board
signaled that the Delaware Supreme Court was willing to apply the
policy of enhanced review to the procedures adopted by a company in a
corporate control contest. The emphasis on management fairness, togeth-
er with the clarification of the interplay between \textit{Unocal} and \textit{Revlon},
elevates the principle of shareholder primacy to the core value in corpo-
rate law. Yet the court still did not clearly define the scope of the tests
it applied. The issue of when the \textit{Revlon} auction duty applies remained
unanswered because in \textit{MacMillan}, the court merely concluded that \textit{Re-
vlon} applied, without stating when that point was reached.\textsuperscript{171}

It would be wrong to portray the Delaware courts as uniformly
advancing shareholder interests in an open market for corporate control
by invalidating management defensive tactics, or that the law was in any
sense a “seamless web” laying out all permissible responses to an offer.
In \textit{TW Services, Inc. v. SWT Acquisition Co.},\textsuperscript{172} the Delaware Chan-
cery Court upheld a board’s refusal to redeem a poison pill or to negoti-
ate with an offeror. The court accepted the argument that management
could refuse to negotiate in furtherance of its responsibilities to manage
the corporation for the long-term interests of the shareholders, even if
the short-term value of the stock will be negatively affected by the re-
refusal to negotiate.\textsuperscript{173} In \textit{Shamrock Holdings, Inc. v. Polaroid Corpora-

\begin{itemize}
\item 170. \textit{Id.} at 1288.
\item 171. \textit{Id.} at 1285. “This case does not require a judicial determination of \textit{when}
\textit{Macmillan was ‘for sale.’}” (footnote omitted) (emphasis in original). In a footnote, the
court noted the vagueness of its position; “Clearly not every offer or transaction af-
flecting the corporate structure invokes the \textit{Revlon} duties.” \textit{Id.} at 1285 n.35. The issue
is what types of offers or transactions do invoke the auction duty.
\item 173. \textit{Id.} at 92,182. The opinion is interesting because the Chancery Court con-
sidered the issue of which interests the board should protect in responding to an
offer. The Court posed the question this way:

\begin{quote}
\textit{[T]o what interest does the board look in resolving conflicts between inter-
estes in the corporation that may be characterized as “shareholder long term
interests” or “corporate entity interests” or “multi-constituency interests” on
the one hand, and interests that may be characterized as “shareholder short-
term interests” or “current share value interests” on the other?}
\end{quote}
\textit{Id.} at 92,178 n.5. The competing interests of the corporation and shareholders were
reconciled on the basis that the long run interests of the corporation and the share-
holders are congruent, although the opinion does not identify the long run interests.
the Chancery Court upheld a self-tender and creation of an ESOP that effectively stopping a hostile offer and proxy fight to replace the board. The Court found that Polaroid had a valuable patent claim that shareholders may not adequately assess. Therefore, the cash tender offer posed a threat to shareholders who may undervalue their shares.

**TW Services** and **Polaroid** were decided by the Chancery Court after **Macmillan**, and demonstrated that management’s defensive tactics were not doomed to failure. Moreover, it was unclear whether there was any consistency in the decisions spawned by the policy of heightened scrutiny. The Delaware Supreme Court had not yet clarified the scope of **Unocal** and **Revlon** by adopting a clear application of the enhanced review standard. Nor had the court established a more precise definition of when the auction duty applied, thereby still retaining its seat at the table even after reviewing a number of challenges to defensive tactics designed to thwart offers.

### E. Time Trumps the Shareholders

After **Macmillan**, the balance between shareholders and management was tilting toward the shareholders, although there was no sure basis to predict the outcome of a challenge to management’s defensive tactics in any particular case. In **Paramount Communications, Inc. v. Time Inc.**, the Delaware Supreme Court reoriented the law back in favor of management and, quite possibly, brought an end to the policy of “enhanced review” requiring maximization of shareholder interests first signalled in **Van Gorkom**, announced as a new standard in **Unocal**, and extended in **Revlon**. **Time** does not explicitly reverse these prior precedents, but it uses the rhetoric of enhanced review to reach a conclusion that effectively drains those decisions of their meaning. Ultimately, the decision relinquishes the court’s seat at the table. The law began with dissatisfaction with **Cheff**; **Time** returns to management the discretion it once had in responding to challenges. The important question is whether the Delaware Supreme Court will adhere to the **Time** decision and allow management to respond to challenges for control without meaningful oversight during the next wave of mergers and acquisitions.

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175. 559 A.2d at 290.
176. 571 A.2d 1140 (Del. 1990).
1. The Transaction

In 1987, Time, a publishing and entertainment company, reviewed its need to expand globally by acquiring concerns with access to worldwide markets. Time's board ultimately authorized management to begin discussions with other companies, including Warner Communication, Inc. as part of a strategic plan. Time's board acted with the proviso that Time's management control the company after any acquisition. Moreover, the board stressed that any acquisition required careful planning to avoid putting Time "in play." The board considered further defensive measures beyond the poison pill and other shark repellant devices it had already adopted.

Time and Warner negotiated throughout the latter part of 1988 and into 1989 concerning the structure of an acquisition and management of the new corporation. In March 1989, Time and Warner's boards approved a merger in which the Warner shareholders would own 62% of the new corporation after an exchange of stock. The Warner shareholders received a 12% premium for their shares because Time retained control of management as a means of protecting the "Time Culture." Time's board also adopted additional defensive measures, including a share exchange agreement with Warner, a no-shop provision, and agreements with various banks prohibiting those banks from lending to third parties seeking to acquire Time. On the public relations front, Time announced the transaction and applauded itself for reaching an agreement that did not involve debt financing.

The Time-Warner merger proceeded swimmingly until June 7, 1989, when Paramount announced a cash tender offer for Time at $175 per share, causing the stock to soar $44 (approximately 35%) in one day. After three meetings, Time's board rejected Paramount's bid as

177. Time favored the outright acquisition of Warner in an all cash, or cash and securities transaction, while Warner sought a stock swap in order that its shareholders could retain their equity in the corporation. Time agreed to Warner's proposal, but the negotiations temporarily founded on the issue of who would become the CEO and who would be in the line of succession to that position. Time's board considered control of the company's governance crucial in order to maintain the "Time Culture." Id. at 1145. Negotiations resumed in January 1989 when Steven Ross, Warner's CEO, agreed to Time's proposed management structure. Id. at 1145-46.

178. Id. at 1146. The new corporation, Time Warner, would have a 24 person board, with equal representation from both companies, and co-CEOs from both companies for five years. The board would create editorial and entertainment committees to oversee those operations controlled by Time and Warner, respectively. Id.

179. Id. at 1147. Time's CEO immediately fired off a letter to Paramount, at-
inadequate, concluding that the merger with Warner "was the better course of action" and declined to negotiate with Paramount. The rules of the New York Stock Exchange (NYSE), on which Time listed its shares, required a vote by Time's shareholders to approve the Warner transaction. Time sought permission from the NYSE to proceed with the merger without shareholder approval because its directors "expressed their concern that Time stockholders would not comprehend the long-term benefits of the Warner merger;" the NYSE rejected the request.\(^{181}\)

The board considered the Paramount bid a threat to the "Time Culture," and decided to reformulate the transaction as an outright acquisition of Warner through a two-tiered offer at $70 per share.\(^{182}\) The new transaction required Time to finance the deal by assuming $7-10 billion of debt, and agreed to waive its poison pill against Warner. Paramount raised its offer to $200 per share. Despite offering a 60% premium over the price of Time stock before Paramount's initial offer, Time's board rejected Paramount's offer as inadequate because the Warner transaction "offered a greater long-term value for the stockholders and, unlike Paramount's offer, did not pose a threat to Time's survival and its 'culture.'\(^{183}\) Paramount and Time shareholders sued to enjoin the Warner acquisition.

2. The *Revlon* Analysis

The Delaware Supreme Court began by examining the plaintiffs' argument that Time's board must conduct an auction for the company under *Revlon*. The Chancery Court found *Revlon* inapplicable because the merger did not constitute a change of control since no single shareholder gained or lost a controlling interest in the surviving entity.\(^{184}\)

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\(^{180}\) Tackling that company's president and denigrating the offer as "smoke and mirrors." As might be expected, Time's board heartily approved the response after being shown the letter.

\(^{181}\) Interestingly, the Time board's investment adviser valued the company in March between $189 and $212 per share, while in June after the bid by Paramount, its valuation range was $40 per share higher. Paramount Communications, Inc. v. Time Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,272 (Del. Ch. 1989). Time asserted that the second valuation included a control premium, while the March valuation served a different purpose. *Id.*

\(^{182}\) Id. at 1148.

\(^{183}\) The offer entailed the purchase of 51% of Warner at $70 cash, and a back-end merger in an exchange of cash and securities. *Id.*

The Delaware Supreme Court adopted a much more restrictive approach in defining when *Revlon* applies. The court found that there are two circumstances requiring an auction: first, when a corporation initiates an active bidding contest involving the clear break-up of the company; and second, when the target abandons its long term strategy and seeks an alternative transaction involving the break-up of the company in response to an offer. The court tried to retain some flexibility in its definition of when the auction duty applies by stating that it was not excluding other possibilities. Yet, the opinion’s precise language describing when *Revlon* applies makes clear that those other possibilities are not easily imagined, and are likely only theoretical.

Either circumstance triggering *Revlon* necessarily requires the target board to make the decision to commence the auction process. The key to the analysis is its focus on the “break-up” of the corporation clearly diminishing the economic entity such that it is a different enterprise. Therefore, the court reasoned, the decision to change the transaction from a merger to an outright acquisition of Warner had no effect on whether the *Revlon* duty applied because the change did not require the board to abandon its strategic plan or otherwise make the sale of Time inevitable. By adopting the break-up of the company as the crucial event under *Revlon*, the court avoided the position adopted by the Chancery Court of examining whether a “change of control” occurred. Instead, the Delaware Supreme Court chose a much higher threshold for the auction duty.

More than raising the *Revlon* threshold, however, the court narrowed *Revlon* to the point of irrelevancy by requiring that the directors affirmatively choose to bring about the break-up of the corporation. In *Revlon*, the court emphasized the need to serve shareholder interests by maximizing the value of the stock. Under *Time*, that interest is contingent on a board’s determination that it will undertake to engage in a course of action to maximize the stock’s value, a decision that necessarily implies the effective dissolution of the corporation. Among the concerns that a director may consider in responding to a takeover are the non-shareholder interests articulated in *Unocal*. Those interests can sup-

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185. 571 A.2d at 1150.
186. *See Johnson & Millon, The Case Beyond Time, 45 Bus. Law. 2105, 2111 (1990) [hereinafter Beyond Time] (court intended *Revlon* to apply if continued existence is abandoned by diminution).
187. 571 A.2d at 1151.
port a decision to reject a bid and not enter the Revlon mode, regardless of whether that decision results in maximizing shareholder welfare in the short or long term. In short, management will have little trouble avoiding Revlon because shareholder interests are no longer the driving force in determining the proper response to a bid. The power of directors to decide whether to even respond to an offer means the likelihood of a Revlon auction is remote.

3. The Unocal Analysis

After disposing of the Revlon argument by vesting the decision to invoke the auction duty in the board of directors, the Time decision turned to the plaintiffs’ Unocal challenge to the merger. The Unocal analysis required the Delaware Supreme Court to first determine the nature of the threat posed by Paramount’s $200 per share all cash tender offer. Interco and Pillsbury began their enhanced review assuming that a cash tender offer is not coercive to the corporation, only to the shareholders. Under this analysis, the degree of coercion is derived solely from the inadequacy of the offer. Under those opinions, once management responds by proposing its own plan in response to the original offer, the inadequacy of the offer is ultimately an issue for the shareholders to decide. The court’s role is to ensure that shareholders have the power to choose between roughly equivalent offers.

Time rejects the premise of Interco and Pillsbury at the outset, stating that the court disapproves “of such a narrow and rigid construction of Unocal” and will not undertake to judge what offer is best for shareholders. Instead, the court determined that Paramount’s offer constituted a threat to Time because its shareholders “might elect to tender into Paramount’s cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce.” According the timing of Paramount’s offer was designed to upset and confuse Time’s shareholders.

Paramount’s proposed takeover also posed a threat to Time’s strategic plan to protect the unique “Time Culture” while pursuing global

189. See Johnson & Millon, Beyond Time, supra note 186, at 2119 (consideration of non-shareholder interests means Revlon’s days may be numbered); Norwitz, supra note 21, at 381 (Time clearly increases the board’s discretion).
190. 571 A.2d at 1151-55.
191. 571 A.2d at 1153. The Court went on to note that “Unocal is not intended to lead to a simple mathematical exercise: that is, of comparing the discounted value of Time-Warner’s expected trading price at some future date with Paramount’s offer and determining which is higher.” Id.
192. Id.
expansion. The court adopted a position advanced in *Van Gorkom* that a firm’s market price may not adequately reflect the true value of the corporation. Therefore, management may consider shareholder “igno-
rance” of the value of staying the course in resisting an offer. Moreover, a takeover which threatens corporate objectives may be the basis for rejecting an offer. By analyzing only the effect of a bid on the corporation rather than the type of bid and its value to shareholders, the Delaware Supreme Court transformed the first part of the *Unocal* test from evaluating whether an offer constitutes a threat to examining whether the board has any plausible basis for adopting a defensive mea-
sure. *Time* gave directors the power to designate an offer as a threat to the corporation, allowing the court to hold that the “board was under no obligation to negotiate with Paramount.”

The second prong of the *Unocal* test permits the court to decide who should determine whether the corporation will pursue a short-term strategy to maximize the value of the shares or a long-term strategy to achieve corporate goals. *Revlon* decided that a board must maximize shareholder value once the break-up of the firm is inevitable. *Interco* and *Pillsbury* endorse the concept of shareholder choice to determine the ultimate direction of the corporation. *Time* reverses that trend by holding that Delaware law confers on management and the board the duty to manage the enterprise, including “the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders.” An offer does not require management to “abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.” The court’s analysis leads inexorably to the conclusion that restructuring the Warner transaction was a reasonable response to Paramount’s threat.

4. An Analysis of *Time*

*Time* removes the Delaware courts from their previous role of determining the value of an offer or other extraordinary corporate transactions, such as recapitalizations and special dividends. Under *Interco* and *Pillsbury*, the Chancery Court critiques the valuations of management’s responses to hostile offers and concludes that the compet-
ing transactions were essentially equal. The business judgment rule, however, operates on the premise that courts are not equipped to make

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193. *Id.* at 1150 n.12.
194. *Id.* at 1154.
195. *Id.*
196. *Id.*
business decisions, such as estimating the value of securities and debt instruments. Under the business judgment rule, the courts should defer to the expertise of a properly informed board. Once the court travels down the path of evaluating competing offers, board decisions will be disrupted by post hoc judicial review that will likely not clarify acceptable standards of conduct.

Time is also important because the opinion refocuses the court on the primary role of directors in determining the proper course for the corporation. The analysis of what constitutes a "threat" after Unocal narrowed as offerors made all cash bids. The trend toward allowing greater shareholder choice may have ultimately resulted in a rule whereby shareholders alone decide whether to accept a cash tender offer since there was no threat to the corporation. The Interco and Pillsbury decisions approach the passivity thesis for responding to offers by asserting that management cannot block the shareholders' right to accept reasonably equivalent offers once the defensive measures had achieved their purpose of inviting competing bids. Whether or not this development was welcome, the Delaware Supreme Court had long adopted a pro-management position that would never countenance such a radical departure in favor of shareholders. Time is a natural reaction to the enhanced scrutiny standard, which backs on the power of both management and the board to respond to offers. Thus, Time reiterates the basic message of Unocal that directors do not lose the protection of the business judgment rule in responding reasonably to an offer.

Time answers the question left open in Unocal concerning the definition of a threat by granting the board power to determine whether a bid constitutes a threat to the corporation or its shareholders. Language used by the court clearly shows that the threat need not be to shareholders and that a corporation may reject an offer even if shareholders would realize a short-term profit. If the board may consider "corporate" interests that may be opposed to the shareholders' goal of maximizing the value of their investment, then every bid can be a threat to the corporation no matter how shareholders value it or whether they want to accept it. The court's analysis of what constitutes a threat

197. Note, Time and Time Again, supra note 128, at 204. See Hazen, Corporate Persona, supra note 28, at 293 (court favors management in power struggle for control of corporation by raising exit price for shareholders).
198. See supra note 181 and accompanying text.
199. See Johnson & Millon, Beyond Time, supra note 186, at 2115 (court focused on the corporate enterprise interests rather than only shareholder interests, which the board may consider in responding to an offer).
comports with its rejection of the efficient market theory because corporate goals are not restricted to maximizing the price put on the firm as reflected by stock prices. Under the Time analysis, the value of a corporation can exceed the aggregate price of its stock. Therefore, the board may adopt defensive measures to preserve the corporation based on its own conclusion that the offer is less than the “true value” of the corporation.

The weakness of Time is its failure to perform more than a cursory review of the reasonableness of the board’s response to the threat from Paramount’s bid. Time confines its analysis under the second part of Unocal to reverential recapitulations of the need to preserve the “Time Culture” and the value shareholders would ultimately realize from the merger of Time and Warner. Yet the court makes no effort to determine whether these claims are even reasonable on their face. The point is not that the Delaware Supreme Court should have judged valuations as the Chancery Court did in Interco and Pillsbury. But there is not even the slightest effort in Time to scrutinize whether management has a basis for its argument that its strategic plan will ultimately result in greater shareholder value. The court reduces the second prong of Unocal to a dead letter by blithely accepting Time’s strategic plan as the basis for rejecting the offer. The court clearly signals management that they should have the board adopt some form of a long-term company plan that will be plausibly beneficial to the enterprise and its shareholders. Once the plan is in place, the board may refuse to negotiate with any offeror and, indeed, keep the company from ever being acquired through a hostile offer by refusing to consider any proposed transaction. Time brings corporate law to a point far removed from the Court’s starting point in Van Gorkom and Unocal. Time effectively rejects the shareholder welfare principle that had long guided corporate law, thereby

200. The Court’s use of the “Time Culture” as an apparent basis for the board to reject the offer is hard to accept at face value. The vaunted “Culture” to be preserved includes People magazine and an annual issue of Sports Illustrated dedicated to the latest in women’s swimwear exhibited in exotic locales, in addition to Time and its history of journalistic independence. Any company can claim that its culture is unique and worth preserving, yet that argument should not be the sole basis for rejecting all mergers, and no guidance is given as to what cultures are worthy of preservation.

201. See id. at 2121 (continued vitality of Unocal called into question by Time); Note, Time and Time Again, supra note 128, at 206 (Time marks the end of any meaningful proportionality review under Unocal); Note, Business Judgment Rule, supra note 11, at 969 (Time suggests that the business judgment rule protects the board of directors as long as strategic goals exist.).
giving management virtually unfettered discretion over the corporate enterprise. The Time decision may signal that the Delaware Supreme Court has decided to give up its seat at the table in reviewing defensive tactics in corporate control contests.

5. The Aftermath of Time

There is no sure method to predict whether a merger will be successful or how the Delaware Supreme Court will apply Time to future corporate control contests. The takeover of Pillsbury by Grand Met has been successful, even though it started as a hostile offer. Meanwhile, a number of companies adopting defensive measures, such as LBOs, have ended up in bankruptcy court. The impossible question is whether shareholders and the corporation would have benefitted more if the hostile offers had been accepted, rather than allowing management to thwart the takeovers through defensive measures. Although hindsight is perfect, it is fair to question whether the Time Warner merger has been successful. Time’s management premised its refusal to even negotiate with Paramount on the basis that it had a strategic plan that would bring shareholders even greater value in the long term while protecting the “Time Culture” from outside bidders. Approximately two years after Time first rejected Paramount’s offer and continued its pursuit of the merger with Warner, the transaction can fairly be judged a failure from the point of view of both shareholders and other constituencies of the corporation.

In June 1991, Time Warner announced a plan to refinance the heavy debt it assumed to complete the Warner purchase through a complicated stock rights offering under which the company’s current shareholders would have to purchase rights at a price between $63 and $105. The market swiftly reacted to the rights offering as Time


203. Landler, supra note 18 at 70-71. Time Warner needs the funds raised through the equity offering to pay down $4.3 billion of debt due in 1993. Id. at 71.
Warner's stock fell more than $29 after the announcement. Moreover, the company's stock had languished in a range of $100-125 per share throughout 1990 and 1991, far below the Paramount offer of $200 per share. The long-term growth of Time Warner through global expansion and the synergy between Time's publishing properties and Warner's entertainment acumen have not been reflected in the stock price.\textsuperscript{204} Time Warner even announced layoffs at its magazines, the very type of action the company said it would not do in assuming the large debt to finance the Warner purchase. Among the changes being considered by management is converting \textit{Time} magazine from a newsmagazine to a journal of essays and criticism.\textsuperscript{205} The highly prized "Time Culture" is obviously not immune to the requirements of debt service. The venerable editorial integrity does not rule out a radical change in the flagship periodical in a highly competitive environment.

The problems faced by Time Warner do not necessarily mean that the merger was wrong. The weakness of the \textit{Time} decision, however, is that the Delaware Supreme Court accepted management's contentions that the transaction would enhance the value of the company without requiring the directors to do anything more than assert that they had a strategic plan that would not survive a hostile offer. Without more, \textit{Time} allows management to adopt any self-serving plan to shield itself from a hostile transaction whether or not that plan can succeed.\textsuperscript{206}

The court in \textit{Time} should have required management to put forth the details of its plan and defend it as a reasonable business decision that will benefit the corporation and its shareholders.\textsuperscript{207} Such a re-

\begin{footnotes}
\footnotetext[204]{The company eventually withdrew its rights offering and opted for a more traditional equity offering of $2.6 billion of common stock. Dobrzynski, \textit{Time Warner Feels the Force of Shareholder Power}, BUS. WEEK, July 29, 1991, at 58-59.}
\footnotetext[207]{This is a perverse reversal of the implicit requirement of \textit{Van Gorkom}, discussed supra at note 11, that the board adopt additional procedures to ensure proper documentation of its decision-making process in reviewing an offer. In \textit{Time}, the strategic plan takes the place of the board's procedures as the method of policing management without the Delaware Supreme Court requiring that the plan have any content or that the board even consider an offer.}
\end{footnotes}
requirement may not have changed the decision whether the board acted reasonably in response to an offer. At a minimum, management would have been forced to divulge a plan it could defend in court. The very act of arguing for its plan as a defensive measure gives shareholders information to judge whether the plan has any likelihood of succeeding.

_Time_ divorces the board's decision to pursue a strategic plan from the principle that the corporation exists for the benefit of the shareholders. Therefore, the court does not have a logical method to evaluate the plan beyond accepting the board's declaration that the corporation will benefit. Instead, shareholders bear the brunt of the decision to reject a $200 per share offer to pursue a course that has worked to their detriment. While _Time_ extols the virtues of a board's decision to act for the long-term benefit of the company, the decision does not reach the issue of whether the corporation's other constituencies can rely on the board to protect their interests. Section IV of this article examines whether stakeholders and other investors in the corporation have gained any real protection from the changes in corporate law brought about by the battle for corporate control in the 1980s.

IV. STAKEHOLDERS AS THE NEW PLAYERS IN THE GAME

The underlying principle of corporate law has been that management conducts the affairs of the corporation under the general oversight of the board with the company operating for the benefit of its shareholders. That simplistic approach was challenged in the 1980s, as shown in the preceding section. Moreover, regardless of whether that principle is sufficient to arrange the primary relationship between management and shareholders, it ignores the interests of other constituencies, such as owners of the company's debt securities (i.e., bondholders), employees, suppliers, and the local communities surrounding a company's operations. As the disruptive effects of takeovers reached these other constituencies, they clamored for a voice in the decision-making process.

The Delaware Supreme Court acknowledged the possibility that parties other than the shareholders may have a claim on the board's consideration in _Unocal_, stating that the effect of a tender offer "on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps the community generally)" can be considered in the directors' analysis of the proper defensive measure. 208 In _Time_, the court emphasized that Paramount's offer was a threat to the corporation

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that is reasonably likely to achieve the goal." Gilson & Kraakman, Delaware's Intermediate Standard, supra note 86, at 270-71.

208. 493 A.2d at 955.
rather than its shareholders. The company's adherence to its strategic plan, therefore, is part of the board's inherent power to manage the corporation for the long term, a duty that cannot be delegated to shareholders.209

Stakeholders in a corporation depend on a firm's stability and its continuation as an enterprise to protect their investments; in short, stakeholders are risk-averse.210 Although corporate law did not provide direct protection to anyone other than shareholders, owners of the corporation's bonds unsuccessfully sought to use the traditional corporate and contract law principles of fiduciary duties and good faith to protect themselves from management's restructuring of corporations.211 Unlike

209. 571 A.2d at 1153-54; see Johnson & Millon, Beyond Time, supra note 186, at 2114 (Unocal and Time concern threats to the corporate enterprise, not to shareholders; moreover, the impact of a coercive bid is on constituencies other than shareholders); see also, Credit Lyonnais Bank Nederland v. Pathe Communications Corp., No. 12150 (Del Ch. Dec. 30, 1991) (WESTLAW, 1991 WL 277613 at *33, n.55) (Board of directors does not act improperly, if in an informed, good-faith effort to maximize a corporation's long-term wealth, the board diverges from the choice the stockholders [or any single group interested in the corporation] would have made if they had the opportunity to act).

210. See W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 42-44 (3d ed. 1988) (decisions that increase risk will result in increased stock but decreased band value); Macey, Fundamental Corporate Changes, supra note 3, at 181 (fixed claimants do not receive a greater return on investment if firm performs well).

211. See, e.g., Simons v. Cogan, 549 A.2d 300, 301 (Del. 1988). The Delaware Supreme Court held that convertible debentures embody "a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties." Id. at 303. The issue of what protection bondholders have outside the trust indenture when the issuer of the debt securities undertakes an LBO arose in Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989). Two insurance companies purchased various bonds issued by RJR Nabisco before its $24 billion LBO in which RJR assumed $19 billion of new debt. The insurance companies sued when RJR Nabisco’s debt was downgraded after the LBO, causing multimillion dollar loses in the value of the insurance companies' debt securities. Id. at 1506. The insurance companies alleged a breach of fiduciary duty and violation of the implied covenant of good faith and fair dealing not to incur substantial debt to liquidate the company’s shareholders when that transaction dramatically impairs the value of the company’s bonds, notwithstanding the fact that express provisions of the indenture did not prohibit the transaction or assumption of additional debt. Id. at 1508. The district court noted that “[i]nvestors as sophisticated as [these plaintiffs] would be hard-pressed to plead ignorance of these market risks.” Id. at 1514. The court held that the implied covenant of good faith and fair dealing does not "permit an implied covenant to shoehorn into an indenture additional terms plaintiffs now wish had been included." Id. at 1519; see Coffee, Unstable Coalitions:
Corporate Governance As a Multi-Player Game, 78 GEO. L.J. 1495, at 1508-09 (1990) [hereinafter Unstable Coalitions] (the problem with the insurance companies argument is that duty of good faith and fair dealing constrains a party’s exercise of discretionary power under a contract, and does not overrule express terms or substitute implied terms). The district court also rejected the insurance companies’ breach of fiduciary duty claim, adopting the holding of Simons that bondholders are not owed any fiduciary duty but instead are limited to the terms of the trust indenture. 716 F.Supp. at 1524.

Metropolitan Life has been criticized because it accepts the indenture at face value as a contract negotiated between the issuer and the bondholders. Mitchell, supra note 22, at 1188-89. Yet, the issuer and underwriter create the indenture before the securities are sold and incorporate the minimum degree of protection necessary in the indenture to sell the debt securities at the lowest cost to the issuer. Even sophisticated insurance companies must accept the indenture as written; therefore, bondholders should be protected by imposing additional fiduciary duties on management similar to those protecting shareholders. Id. Professor Mitchell argues that imposing fiduciary duties on behalf of bondholders will protect “a disenfranchised and practically powerless group of corporate investors.” Id. at 1228. It is hard to imagine as “practically powerless” large institutional investors such as insurance companies, that manage securities trading accounts with billions of dollars of debt, equity, and derivative securities. Any argument on behalf of such investors based on a need to overcome their ignorance is not intuitively appealing. See Carney, Defining Constituencies, supra note 21, at 405 (“Arguments that sophisticated institutional bondholders have been victimized, either by the monopoly power of issuers or the naivete of buyers, do not sit very well.”).

The problem with the notion of extending fiduciary duties to debt securities is that the indenture is a widely disseminated public document setting forth the basic relationship between the parties only if a person or institution wants to purchase the bond. Investors are not compelled to purchase the bond, and claims for breach of fiduciary duty seek to expand the rights of bondholders to cover events that are not prohibited by the indenture. Permitting bondholders to assert claims of breach of a fiduciary duty to recover losses on their investments will impose additional costs on the issuer and, ultimately, its shareholders. This claim will not add any real value to the debt securities because the bonds are priced to include the risk that a company will default on its interest and principal payments.

Bondholders, however, have had success challenging LBOs as fraudulent conveyances when the company falls into bankruptcy. Bondholders now routinely challenge LBOs in which the company ends up in bankruptcy as fraudulent conveyances. The courts have become more receptive to the claims. See, e.g., Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846 (10th Cir. 1990); Murphy v. Meritor Savings Bank (In re O’Day Corp.), 126 Bankr. 370 (Bankr. D. Mass. 1991); Mellon Bank v. Metro Communications, Inc. (In re Metro Communications, Inc.), 95 Bankr. 921 (Bankr. W.D. Pa. 1989). This trend has resulted in greater payments to bondholders to settle their claims to allow companies to emerge from bankruptcy. See McCartney, A Move Toward Reparations for Losers in Empire’s Demise, Wash. Post, August 18, 1991, at H1 (bondholders of Allied Stores Corp. agreed to settle their fraudulent conveyance claim for $192 million [approximately $.32 on the dollar] against Robert Campeau and third-party lenders in connection with the Federated Stores LBO fi-
bondholders, however, the other corporate constituencies could not even attempt to invoke formal legal principles to protect their interests. Their claim on the firm is indirect and generally not recognized by corporate law, even though their interests are no less important than the claims of shareholders and bondholders. These stakeholders, therefore, turned to state legislatures to protect corporations from hostile takeovers and limit the adverse impact of these transactions on the employees and the communities in which the companies operated. In response, state legislatures passed antitakeover legislation and explicitly empowered corporate boards to consider non-shareholder interests.

As a result, corporate law is now enmeshed in the conflicting demands of shareholders and stakeholders that the corporate enterprise be managed to protect each group's interests, even at the expense of other interests.

A. Stakeholders and the Rise of Antitakeover Legislation

Shareholders and bondholders have a quantifiable investment in the corporation that can usually be sold in the secondary market. The "Wall Street Rule" permits investors to express their disagreement with the management and minimize their losses by selling their investment in the securities markets. Unlike shareholders and bondholders, stakeholders in the corporation do not have that option because their "investment" is an intangible commitment of labor and energy in the corporation or an investment in businesses and services that support the corporate enterprise and its employees. These firm-specific investments cannot be liquidated in the same way a shareholder might sell stock in the corporation or as bondholder may sell a debt security. In addition, there is no legal mechanism similar to a derivative suit to preserve the value stakeholders have built up in the corporation. Disruptions that can occur from an extraordinary corporate transaction reach far beyond the financial markets and may deprive employees, suppliers and communities of a lifelong commitment to a corporation.

The difficult question concerning the mergers and acquisitions boom in the 1980s is whether it was beneficial to society. A strict economic approach to corporate restructuring views the changes as follows:

[Not only are takeovers beneficial to the shareholders of the firms being acquired, takeovers also provide substantial benefits to society at large. These gains come in the form of improving the productivity of American corporations so that goods and services reach Americans at

nanced in part through transfers from Allied Stores).
lower prices, and enabling American firms to compete more effectively in global product markets.\textsuperscript{212}

According to this view, any perceived detrimental effects on stakeholders can be remedied through a private contracting process between the corporation and its various constituencies. Stakeholders suffering dislocations can be compensated through side payments by the firm outside the takeover context.\textsuperscript{213} The value derived from takeovers and corporate restructuring is easily measured by calculating the amount of the premium received by shareholders over the price of the firm’s securities prior to the transaction.

Commentators have questioned the assumption that the premiums received by shareholders is a fair measure of the value of transactions because the premiums may overestimate the actual benefits of a transaction.\textsuperscript{214} If the benefits from takeovers are not as great as first estimated, the social costs of the transactions may outweigh any economic benefits.\textsuperscript{215} Moreover, it is small consolation to an employee who was laid off or a restaurateur whose clientele have been transferred that, in

\textsuperscript{212} Macey, \textit{State Anti-Takeover Legislation, supra} note 19, at 472.

\textsuperscript{213} See Macey, \textit{Fundamental Corporate Changes, supra} note 3, at 175 (“Dislocations to non-shareholder constituencies, while real, can best be remedied by side payments, made through intra-firm contracts.”). For example, suppliers can enter into long-term contractual relationships or seek outright vertical integration into the corporation with which they conduct business. \textit{Id.} at 191. The role of the court under the contract approach to protecting stakeholder interests is to discover the implicit contracts, police any \textit{ex post} opportunism that exploits firm-specific capital investments, and respect the special needs of shareholders as residual claimants on the corporation’s value. \textit{Id.} at 180.

\textsuperscript{214} See Stout, \textit{Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law}, 99 YALE L.J. 1235 (1990) [hereinafter \textit{Takeover Premiums}]. Professor Stout makes the seemingly obvious but overlooked point that a corporation’s supply of stock is generally inelastic. Therefore, a tender offer may exert price pressure on the limited supply of shares and bid up the market price of the stock. \textit{Id.} at 1247. Takeover premiums may reflect the downward sloping demand curve for stock. The fact that a premium is paid does not necessarily prove that a takeover is beneficial because it creates efficiency gains. \textit{Id.} at 1275. Professor Wolfson makes a related point that successful bidders may be infected with the “winners curse” because they will systematically overestimate the value of the target. Therefore, any gains from a takeover may reflect overbidding rather than other economic forces. Wolfson, \textit{Efficient Markets, Hubris, Chaos, Legal Scholarship and Takeovers}, 63 ST. JOHNS L. REV. 511, 518 (1989). \textit{See also} Coffee, \textit{Takeover Reform, supra} note 16, at 443 (source of takeover gains remains a mystery).

\textsuperscript{215} Coffee, \textit{Takeover Reform, supra} note 16, at 447. Coffee notes that even if the private gains from takeovers outweigh the social costs, the wealth transfer is probably “anti-egalitarian.” \textit{Id.} at 448.
the aggregate, shareholder gains will outweigh the relatively minor loss caused by corporate restructuring. Academic descriptions of the contracting process by which stakeholders can protect their firm-specific capital have a certain metaphysical quality that does not seem to reflect the reality of losing a job or a business.

Whether takeovers work to the ultimate benefit of society, management and stakeholders fought the threat of hostile offers by turning to their state legislatures. The Supreme Court initially rebuffed attempts to regulate hostile tender offers in *Edgar v. MITE*, when the Court found the state law violated the Commerce Clause, holding that the Williams Act preempted the state legislation.\(^\text{216}\) Pressure in the states for protective legislation, however, only increased as the pace of corporate transactions exploded in the 1980s. A series of second generation antitakeover statutes appeared that attempted to avoid the problems identified in *MITE* by ostensibly regulating only the internal affairs of domestic corporations. These statutes generally were of two types: one set regulated the terms of an offer by requiring a fair price for all shares or pre-approval by all disinterested shareholders prior to acquisition of a control share of a target, ostensibly to eliminate the threat of two-tiered tender offers;\(^\text{217}\) a second type was business combination statutes prohibiting persons acquiring more than a defined percentage of shares from engaging in a business combination with the target corporation for a certain number of years without the prior approval of the board.\(^\text{218}\)

1. **CTS Corp. v. Dynamics Corp. of America:** The Supreme Court Upholds Second-Generation Antitakeover Statutes

In *CTS Corp. v. Dynamics Corp. of America*,\(^\text{219}\) the Supreme Court upheld an Indiana statute that placed some restrictions on the conduct of a hostile tender offer, and in the process, the Court opened

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\(^{216}\) 457 U.S. 624 (1982); see supra notes 65-70 and accompanying text.


up the field to broad state regulation of the market for corporate control. Indiana enacted a control share statute that applied to companies incorporated in Indiana meeting certain criteria. 220 Any entity that acquired a threshold amount of the stock of a corporation covered by the statute could not vote the shares unless a majority of the corporation’s disinterested shareholders voted to give the acquiring entity the right to vote its shares. 221 The question of whether to allow the acquiring entity to vote its shares had to be submitted to a disinterested shareholder vote at a special meeting within fifty days of the acquiring entity’s request for the special meeting. 222 The Indiana statute avoided the problems identified by the Supreme Court in MITE of favoring incumbent management by interfering with the timing provisions of the Williams Act and allowing state officials to block takeovers. The Indiana legislature limited the antitakeover provision to regulating the internal affairs of the corporation, i.e. the relationship between the corporate issuer and its shareholders, and only applied to companies incorporated in Indiana with minimum threshold contacts to the state.

Six days after the Indiana statute went into effect, Dynamics announced a tender offer for one million shares of CTS, bringing its holdings to 27.5% of CTS. 223 Dynamics sought to enjoin CTS’ use of the act and the district and circuit courts sided with Dynamics. 224 In the Supreme Court, Dynamics reiterated its arguments that the Indiana statute impermissibly burdened interstate commerce, and therefore was unconstitutional under the dormant Commerce Clause. 225 Dynamics also

220. The criteria are: (1) 100 or more shareholders; (2) principal place of business, principal office, or substantial assets in the state; and (3) either a certain number of shares owned by Indiana residents or a certain percentage of the company’s shareholders are Indiana residents. IND. CODE ANN. §§ 23-1-42-4 (Burns 1990).

221. The thresholds for triggering the “control share” voting restriction are 20%, 33.3%, and a majority. Id. § 23-1-42-3. “Interested” shareholders include both the acquiring entity or any members of a group that crosses the percentage threshold and the officers and directors of the target corporation. Id. §§23-1-42-1.

222. The acquiring entity must make certain specified disclosures with the request for a meeting and must pay the expenses for the special meeting. Id. §§23-1-42-7, 8. If the disinterested shareholders grant the acquiring entity the right to vote its shares, then shareholders are entitled to dissenters rights based on the highest price paid by the acquiring entity for its control shares. Id. § 23-1-42-11. If the right to vote is denied, then the corporation has the right, but not the obligation, to purchase the acquiring entity’s shares for “fair value.” Id. § 23-1-42-10.

223. 481 U.S. at 75. Dynamics owned 9.6% of CTS.

224. CTS 481 U.S. at 75-76 (reviewing Dynamics Corp. of America v. CTS Corp., 637 F. Supp. 389 (N.D. Ill. 1986), aff’d, 794 F.2d 250 (7th Cir. 1986)).

225. Id. at 87-88.
asserted that the Williams Act preempted the state regulation because it delays completion of a tender offer, conflicting with the requirements of the Act.\(^{226}\)

The Court rejected the preemption argument, holding that even under the reasoning in \textit{MITE}, the Indiana statute "passes muster" because the legislation protects shareholders from the coercive aspects of a tender offer.\(^{227}\) The fifty day waiting period before the shareholder vote could cause some delay in completing an offer. However, the Court refused to require that the timing provisions of the Williams Act control all aspects of a tender offer.\(^{228}\) The Court held that the delay itself did not create a conflict with federal law. To hold otherwise "would preempt a variety of state corporate laws of hitherto unquestioned validity."\(^{229}\) The Court also concluded that because of the states' historic role in regulating corporations, "if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly."\(^{230}\)

The Court also rejected the Commerce Clause argument, reasoning that the Indiana legislation did not subject corporations to inconsistent regulations because the statute only applied to corporations chartered in the state and not to foreign corporations that might have to comply with more than one set of regulations.\(^{231}\) The Court went on to analyze the state's interest in chartering and regulating corporations, especially the voting rights of shareholders. The Court held that the Indiana statute did not prohibit tender offers for corporations subject to the control share provisions.\(^{232}\) Although the legislation may decrease the number of

\(^{226}\) \textit{Id.} at 78-79.

\(^{227}\) \textit{Id.} at 82-83. The Court contrasted the Indiana statute, which did not give management or the offeror an advantage in communicating with shareholders, and the state statute reviewed in \textit{MITE}, which favored management by prohibiting offerors from communicating with shareholders and allowed the state government to interpose its views of the transaction. \textit{Id.} at 83.

\(^{228}\) \textit{Id.} at 84-85.

\(^{229}\) \textit{Id.} at 85.

\(^{230}\) \textit{Id.} at 86.

\(^{231}\) \textit{Id.} at 89. The Court emphasized that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders." \textit{Id.} The Indiana statute upheld in \textit{CTS} was at best a mild deterrent on tender offers. The legislation even had a beneficial effect for offerors because it provided a mechanism to force a shareholder vote to consider a hostile bid that management would otherwise never permit. \textit{See Weiss, Emperor Has No Clothes I, supra} note 71, at 1668 & n.82.

\(^{232}\) 481 U.S. at 89-93.
successful tender offers, such an effect does not invalidate the statute under the Commerce Clause.\(^{233}\)

CTS makes clear that state regulation of the internal affairs of domestic corporations does not always violate the Commerce Clause.\(^{234}\) The preemption analysis, however, is more problematic. The Indiana statute was clearly passed to protect in-state corporations from takeovers by making them harder, or at least more cumbersome, to consummate. Yet, the Court chose to focus solely on the shareholder protection aspect of the statute to support its conclusion that the law favored neither management nor offerors in conformity with the Williams Act neutrality policy. The Court then reviewed two factors supporting its preemption analysis: first, Congress did not intend to preempt all state regulation in this area, recognizing the state's pervasive control of corporate law, and second, any delay caused by the Indiana statute presented only a de minimis conflict with the Williams Act.\(^{235}\) CTS does not state how the factors relate to one another or whether both factors must be satisfied for a state statute affecting takeovers to avoid preemption. The preemption discussion in CTS appears to be deliberately vague in reaching its conclusion. The decision does not state what principles lead the court to find no conflict between the state and federal laws. This approach has been attributed to the Court's desire to retain flexibility for lower courts and itself in reviewing future challenges to state antitakeover laws.\(^{236}\)

233. "Accordingly, even if the Act should decrease the number of successful tender offers for Indiana corporations, this would not offend the Commerce Clause." Id. at 94 (citation omitted).

234. See Weiss, Emperor Has No Clothes I, supra note 71, at 1677-78 & n. 133 (although CTS applies two Commerce Clause analyses, one can predict that courts will uphold internal affairs antitakeover laws and strike down laws regulating foreign corporations under the Commerce Clause). The Commerce Clause portion of the opinion is not a model of clarity, however, because the court appears to apply a traditional balancing test to review the Indiana legislation in addition to finding that the law only regulates the internal affairs of domestic corporations. The court never states explicitly that it is undertaking a balancing test, making it difficult to determine what principle should guide the review of other state regulations. See 481 U.S. at 95 (Scalia, J., concurring in part) (balancing inquiry is ill-suited to judicial function); Weiss, Emperor Has No Clothes I, supra note 71, at 1677; Sroufe & Gelband, supra note 218, at 905 (court did not expressly apply balancing test). Lower court decisions after CTS support the proposition that statutes regulating takeovers of corporations incorporated in another state will not survive Commerce Clause scrutiny. See, e.g., Tyson Foods, Inc. v. McReynolds, 700 F. Supp. 906 (M.D. Tenn. 1988), aff'd, 865 F.2d 99 (6th Cir. 1989) (invalidating Tennessee antitakeover laws applied to Delaware corporation); TLX Acquisition Corp. v. Telex Corp., 679 F. Supp. 1022 (W.D. Okla. 1987) (invalidating Oklahoma control share law applied to Delaware corporation).

235. 481 U.S. at 83.

236. See Weiss, Emperor Has No Clothes I, supra note 71, at 1683-84. Weiss
The Court did not limit its analysis in *CTS* to control share statutes. The decision allows legislatures to limit takeovers of companies incorporated in the state by regulating the internal affairs of corporations and expanding the areas a board may consider in responding to a takeover to include the interests of other constituencies. Thus, *CTS* provided the legal foundation for states to pass legislation that restricts hostile takeovers. Within two years of the decision, a majority of the states adopted new laws or amended provisions to strengthen their takeover protections, including twenty-eight states passing "stakeholder" provisions. The unanswered question after *CTS* was how far the lower federal courts would allow states to go in restricting takeovers through regulation of corporate internal affairs.

2. *BNS* and *Amanda Acquisition*: The Limits of State Power

In *BNS Inc. v. Koppers Company, Inc.*, the United States District Court for the District of Delaware considered a constitutional challenge to Section 203 of the Delaware business combination statute. Section 203 prevents a business combination between an "interested stockholder" that acquires more than 15% of the outstanding stock and the company for three years, unless the transaction comes under one of the three exceptions to the act’s coverage. The district court brushed


239. [DEL. CODE ANN. tit. 8, § 203 (1988).] BNS made an all cash tender offer for Koppers at $60 per share, conditioned on a finding that Section 203 was unconstitutional or inapplicable to the offer. 683 F. Supp. at 461.

240. The exceptions to Section 203 are: (1) if the interested stockholder acquires more than 85% of the stock in the transaction in which the 15% threshold is crossed; (2) if the board and two-thirds of the disinterested shareholders approve the business combination; and (3) if an offer is made after the board approves a friendly business combination. [DEL. CODE ANN. tit. 8, § 203(a).] The statute also permits the board to approve a business combination if the offeror purchases at least 85% of the stock. *Id.* at § 203(b). Delaware had decided against adopting a control share statute similar to the Indiana legislation because corporate management thought such a statute might have the effect of encouraging takeovers. Special Report, *The Battle Over Tender
Corporation Restructuring After the Eighties

Aside the Commerce Clause argument, noting that Section 203 is "exquisitely crafted" to reach the limits of the state's constitutional power to regulate corporations. The court's preemption analysis began with the proposition that a state cannot completely eradicate tender offers because favoring management to such a degree would violate the Williams Act's neutrality policy. To determine the permissible scope of state regulation, the court proposed a test that a state may enact legislation to restrict tender offers "so long as hostile offers which are beneficial to target shareholders have a meaningful opportunity for success" under the statute. Adopting the "meaningful opportunity for success" standard allowed the district court to apply CTS to a business combination statute that raises a very different preemption problem than the Indiana control share provision reviewed in CTS.

The Delaware statute obviously favors management since hostile takeovers cannot be completed for three years unless a significant portion of the company's stock is purchased or the board agrees to cooperate with the offeror. As the Supreme Court acknowledged in CTS, the fact that the state legislation conflicts with federal law is not dispositive. Section 203 does not protect shareholders from coercive offers, as does a control share statute. Yet, CTS found that some interference with the Williams Act is permissible because of the states' broad power to regulate corporate internal affairs. The BNS test sets an outer limit

Offer Reform: From the States and the Courts to Congress, 20 SEC. REG. & L. REP. (BNA) 60, 63 (Jan. 15, 1988).

242. Id. at 468.
243. Id. at 469.
244. The preemption issue in CTS concerned whether the Williams Act prevented states from enacting legislation that affects the timing of a tender offer and the right to vote acquired shares. See supra notes 221-22 and accompanying text. The Delaware legislation raises the broader issue of whether federal law prohibits states from imposing conditions on share acquisitions or by regulating corporate management decisions to limit takeovers. See supra notes 239-40 and accompanying text. The Delaware legislation does not interfere with the operation of the Williams Act in any way, but raises the more challenging issue of whether states have any power to regulate takeovers in light of the federal legislation.

245. The district court described the effect of holding constitutional the Delaware business combination statute, stating, "Section 203 alters the balance between target management and the offeror, perhaps significantly. Yet, the section will be constitutional notwithstanding its pro-management slant, so long as it does not prevent an appreciable number of hostile bidders from navigating the statutory exceptions." 683 F.Supp. at 470.
246. See supra note 230 and accompanying text.
of interference with the Williams Act, allowing states to regulate takeovers. BNS requires that states preserve at least a semblance of a market for corporate control through hostile offers. The district court examined the three exceptions to Section 203 and concluded that, although the preemption issue is a close question, the statute allowed bidders a meaningful opportunity to succeed in an offer and therefore the degree of conflict with the Williams Act did not warrant voiding the statute.247

While the Delaware district court took a measured approach to CTS, the United States Court of Appeals for the Seventh Circuit took the Supreme Court's preemption analysis as a signal that all state laws regulating the internal affairs of corporations do not conflict with the Williams Act. In Amanda Acquisition Corp. v. Universal Foods Corp.,248 the Seventh Circuit reviewed a challenge to Wisconsin's antitakeover law prohibiting mergers for three years unless the target's board of directors agrees in advance.249 Amanda had commenced a tender offer at $30.50 per share for Universal Foods.250 Amanda sued to have the statute declared both unconstitutional as a violation of the Commerce Clause and preempted by the Williams Act. Unlike the Delaware statute, the Wisconsin antitakeover law did not have a threshold ownership level above which the merger prohibition did not apply, and a corporation could not opt out of coverage.251

The Seventh Circuit's opinion by Judge Easterbrook, a leading scholar on corporate law, begins by lambasting the Wisconsin legislature for passing the statute, stating that “[i]f our views of the wisdom of


248. 877 F.2d 496 (7th Cir. 1989).

249. Wis. STAT. ANN. § 180.726 (West 1957 & Supp. 1988). The statute applied to every company incorporated in Wisconsin with its headquarters, substantial operations, or 10% of its shareholders in the state. Id. at § 180.726(2). The antitakeover provisions were triggered by acquiring 10% of a corporation's stock unless the board approved the transaction before acquisition of the stock. Id. at § 180.726(1).

250. 877 F.2d at 498.

251. This statute was among the most extreme of the business combination statutes passed by the states after CTS. 877 F.2d at 498.
state law mattered, Wisconsin’s takeover statute would not survive . . . . We believe that antitakeover legislation injures shareholders.”252 The power of the legislature to make unwise decisions was not at issue, however, and the court turned to the question whether federal law preempted the Wisconsin statute.

The Seventh Circuit first determined that the Supreme Court’s decision in CTS lifted the “weight of precedent” of MITE concerning the preemptive effect of the Williams Act, thereby freeing the circuit court to determine what effect the federal law had on the state’s power to regulate takeovers.253 The court began with the proposition that the Williams Act regulates only the process of tender offers by mandating time limits for shareholders to respond and specifying rights of equal treatment.254 State regulation of internal affairs, such as super-majority approval of mergers and staggered director terms, and various models of ownership that do not involve traditional common stock with voting rights, all make tender offers less attractive. However, these state law provisions are not preempted by federal law. More importantly, although a delay mandated by state law in completing a second stage merger may depress or deter bids, postponing completion of the bidder’s business strategy does not affect the conduct of a tender offer in violation of the Williams Act.

The Seventh Circuit’s analysis leads to the rather simple point that “[o]nly if the Williams Act gives investors a right to be the beneficiary of offers could Wisconsin’s law run afoul of the federal rule. No such entitlement can be mined out of the Williams Act, however.”255 The

252. Id. at 500 (footnote omitted). Ignoring its own admonition, the court then attempts to instruct legislators (and perhaps future judges) about the value of an unfettered market for corporate control, a position Judge Easterbrook powerfully argued before his elevation to the bench. See Easterbrook & Fischel, Proper Role, supra note 13 at 164.

253. 877 F.2d at 502-503. The court stated, “The rough treatment our views received from the [Supreme] Court—only Justice White supported the holding on preemption—lifts the ‘weight of precedent’.”(sic) Id. at 503. Weiss describes the Seventh Circuit’s reasoning supporting the analysis of the preemptive effect of the Williams Act as “disingenuous.” He further describes the Supreme Court’s allegedly “rough treatment” of the circuit court’s preemption analysis in CTS as “blatantly inaccurate.” Weiss, Emperor Has No Clothes II, supra note 71, at 260-61. Although the circuit court said that its opinion would “stop short of the precipice, “ 877 F.2d at 503, the restrictive approach to the preemption issue can only be seen as a leap into the void of allowing the states unfettered discretion to pass any antitakeover bill that ostensibly regulates a corporation’s internal affairs.

254. 877 F.2d at 503-04.
255. Id. at 504.
court then made its point even more starkly, stating, "[i]nvestors have no right to receive tender offers." The statute makes tender offers less likely, and ownership of Wisconsin corporations potentially less rewarding. Yet, the state legislation does not interfere with the bidding process once a bidder appears, and therefore is not preempted by the Williams Act.

Amanda Acquisition is an opinion seemingly at war with itself because the circuit court simultaneously excoriates a law it believes to be bad while adopting a legal analysis allowing states the broadest power to adopt even more extreme legislation. In addition, the decision rejected the more measured approach proposed by the Delaware district court. The Seventh Circuit, or perhaps more pointedly, Judge Easterbrook is sending a message that he will adopt the starkest position possible on the preemption issue so that Congress will be forced to confront the issue of state regulation of takeovers by amending the Williams Act to prohibit legislative efforts to restrict the market for corporate control. The Seventh Circuit never states the conclusion

256. Id.

257. The Seventh Circuit did acknowledge the BNS “meaningful opportunity for success” test. The court stated that the Wisconsin statute allowed some chance of success because a bidder may, for example, operate a target as a subsidiary for three years, even though that may be a less attractive alternative. Id. at 508. The court also rejected the Commerce Clause challenge to the Wisconsin statute, noting that it only regulated the internal affairs of a corporation and therefore would not cause enough interference with interstate commerce to warrant invalidating the law. Id. at 506. The court’s analysis of the “meaningful opportunity for success” test comes in its review of whether the statute violates the Commerce Clause. The Delaware district court had, however, formulated the test as a means to determine whether the statute conflicted with the Williams Act. BNS, 683 F.Supp. at 469. The Seventh Circuit’s logic that a bidder can overcome the hurdles erected in the Wisconsin statute seems to be an attempt to acknowledge the BNS decision without overtly rejecting it by addressing the BNS analysis in connection with an unrelated issue. The court’s clear goal is to confine the role of the Williams Act. Addressing the “meaningful opportunity for success” test in its proper context would require the court to acknowledge that the Williams Act has some preemptive effect beyond regulating the process of tender offers. See Sroufe & Gelband, supra note 218, at 915 (Amanda Acquisition summarily rejects the “meaningful opportunity for success” test).

258. Weiss accuses Judge Easterbrook of judicial activism in misrepresenting the plaintiff’s claims and addressing arguments in inappropriate contexts. Weiss also acknowledges that the Seventh Circuit’s analysis of the preemptive effect of the Williams Act is certainly not unreasonable. Weiss, Emperor has No Clothes II, supra note 71, at 258. While the moniker of “judicial activist” may be anathema to many conservative judges, Judge Easterbrook has proposed that courts and legislatures intervene in the area of takeovers to restrict management’s power to resist tender offers. See Easterbrook & Fischel, Proper Role, supra note 13, at 1194 (proposing rule limit-
this explicitly. However, *Amanda Acquisition* stands for the proposition that state regulation of the internal affairs of a corporation will never be preempted by the Williams Act, no matter whether a tender offer can ever succeed under the statute, unless the state legislation directly alters specific timing requirements of federal law. The *Amanda Acquisition* test, as formulated here, presents no problem to a state legislature considering antitakeover proposals because it limits the Williams Act’s coverage to a narrow area of tender offer regulation while the states retain the broad field of “internal affairs” to enact legislation that protects corporations from unwanted offers.

3. Pennsylvania Takes the Law Even Further

The full extent of a state’s power to pass legislation to restrict takeovers incorporated in that state may depend on whether the laws are reviewed under *BNS* or *Amanda Acquisition*. Yet, both decisions clearly hold that the states have substantial authority to restrict completion of hostile offers and effecting mergers. After *CTS*, more states jumped on the bandwagon, passing antitakeover laws in response to pressure from corporations subject to hostile offers and from employees, suppliers, and communities who believed their economic well-being was threatened by the prospect of a takeover. The states expanded their reach under the internal affairs doctrine beyond control share and business combination statutes, passing measures expanding a board’s power to consider non-shareholder interests, requiring severance payments to workers laid off after a transaction, and deterring hostile raids seeking greenmail payments.259 State legislatures passed many of these laws to protect specific corporations from threatened or actual hostile offers.260

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259. See MASS. GEN. L. ch. 156B, §65 (Supp. 1991) (nonshareholder protection); OHIO REV. CODE ANN. § 1701.59 (Baldwin 1992) (nonshareholder protection); PA. CONS. STAT. ANN. § 1715 (nonshareholder protection), § 2572 (greenmail protection), § 2581-83 (severance payment to any worker terminated within one year of a control share fight) (Purdon Supp. 1991).

260. See *supra* note 19 (listing states that passed antitakeover legislation to protect a particular company in the state).
Perhaps the most far reaching antitakeover statute is Pennsylvania’s legislation adopting a traditional control share provision similar to the Indiana law approved in CTS but also extending the reach of the state’s power to deter hostile transactions through new approaches. Like many other statutes protecting a specific company, the Pennsylvania antitakeover provisions were enacted in 1990 to thwart a hostile offer by the Belzberg family for Armstrong World Industries. The law requires that any controlling person or group acquiring or disclosing an intention to acquire 20% of a corporation, or to otherwise seek control of the corporation, must pay the target corporation all profits from sales of stock the target corporation’s consulated between two years before and eighteen months after the purchaser becomes the controlling person or group. The disgorgement provision is not limited to hostile offers, but also covers proxy contests for control and friendly offers. The ostensible purpose of the provision is to prevent “greenmailers” and other corporate raiders from putting a corporation into play. However, the provision is not narrowly tailored to meet that purpose. Other provisions of the Pennsylvania law allow directors to fulfill their fiduciary duties by considering the effect of a transaction on non-shareholders, the short and long-term interests of the corporation, and the intent and conduct of a bidder in responding to an offer. Moreover, the board is not required to put the interests of shareholders before those of any other group. Finally, Pennsylvania provides a “tin parachute” of severance pay based on the number of years worked to those employees terminated within ninety days of the acquisition of a control share of the


265. Directors of the corporation shall not be required “to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor.” Id. at § 1715(b).
company's stock, or two years after the acquisition. 266 The new reach of the Pennsylvania antitakeover legislation may have depressed the value of the stock of companies incorporated in the state, 267 generating pressure on a number of large companies to opt out of coverage of all or parts of the law. 268

Assuming their company is not subject to an actual or potential unwanted offer, the expanded protection from hostile offers enacted by the states often presents management with a hard choice, as shareholders pressure management not to accept the shield provided by the law. Meanwhile, stakeholders generally support these provisions and clamor for greater protection. The market for corporate control forces management to make explicit where its sympathies lie because the new statutes have nothing to do with shareholder protection, a misnomer often applied to second-generation statutes to hide the true purpose of the legislation. 269 If management opts for the protections offered by the state legislatures, as many have done, the key issue is determining what stakeholders have gained through the political exercise of enacting antitakeover laws, and whether shareholders have lost anything in the process.

B. The Balance Between Shareholders and Stakeholders.

The expanded scope of state antitakeover legislation after CTS has altered the balance in corporate law from the simple dichotomy of management and shareholders to a complex set of relationships between a corporation, the shareholders, and the variety of interest groups falling under the label of stakeholders. 270 At this stage of corporate law's de-

266. Id. at § 2582(a).
267. See Demick, Study Links Loss By Pa. Stocks to the Takeover Law, Phila. Inquirer, October 14, 1990, at D1 (study estimated Pennsylvania companies lost 9% of value after introduction of legislation, compared with 3% loss of other stocks); Zweig, supra note 261, at 43 (study of Pennsylvania companies shows stock prices lagging market by 2-3%).
268. See Klein & Greenbaum, supra note 261, at 15 (many companies announced they opted out to remain attractive to investors, although some felt disgorgement and control share provisions may also have been threatening to management).
269. See Garfield, State Competence, supra note 19, at 559 (true motivation for state legislation is protection of large local employers threatened by takeovers); Johnson & Millon, Missing the Point, supra note 15, at 848 (principle aim of state laws is not to maximize share value but to protect non-shareholders from disruptive impact of restructuring); Macey, State Anti-Takeover Legislation, supra note 19, at 468 (statutes protect interests of individual firms rather than interests of public or shareholders).
270. Coffee argues that corporate law has become a multi-player game in which
velopment, shareholders have seen their position eroded by the states through the antitakeover and nonshareholder constituency statutes permitting a board to consider other interests, and by the courts. The *Time* opinion grants management broad power to respond to "threats" to the corporation and its constituencies without considering the shareholders' desire to sell their shares. While shareholders appear to have lost some of their standing, it is not clear that stakeholders have truly gained anything in a process enhancing management's power to control the corporation.

1. The End of Shareholder Primacy

An increase in management's power to run the corporation is not a novel phenomenon. As discussed in the earlier review of the status of corporate law before the mergers and acquisition boom, management had broad power to respond to offers under *Cheff*. In addition, the proxy rules and the business judgment rule worked decidedly in management's favor. One might be tempted to view the result of the legal and legislative changes as much ado about nothing, a facade behind which the power of incumbent managers remains once and forever protected. That analysis, however, ignores the reality of the corporate restructuring that occurred in the 1980s, including displacements, enormous wealth transfers, and its effect on the basic rationale of corporate law.

The new emphasis on the rights of stakeholders means that shareholders can no longer claim to be the primary beneficiaries of the corporate enterprise.\(^{271}\) The corporate entity exists to serve a number of interests and represents an investment by more than just the equity owners. Employees have firm-specific capital investments in a company. Bondholders have an interest in the continued operation of the corporation in approximately the same form to ensure repayment of debts. Suppliers seek stability of demand for products and services. Communities want the presence of the corporation or its operating subsidiaries for the continued contributions to the public good.\(^{272}\) The current change in corporate law is the explicit acknowledgement that the board must now

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\(^{272}\) Id. at 234-35.
account for these interests in making decisions. A key question not addressed in the shift away from the older focus on the shareholder-management relationship is where shareholder interests reside in the panoply of interests management must consider.

Professor Millon argues that the nonshareholder constituency statutes and the Time decision demonstrate the shift away from a private law conception of the corporation to a public law approach.\(^{273}\) Rather than viewing the corporation as a private ordering between management and shareholders, the law is beginning to acknowledge the public nature of the corporation that involves obligations to communities and the other constituencies with an interest in the firm.\(^{274}\) The preeminent position of the shareholders cannot continue because a corporation has duties beyond the short-term wealth interests of the owners of its equity, which constitute only one investment in the corporation. This approach has strong historical roots in the nineteenth century conception of the corporation as a creation of the state in the public’s interest.\(^{275}\) The move away from shareholder primacy means that the interests of other constituencies may be considered in corporate decisions. It is not clear, however, what that additional consideration involves, or what a board should do to respond to the new conception of corporate law.

While shareholders no longer have the primary claim on the corporation, no one advocates that their interests be removed completely from consideration. The states have not, however, given any content to the new regime of nonshareholder interests by designating whose interests are of greater or lesser importance or what circumstances require consideration of one group’s concerns over another.\(^{276}\) To announce that shareholders are one among equals means that there is no hierarchy to weigh the interests of the different competing interest groups. Management would be left to reach decisions that may favor one group over another without any principled basis to support its decision.\(^{277}\) Corporate law will have to regulate a series of relationships without any values assigned to different interests. Therefore, it would be impossible to make a fair judgment of management’s decision that may favor one constituency over others.\(^{278}\)


\(^{274}\) Id.

\(^{275}\) Id. at 209-10; see also Note, *State Takeover Statutes and Corporate Theory: The Revival of an Old Debate*, 64 N.Y.U.L. REV. 806, 842-44 (revival of earlier theory that corporation is creature of state and ultimately dedicated to interests of society as a whole).


\(^{277}\) Id. at 245.

\(^{278}\) See Millon, *Corporate Law*, supra note 271, at 243 (statutes offer little if
2. Enforcement of the New Corporate Rules

A leading corporate law practitioner argues that there is little chance the meaning of the nonshareholder constituency statutes will be tested in the courts because "only a reckless corporate advisor would permit board minutes, or an accurate rendering of the advice given a board, to suggest that the board put non-shareholder interests before those of shareholders." The new constituency statutes may be meaningless if corporate boards simply ignore them, considering them little more than a legislative bone thrown to whining interest groups. That attitude may be overly cynical, but it demonstrates the more telling argument that shareholder constituency statutes grant management unfettered power to make decisions with no principled check on a board if shareholders are not the primary beneficiary of the corporate enterprise. Managers that can respond to the demands of multiple constituencies with equal claims are accountable to no one.

any guidance as to how management should exercise its discretion in considering nonshareholder interests).


280. See Carney, Defining Constituencies, supra note 21, at 419 ("there is no rational way for managers to consider the relative preferences of multiple constituencies"); Ribstein, supra note 21, at 149 ("Instead of following an explicit standard of maximizing shareholder welfare, the managers can hide behind vague duties to conflicting groups."); Garfield, Evaluating State Anti-Takeover Legislation, supra note 21, at 127-28 (legislation provides no real protection to constituencies, but only fosters management entrenchment); Macey, State Anti-Takeover Legislation, supra note 19, at 477 (state legislation is "positively detrimental" to shareholders by granting power to management to negotiate on their behalf); Easterbrook & Fischel, Proper Role, supra note 13, at 1191-92 (manager responsible to two conflicting interests is answerable to neither). The contractarian approach to corporate law rejects the nonshareholder constituency statutes as an ineffective means to protect interests which can be better served through judicial enforcement of private contracting arrangements. Carney, Agency Cost Model, supra note 5, at 387-88 (constituency representation on board will not add to protection of contracts); Macey, Fundamental Corporate Changes, supra note 3, at 174-76 (contracting process generates results superior to governmental regulation of rights in corporation).

Millon argues that the constituency statutes should be interpreted by courts to limit management's right to ignore the concerns of non-shareholders in pursuing a course of action that will benefit the short-term interests of shareholders. He argues that the non-shareholders should have a right to sue for management's failure to consider their interests in reaching a decision. Millon, Corporate Law, supra note 271, at 265-76. Millon analyzes the fundamental problem with the constituency statutes, that
Professor Johnson, a leading proponent with Millon of nonshareholder constituency statutes, acknowledges that protections under constituency statutes are indirect because legislation can only impair the shareholders' autonomy to accept an offer and sell their stock. The indirect protection comes through the board of director's broad power to resist an offer and prevent shareholders from selling their stock to an offeror. Therefore, non-shareholders depend on the board for protection. This result is anomalous in comparison with the tenet of corporate law that management's power must be restrained by imposing fiduciary duties. One can argue that management is still governed by the same fiduciary duties. However, now they also apply to decisions to protect non-shareholders. Nonetheless, that approach fails because management must serve two conflicting interest groups-shareholders and stakeholders. Any decision will usually prove costly to one group. The premise of the constituency statutes is that management must have virtually unchecked power to decide between competing interests and, if necessary, reject a transaction that enriches some and harms others. That position is at odds with the rationale of imposing fiduciary duties, which impose certain accountability requirements on management and the board to justify decisions as the proper exercise of business judgment on behalf of parties owed the duty.

Rather than argue that state statutes protect non-shareholders directly, Martin Lipton and Steven Rosenblum recognize that the goal of constituency statutes is only to "permit directors to take into account the interest and role of non-stockholder constituencies in the corporation's long-term vitality." State statutes are not for the protection of non-shareholders per se, but are designed to permit directors to focus on the corporation as a business enterprise. All constituencies will benefit from board decisions that will strengthen the corporation for the long-

they do not provide any enforcement mechanism requiring management to consider nonshareholder interests. Id. at 226. Even if a court were to allow non-shareholders to sue management under the constituency statutes, expanding the right to seek legal re- dress for business decisions may not be the best method of promoting the corporate enterprise. Millon acknowledges that a more radical restructuring of corporate law may be necessary to protect the interests of all persons with investments in the corporation. Id. at 276-77 (current corporate structure may be replaced with one in which decision-making power is distributed downward to include employees and non-shareholders).

282. Id.
283. Lipton & Rosenblum, Quinquennial Election, supra note 2, at 215.
284. Id.
term, rather than transactions that only serve the short-term orientation of shareholders. 285 This conception of corporate law places its highest trust in management to weigh competing interests. This position is not troublesome, according to Lipton and Rosenblum, because charges of managerial self-interest and entrenchment are "simply unfounded." 286

Reliance on management to protect the interests of non-shareholders often rests on denigrating shareholders' interests in the corporation. Lipton and Rosenblum support their argument in favor of management by disparaging shareholders as having as much interest in the corporation as,

[the holder of a betting slip views a racehorse. Just as the bettor does not really care about the fate of the racehorse as long as it provides him a financial payoff, so too the stockholder/investor does not really care about the fate of the corporation as long as the stock generates a profit.] 287

This description may fit stock arbitragers. But such an overly broad indictment of shareholders and their reasons for investing includes, for example, the employees and management of a corporation who own shares in their corporate employer. It is doubtful that they look upon their investment as a chance to emulate the sport of kings. Moreover, nonshareholder concerns are generally portrayed as much more worthy than the shareholder's mere investment of money because the corporation's constituencies are much broader and even represent the general welfare. Attacking the motives of shareholders or comparing the relative value of the interests of different constituencies does not resolve the issue of managerial accountability unless one begins with the assumption that managers are sufficiently attuned to the interests of all constituencies to protect each of them. Alternatively, one can assume that the emerging corporate order will impose a new structure on the corporation as a substitute for the generally ineffectual power of share-

285. "[T]he ultimate goal of corporate governance is the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy." Id. at 189.

286. Id. at 195; see also Johnson & Millon, Missing the Point, supra note 15, at 853 (simplistic equation of management sponsorship of antitakeover statutes with selfish entrenchment may be questionable).

287. Lipton & Rosenblum, Quinquennial Election, supra note 2, at 194 (citing Capitalism, THE ECONOMIST 8 (May 5, 1990); see Norwitz, supra note 21, at 387 ("For the overwhelming majority of the time, the shareholder is merely one type of investor, usually with a diversified portfolio, and so with a smaller interest in the fate of any one company than that company's employees, creditors, support industries or perhaps even customers.").
holders to constrain management.

The rationale for protecting nonshareholder interests is to limit damage from corporate restructuring caused by, among other things, hostile takeovers. In order to protect those interests, the corporation must be shielded from any threats that will cause disruptions in relationships that have emerged with the various nonshareholder constituencies. Millon reads the *Time* opinion as an "endorsement of corporate management's power to favor stability and gradual adaptation to consumer preferences over short-term shareholder gain..." These preferences may allow protection of any substantial company which is an established feature of the corporate landscape from the damaging effects of a hostile offer. Similarly, Lipton and Rosenblum argue that the corporate governance structure should be altered to provide management with the stability necessary to achieve long-term operating successes with a corporation. The goal of protecting nonshareholder interests seems to be designed to preserve the status quo for corporations. Change should be resisted unless it is gradual and has the support of management as part of a strategic plan. Such an approach is extremely conservative, even reactionary, because, in order to protect relationships built over time, it seeks to impede the process of change that necessarily occurs in any economic system. It is not irrational to fear change. But the protection of nonshareholder interests in the corporation should not be a facade to protect companies from changes in markets, including changes brought about by hostile takeovers.

Expanding management's power under the guise of protecting nonshareholder interests may be to slow the pace of hostile offers. Yet, the disruptive effects of corporate restructuring have not stopped. The banking sector currently has seen consolidation of large money-center banks through friendly mergers. The primary motivation for these transactions is to cut costs by eliminating duplicative operations, such as branches and back-office operations. One obvious effect of transac-

290. Three large bank mergers announced in the summer of 1991 involved Chemical Bank and Manufacturers Hanover in New York, NCNB and C&S/Sovran in the southeast, and Bank of America and Security Pacific in California. The parties justified the transactions as moves that will generate savings through consolidating operations. See Hector, *Do Bank Mergers Make Sense?*, FORTUNE, Aug. 12, 1991, at 71 (Chemical-Manufacturers Hanover merger will close 70 branches and lay off 6,200 employees, generating savings of $650 million per year); Mitchell, Hamilton, Kerwin & Glasgall, *Bank of America's Big Bang*, BUS. WEEK, Aug 26, 1991, at 25 (Bank of America - Security Pacific merger will involve $1 billion of cost cutting per year
tions premised on realizing cost savings is the disruption of longstanding relationships, through employee layoffs and reduced presence in communities. Constituency statutes do not specifically address friendly transactions, and nonshareholder interests do not appear to be a check on management’s decision to pursue transactions that involve disruptions through consolidation of operations that create gains by cutting expenses.

The position of stakeholders after the legislative and judicial decisions recognizing their interests in the corporation does not appear to have changed in any significant way because non-shareholders ultimately depend on management for protection of their interests. This position does not entail any real change in corporate law in place prior to the mergers and acquisition boom. The state statutes do not impose any additional duties on management commensurate with the expanded power to consider the interests of other constituencies. On the other hand, shareholders have lost ground because corporate law is no longer a simple balance between management and owners of the corporation, with shareholder primacy the governing principle. Both Time and the constituency statutes mean that shareholders must fight for recognition of their position rather than assuming any corporate decision will be for their benefit. The corporate law system has been inexorably changed by the battle for corporate control in the 1980s. The remaining question is how the law will address the tension between management, shareholders, and stakeholders.291


IV. HOW CHANGES IN THE MARKET MAY ALTER THE MIX

A. Can Institutional Investors Change the Relationship of Shareholders with Management?

The classic conception of shareholders as individuals with modest investments in a variety of companies may never have been a completely accurate profile of stock ownership in the United States. But in 1950, individuals directly owned over 90% of the equity in public companies. By the end of the 1980s, the market had radically changed with the phenomenal growth in institutional investments. Institutions now own at least 44% of the total equities in the United States, with assets reaching approximately $5.7 trillion. Not only is the aggregate size of institutional equity holdings staggering, approximately $1.7 trillion, but the assets under institutional management have grown through appreciation and additional contributions. Comparatively, individual investors have decreased their direct investment in stock.

The advent of institutional investors affects not only the relationship between the corporation and its shareholders, but also the marketplace for securities through the introduction of new trading products. Institutions manage funds on behalf of and owe a fiduciary duty to their investors. Among the largest institutions are pension funds.

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292. NEW YORK STOCK EXCHANGE, INSTITUTIONAL INVESTOR FACT BOOK 1991 5.

293. Id. at 5-6.

294. The equity assets of institutions have grown primarily through appreciation. The relative holdings of institutions compared to individuals has changed so noticeably because individuals had net sales of equities of over $750 billion in the 1980s, while institutions increased their holdings through purchases by approximately $296 billion. This shift in ownership was exacerbated by a decline in the overall equity market of over $500 billion through corporate restructuring. Id. at 5, 11.

Institutional ownership in individual companies varies, with a greater concentration in larger public companies. The aggregate size of institutional ownership of some companies is quite high. For example, in 1989 institutions owned 88% of Capital Cities/ABC, 71% of Digital Equipment, and 69% of Minnesota Mining and Manufacturing. Brancato, The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project, 19-20 & tables 4, 7 (Center for Law and Economic Studies, Columbia University School of Law, 1990). The equity assets of different types of institutions as of 1989 has been estimated as follows: private pension funds/$667 billion; public pension funds/$290 billion; life insurance companies/$116 billion; other insurance companies/$94 billion; mutual funds/$239 billion; bank trust departments/$305 billion. Id.
pension funds are governed by federal standards enunciated in ERISA that require managing assets solely in the interest of the beneficiaries.\(^{295}\) In order to fulfill their fiduciary and statutory duties, fund managers seek to spread the risk of investing through diversification of assets. A prime method of achieving this goal is through index investing in the equity markets.\(^{296}\) Futures and option contracts on foreign market indices, debt securities, currencies, and commodities also allow institutions to hedge their positions and limit their exposure to downside risks outside the domestic equity markets.

Institutional investors are similar to individual investors in that each seeks a high return on an investment, and both supported the wave of mergers and corporate restructurings that transferred substantial wealth to shareholders. The institutional investor has an added incentive to support these extraordinary corporate transactions because they provide a convenient means of liquidating a position, at virtually no cost to the fund, while realizing a substantial gain on the investment.\(^{297}\) The sheer size of institutional holdings, however, has an important limiting effect on how large investors can react to changes in a corporation. The traditional "Wall Street Rule" is that shareholders who do not like management or are dissatisfied with results should sell their investment. Institutional investors may not have that option, at least to the extent the individual investor can liquidate a position.\(^{298}\) An institution that wants to sell its


\(^{296}\) See, e.g., Bartlett, A California Pension Fund Cuts the New York Umbilical Cord, N.Y. Times, Aug. 26, 1990, at F12, col. 1 (seventy-seven percent of equity portfolio of California's largest state employee retirement fund is indexed). Stock indexes are composites of stocks that represent a portion of the market, such as the S&P 500, or even the entire market, and will reflect the value of the selected market. Gilson & Kraakman, Reinventing the Outside Director, supra note 43, at 864 n.3 (citing Clark, Why Dale Hanson Won't Go Away, INSTITUTIONAL INVESTOR, April 1990, at 79.). Indexing means that the investments are passive to the extent that any change in the components of an index will require an institution to adjust its holdings by buying or selling shares, but otherwise there is no trading of stocks to increase gains or limit losses. The securities and commodities exchanges have responded to increased demand by institutional investors for broad market investments by creating derivative securities allowing investment in an index without actually purchasing all the stocks that compose a particular index, including indexes on foreign stocks. Investments in index funds can also lower transaction costs because the fund does not need to pay for securities analysis and trading commissions because index funds do not require active trading.

\(^{297}\) See Rock, supra note 36, at 484-85 ("Institutional investors receive a clear benefit from exiting via tender offers: a substantial premium over market price.").

\(^{298}\) See Coffee, Liquidity Versus Control: The Institutional Investor as Corpo-
holdings usually requires block trades that can involve transactions from
10,000 to as many as one million shares. Flooding the market with that
much stock at one time will likely depress its price. If the fund manager
is reacting to negative news, then the downward pressure on the price
will be exacerbated.\(^2\) The option of simply walking away from an
investment that may be souring temporarily is not feasible for institu-
tions that must weigh the effect of their decisions on a broad portfolio
and, where applicable, the strict duties imposed by ERISA. Moreover,
the institutional investor who indexes a portion of the managed funds
cannot pick and choose the stocks owned in the market composite;
indexes are, by definition, a broad sampling of stocks that include more
than a few lemons. In short, institutional investors cannot shun the equi-

ty market for any length of time without endangering the continued
growth of the funds under management.

The decline in the market for corporate control and the increase in
institutional ownership of stock refocuses the tension between sharehold-
ers and management away from the hostile offer as a means of disci-
plining management and towards reforming the system of corporate
governance. Institutions have become more active in opposing manage-
ment-sponsored antitakeover devices and have sought to make manage-
ment more responsive to the needs of large shareholders.\(^3\) The end

rate Monitor, 91 COLUM. L. REV. 1277, 1288-89 (1991) [hereinafter Liquidity Versus
Control] (institutional ownership of large blocks of stock makes selling out position
hard without substantial price discount); but see Sommer, Corporate Governance in
the Nineties: Managers vs. Institutions, 59 U. CIN. L. REV. 357, 367 [hereinafter
Corporate Governance] (most institutions express dissatisfaction through the “Wall
Street walk”). Sommer notes, however, that the trend may be away from selling hold-
ings in companies. Id. at 376.

299. Under the Capital Asset Pricing Model of stock valuation, all shares are
valued by the market relative to other shares with equivalent risk, and demand for
stock is perfectly elastic. Therefore, under this theory, the sale (or purchase) of a
large block of shares should have no effect on the price. See W. KLEIN & J. COF-
FEE, BUSINESS ORGANIZATIONS AND FINANCE 323 (3d ed. 1988); Gilson & Kraakman,
The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 630 (1984). If demand is
inelastic, however, then transactions involving large blocks of stock can exert price
pressure, and institutional investors cannot conduct transactions without considering
whether they will incur additional costs outweighing the benefit of retaining their
investment. See Stout, Takeover Premiums, supra note 214, at 1247 (“Investor demand
for stocks is not perfectly elastic: incremental changes in price produce incremental
changes in quantity demanded.”).

300. See, e.g., Anand, Proxy Fight Schedule Looks Quieter Than Last Year’s,
INVESTOR’S DAILY, April 3, 1991, at 8 (corporate boards are reacting to demands
from institutional shareholders); Dickson, Shareholders Stand Up and Are Heard, FIN.
TIMES, March 4, 1991, at 17 (institutional shareholders are concentrating on proxy
of the mergers and acquisition boom coincides with the rise of institutional investor activism to influence corporate policy.

Institutions began by opposing antitakeover measures proposed by management because tender offers are usually beneficial to shareholders. However, the market for corporate control is an imperfect means of disciplining management. Accordingly, institutional investors have expanded their horizon to focus on reforming the structure of corporate governance to increase discipline over management as another method to improve the performance of their investments. The mechanism for using their growing power is the proxy process. Recently, institutions have started to use their voting power to oppose management and support director slates proposed by insurgents to force management to address institutional concerns.301

Institutional investors may be able to overcome the collective action problems that plagued shareholders of the earlier era because management no longer faces an electorate composed of small shareholders with little incentive to educate themselves and organize to support alternatives. The problem of rational apathy is not present since institutional ownership of stocks is not a transient investment. Therefore, fund managers will have an incentive to protect their sizeable investments by scrutinizing management. The increased concentration of voting power means that fund managers can more easily organize themselves to effectively influence the corporation. This control diminishes the problem of free riding because institutional holdings are usually large enough to justify bearing the cost of collective action.302

The involvement of institutional investors in proxy contests has been “uneven, episodic, and trendy.”303 The process of institutional involvement on any large scale is still in an embryonic stage as different types of institutions test the best method to exercise their voting power and influence on corporations, and determine which issues their con-

301. See, e.g., Schine & Zellner, Lockheed: Oh What a Difference a Year Makes, BUS. WEEK, Feb 25, 1991, at 37 (support for management by institutions in proxy contest after turnaround in performance one year after institutions supported outside slate of directors); Fromson, The Big Owners Roar, FORTUNE, July 30, 1990, at 66 (describing institutional investors opposing management sponsored antitakeover provisions and supporting insurgents seeking election to board).

302. Coffee points out, however, that institutional ownership brings with it new collective action and rational apathy problems limiting the effectiveness of institutions as corporate monitors. See Coffee, Liquidity Versus Control, supra note 298.

stiuencies will support. Consequently, no clear guidelines remain for institutions.

CalPERS (California Public Employee Retirement Systems), one of the largest and most active public pension funds, has changed its method over the past four years from a scattershot approach in supporting corporate governance proposals to selecting a few specific companies that will be the target of its pressure and, if necessary, opposition in the proxy vote.304 Institutional investors have begun to concentrate on increasing management's responsiveness by proposing shareholder advisory committees to enhance communication about the company from management to shareholders, and using secret balloting in proxy votes to discourage management from pressuring shareholders into supporting management's proposals. The SEC has even responded to increased political pressure on the issue of corporate governance by proposing a change to the proxy rules that will require greater disclosure of executive pay, including stock options that can dramatically increase compensation.305

The problem of collective action among shareholders has been diminished by rising institutional ownership, but it has not been eliminated. Institutional investors must still overcome coordination among large shareholders and management opposition to institutional involvement. Grouping fund managers under the heading of institutional investor implies a unity of interest that not present because the funds serve a variety of beneficiaries with differing, and sometimes conflicting interests. Institutional investors entail six different types of organizations: public pension funds, private pension funds, investment companies, insurance companies, bank trust funds, and charitable/non-profit foundations and endowments.306

Different types of institutions are subject to different pressures that affect cooperation in advancing their individual interests. Professor Rock

305. See Executive Compensation Disclosure, Rel. No. 33-6940, 57 Fed. Reg. 29582 (July 1, 1992) (proposed rules will provide clear presentation of executive compensation); Salwen, Shareholders Likely to Get Vote on Pay, Wall St. J., February 3, 1992, at A3 (SEC proposal is response to political heat on issue that "has reached searing levels").
306. See Sommer, Corporate Governance, supra note 298, at 362-63. Even listing six types of institutional investor overlooks differences within groups, such as public pension funds including states, municipalities, and teacher pensions, and investment companies, consisting of both open and closed-end funds. Rock, supra note 36, at 480.
points out that private fund managers face great costs if they oppose management, while public pension funds and mutual funds are more likely to take positions that enhance the position of shareholders.\textsuperscript{307} Within a single corporation the institutional investors may line up on opposite sides. For example, a proposal recommending that the company opt out of a state antitakeover law may be supported by public fund managers because it increases the possibility of a tender offer for the company. Yet, a corporate pension fund may oppose the proposal because it is under the direct control of management or subject to pressure to adopt a position in support of management.\textsuperscript{308} In that situation it is misleading to consider institutional investors in that instance as representing a single interest.

Corporations have stepped up their efforts to keep institutional investors from opposing the company’s proposals. One means for management to limit institutional power is to retain control of stock voting rights owned by the company’s pension funds and create support groups on behalf of management proposals at a variety of companies.\textsuperscript{309} Management can also pressure insurance companies and banks to oppose shareholder proposals with the implied threat that management will withhold future business if those companies and banks oppose management’s position.\textsuperscript{310} Public pension funds are generally considered immune from pressures exerted by management.\textsuperscript{311} Yet, even they may not be able to avoid management’s fight to retain control of the proxy process. It was rumored that California’s governor sought to rein in CalPERS’ shareholder activism by changing the fund’s board to include a majority of directors appointed by the governor, who presumably would restrict the huge pension fund’s efforts to change the corporate governance system.\textsuperscript{312} Public funds are subject to political interfer-

\textsuperscript{307.} Rock, \textit{supra} note 36, at 469.
\textsuperscript{308.} \textit{Id.} at 475 & n.99 (private fund managers are subject to the most amount of pressure to vote with management from client corporations).
\textsuperscript{309.} \textit{See} Franklin, \textit{Voting Proxies: Companies Take Pension Fund Voting In-House}, N.Y.L.J., Nov. 30, 1989, at 5 (Business Roundtable urges members to retain voting rights in corporate pension funds); Sommer, \textit{Corporate Governance, supra} note 297, at 372 (corporate response to increasing success of shareholder proposals includes taking back voting rights of pension fund stocks).
\textsuperscript{310.} Rock, \textit{supra} note 36, at 469-71 (describing various means to pressure money managers to support management).
\textsuperscript{311.} \textit{See}, Sommer, \textit{Corporate Governance, supra} note 298, at 373; Rock, \textit{supra} note 36, at 471.
ence, and there is no reason to believe that state legislatures willing to pass stringent antitakeover statutes may not also try to constrain the independence of pension funds threatening management’s prerogatives by active involvement in the proxy process. 313 Management’s opposition to the involvement of institutional investors is not surprising because it threatens management’s control over proxy voting and may portend greater shareholder involvement in reviewing corporate performance. 314

The important point about shareholder activism, however, is that it need not be limited to the paradigm of shareholders battling management to maintain a thriving market for corporate control. Institutional investors represent the collective interests of the beneficiaries of the funds: the stakeholders of the corporation. Corporate pension funds hold the assets of a company’s employees, and therefore must work to protect the interests of those employees, while public pension funds contain the assets of millions of individuals. Investment companies have accounts of both individuals and businesses (including retirement accounts), while mutual life insurance companies invest premiums on behalf of policyholders. These beneficiaries are the employees, suppliers, customers, and charitable organizations who have invested firm-specific capital in the corporation along with the pool of investments managed by institutions. In most instances, the institutional investor is both a shareholder and a fiduciary of stakeholders in corporations.

Much of the commentary on institutional investors ignores beneficiaries of the assets and the crucial role the fund manager can play as an intermediary. Institutional investors can use the proxy process to oppose management’s efforts to stop hostile offers, a position consonant with their interests as shareholders. They can also use this power to improve corporate governance so that management goes beyond giving lip service to the interests of nonshareholder constituencies. Decisions affecting employees and local communities, such as restructurings and plant closings designed to cut costs, should be subject to close review by the board of directors and, where applicable, by shareholders. Greater institutional involvement in electing directors and increased disclosure of

313. See Black, Shareholder Passivity Reexamined, supra note 25, at 599 (public fund managers need to be good politicians because of potential political involvement in decisions).

314. The Business Roundtable warns that “governance by referendum in the proxy statement can also chill innovation and risk-taking.” Business Roundtable, supra note 4, at 252. Never stepping out of character, the Business Roundtable opposes changes in the proxy rules allowing institutional investors to coordinate their actions without to complying with proxy filing and disclosure requirements. See infra, notes 318-26 and accompanying text (discussing proposed changes to proxy rules).
management’s plans to the public will allow decisions affecting non-shareholders to be based on a consensus, rather than the power of management to control a company’s operations with minimal board oversight. 315

The weakness of the constituency statutes can be overcome by recognizing the obligation of institutional investors to represent their beneficiaries as both shareholders and stakeholders. Legislative and judicial pronouncements permitting consideration of the interests of non-shareholders grants a board almost unlimited discretion in making decisions, without meaningful review. Institutional investors can begin to provide the oversight necessary to police management’s decisions since those institutional shareholders incorporate the interests of stakeholders in try to achieve a stable healthy enterprise over the long-term. However, institutional ownership of stock is not a panacea. The tension between shareholders and stakeholders will not magically disappear. Nor will management suddenly become accommodating to institutional shareholders. It is important to recognize, however, that institutional ownership holds the promise of decreased tension between shareholders and stakeholders since those interests must coexist in the funds managed by institutions. Institutional investors are in the equity market for the long-term, and will be a presence in corporate board rooms and proxy contests for the foreseeable future. 316 These investors have every interest in protecting the rights of shareholders to choose to accept or reject a tender offer while also ensuring that corporations are managed to protect the interests of those who invest in the fund. Institutional investors can bring a greater measure of societal orientation to corporations.

The mere fact of large-scale institutional holdings will not, of its own accord, overcome management’s opposition and the legal obstacles to collective action. Among the most frequently cited barriers to institutional cooperation are the proxy rules promulgated under the federal securities laws. 317 The SEC responded to requests by institutional in-

315. This understanding of the dual role of institutional investors as shareholders and fiduciaries for the owners of the assets does not overlook the problem that fund managers are generally not directly accountable to contributors. While federal and state law imposes certain duties on the managers, there is no direct accountability similar to a shareholder derivative suit. See Coffee, Liquidity Versus Control, supra note 298, at 1335 (public pension funds have been most active in corporate governance movement, but are the least accountable to their beneficiaries).

316. See Fromson, supra note 301, at 67 (quoting public pension fund manager that fund will not sell its stake if it disapproves of the company’s performance but will “stay and work with management”); Coffee, Liquidity Versus Control, supra note 298, at 1339 (indexed investors tend to hold stocks for the long-term).

317. See, e.g., Black, Shareholder Passivity Reexamined, supra note 25, at 536
vestors to reform the proxy system. In 1992, the SEC proposed amendments to its proxy rules that would facilitate communications between shareholders without requiring compliance with the rules’ filing and disclosure requirements. The Commission’s efforts are an important first step in swinging the pendulum of corporate law away from management and in favor of institutional shareholders who also represent stakeholders’ interests in an enterprise.

The proposed rules contain a crucial change in the proxy rules that would significantly lower the barriers to cooperation by institutional investors. “Disinterested” shareholders who have no economic interest in the subject matter of the proxy, other than their ownership of securities, would be exempt from the proxy rules so long as the shareholders do not solicit a proxy, consent, or authorization. This rule allows any person or group, including institutional investors, whether or not they are shareholders, to communicate with other shareholders about a proposal in a proxy statement, including how to vote the proxy. The

(proxy rules impose costs, delays, and legal risks on shareholder communication); Rock, supra note 36, at 478 (substantial legal impediments to collective action include proxy rules); Sommer, Corporate Governance, supra note 298, at 368 (SEC rules are obstacles to concerted action); Johnson, An Insider’s Call for Outside Direction, HARV. BUS. REV., March 1990, at 52 (proxy and disclosure requirements restrict shareholder communications); but see Gilson & Kraakman, Reinventing the Outside Director, supra note 44, at 895 (compliance with proxy rules not a significant burden to electing a minority of professional directors).


319. Two other changes proposed by the SEC would eliminate staff review of certain types of material related to a proxy solicitation and make public the initial proxy filings. Proxy Proposal, supra note 319, at 29568.

320. Id. at 29,577 (to be codified at 17 C.F.R. § 240.14a-2(b)(1)). There is no filing requirement if the exempt solicitation is oral or by means of publication in the media Id. at 29,578 (to be codified at 17 C.F.R. § 14a-6(g)).

321. Those who would not be “disinterested” are defined in the proposed rules
SEC stated that the broad interpretation of "solicitation" under the federal securities laws may deter some communication, with the proposed rules permitting shareholders to communicate without abandoning the flexible meaning of solicitation.\(^{322}\)

The SEC's proposed rules would eliminate a significant constraint on institutional cooperation by lowering the costs of communicating, encouraging shareholders to undertake the costs of opposing management and proposing alternatives.\(^{323}\) The potential for greater involvement in corporate governance increases if some form of the proposed rules are eventually adopted because the changes will permit institutional investors to assert their roles as both shareholders and representatives of stakeholders.

The prospect of institutional involvement in corporate governance through the proxy process presents a substantial challenge to management, and an opportunity to foster closer cooperation between the corporation and its shareholders. Two recent articles discuss the possibility of greater institutional involvement in overseeing the corporation and working with management to enhance the value of investments in equities. One proposal, put forth by Lipton and Rosenblum, recommends a five year term for directors with no non-consensual changes in the company or its board.\(^{324}\) After the five year term, the company would provide a detailed report describing its performance over the past five years and forecasting operations for the next five years, including the expected return on investment in the company.\(^{325}\)

to include the company, affiliates of the corporation, officers and directors of the company or its affiliates, any person soliciting proxies in opposition to an extraordinary corporate transaction, and anyone receiving compensation from the company or its affiliate. Id. Employees of the company would be "disinterested" and could communicate with shareholders about a proxy. Id.

\(^{322}\) Id. at 29,566.


\(^{324}\) Lipton & Rosenblum, Quinquennial Election, supra note 2, at 225-26. Shareholders could only remove directors before the expiration of their term for personal illegal conduct or willful malfeasance. Id. Extraordinary transactions before the quinquennial meeting could only occur with the approval of the board. Id. at 226-27.

\(^{325}\) Id. at 226. An independent advisor, such as an investment bank or accountant, would provide a detailed evaluation of the corporation's report. Id. Any shareholder owning 5% of the company's shares, or shares valued at $5 million, which usually encompasses institutional ownership, would have access to the proxy machinery, at the corporation's expense, to support an opposing slate of directors. Id. at 236.
Gilson and Kraakman approach the corporate governance issue in a different way, accepting the problem of managerial accountability, rejected by Lipton and Rosenblum as "unfounded." Gilson and Kraakman emphasize the role institutional shareholders can play in electing truly independent directors who will be accountable to shareholders in overseeing management. They propose that institutional shareholders band together to elect professional directors, each of whom would be a director for up to six companies and whose position would require the support of institutions for election and continuation in office.

The threshold ownership requirement is designed to exclude "gadfly" shareholders from the process. Id. at 231. Lipton and Rosenblum argue that their proposal will permit management to focus on the long-term health of the corporation by insulating them from the debilitating effects of hostile takeovers, which force corporations to operate for the short-term and ignore the ultimate health of the corporation as a continuous enterprise. Id. at 224-25. The argument that the threat of takeovers causes management to focus on short-term gains detrimental to the long-term health of the corporation has been criticized as operating on a flawed understanding of how a firm's shares are valued. See Macey, *State Anti-Takeover Legislation*, supra note 19, at 481 ("[T]he distinction between maximizing firm value for the present versus maximizing firm value for the future is wholly false. What matters in determining the value of a firm's shares is the present value of all flows—present and future.").

The weakness of the quinquennial proposal is that everything hinges on creating a system for a meaningful quinquennial election when the pressures of economic change cannot be forced into a five-year time span. The incentive created by such a system is that management will structure corporate performance and earnings to show a slow but steady growth, reaching a crescendo during the fifth year. Then dividends can be arranged to provide their greatest return near election time. Much like voters in the political arena, management can count on shareholders, even institutional owners, to vote their pocketbooks, even if managing earnings and dividends ultimately harms the corporation. The independent evaluation of the corporate report provides only a minimal check on management in much the same way that the valuation of assets during hostile offers can be manipulated to reflect management's wishes. The independence of an investment bank or accountant may be open to question because that firm may seek future employment with the corporation, assuming it does not have such a relationship at the time of the election.


327. Id. at 885-86. The position is full-time only to the extent that a director serves on enough boards to equate a professional position. The director's salary and benefits will be the aggregate payments from the companies on whose boards the director serves. Id. The directors would be directly responsive to the institutional shareholders, and could work with management and other independent directors elected with management support to monitor corporate performance and discipline management. Coordination of institutional investors and monitoring professional directors can be achieved by creating a permanent, institutionalized operation devoted to the task. Id. at 886-87.
Although neither proposal is likely to be fully adopted any time soon, each proposal reflects the radical change in the relationship between the corporation and its shareholders caused by the rise of institutional investors.\textsuperscript{328} The key issue is how great an effect institutional investors will have on the system of corporate governance.\textsuperscript{329}

B. Will Management Try to Curtail The Right to Vote?

Management will oppose attempts by shareholders to control company operations, and corporate law is designed to protect the provinces of each side. Not surprisingly, the law is constantly attempting to balance the interests of each side as they struggle to assert their positions. This process is complicated by the presence of third-party stakeholders seeking recognition of their interests. Management’s opposition to institutional shareholder activism is nothing more than the traditional assertion of power constrained by the requirements of corporate law that shareholders control certain corporate decisions and may suggest policy to the board. The SEC’s proposed amendments to the proxy rules may help balance the competing interests by curtailing management’s traditional dominance of the shareholder voting process. If management can win control of the proxy process by diminishing the voting power of institutional shareholders, however, the balance of power will have

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\textsuperscript{328} The proposal for creating a class of directors controlled by institutional investors has at least two questionable aspects. First, the task of monitoring the directors is delegated to a new bureaucratic organization because the institutional investors do not have the time or expertise to conduct that function. But how is the accountability of that organization policed: who will monitor the monitor monitoring the monitors? Second, Gilson and Kraakman argue that it would be difficult for management to justify opposing the professional directors. \textit{Id.} at 893. That assumption may be naive. Proxy battles between management and dissidents should make even politicians wince. One can almost hear management’s arguments to shareholders that these outsiders are trying to disrupt your company by bringing in hired guns that will only serve the interests of short-term investors seeking to liquidate the corporation for immediate gains. Management is unlikely to welcome truly independent directors to the board and may try to actively obstruct any oversight by professional directors.

\textsuperscript{329} The quinquennial election program requires legislation at the federal and state levels, a laborious process. Also, the professional director proposal entails a substantial commitment of time and resources to coordinate support among institutional investors and create a structure to actually select and supervise the directors. Gilson and Kraakman acknowledge that their proposal is not a “panglossian cure,” and the structure may fail to improve corporate performance in every company. \textit{Id.} at 892.

\textsuperscript{328} See Coffee, \textit{Liquidity Versus Control}, supra note 298 (arguing that institutional investors may become effective monitors of corporations if legal rules are changed and if sufficient incentives are created to overcome collective action and agency cost problems).
swung completely away from shareholders. In much the same way corporations adopted antitakeover measures to prevent transactions threatening to usurp management's power, so too can management undermine the power of institutional shareholders by diluting or restricting their voting power.

Some targets employ an antitakeover device creating an ESOP into which the company transfers a sufficient number of shares to preclude majority approval of the merger. Likewise, some targets will simply refuse to tender these ESOP shares precluding the target from gaining a controlling block. In Shamrock Holdings, Inc. v. Polaroid Corp., the Delaware Chancery Court upheld the creation of an ESOP, which received 14% of the target's stock, effectively blocking a tender offer. Corporations adopted ESOPs as a defensive measure in light of Polaroid because the plans are perceived to put shares in friendly hands, i.e. employees, who tend to support management.

ESOPs can also be an effective tool to dilute the voting power of institutional investors. When a plan is created, shares of the corporation are transferred to the ESOP and then allocated to the individual participants according to the provisions of the plan for acquiring shares. The company appoints a trustee for the plan, with the ESOP holding the unallocated shares on behalf of the present and future participants. The participants control the voting rights of the allocated stock. A proportional voting provision incorporated in most ESOPs requires the trustee to vote the unallocated shares in the same proportion as the allocated shares. The effect of this proportional voting rule provides a substantial aid to management in a proxy contest. Employees tend to

330. ESOPs are benefit plans in which employees may invest in shares of their employer. Congress encourages the creation of the plans through favorable tax treatment. 26 U.S.C. § 4975(e)(7) (1986); 29 U.S.C. § 1107(d)(6) (1988). In addition to ESOPs, employees can invest in their company's stock through profit sharing plans, stock option plans, and 401(k) contribution plans. Most public companies have some form of stock investment plan for their employees.

331. 559 A.2d 257 (Del. Ch. 1989).

332. Id. at 273-4. The Chancery Court applied the entire fairness analysis, not the business judgment rule, to the decision to create the ESOP. The court concluded that even under the highest standard, the plan was entirely fair to the company's shareholders. Id. at 276.


335. See id. at 838 n.81 (as an anti-takeover device, "proportional voting could
vote in management's favor, and will be subject to great pressure to support the company in light of the "threat" that management will describe if an opposing proposal or slate of directors wins the election. Proportional voting magnifies the effect of the ESOP because shares that are not owned by management nor directly controlled by employees can be effectively controlled through a provision of the ESOP.\footnote{\textsuperscript{336}} An ESOP with a substantial block of stock is a competing institution that management can rely on to counterbalance some of the voting power of activist institutional investors. Although the ESOP will not block all proposals opposed by management, it adds to the pro-management bias built into the proxy process that institutional ownership is only beginning to overcome.

A greater threat to the voting power of institutional shareholders is dual class voting stock. Through this stock management controls a majority of the votes without owning an equivalent amount of the corporation's stock. A corporation can issue different classes of stock with different voting rights, such as class A shares with multiple votes and class B shares with one vote. Management will usually control the shares with greater voting rights giving it effective control over the company.\footnote{\textsuperscript{337}} Similar to ESOPs, dual class common stock can be an antitakeover device and remains one of the most powerful weapons against an unfriendly offer because management controls the voting power necessary to approve any transaction. A hostile bidder cannot circumvent management's control of the voting power.\footnote{\textsuperscript{338}}

\footnote{\textsuperscript{336}} The Comment argues that proportional voting violates the exclusive benefit rule under ERISA because the plan trustee does not act for the benefit of the participants and beneficiaries. Instead, the Comment argues, the trustee should disregard proportional voting provisions and vote the un-allocated shares in the best interests of the participants and beneficiaries. \textit{id.} at 864-65.

\footnote{\textsuperscript{337}} For a description of the variety of dual class voting structures adopted by corporations, see Fischel, \textit{Organized Exchanges and the Regulation of Dual Class Common Stock}, 54 U. Chi. L. Rev. 119, 134-45 (1987) [hereinafter \textit{Dual Class Common Stock}].

\footnote{\textsuperscript{338}} See Gordon, \textit{Shareholder Choice}, supra note 38, at 4 (no secret that popularity of dual class stock is a response to hostile takeovers); Seligman, \textit{Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy}, 54 Geo. Wash. L. Rev. 687 (1986) ("Few takeover defenses are more likely to be successful than dual class capitalization."); but see Fischel, \textit{Dual Class Common Stock}, supra note 339, at 149 (equating dual class stock with other defensive tactics is misleading). Professor Seligman notes that Fischel's arguments that dual class common stock is not predominantly an antitakeover device represents "the triumph of hope
The NYSE, the nation’s primary stock market, has long banned listing more than one class of common stock with different voting rights to avoid the wrath of Congress or the SEC, both of which opposed listings violating the principle of one-share, one-vote.339 In the 1980s, however, the NYSE proposed a change to its rules eliminating the dual class voting stock ban because of increased competition from the American Stock Exchange (AMEX) and NASDAQ, an automated quotation system for over-the-counter stocks. Both of these institutions permitted trading of dual class voting stocks.340 The SEC responded to the NYSE’s proposed abandonment of the one-share, one-vote requirement in 1988 by adopting Rule 19c-4. This rule prohibits all exchanges and self-regulatory organizations from listing the stock of a corporation that adopts a provision “with the effect of nullifying, restricting or disparately reducing the per share voting rights” of outstanding stock.341

over experience.” Seligman, supra, at 703 n.80. Professor Bainbridge argues that the fundamental problem with creating a dual class stock structure is management’s conflict of interest in pursuing a transaction to protect management’s position when it is not paying for the voting control through acquisition of a majority. Also, management’s decision is not subject to judicial review. Bainbridge, The Short Life and Resurrection of SEC Rule 19c-4, 69 WASH. U.L.Q. 565, 583 (1991) [hereinafter Rule 19c-4].

339. Seligman, supra note 341, at 689 (citing NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 301 (1983)). Seligman provides a detailed history of the NYSE’s rule against listing different voting classes of stock that shows the rule’s roots in the 1920s from federal opposition to allowing management to control large corporations by shutting out small shareholders from any oversight of the company. Id. at 690.

340. See Gordon, Shareholder Choice, supra note 38, at 5-8 (reviewing NYSE decision to change rule in response to competition from AMEX and NASDAQ).


No rule, stated policy, practice, or interpretation of this exchange [or this association] shall permit the listing, or the continuance of the listing, of any common stock or other equity security of a domestic issuer, if the issuer of such security issues any class of security, or takes other corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered pursuant to Section 12 of the Act.

* * * * *

[T]he following shall be presumed to have the effect of nullifying, restricting, or disparately reducing the per share voting rights of an outstanding class or classes of common stock:

* * *

(3) Any issuance of securities through an exchange offer by the issuer for shares of an outstanding class of the common stock of the issuer, in which the securities issued have voting rights greater than or less than
In *The Business Roundtable v. SEC*, the United States Court of Appeals for the District of Columbia invalidated Rule 19c-4 as beyond the scope of the SEC's power to regulate the securities markets under the Commission's authorizing statutes. The SEC adopted Rule 19c-4 to "ensure fair shareholder suffrage," and argued that Section 14 of the Securities Exchange Act of 1934, granting the Commission power over proxy solicitation, authorized the issuance of a rule which advances the purposes of regulating the proxy process. The SEC also relied on its rulemaking power under Section 19, permitting the Commission to review and approve regulations of securities exchanges and self-regulatory organizations. The circuit court rejected the SEC's "immensely broad" perception of its rulemaking power under Section 19, holding that if Rule 19c-4 were validated, then the SEC "would be able to establish a federal corporate law by using access to national capital markets as its enforcement mechanism." The court criticized the SEC for making arguments that took statements out of context. Moreover, the hostile tone of the opinion makes it clear that the SEC's power to regulate voting power apportioned among shareholders is minimal.

The per share voting rights of any outstanding class of the common stock of the issuer.

(4) Any issuance of securities pursuant to a stock dividend, or any other type of distribution of stock, in which the securities issued have voting rights greater than the per share voting rights of any outstanding class of the common stock of the issuer.

The SEC also sought to preempt state antitakeover statutes that conditioned the exercise of voting rights on the approval of disinterested shareholders. Rule 19c-4(d)(4) defined corporate acts in compliance with state law that condition voting rights on approval by independent shareholders as having the effect of "nullifying, restricting or disparately reducing the per share voting rights of listed securities." Id. at § 240.19c-4(d)(4).


344. Id. at 408.

345. Id. at 412. The circuit court noted that "Rule 19c-4 presents the worst of all possible worlds . . . turning regulation of securities markets into the vehicle for federalizing corporate law." Id. at 412 n.7.

346. The circuit court stated that one SEC argument was based on a gamble that the court would accept a position based "on a statutory fragment without even a glance at its context. Wrong court, bad gamble." Id. at 416. The NYSE and NASDAQ enacted rules virtually identical to Rule 19c-4 prohibiting listing shares of with disproportionate voting rights. Exchange Act Release No. 28277 (July 27, 1990), 55 Fed. Reg. 31,465 (1990). The NASDAQ rule received temporary approval from the SEC, while the NYSE rule had been adopted in 1989, before the decision challenging
Changing a corporation’s voting system from one-share, one-vote to a dual class system with management controlling a majority or significant voting block of the votes, requires the shareholders to amend the corporate charter to approve the creation of a class of shares with enhanced voting rights. If the shareholders approve the change in the corporate charter, the new class of shares can be distributed through an exchange offer or a special dividend to shareholders. The possibility of a corporation adopting dual class common stock to limit the voting power of institutional shareholders would seem remote because the institutions will automatically reject any proposal that allows management to entrench itself. The size of institutional ownership does not, however, mean that institutions control the corporate voting process. Management retains significant structural advantages in voting proxies that would likely allow it to convince enough shareholders to approve dual class voting stock. Moreover, the proposal to create a new class of stock need not, and likely would not, be presented as a naked grab for power by management. The proposal can be coupled with “sweeteners,” such as increased dividends or a special shareholder payment requiring approval of the dual class stock as a prerequisite to receiving the benefit. Institutional and individual shareholders can be swayed by the benefits of a short-term gain to vote in management’s favor, even if the long-term effect is to diminish their voting power.

the Rule 19c-4. The AMEX is considering a rule that does not prohibit listing dual class stock, but allows it if the stock is part of an initial public offering or if the shareholders vote to approve the creation of shares with disproportionate voting rights. Special Committee on Shareholder Voting Rights, Report to the Board of Governors of the American Stock Exchange (Feb. 14, 1991).

347. See H. Henn & J. Alexander, Law of Corporations § 345 (3d ed. 1983). The corporate charter may already provide for dual class voting stock. Currently, a number of companies issue stock with limited voting rights in initial public offerings in which the original owners of the company retain the voting power.

348. See Gordon, Shareholder Choice, supra note 38, at 40-42 (describing mechanism for distributing dual class stock); Dent, Dual Class Recapitalization: A Reply to Professor Seligman, 54 Geo. Wash. L. Rev. 725, 740-41 (1986) (same).

349. See Black, Shareholder Passivity Reexamined, supra note 25, at 571 (dual class stock is a “non-issue” because institutional shareholders will not approve unless insiders already control the voting process). Even if insiders currently control the company, they may anticipate a time when public shareholders will own a majority of the stock, either through future offerings or potential sales by insiders. The insiders can insert dual class voting stock into the corporate charter and issue themselves the new stock in order to maintain control of the voting process once they lose actual majority ownership of the corporation.

350. See Gordon, Shareholder Choice, supra note 38, at 47-49 (describing effect of management providing sweeteners on shareholder voting). Gordon also argues that
The contest between management and shareholders has shifted away from tender offers. Defensive measures will now entail restricting the voting rights of shareholders and providing management with greater control of the proxy process without requiring greater ownership of the corporation’s equity. Although the SEC failed to outlaw dual class common stock, the proposed proxy amendments can provide institutional shareholders with a better means to police management proposals that might diminish the voting power of independent shareholders. Dual class common stock and the creation of ESOPs to create a block of friendly shareholders are only two ways to alter the system of shareholder voting. They certainly do not exhaust the methods by which management will protect itself from the activism of institutional investors. The history of takeover defenses shows that management will create new devices to limit the power of shareholders in voting their proxies, exacerbating the tension between management and shareholders.

C. Will the Delaware Supreme Court Try to Retake Its Seat at the Table?

Increasing institutional investment in equities will change the relationship between shareholders and management. The courts, primarily the Delaware courts, will play a crucial role in adjudicating disputes and determining the relationship between the corporation and its shareholders. The current lull in takeovers does not mean that tender offers will never reappear. Challenges to defensive measures will arise in future contests for corporate control. Courts will also be called on to determine whether management’s attempts to block institutional investors from a greater role in the boardroom are permissible. The courts must also decide the extent to which shareholders may be excluded from interfering in areas of corporate operations traditionally reserved to the board. The ultimate issues are not different since corporate law must still determine the contours of the relationship between management and shareholders. However, there will be more cases concerning the use of voting power to require management to pursue a particular course of action and the propriety of defensive measures to limit voting rights. An important issue remaining after the mergers and acquisitions boom is whether the Delaware Supreme Court will extend the rationale of *Time* to give management broad discretion in pursuing corporate interests without requir-

management can play a game of “chicken” with shareholders to gain approval of dual class common stock by describing the negative effect on the value of the company if management’s proposal is not accepted. *Id.* at 49-50.
ing it to accede to the desires of the corporation's shareholders.

The Unocal enhanced scrutiny standard applies to a board's decisions in the context of takeovers because transactions for corporate control implicate inherent conflict of interest in the board's decisions affecting their positions within the corporation. Outside of takeovers, Unocal may not be implicated. The business judgment rule then applies to corporate decisions, such as creation of an ESOP, that affect the voting rights of institutional shareholders. If the Delaware Supreme Court limits enhanced scrutiny solely to cases involving takeovers, institutional investors will receive little assistance from the courts because of the broad protection afforded to management and the board under the business judgment rule. On the other hand, the court could approach decisions that affect voting rights of shareholders under the same reasoning adopted in Unocal since a decision affecting voting rights may have been intended to protect management and the board from shareholder oversight. The potential for management entrenchment pervades any decision giving management greater control over the process of voting shares. Therefore, that decision should be subjected to a higher degree of scrutiny.

Whether or not the Delaware Supreme Court expands the Unocal analysis beyond the takeover context, Time permits a board to both pursue a strategic plan without regard for the short-term wishes of its shareholders and reject an offer without permitting shareholders any input in the decision. The implicit rationale of Time is that management and the board should protect shareholders from their own ignorance or mistaken beliefs concerning the value of the company and preserve benefits accruing from adherence to a strategic plan. That rationale should not apply, however, where shareholders are not individuals with little information concerning the company and no incentive to educate themselves about the value of their investment in comparison to an outstanding offer. While it is questionable whether any significant percentage of shareholders can be described as ignorant or susceptible to coercion, institutional investors are radically different from those con-


352. 571 A.2d at 1153-54.

353. "One concern was that Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce." Id. at 1153.
ceived by the Delaware Supreme Court in *Time*. Institutions are highly sophisticated investors with the ability to judge how a course of action will affect the value of an investment, and perhaps more importantly, how the time frame for one investment relates to the fund manager's overall objectives. Institutional investors are not merely short-term owners, who only want an immediate return on their investment. Institutional investors cannot simply leave the equity market or abandon a company which they believe will be successful in the long-term.354

If the Delaware Supreme Court acknowledges that a significant number of shareholders are institutions, with the expertise to protect their interests, then courts can abandon the highly paternalistic nature of the *Time* opinion. Instead, the focus can shift to the issue avoided in the *Time* decision: whether the strategic plan adopted by the board had a reasonable chance of increasing the value of a shareholder's investment compared to the value of the outstanding offer. The Delaware Supreme Court accepted the Time board's argument that the merger with Warner would create even greater value without requiring management to spell out how the plan would work, what its assumptions were, and when the benefits would be reflected in the stock price, the principle measure of the shareholders' investment.

The key for institutional investors is accurate information from management from which a rational judgment can be made about the value of an investment as well as the probability that the stock will provide a reasonable return. However, *Time* deprives institutions of the very information needed most by accepting management’s arguments without requiring the company to put its information on the record. The Delaware Supreme Court can reclaim its seat at the table without rejecting its decision in *Time* or even limiting that opinion to the unique facts present in the case. The court can require a company opposing an offer under the guise of protecting the interests of the corporation, or attempting to limit shareholder voting rights if the *Unocal* standard applies outside the takeover context, to put forth all the information supporting its argument that its plan will enhance the corporation’s value beyond that offered by the competing party. This disclosure may include the board’s consideration of the corporation’s nonshareholder constituencies’ interests and how the challenged decision will protect those interests.355

354. *But see* Lipton & Rosenblum, *Quinquennial Election, supra* note 2, at 205-06 (institutional investors have little inclination to behave like traditional owners of enterprise, and most will support a hostile takeover or other restructuring that boosts immediate price of stock).

355. The position advocated here is similar to the analysis proposed by Gilson
No manager or board member would dare argue that a long-term plan will harm shareholders or the value of the company. Yet, conclusory statements such as those advanced in Time do not provide any basis for institutional shareholders to judge the adequacy of management’s plan. Institutional shareholders can analyze the benefits of the plan and make their decision to support or oppose management if they know the basis for management’s projections of the corporation’s future value. If the information disclosed by management convinces an institution that continuing its investment is no longer prudent, the institution could risk selling its investment at a loss. Investors owning shares of a company solely because of its inclusion in an index will lose some value. However, they can continue to pressure management to increase the stock price and will stand ready to support a future tender offer.

By requiring management to disclose the basis for its decisions, the Delaware Supreme Court can protect the long-term plans of a corporation while serving the interests of shareholders, rather than simply denigrating the position of equity investors as it did in Time. This approach avoids the problem of requiring a judgment of the value of competing plans since the court’s role is to compel disclosure of the plan’s underlying rationale and to make a preliminary determination that the plan meets the requirements of Unocal, that it is a reasonable response to the threat posed to the corporation. The court polices management only to the extent of requiring the company to make its position explicit, allowing the market to value the plan.

V. CONCLUSION

Corporate law underwent rapid change during the 1980s, and only now is slowing to allow an assessment of the effects of the mergers and acquisition boom. In some ways, the emphasis on defensive measures and enhanced scrutiny only obscured the basic tenet of corporate law: that managers must be free to conduct the affairs of the corporation yet are accountable to shareholders. The tension inherent in the separation of ownership and control has not been dissipated. Much of corporate law still revolves around balancing the needs of management and shareholders. The form of accountability has changed, however, because the corporate law equation is no longer limited to shareholders and managers. It includes nonshareholder constituencies whose claims for attention in the corporate decision-making process have been recognized by courts and state legislatures. For better or worse, the interests of non-sharehold-

and Kraakman concerning how the courts should apply the Unocal test. See Gilson & Kraakman, Delaware’s Intermediate Standard, supra note 86, at 272.
ers are a legitimate concern for the board on a footing that may be equal to those of shareholders. Whether stakeholders are better protected by pursuing contract claims does not change the reality that a majority of the states permit directors to consider their interests. Moreover, the board must consider the investment of employees, suppliers, and communities in making basic corporate decisions. Nonshareholder constituency statutes may have their genesis in the drive by management for greater protection from takeovers. Yet, the statutes present an opportunity to shift corporate decision-making to a broader perspective. Further, states are not likely to reverse their course, thereby requiring corporate law to adjust to a new environment.

The more subtle change that will ultimately occur is not directly attributable to the corporate restructuring of the 1980s, but to a new pattern of equity ownership. Institutional investors present a new model of the shareholder. Corporate law must adjust its focus away from viewing shareholders as individual owners of small stakes in a corporation who devote little attention to their investment beyond watching the stock price and dividend yield. Institutional investors invest their assets into virtually all parts of the securities markets. Accordingly, institutional investors must develop expertise to evaluate corporate profitability and management. These investors represent the concerns of all the beneficiaries of the institution's assets as well as the interests of its shareholders. Thus, institutional investors are uniquely qualified as the best representative to ensure management's accountability. Managers and boards will resist institutional involvement in governing the corporation. However, the new structure of corporate law will not allow them to insulate themselves from outside influences. State constituency statutes and institutional ownership require management to respond to the interests of both shareholders and non-shareholders. If the courts require companies to reveal their strategic plans, the market for corporate control will remain as a final check on management.