PARAMOUNT: THE MIXED MERITS OF MUSH

By Alan E. Garfield*

"Which way did they go?"
—Willoughby, the Saint Bernard**

I. Introduction

In February 1990, the Delaware Supreme Court issued its much anticipated written opinion in *Paramount Communications, Inc. v. Time Inc.*[1] *Paramount* was the most significant takeover case to reach the supreme court in a number of years. Merger and acquisition specialists expected the court's decision to be the new touchstone by which management conduct in the takeover context would be evaluated.

When the supreme court's decision finally issued, it lived up to much of the expectation. It was bold. In one fell swoop, the supreme court rejected much of the precedent that had been methodically developing in the lower court of chancery.[2] It was significant. In rejecting this precedent, the court took a decisive turn in takeover jurisprudence in favor of management.[3]

All that the *Paramount* opinion lacked, unfortunately, was clarity. Unlike the lower court precedents rejected by the decision, which had developed relatively straightforward rules as to what target managers could do in the takeover context, *Paramount* left no clear standards in its wake. While the decision seemed to lean in favor of more managerial discretion in the takeover context, it is not clear

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* Associate Professor of Law, Widener University School of Law. B.A. 1979, Brandeis University; J.D. 1983, University of California at Los Angeles. The author wishes to thank Justice William Duffy, R. Franklin Balotti, John G. Culhane, William A. Klein, Donald E. Pease, Laura K. Ray, Andrew J. Turezyn, and John D. Wladis for their thoughtful comments on earlier drafts of this article. Deborah S. Masinos, Class of 1993, provided helpful research assistance. The author bears sole responsibility for the thoughts (and any errors) expressed herein.

** J. Becker & W. Friedwald, Looney Tunes and Merry Melodies 110 (1989) (quoting Warner Brothers cartoon "Of Foxes and Hounds"). Willoughby, the Saint Bernard, is on a fox hunt. When he finds the fox, named George, he asked him: "Which way did they go? Do you know where the fox is?" *Id. Compare id. with* Steinbeck, *Of Mice and Men*, *in* The Short Stores of John Steinbeck 226 (1981) (Curly asking George: "Well, which way'd she go?").

1. 571 A.2d 1140 (Del. 1990). The supreme court had previously issued a bench ruling affirming the chancery court decision. *Id.* at 1142.

2. *See infra* notes 6-63 and accompanying text.

3. *See infra* notes 57-63 and accompanying text.

how far it leaned, or how closely tied the court's reasoning was to the peculiar facts of the case. Commentators and practitioners who read the decision were left with little more than mush.

That "mush" is the subject of this commentary. Other commentators have already praised or condemned the *Paramount* decision because of its bias towards more management discretion in the takeover context.[4] This commentary instead focuses on the decision's murkiness. It stops to consider the merits of moving takeover jurisprudence away from the clearer standards that had been evolving in the lower courts. It considers whether an undefined standard that leaves courts with broad discretion to evaluate management defensive actions is appropriate in light of the complexity of the takeover phenomenon.

II. THE RISE AND FALL OF CLEAR STANDARDS: DELAWARE TAKEOVER JURISPRUDENCE FROM *UNOCAL* TO *PARAMOUNT*

The primary function of courts in the takeover context is to determine when a target's defensive actions should be permitted. Defensive actions are virtually inevitable when a hostile bid is made for a company. The problem is determining whether an action is legitimate.

Logic would suggest that the legitimacy of a defensive action should depend on whether there is a valid reason for a target to oppose an acquisition. If there is no reason to block an acquirer's tender offer, and no reason why a target's shareholders should not be allowed to accept it, then a defensive action would seem to be improper. This is at least true if the effect of the defensive action is to permanently preclude the shareholders from receiving the offer.

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4. *Compare* Prentice & Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377, 480 (1990) ("applaud[ing]" *Paramount*) *with* Steinberg, *Nightmare on Main Street: The Paramount Picture Horror Show*, 16 DEL. J. CORP. L. 1, 31-32 (1991) (suggesting that *Paramount* "neglects legitimate shareholder interests" and "can be perceived as a continuation of Delaware's quest to placate a vital component of its clientele, namely, incumbent management"); Cohen, *Opinion*, 4 M&A & CORP. GOV. L. REP. 281, 284 (1990) (suggesting that *Paramount* diminishes the "legitimacy and authority" of Delaware corporate law); *and* Ribstein, Paramount: *The Twilight of Delaware Law?*, 4 M&A & CORP. GOV. L. REP. 297, 297 (1990) (suggesting that *Paramount* "could mark the beginning of the end of Delaware's prominence in corporate law").

There would simply be no reason, as the trade parlance would put it, for the target's managers to "just say no" to the offer.[5]

When this commentary suggests that *Paramount* "mushed-up" Delaware takeover jurisprudence, it means that *Paramount* replaced clearer rules for determining when a target management could take preclusive action—or "just say no" to an offer—with vaguer, fact-based rules.[6] To understand what *Paramount* did, it is first necessary to consider what came before it.

A. The Unocal *Two-Prong Test*

The modern age of Delaware takeover jurisprudence dawned in 1985 with the Delaware Supreme Court's decision in *Unocal Corp.*

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5. *See* Prentice & Langmore, *supra* note 4, at 391-92 (discussing the etymology of the "just say no" defense).

6. While this commentary does not focus on *Paramount*'s treatment of the *Revlon* auction requirement, it should be noted that *Paramount* "mushed-up" that test too. The *Revlon* decision declared that once it was inevitable that a "company was for sale," a board's duty changed from that of preserving the corporate entity to one of maximizing shareholder value in a sale of the company. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). As the Delaware Supreme Court put it: "The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.*

After *Revlon*, the remaining question was when this *Revlon* auction requirement was triggered. When was the sale of a company "inevitable"?

A number of lower courts (and the supreme court in Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989)) appeared to answer this question by applying a "change of control" test. Under that test, if a target company engaged in a transaction that had the effect of locking-up control of the company (whether it be in the hands of a white knight or current management), *Revlon* would be triggered. Consequently, the management had to hold an auction for the company and allow others to make a bid for it. *See* R. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 270-79 (Supp. 1990); Gilson & Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37 (1990).

This "change of control" test added considerable clarity to *Revlon*. Ambiguities still remained, such as whether the transfer of effective control (but less than an absolute majority of stock) would trigger *Revlon*, but at least it was clear what the dispute was about. GILSON, *supra*, at 278-79.

In *Paramount*, however, the court seemed to reject the change of control analysis. Instead, it announced "two circumstances which may implicate *Revlon* duties." *Paramount*, 571 A.2d at 1150. The first "is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company." *Id.* The second occurs "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company." *Id.*

The court unfortunately offered little guidance as to when an alternative transaction involves the "breakup" of a company. *See generally* GILSON, *supra*, 414-16.

v. Mesa Petroleum Co.[7] Prior to *Unocal*, Delaware courts gave only limited scrutiny to defensive actions.[8] Applying the so-called "primary purpose" test, courts had invalidated defensive actions if their sole or primary purpose was to entrench target management.[9] As a practical matter, courts rarely invalidated defensive actions under this test because well-advised managers could always come up with some explanation for opposing an offer, and courts rarely second-guessed these explanations.[10]

Unocal replaced the primary purpose test with what appeared to be a more rigorous standard. Recognizing the "omnipresent spectre" that a board faced by a hostile bid "may be acting primarily in its own interests," the supreme court announced a new two-pronged test for determining the validity of defensive actions.[11] Actually, the first prong seemed to be just a reiteration of the older primary-purpose standard. It requires directors to justify a defensive action by showing "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[12] As with the primary purpose test, this test appears to be satisfied if directors can present any legitimate reason for opposing an offer.[13]

By contrast, *Unocal*'s second prong seemed to make an important substantive addition to the judicial review of defensive actions. Under this prong, a court is required to independently determine whether a defensive action is proportionate to the threat posed by the hostile

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7. 493 A.2d 946 (Del. 1985).

8. *See* Prentice & Langmore, *supra* note 4, at 383 n.28.

9. Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964) ("if the board had acted solely or primarily because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper"). *See generally* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 827-31 (1981).

10. *See* Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 249 (1989) ("Because competent counsel could always document a policy conflict between a would-be acquirer and defending management, the *Cheff* test [policy conflict/primary purpose] inevitably reduced to a routine application of the business judgement standard."); Gilson, *supra* note 9, at 829 ("Since management can almost always find a conflict over policy between itself and an insurgent, the motive analysis collapses into the business judgment standard.").

11. *Unocal*, 493 A.2d at 954.

12. *Id.* at 955.

13. *See, e.g.*, AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103, 112 (Del. Ch. 1986) ("I take this aspect of the test to be simply a particularization of the more general requirement that a corporate purpose, not one personal to the directors, must be served by [the defensive action].").

offer.[14] The defensive action is to be upheld only if it is "reasonable in relation to the threat posed."[15]

After *Unocal*, the question for courts was whether this latter "proportionality" test would be one of substance or of form. Would a defensive action pass the test, for instance, if management simply alleged that there was a "threat" to the corporation, or would courts actually determine whether the threat was credible? Would any defensive action be "reasonable" in relation to a threat, or would courts actually test for proportionality?[16]

In addition, there was the further question of whether judicial application of the proportionality test would produce clear rules for management conduct in the takeover context, or more vague, fact-based rules. Courts, for instance, could narrowly define what would constitute a "threat" to a target, and what would be "reasonable" in relation to that threat, or courts could leave those issues wide open for courts to resolve on a case-by-case basis. *Unocal*, for example, seemed to favor the latter approach: In discussing what target directors could consider as a "threat" to their company, the decision listed a wide range of open-ended factors.[17]

B. Explication of the Unocal *Test by the Lower Courts*

Despite *Unocal*'s suggestion that the proportionality test be open-ended and highly fact-specific, some lower courts did not apply it that way. The major benefit of these decisions was that they helped provide clear rules as to what managers could do in response to a

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

15. *Id.*

16. In the aftermath of *Unocal*, Professors Gilson and Kraakman wrote an influential article which suggested a way to give substance to *Unocal*'s proportionality test. *See* Gilson & Kraakman, *supra* note 10.

17. The court stated:

> This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: 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 the securities being offered in the exchange. . . . While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.

Unocal, 493 A.2d at 955-56.

hostile bid. The decisions also, however, severely restricted managements' option to "just say no" to an offer.

Before considering these cases, it must be acknowledged that this commentary overstates its case when it suggests that the Delaware Court of Chancery had developed "clear" rules for management conduct in the takeover context. Case law is rarely "clear," and the lower court decisions explicating *Unocal* were no exception to this rule. Nevertheless, a fair reading of two of the most important decisions interpreting *Unocal*, *City Capital Associates Ltd. Partnership v. Interco Inc.*[18] and *Grand Metropolitan Public Ltd. v. Pillsbury Co.*,[19] did suggest relatively straightforward rules for antitakeover actions. While subsequent lower court decisions qualified and seemingly limited these decisions,[20] for the most part their reasoning remained intact up until the supreme court's decision in *Paramount*.[21] Indeed, their rules were sufficiently viable at the time of *Paramount* that the plaintiffs in *Paramount* relied on them to make their argument, and the supreme court felt obliged to expressly state its rejection of these cases.[22]

1. *Interco* and *Pillsbury*

Read broadly, both *Interco* and *Pillsbury* seemed to confront the "just say no" question directly.[23] In both cases, the issue was whether a target's board would be required to redeem a poison pill. In both cases, the effect of leaving the pill in place would have been to deny the shareholders the opportunity to receive a hostile tender offer.

Interco and *Pillsbury* each answered this "just say no" question in a straightforward manner. They did so by narrowly defining what a board could consider as a "threat" under *Unocal* and by narrowly construing what would be considered "reasonable" in relation to such a threat.

Interco, for instance, suggested that when an offeror makes an offer for all of the outstanding stock of a company, the only threat

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18. 551 A.2d 787 (Del. Ch. 1988).

19. 558 A.2d 1049 (Del. Ch. 1988).

20. *See infra* note 38 and accompanying text.

21. *See infra* note 57. *See* Prentice & Langmore, *supra* note 4 (discussing Delaware takeover jurisprudence between *Unocal* and *Paramount*).

22. *See infra* note 58 and accompanying text.

23. Neither decision need be read so broadly. *See infra* notes 37-38 and accompanying text. *Interco* even disavows that it is addressing a pure "just say no" issue. *Interco*, 551 A.2d at 798 n.13 ("I leave aside the rare but occasionally encountered instance in which the board elects to do nothing at all with respect to an any and all tender offer [while leaving a poison pill in place].").

that the offer can pose is one which affects shareholder interests.[24] The decision's logic, apparently, was that if all the current shareholders are going to be bought out by an acquirer, then they can no longer have a stake in the continuance of any given corporate policy. Thus, the decision states: "[I]n the special case of a tender offer for all shares, the threat posed, if any, is not importantly to corporate policies . . . but rather the threat, if any, is most directly to shareholder interests."[25]

Interco further narrowly defined what could constitute a "threat" to shareholders. The decision suggests that threats to shareholder interests can be only one of two types: "threats to the voluntariness of the choice offered by the offer, and threats to the substantive, economic interest represented by the stockholding."[26]

Threats to the "voluntariness" of shareholder choice, the court explained, meant offers which coerce shareholders into tendering, such as two-tiered offers and partial offers.[27] *Interco* suggested that coercive offers are clearly adverse to shareholder interests and that defensive actions to protect shareholders from them are to be countenanced. Indeed, the court noted that the defensive action upheld in *Unocal* was in response to a coercive offer.[28] In addition, the Delaware Supreme Court had upheld defensive actions in two other instances in which shareholders were threatened by a coercive offer.[29]

Threats to the "substantive, economic interests" of shareholders, the court explained, meant offers that were not coercive, but "inadequate" in price.[30] Unlike its rule for coercive offers, however, the court seemed to narrowly define what would be considered "reasonable" in response to such a threat. The strong suggestion of *Interco* was that shareholders should decide whether an offer is adequate. Consequently, the court suggested that a board's response to an inadequate offer could not permanently preclude the shareholders from receiving the offer.[31] A defense could only be used to gain time for the managers to search for, or arrange, a better offer.

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24. *Interco*, 551 A.2d at 797.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.* (citing Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985)).
30. *Id.*
31. *Id.* at 797-800.

But once a reasonable time had elapsed, any preclusive defensive action (such as the poison pill employed by the target management in *Interco*) had to be rescinded. As Chancellor Allen explained:

> To acknowledge that directors may employ the recent innovation of "poison pills" to deprive shareholders of the ability to effectively choose to accept a noncoercive offer, after the board has had a reasonable opportunity to explore or create alternatives, or attempt to negotiate on the shareholders' behalf, would, it seems to me, be so inconsistent with widely shared notions of appropriate corporate governance as to threaten to diminish the legitimacy and authority of our own corporation law.[32]

In short, *Interco* developed a relatively straightforward model for management conduct in the takeover context. Defensive actions would be allowed if an offer clearly posed a "threat" to shareholders, such as a coercive offer. But in the absence of such a threat, managers would only be allowed to temporarily block an offer while searching for a better offer for the shareholders. Once a reasonable period of time had elapsed, defensive actions that precluded shareholders from accepting an offer would not be tolerated. The decision concerning the offer's merits was to be left to the shareholders.

Pillsbury, which came after *Interco*, followed *Interco*'s reasoning. The court suggested that Delaware cases had only sanctioned the use of a poison pill to protect shareholders from coercive offers.[33] It expressed concern that it would be turning the "shareholder protective principles" of these cases on their head if the pill could also be used to preclude shareholders from receiving a noncoercive offer.[34] Instructive of the court's reasoning is the language of a federal court decision which *Pillsbury* quoted in a footnote:

> What is sometimes lost sight of in these tender offer controversies is that the shareholders, not the directors, have the right of franchise with respect to shares owned by them; "stockholders, once informed of the facts, have a right to make their own decisions in matters pertaining to their

32. *Id.* at 799-800.

33. *Pillsbury*, 558 A.2d at 1058 ("In the principal, if not in all, Delaware cases validating use of the Pill, it is apparent that the purpose thereof was to create a 'defense' against hostile, coercive acquisition techniques.").

34. *Id.* at 1059.

> economic self-interest, whether consonant with or contrary to the advice of others, whether such advice is tendered by management or outsiders or those motivated by self-interest."[35]

C. *Descent into Mush*—Paramount's *Rejection of* Interco

Read broadly, *Interco* and *Pillsbury* established clear-cut rules for determining when a preclusive defensive action could be employed against a hostile bid. Managers could not "just say no" to an any-and-all noncoercive tender offer. They could use defensive actions to shop for a better offer; they could try to create their own alternative; but ultimately they had to allow the shareholders to entertain the offer.[36]

To be sure, case law is always ambiguous, and one need not read either *Interco* or *Pillsbury* so broadly.[37] Indeed, only months after

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35. *Id.* at 1060 n.10 (quoting Conoco Inc. v. Seagram Co., 517 F. Supp. 1299 (S.D.N.Y. 1981)).

36. *See, e.g.*, GILSON, *supra* note 6, at 390-91 ("a fair reading of the language of *Interco* and *Pillsbury* suggested that, in the end, a court would order a pill redeemed, leaving the target company's future in the hands of its shareholders"); Coffee, *Opinion*, 1 M&A L. REP. 981, 987 (1989) (concluding from *Interco*, *Pillsbury*, and several other chancery court decisions, that the Delaware Court of Chancery judges had reached a consensus that a "poison pill can be used to run an auction, but not to block a noncoercive bid, at least not based simply on the prediction that share value will in time reach a level higher than the tender offer price").

37. *Interco*, for instance, had language which suggested that it might be proper in some circumstances for a board to take preclusive action even in the face of a noncoercive offer:

> Perhaps there is a case in which it is appropriate for a board of directors to in effect permanently foreclose their shareholders from accepting a noncoercive offer for their stock by utilization of the recent innovation of "poison pill" rights. If such a case might exist *by reason of some special circumstance*, a review of the facts here show this not to be it.

Interco, 551 A.2d at 798 (emphasis added). The question remaining after *Interco* was when did such a "special circumstance" exist? Was this a gaping hole in *Interco*'s general rule that a board could not "just say no" to a noncoercive offer, or was it a minor exception? Certainly the language of the decision suggested the latter. *See* Prentice & Langmore, *supra* note 4, at 391 (recognizing that *Interco* left open the possibility of a case in which it would be appropriate for a board to foreclose shareholders from receiving a noncoercive offer, but stating that the decision "did not indicate any confidence that such a case might truly arise").

The *Pillsbury* decision also seemed to leave room for a "just say no" defense in the face of a noncoercive offer, at least when the offer threatened nonshareholder constituencies. Whereas *Interco* seemed to suggest that an any-and-all offer could only pose a threat to shareholders (*see supra* text accompanying note 25), *Pillsbury*

writing *Interco*, Chancellor Allen himself seemed to limit the decision's reach in *TW Services, Inc. v. SWT Acquisition Corp.*[38] Nonetheless, the broad reading of *Interco* and *Pillsbury*—that managers could not permanently preclude shareholders from receiving a noncoercive offer—remained viable up until the Delaware Supreme Court's decision in *Paramount*.

Before considering *Paramount*'s treatment of *Interco* and *Pillsbury*, it is helpful to review the facts of the case.

1. The Facts of *Paramount*

As early as 1983, Time Inc. began considering the possibility of expanding its operations into the entertainment business.[39] Time's

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quite clearly suggested that an any-and-all offer could still be considered a threat to nonshareholder groups and that such a threat might justify a board's defensive action. *Pillsbury*, 558 A.2d at 1056 n.8 (listing the factors which *Unocal* said a board could consider in responding to a hostile bid, including the impact on constituencies other than shareholders). On the facts of the case, however, Justice Duffy did not find a threat to the corporation or the nonshareholder constituencies. *Id.* at 1058 ("I say again, and I emphasize, that the only 'threat posed' here is to shareholder value—nothing whatsoever affects the *corporate entity or any other constituency.*") (emphasis added). *See generally* Coffee, *supra* note 36, at 984-85.

The broader implications of *Interco* and *Pillsbury* could also be avoided by limiting the decisions to the particular facts of each case. In both cases, management was not only trying to preclude the shareholders from accepting a hostile tender offer; they were also trying to implement a major restructuring of the target company. Thus, the decisions could be read as simply saying that management cannot "just say no" to a noncoercive offer when management is at the same time trying to "cram down" an alternative transaction on the shareholders. *See infra* note 38.

38. Nos. 10,427 & 10,298 (Del. Ch. Mar. 2, 1989), *reprinted in* 14 DEL. J. CORP. L. 1169 (1989). In *TW Services*, Chancellor Allen argued that neither *Interco* nor *Pillsbury* answered the "just say no" issue. In those cases, he said, the crucial fact was that the targets' managers were not only trying to prevent shareholders from accepting a hostile bid, they were also trying to "cram down" an alternative transaction on the shareholders. It was the existence of these coercive alternative transactions that led the courts to require an auction of the company, and thus allow the shareholders an opportunity to receive the hostile bid. *Id.*, slip op. at 24-25, *reprinted in* 14 DEL. J. CORP. L. at 1186-87. Chancellor Allen had a similar discussion of *Interco* and *Pillsbury* in his chancery court decision in *Paramount*:

> In each of those cases, the board sought to assure continued control by compelling a transaction that itself would have involved the sale of substantial assets, an enormous increase in debt and a large cash distribution to shareholders. In other words, in those cases, management was presenting and seeking to "cram down" a transaction that was the functional equivalent of the very leveraged "bust up" transaction that management was claiming presented a threat to the corporation.

Paramount Communications, Inc. v. Time Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283 (1989). *See also* GILSON, *supra* note 6, at 391; Mirvis, *"TW Services": Just Another Brick in the Wall? The Return of "Just Say No,"* N.Y.L.J., Mar. 30, 1989, at 5.

39. *Paramount*, 571 A.2d at 1143.

management thought such an expansion was necessary for Time to control the quality of the products being distributed on Time's home cable television network, Home Box Office (HBO).[40] It also thought the expansion would help Time compete in the increasingly global media market.[41] By 1988, Time's Board had considered a variety of merger partners, including both Warner and Paramount.[42] Eventually, Time sought to merge with Warner.[43]

The merger negotiations with Warner were long and drawn out. A major sticking point concerned the leadership of the new entity. Time wanted Warner's chief executive officer, Steven Ross, to act as a co-CEO for five years, but then to retire, leaving control of the combined entity to Time's senior management.[44] Ross at first balked at this suggestion, but eventually agreed, paving the way for board approval of the merger.[45]

The merger agreement provided for an equity exchange in which the shares of Warner would be exchanged for newly issued shares of Time.[46] Delaware law required the shareholders of Warner to approve the merger.[47] New York Stock Exchange rules required the shareholders of Time to approve the issuance of stock to the Warner shareholders.[48]

After the proxy materials for the Time vote were sent, but before the Time vote, Paramount Communications suddenly announced an all-cash offer for Time stock.[49] Fearing that Time shareholders would prefer this offer to the merger with Warner, Time's Board immediately restructured its deal with Warner. Rather than the stock-for-stock merger, which required approval by the Time shareholders, Time instead elected to buy Warner outright by making a tender offer for Warner stock.[50] To complete this purchase, Time was forced to borrow billions of dollars.[51]

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40. *Id.*
41. *Id.*
42. *Id.* at 1144. Other companies considered by the Time Board were Columbia, M.C.A., Fox, MGM, Disney, and Orion. *Id.*
43. *Id.* at 1144-45.
44. *Id.* at 1145.
45. *Id.*
46. *Id.* at 1146.
47. *Id.*
48. *Id.*
49. *Id.* at 1147.
50. *Id.* at 1148.
51. *Id.* ("To provide funds required for its outright acquisition of Warner, Time would assume 7-10 billion dollars worth of debt.").

Paramount and some Time shareholders went to Delaware court to prevent Time's purchase of Warner. By the time the case reached the Delaware courts, Paramount was offering $200 for Time stock (a substantial premium over Time's pre-offer stock price of $126).[52] The offer was subject to certain conditions, including the obtaining of financing and Time's abandonment of its merger agreement with Warner.[53]

2. The Chancery Court Decision

Chancellor Allen, the author of *Interco*, was the first to wrestle with the claim that Time's tender offer for Warner was an unlawful defensive response to Paramount's bid. He concluded that the action was lawful using reasoning which allowed him to sidestep the "just say no" issue.

Specifically, Chancellor Allen found that Time's purchase of Warner did not preclude Time shareholders from accepting a hostile offer.[54] Although the new Time-Warner entity would be much bigger than the original Time, nothing would prevent Paramount or anyone else from buying the merged entity. Indeed, Chancellor Allen noted that such large scale acquisitions had occurred in the past.[55]

Using this logic, Chancellor Allen was able to avoid the holding in *Interco*. The question was not whether a board could preclude shareholders from accepting a hostile offer. The Time Board was not doing so. All they were doing was going forward with a long-term business plan, and a hostile acquirer could hardly expect a board to abandon all of its plans simply because a non-coercive offer had been made for the company. Thus, Chancellor Allen never had to answer, or alter, the rules as to when directors could adopt a defensive action that precluded shareholders from receiving a non-coercive offer.[56]

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52. *Id.* at 1149. After Paramount's initial offer of $175, Time's stock rose from $126 to $170. *Id.* at 1147.

53. *Paramount*, Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,271. Other conditions included Paramount's procurement of cable franchise transfers from Time and a judicial determination that Delaware's antitakeover statute was inapplicable to any Time-Paramount merger. *Paramount*, 571 A.2d at 1147.

54. Paramount Communications, Inc. v. Time Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 (Del. Ch. 1989) (stating that Time's " 'defensive step' does not legally preclude the successful prosecution of a hostile tender offer").

55. *Id.* (alluding to the recent acquisition of RJR Nabisco).

56. While Chancellor Allen may have avoided answering the "just say no"

3. The Supreme Court Decision

The supreme court affirmed Chancellor Allen's lower court decision but chose not to sidestep *Interco*. Instead, the court seized upon *Paramount* as an opportunity to express its disagreement with *Interco*.

The plaintiffs in *Paramount* relied upon *Interco* to make their argument that Time's defensive action was unlawful. Specifically, they claimed that Time's action was inappropriate because their offer posed no threat to Time. Their offer was noncoercive, the plaintiffs claimed, and was not inadequate. Therefore, it was inappropriate for Time to preclude its shareholders from accepting the offer.[57]

The supreme court responded to this argument by launching an attack on *Interco*:

> Plaintiffs' position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment as to what is a "better" deal for that of a corporation's board of directors. To the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis. *See, e.g.*, *Interco*, 551 A.2d 787 and its progeny. . . .
>
> The usefulness of *Unocal* as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios. *Unocal*

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issue in *Paramount*, it is true that his opinion, like his earlier opinion in *TW Services*, took a narrow view of *Interco* and *Pillsbury* and seemed to lean in favor of giving directors broad discretion in the takeover context. Paramount Communications Inc. v. Time Inc., Nos. 10,866, 10,670 (Consolidated) & 10,935 (Del. Ch. July 14, 1989) (revised July 17, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 749-50 (1990) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."). *See supra* note 38.

57. *Paramount*, 571 A.2d at 1152-53. The court summarized what it perceived as the plaintiffs' argument:

> Implicit in the plaintiffs' argument is the view that a hostile tender offer can pose only two types of threats: the threat of coercion that results from a two-tier offer promising unequal treatment for nontendering shareholders; and the threat of inadequate value from an all-shares, all-cash offer at a price below what a target board in good faith deems to be the present value of its shares. . . . Since Paramount's offer was all-cash, the only conceivable "threat," the plaintiffs argue, was inadequate value. We disapprove of such a narrow and rigid construction of *Unocal* . . . .

Id. at 1153.

> is not intended as an abstract standard; neither is it a structured and mechanistic procedure of appraisal. Thus, we have said that directors may consider, when evaluating the threat posed by a takeover bid, the "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders[,] . . . the risk of nonconsummation, and the quality of securities being offered in the exchange." The open-ended analysis mandated by *Unocal* is not intended to lead to a simple mathematical exercise . . . .[58]

In short, the supreme court rejected *Interco* and its progeny to the extent that they had laid down a restrictive, mechanistic formula for *Unocal*. *Unocal* was intended to be a flexible test in which a board could consider a variety of factors. It was to be "open-ended" or, as this commentary puts it, "mushy."

After reconfirming that the *Unocal* test was to be an open-ended analysis, the court proceeded to apply such an analysis to the facts of *Paramount*. First, the court made clear that there were a wide range of factors that the Time Board could have perceived as a "threat" to Time, even in the face of an any-and-all noncoercive offer.[59] The court ran through a litany of such factors without clarifying whether each factor individually, or only all *in toto*, justified Time's defensive response.[60] The court especially emphasized the Time Board's interest in continuing with its long-term business plan of merging with Warner.[61] Also among the factors, however, and in stark contrast to *Interco* and *Pillsbury*'s suggestion that shareholders should judge the adequacy of an offer, the court suggested that one of the threats the Time Board reasonably perceived from the Paramount offer was that Time's shareholders might mistakenly accept it. "One [board] concern," the court said, "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."[62]

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58. *Id.* at 1153 (quoting *Unocal*, 493 A.2d at 955).
59. *Id.*
60. *Id.*
61. *Id.* at 1153-54 ("Although the Chancellor blurred somewhat the discrete analyses required under *Unocal*, he did conclude that Time's board reasonably perceived Paramount's offer to be a significant threat to the planned Time-Warner merger and that Time's response was not 'overly broad.' ").
62. *Id.* at 1153. *Compare id. with Interco*, 551 A.2d at 799-800.

As to what would be considered "reasonable" in relation to these threats, the court was somewhat unclear in the extent to which it was departing from *Interco*. On the one hand, it seemed to adopt Chancellor Allen's narrow reasoning that Time's response was reasonable because it did not preclude Paramount from pursuing its offer; Paramount only now had to make an offer for the larger Time-Warner entity.[63] If the supreme court's decision ultimately rested upon that basis, the argument that management cannot "just say no" to a noncoercive offer remains alive. But the tenor of the supreme court's decision, its explicit rejection of *Interco*, and the court's other language emphasizing the need for broad management discretion to respond to takeovers all suggest that the court was backing away from *Interco*'s mechanistic approach as to when a board could "just say no."

III. CRITIQUE OF *PARAMOUNT*: THE MIXED MERITS OF A MUSHY APPROACH

While *Paramount* may not have clearly approved the "just say no" defense, and while *Interco* may not have clearly rejected it, it is nevertheless helpful for the purposes of evaluating *Paramount* to think of each of these decisions in such absolute terms. Doing so better frames the question as to what the law should be: Which approach to the "just say no" defense is better—*Interco*'s mechanistic approach or *Paramount*'s mushy approach?

This question can only be addressed in light of the larger issues raised by takeovers. This section suggests that takeovers raise two primary issues—agency issues and externality issues—and analyzes *Paramount* in the context of each.

A. The Agency Issue—"Other People's Money"

The agency issue posed by corporate takeovers is the same one confronted by all of corporate law: namely, how to regulate people

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63. The court stated:

> The Chancellor noted that the revised agreement and its accompanying safety devices did not preclude Paramount from making an offer for the combined Time-Warner company or from changing the conditions of its offer so as not to make the offer dependent upon the nullification of the Time-Warner agreement. Thus, the response was proportionate. We affirm the Chancellor's rulings as clearly supported by the record.

Paramount, 571 A.2d at 1155.

who manage "other people's money"?[64] While shareholders invest their money in a company and enjoy or suffer the company's profits and losses, it is their agents—the board of directors and the officers appointed by them—who manage the company. The central concern of corporate law is to insure that managers use this power properly; that is, that managers use it to maximize shareholder wealth, and not their own.[65]

Of course, this agency problem would be illusory if shareholders adequately policed management conduct themselves, but historically that has not been the case. Individual shareholders rarely own enough of a stake in an enterprise to justify the costs of supervision.[66] Consequently, the job of policing management has largely been left to a combination of judicial regulation and market regulation.[67] Corporate takeovers are significant because they come at the crossroads of these two regulatory regimes.[68]

Judicial regulation, for instance, has been largely confined to the most egregious type of corporate mismanagement: self-dealing by corporate managers. Courts scrutinize such transactions carefully,

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64. L. BRANDEIS, OTHER PEOPLE'S MONEY (1914). Time-Warner is familiar with this issue. *See Other People's Money* (Warner Bros. 1991).

65. *See generally* Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 878-80 (1990); Gilson, *supra* note 9, at 833-36.

66. *See generally* Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (discussing the general assumption about shareholder passivity but also questioning its continuing relevance, especially given the rise of institutional investors). *See also* Gilson, *supra* note 9, at 831-36. For other articles considering the impact of institutional investors on shareholder monitoring of corporate managers, see Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C.L. REV. 1135 (1991); Lipton & Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

67. *See* Gilson, *supra* note 9, at 836-40 (describing market and legal constraints on management conduct). There are other checks on management conduct besides judicial and market checks. Outside directors, for instance, can provide an important check on management conduct, and management incentive plans can align management interests with shareholders. Ribstein, *supra* note 4, at 299. To the extent that these checks operate effectively, the less of a need there is for judicial or market regulation of management. Nevertheless, there is considerable doubt as to the effectiveness of these checks. *Id. See also* Gilson & Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 876 (1991) ("both more or less sympathetic observers of boards of directors have come to acknowledge what should have been obvious all along: The traditional corporate solution of introducing outside directors to bridge the separation of ownership and control has dramatic limitations").

68. *See* Gilson, *supra* note 9, at 841-45 (discussing the critical role of takeovers in supplementing legal regulation of managers).

oftentimes insisting that managers prove that a transaction was "intrinsically fair" to the corporation (i.e., that the consideration paid to the manager was a "fair" value).[69]

Unfortunately, however, self-dealing is only the most obvious way in which managers can exploit corporate resources. There remain many more subtle ways in which managers can steer a company in favor of their own interests. Managers whose prestige and salaries are tied to a company's size, for instance, might prefer a policy of corporate growth even when such growth is not the most efficient use of corporate resources.[70] Managers may also be more conservative in their policymaking than shareholders, being more concerned with the long-term stability of their company (and thus their jobs) than would be a risk-taking investor.[71]

This latter form of corporate mismanagement has largely gone unregulated by courts. The primary obstacle to judicial regulation is that it is virtually impossible for courts to distinguish between ordinary business decisions and business decisions intended to benefit management. How can a court tell, for instance, whether a decision to grow was made in a corporation's or in management's best interests? Indeed, courts have long recognized that it is neither proper nor desirable for them to second-guess business decisions, and they have expressed this principle in the business judgment rule, which presumes that business decisions are made in good faith and on an informed basis.[72]

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69. *AC Acquisitions*, 519 A.2d at 111 ("where a self-interested corporate fiduciary has set the terms of a transaction and caused its effectuation, it will be required to establish the entire fairness of the transaction to a reviewing court's satisfaction"). *See* Gilson, *supra* note 9, at 824-25. The author states:

> In contrast to judicial restraint under the business judgment rule, courts adopted an active regulatory posture with respect to transactions posing conflicts of interests: A court would "review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation."

Id. (quoting Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35, 43 (1966)).

70. *See generally* Jensen, *The Takeover Controversy: Analysis and Evidence in* KNIGHTS, RAIDERS, AND TARGETS 314, 321-22 (J. Coffee, Jr., L. Lowenstein & S. Rose-Ackerman eds. 1988); Coffee, *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1499-50 (1990) (discussing literature concerning management empire building).

71. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web in* KNIGHTS, RAIDERS, AND TARGETS, *supra* note 70, at 77, 82-85.

72. Aronson v. Lewis, 473 A.2d 805 (Del. 1984). In AC Acquisitions v. Anderson, Clayton & Co, 519 A.2d 103 (Del. Ch. 1986), the court explained how

This refusal by courts to police ordinary business decisions would be disturbing but for the concomitant regulation of managers by markets. Even in the absence of legal restraints, managers must run their companies efficiently (and thus in the shareholders' best interests) because, if they fail to do so, the price of their company's stock will decline and the company will become a takeover target in the market for corporate control.[73] To avoid this prospect, managers must deploy their company's resources efficiently, leaving them little room to favor their own interests over those of shareholders.[74]

The jurisprudential problem of corporate takeovers arises when managers prevent this market regulation from operating by taking actions to preclude takeovers. Some kind of judicial policing is critical at this point, not only because the managers may be favoring their own interests over those of shareholders', but more importantly, because the viability of takeovers is arguably the theoretical underpinning that justifies judicial restraint for all other business decisions.[75] If courts fail to police management responses in the takeover

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the business judgment rule works:

> Ordinarily when a court is required to review the propriety of a corporate transaction challenged as constituting a breach of duty or is asked to enjoin a proposed transaction on that ground, it will, in effect, decline to evaluate the merits or wisdom of the transaction once it is shown that the decision to accomplish the transaction was made by directors with no financial interest in the transaction adverse to the corporation and that in reaching the decision the directors followed an appropriately deliberative process. . . . This deference—the business judgment rule—is, of course, simply a recognition of the allocation of responsibility made by section 141(a) of the General Corporation Law and of the limited institutional competence of courts to assess business decisions.

Id. at 111. *See generally* Gilson, *supra* note 9, at 822 ("The business judgment rule does not express the measure by which a court determines whether management has discharged its duty of care; rather, its application reflects a conclusion that the management action in question will not be reviewed at all.").

73. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). Other markets, such as product, employment, and capital markets, also operate to constrain management discretion. *See* Gilson, *supra* note 9, at 824. To the extent that these market forces adequately restrain management misconduct, they decrease the importance of the market for corporate control. Nevertheless, the latter market may continue to be an important final check on management misconduct. *Id.* at 836-45.

74. *See generally* Easterbrook & Fischel, *supra* note 73 (describing monitoring effect of corporate takeovers).

75. Gilson, *supra* note 9, at 844 ("To the extent that the business judgment rule presupposes effective nonlegal constraints on management decisions, it is inconsistent with management control over tender offers."); Ribstein, *supra* note 4,

context, they in effect immunize business decisions from both judicial regulation and market regulation.[76]

The problem becomes how to police the management responses. To do so, courts have essentially three choices. The first is to let shareholders be the judge of offers. This is the *Interco* approach. Management can oppose coercive offers and management can use defensive tactics to search for a better offer. But ultimately, the decision as to whether to accept a noncoercive offer must be left to the shareholders.

From a theoretical standpoint, this approach seems the best. The decision whether to tender into an offer or to continue investing in a company is essentially an investment decision. It makes sense for investors to make it.[77] Allowing shareholders to decide also avoids the sticky agency problem raised by takeovers. Courts need not worry that managers will oppose an offer solely to protect their jobs because the shareholders, and not the managers, will decide the merits of the offer. Finally, by not allowing managers to block the market for corporate control, courts insure that this market will continue to perform its larger regulatory function of policing management's day-to-day decision making.[78]

A second choice for courts is to let the target's board decide when shareholders should be able to accept an offer. This approach is desirable to the extent that directors might be better able to evaluate an offer than shareholders.[79] It is highly undesirable, however, to the extent that a board might be controlled by or simply defers to management.[80] In this latter instance, treating the board's decision

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at 299 ("directors are immune from judicial second-guessing only because hostile takeovers are available as a last resort to ensure that managers act in a shareholders' interests").

76. Gilson, *supra* note 9, at 841-48.

77. *Id.* at 827.

78. *See supra* notes 73-76 and accompanying text.

79. *See infra* notes 84-85 and accompanying text.

80. Judge Posner recognized this problem in Dynamics Corp. v. CTS Corp.:

> When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest and *it is not cured by vesting the power of decision in a board of directors in which insiders are a minority. . . .* No one likes to be fired, whether he is just a director or also an officer. The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to

as an ordinary "business judgment" would simply give management a *carte blanche* to perfunctorily reject all offers except for those which guarantee them long-term employment contracts or a king's ransom to leave.[81]

Finally, the third choice is for courts to determine themselves whether shareholders should be able to entertain an offer. This, in essence, is the *Paramount* approach. The court neither accepted the board's decision outright nor automatically required that shareholders receive a non-coercive offer. Instead, the court acted as a gatekeeper, subjecting the defensive action to an open-ended analysis that considered the full factual setting. Thus, while *Paramount* criticized *Interco* because "it would involve the court in substituting its judgment as to what is a 'better' deal,"[82] that is precisely what *Paramount* did![83]

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whom they are likely therefore to defer.

794 F.2d 250, 256 (7th Cir. 1986) (emphasis added), *rev'd on other grounds*, 481 U.S. 69 (1987). *See also* Gilson & Kraakman, *supra* note 67; Prentice & Langmore, *supra* note 4, at 472-76.

To be sure, outside directors have performed admirably in some takeover battles (*see* Allen, *Independent Directors in MBO Transactions: Are They Fact or Fancy?*, 45 BUS. LAW. 2055 (1990) (comparing cases in which outside directors performed well and poorly)), and courts have certainly expressed a greater willingness to defer to a board decision made by independent directors. *See, e.g.*, *Paramount*, 571 A.2d at 1154 ("The evidence supporting this finding [that the board was informed] is materially enhanced by the fact that twelve of Time's sixteen board members were outside independent directors."); *Moran*, 500 A.2d at 1356; *Unocal*, 493 A.2d at 955.

81. Gilson & Kraakman, *supra* note 10, at 247-48 ("Target managers who approve an offer may be improperly influenced by post-transaction benefits; target managers who reject an offer may act largely to secure their own positions.").

82. *Paramount*, 571 A.2d at 1153. In *Interco*, the court specifically refused to exercise its judgment as to what was a "better" deal. *Interco*, 551 A.2d at 799 ("The point here is not that, in exercising some restrained substantive review of the board's decision to leave the pill in place, the court finds Drexel's opinions more persuasive than Wasserstein Perella's. I make no such judgment."). Indeed, Chancellor Allen was well aware of the "danger" that courts would use *Unocal*'s flexible test "to assert the primacy of their own view on a question upon which reasonably, completely disinterested minds might differ." *Id.* at 796.

83. To be sure, there is language in *Paramount* which suggests that the court was completely eviscerating the *Unocal* test and essentially treating a board's decision in the takeover context as a protected business judgment. *See* Ribstein, *supra* note 4, at 298-300. If this is true, then the court was correct in suggesting that it was not substituting its judgment for that of a board's. This is certainly what the court appears to have done in its application of *Unocal*'s first prong. *Paramount*, 571 A.2d at 1153-54.

Nevertheless, there is also language in *Paramount* which suggests that the court will continue to give defensive actions a more rigorous review. Indeed, the court explicitly "reject[ed]" the view espoused by some scholars that *Unocal*'s enhanced

1. The Mixed Merits of a Judge-Centered Approach

As previously mentioned, the *Interco*-shareholder approach seems like the best approach. Not only does it solve the agency problems raised by takeovers, it also insures that takeovers will continue to be a viable market check on management conduct. Nevertheless, the judge-centered approach taken in *Paramount* is not without merit. This is especially true if courts are dubious of the theories underlying the shareholder approach.

The shareholder approach, for instance, assumes that shareholders know what is best for themselves. It assumes that shareholders

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business judgment rule is satisfied "once the board's deliberative process has been analyzed and found not to be wanting in objectivity, good faith or deliberateness." *Id.* at 1154 n.18. The opportunity for future judicial review is most notable in the court's application of *Unocal*'s second prong—the proportionality test. In that context, the court stated:

> Here, on the record facts, the Chancellor found that Time's responsive action to Paramount's tender offer was *not aimed at "cramming down" on its shareholders a management-sponsored alternative*, but rather had as its goal *the carrying forward of a pre-existing transaction in an altered form*. Thus, the response was reasonably related to the threat. The Chancellor noted that the revised agreement and its accompanying safety devices *did not preclude Paramount from making an offer for the combined Time-Warner company* or from changing the conditions of its offer so as not to make the offer dependent upon the nullification of the Time-Warner agreement. Thus, the response was proportionate.

Id. at 1155 (emphasis added). This language would seem to give courts room to continue to second-guess defensive actions. What would a court do, for instance, if management was "cramming down" on shareholders a management-sponsored alternative, if management was not just carrying forward a pre-existing transaction, or if management's defensive action did preclude the acquisition of the company? *See also id.* at 1155 n.19 (suggesting that the employee stock ownership plan upheld in Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989), was proper because it "did not appear to be primarily a *device to affect or secure corporate control*") (emphasis added). *See generally* GILSON, *supra* note 6, at 413 (suggesting that the status of the "just say no" defense remains in doubt after *Paramount*); Ribstein, *supra* note 4, at 301 (advocating a narrow reading of *Paramount* that would continue to allow for judicial policing of defensive actions).

But again, *Paramount* can be read as eviscerating *Unocal*'s second prong. Most notable is the following language in the decision.

> Delaware law confers the management of the corporate enterprise to the stockholders duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders. Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is *clearly no basis to sustain the corporate strategy*.

Paramount, 571 A.2d at 1154 (emphasis added) (citations omitted).

can adequately judge whether it is better for them to sell their shares into an offer or to hold on to their stock for the long term. It is perfectly plausible, however, for a court to reject this assumption. Shareholders, after all, certainly know less about a company than the company's management. A court could reasonably believe that a management action which precludes shareholders from receiving an offer is actually protecting the shareholders from mistakenly accepting an inadequate offer.[84] In *Paramount*, for instance, the Time managers claimed that the Time-Warner merger would be more profitable for the Time shareholders in the long term than the Paramount offer.[85]

One response to this concern over shareholder mistake is that the danger of mistake is alleviated by the securities markets which so efficiently process information that they can effectively value offers against alternative business prospects. The securities markets, for instance, are said to factor the long-term prospects of a company into its present value. Thus, in light of this efficiency, there is arguably no need for managers to prevent shareholders from receiving an offer. The shareholders can be expected to make an intelligent choice because the securities markets will essentially make the choice for them.[86]

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84. The lower court decision in *Paramount* refers to examples of when management defensive tactics ultimately redounded to the benefit of the target shareholders:

> The Walt Disney Company is an example of an entertainment company that rejected a $72.50 hostile offer in June 1984 and is now trading at the equivalent of $380 per 1984 share. Another example of an entertainment company that achieved better results by remaining independent and growing than by cashing in when it was undervalued in the market is Warner itself. In early 1984, Warner was the subject of unsolicited interest on the part of Rupert Murdoch. At that time, Warner was selling for $10 to $12 a share, adjusted for a subsequent two-for-one split. Today, of course, five and a half years later—Warner is subject of a $70 per share merger agreement with Time and was selling at $45 (or about four times its early 1984 price) before its merger with Time was announced.

Paramount, Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277 (quoting Crawford Affidavit). For an opposing view, see Gilson, *Just Say No to Whom?*, 25 WAKE FOREST L. REV. 121, 124 (1990) (challenging the argument that managers need to "save shareholders from themselves").

85. *See, e.g.*, *Paramount*, Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,273-74. As the chancery court recognized, the Time "board chose less current value in the hope . . . that greater value would make that implicit sacrifice beneficial in the future." *Id.* at 93,276.

86. Chancellor Allen, for instance, recognized that, for some, the distinction

Courts, however, may also question this secondary assumption about the securities markets. Many scholars, for instance, are doubtful whether the securities markets are as efficient as claimed,[87] and there is certainly nothing in corporate law which insists that courts adopt the theory of an efficient capital market. As Chancellor Allen eloquently put it: "[J]ust as the Constitution does not enshrine Mr. Herbert Spencer's social statics, neither does the common law of directors' duties elevate the theory of a single, efficient capital market to the dignity of a sacred text."[88]

If courts believe that markets cannot be relied upon to mitigate the danger of shareholder mistake, then perhaps there is a need for a judge-centered approach to corporate takeovers. While courts cannot just let a target's board decide what is best for shareholders because of the "omnipresent spectre" that the board might act in its own interests,[89] they can at least hear a board's claim as to why an offer is not in the shareholders' best interests. If the court finds the board persuasive, it can then validate a defensive action that precludes the shareholders from receiving the offer.

Nevertheless, even if such judicial supervision is warranted, there remain serious questions about the competence of courts to decide when an offer is "good" for shareholders.[90] The beauty of the market-

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"the Time board implicitly drew between current share value maximization and long-term share value maximization" of the Warner merger was a false distinction. As the chancellor explained:

> "The lawyers may talk of a premium for control. But to a true believer of efficient markets, there cannot be a premium for control." Therefore, before turning to the legal analysis that does employ that distinction, I pause to address in some brief way the notion that the distinction between any long-term and short-term stock value, at least where there is a large, active, informed market for the shares of the company, is an error; that the nature of such markets is precisely to discount to a current value the future financial prospects of the firm; and that markets with their numberless participants seeking information and making judgments do this correctly (at least in the limited sense that no one without inside information could regularly do it better).

Paramount, Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,276-77 (footnotes omitted).

87. *See* Herman & Lowenstein, *The Efficiency Effects of Hostile Takeovers in* KNIGHTS, RAIDERS, AND TARGETS, *supra* note 70, at 211; Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985); Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988); Wang, *Some Arguments that the Stock Market is Not Efficient*, 19 U. CAL. DAVIS L. REV. 341 (1986). *See also* Prentice & Langmore, *supra* note 4, at 414-20 and sources cited therein.

88. *Paramount*, Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277.

89. *Unocal*, 493 A.2d at 954.

90. *See* Coffee, *supra* note 36, at 990. The author states:

oriented/shareholder approach is that there is an objective standard—the market—to rely on. Once courts start second-guessing the market, what else can they rely on for their judgment?

Courts could listen to what management has to say, but management is hardly trustworthy. In most instances, management may have every incentive to defeat an offer whether or not it is in the best interests of the shareholders. Even outside directors are oftentimes thought to be too closely aligned with management to be reliable.[91]

Courts could listen to the testimony of investment bankers, but experience suggests that investment bankers say what they're paid to say.[92] In *Paramount*, for instance, both the plaintiffs and defendants found banking experts to validate their conflicting arguments.[93]

Courts could exercise their own independent judgment as to what is best for the shareholders, but in that case, what makes the courts any more qualified than shareholders to make this judgment? Indeed, courts have generally refrained from second-guessing business decisions precisely because they lack competence to evaluate such decisions.[94]

Thus, while a judge-centered approach might be warranted to help prevent shareholders from mistakenly accepting inadequate offers, there is considerable doubt as to whether courts can competently perform this task. There may be merit to the judge-oriented approach, but it is certainly mixed.

> [T]he simple truth is that courts have little institutional competence in dealing with problems of predictive valuation. Once they enter this thicket, they will not soon escape it, and most tender offers will come to involve a battle of experts, as investment bankers debate in court their rival methodologies.

Id. Looking at the Time-Warner merger now, one might wonder whether it was "better" for the Time shareholders to have been denied the opportunity to receive the Paramount offer. Consider, for example, the July 22, 1991, issue of *Business Week*. The magazine's cover reads as follows: "Time Warner: Synergy? Not Much. Strategic Alliances? Not Yet. Rights Offerings? Not So Fast. No Wonder Shareholders Are Mad." Bus. Wk., July 22, 1991, cover.

91. *See supra* note 80. *See also* Prentice & Langmore, *supra* note 4, at 472-76.

92. *See generally* Bebchuk & Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27 (discussing unreliability of fairness opinions); Prentice & Langmore, *supra* note 4, at 468-72 (same).

93. *Paramount*, Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,271-73, 93,273 n.8 (stating the reports of Time's and Paramount's financial analysts of the potential value of Time-Warner common stock after the merger). *See also Pillsbury*, 558 A.2d at 1057 ("Investment bankers support and critique each side of the controversy over the more productive way to create shareholder value.").

94. *See supra* note 72 and accompanying text.

The fact that a judge-oriented approach has mixed merits, however, is not to say that it is not desirable. As mentioned above, if it is believed that shareholders can make mistakes about offers, then the shareholder approach also has mixed benefits. Rather than abandoning the judge-oriented approach, perhaps it is best to simply build in procedures which help make the judicial approach more reliable. For instance, Professors Gilson and Kraakman have suggested that if courts are going to entertain management arguments as to why shareholders should be precluded from accepting an offer, then courts should insist that the managers lay out in detail why they think it would be better for the shareholders to continue their interests in the company.[95] Such an approach helps courts evaluate the credibility of management's argument. It will also be instructive if five years down the road another offer is made for the company and the acquirer can show that management has failed to realize any of its earlier predictions.[96]

B. The Externality Issue—"Other People"

In addition to the agency problem raised by takeovers, there is also an externality problem. Even if takeovers are good for shareholders, they still may be bad for nonshareholder corporate constituencies: the bondholders whose bonds are devalued after a leveraged acquisition;[97] the employees who are terminated when an acquirer seeks to cut costs;[98] the communities who suffer when an acquirer moves a target's plant or headquarters to another location.[99] Some commentators even claim that takeovers are bad for the economy as a whole because they force managers to concentrate on short-term planning.[100] Should a board be able to "just say no" to an offer to protect these nonshareholder interests?

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95. Gilson & Kraakman, *supra* note 10, at 266-74.

96. *Id.* at 271-73.

97. *See* Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 26-28 (1987) ("Whether the growth in leverage results from a successful takeover or a successful defense, it makes outstanding bonds riskier and, as a consequence, less valuable."); Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211 (1991); Coffee, *supra* note 70.

98. *See generally* Lipton, *supra* note 97, at 25-26; Garfield, *Helping the Casualties of Creative Destruction: Corporate Takeovers and the Politics of Worker Dislocation*, 16 J. CORP. L. 249 (1991).

99. *See generally* Lipton, *supra* note 97, at 25-26. Justice Powell recognized this problem in a footnote in his concurrence in Edgar v. MITE Corp., 457 U.S. 624, 646 n.* (1982) (Powell, J., concurring).

100. *See* Lipton, *supra* note 97, at 23-25.

Once again, *Interco* and *Paramount* seem to diverge on this issue. The strong suggestion of *Interco* is that directors cannot "just say no" to a noncoercive offer to protect nonshareholder interests. By suggesting that an any-and-all offer can only threaten shareholder interests, *Interco* implies that directors may not consider the interests of nonshareholder constituencies as a reason for precluding shareholders from accepting an offer.[101]

Paramount, by contrast, seems to suggest that a board can "just say no" to protect nonshareholder interests. In its discussion of *Unocal*, for instance, the court quotes directly from *Unocal* for the proposition that directors may consider the interests of nonshareholder groups in responding to a hostile bid.[102] Indeed, the court even seemed to give some deference to such nonshareholder concerns in *Paramount*. The court, for instance, referred to Time's argument that Time needed to oppose the Paramount offer to protect the "Time Culture," that separation of business and journalistic interests at Time which insured the journalistic integrity of its publications.[103]

Thus, as with the agency problem, *Paramount* seems to have taken a judge-oriented approach to the externality problem. The court did not give a board a *carte blanche* to oppose all hostile offers for the sake of nonshareholder constituencies, but neither did it insist that a board could never "just say no" to an offer to protect such groups. Rather, the court left open the possibility that a board could take preclusive action and left it to the courts to review the board's action for its credibility and reasonableness.

1. The Mixed Merits of a Judge-Centered Approach

From a practical standpoint, the *Interco* approach to the externality problem seems to be the better one. Once courts allow directors to "just say no" to an offer in order to protect nonshareholder groups, serious and perhaps irresolvable problems arise.

For starters, there is the age-old agency problem. How is a court to know whether directors opposing an acquisition are trying to further one of these nonshareholder interests (as the directors

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101. *See supra* notes 24-25 and accompanying text. *See also* Coffee, *supra* note 36, at 985.

102. *Paramount*, 571 A.2d at 1153. *See* Norwitz, *"The Metaphysics of Time": A Radical Corporate Vision*, 46 BUS. LAW. 377 (1991); Johnson & Millon, *The Case Beyond Time*, 45 BUS. LAW. 2105 (1990).

103. *Paramount*, 571 A.2d at 1143 n.4, 1145, 1148-49.

might claim) or are really just protecting themselves? Indeed, why should directors ever be responsive to nonshareholder interests when the board is elected by the shareholders and the directors owe fiduciary duties to the shareholders? Either directors are bound to protect shareholder interests or they're not, and, if not, why won't they just pursue their own interests?[104]

Second, even if the separation of ownership and control in large public companies leaves directors with enough discretion to favor nonshareholder interests over shareholder interests, why should directors have the authority to do this? The public did not elect the directors. Why should courts think that corporate directors can adequately speak for community interests or labor interests or the interests of the economy as a whole?[105] Indeed, if corporate directors are going to represent nonshareholder groups, then should not some directors be elected by these groups, and should not these groups have a potential cause of action against the directors if they ignore their interests?[106]

These perhaps intractable problems suggest that corporate law might be better served, and more easily administered, when managers are held solely accountable to further shareholder interests. If society is concerned about these other constituents, there is a wide range of legislative actions it could take to protect them, from changing labor, tax, or pension laws to revising contract and tort laws.

Nevertheless, despite *Interco*'s theoretical appeal, there may again be some merit to the *Paramount* approach, which allows directors to consider the interests of nonshareholder groups and then requires courts to determine whether the directors are properly exercising their discretion in doing so. Most important, while society may in theory be capable of protecting nonshareholder corporate constitu-

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104. *See generally* R. CLARK, CORPORATE LAW 679 (1986) (noting that "[a] single, objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests").

105. *See Other Constiuency Statutes: Potential for Confusion* (ABA Comm. on Corporate Laws), 45 BUS. LAW. 2253, 2270 (1990); Note, *Takeover Dangers and Non-Shareholders: Who Should be My Brothers' Keeper?*, 1 COLUM. BUS. L. REV. 301, 316-19 (1988); Address by Chancellor William T. Allen, *Competing Conceptions of the Corporation in American Law*, Rocco J. Tresolini Lecture in Law, Lehigh University, Oct. 29, 1990, at 15 (discussing arguments of those who favor a single goal of profit maximization for corporate managers).

106. *See* O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991).

encies from the dislocative effects associated with takeovers, in reality, the legislative process for doing so may be so cumbersome and slow to react that any legislative help that might come would be too little and too late. The benefit of the *Paramount* approach is that it allows courts to deal with the externality problem of takeovers in the here and now, when a response is needed. On a case-by-case basis a court can consider the credibility of management's argument regarding the need to protect nonshareholder interests.

Again, however, there is the problem of judicial competence to fulfill this function. For one, will courts really be able to distinguish when management is truly concerned with protecting nonshareholder groups or when it is actually just trying to protect itself? Can judicial proceedings really answer that question?

Just before the *Paramount* decision was issued, for instance, Connie Bruck, an investigative reporter, wrote an article on the Time/Paramount battle which suggested that Time's argument that it needed to protect the "Time Culture" was mostly hooey manufactured for the purposes of the case.[107] Apparently, Time's current chief officers, J. Richard Munro and N.J. Nicholas, Jr., had themselves been dismantling Time's "church and state" separation of business and journalistic interests for years:

> Thus, church and state, that "antiquated" concept which during the tenure of Munro and Nicholas had been maligned, attacked and diminished, and had come within a hairbreadth of being dismantled utterly (with Munro and Nicholas' attempt to remove the editor-in-chief from the [Time] board), now became the rallying cry, the banner for the fight. In a letter to Marvin Davis, Paramount's C.E.O., Munro wrote, "We cannot and will not ignore the public interest. The journalistic integrity of our publications—the independence of their editorial voice—isn't window dressing. It's the essence of who we are and what we do . . . ."[108]

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107. Bruck, *Deal of the Year*, New Yorker, Jan. 8, 1990, at 66.

108. *Id.* at 81. *See also* Landro, *Writer Quits Fortune, Citing Meddling by Time Warner*, Wall St. J., June 26, 1991, at B1, col. 3 (reporting that Graef Crystal, who prepares Fortune magazine's list of highest paid executives, would no longer be preparing the survey because executives of Fortune's parent, Time Warner, had complained about Crystal's compensation figure for Time Warner co-CEO Steven Ross).

In addition, there is the question of whether courts are qualified to balance the interests of nonshareholder groups versus shareholders interests. This decision, after all, seems to be inherently a political judgment that is better left to legislators.

So once again, while there is some merit to *Paramount*'s judge-oriented approach, it is mixed.

C. Paramount *and the Chartering Debate*

One thing certain about the *Paramount* approach is that it is more sympathetic to management interests than the *Interco/Pillsbury* approach. Although it is not clear how far the supreme court intended to go in deferring to management discretion, what is clear is that the court gave new life to the "just say no" defense, and its language strongly suggests that the court is inclined to give great deference to management decisions in the takeover context.

Paramount's tilt toward management in the takeover context could be construed as simply evidence of Delaware engaging in a "race to the bottom." Professor Steinberg made such a suggestion in the last volume of this journal.[109]

Nevertheless, labeling *Paramount* as a "race to the bottom" case may not be giving the court enough credit. As Professor Steinberg himself noted, if Delaware was truly interested in a "race to the bottom," it could do much worse than *Paramount*.[110] All Delaware need do is look across its border to Pennsylvania, which has been actively amending its corporate law in recent years to make it virtually impossible for a hostile acquirer of a Pennsylvania company to succeed.[111] Pennsylvania even statutorily forbids its courts from applying a heightened *Unocal*-like standard in reviewing defensive actions.[112]

Nevertheless, while Delaware may not have felt compelled to win a race to the bottom, one might still wonder whether Delaware could have continued to attract chartering business if its case law was as pro-shareholder and restrictive of management action as *Interco*. Indeed, after the *Interco* decision was issued, Martin Lipton, one of

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109. Steinberg, *supra* note 4.

110. *Id.* at 26-29.

111. *See generally* PENNSYLVANIA TAKEOVER ACT OF 1990 (Pa. Bar Inst. 1990) (discussing provisions of the Pennsylvania Takeover Act of 1990).

112. Act No. 1990-36, 1990 Pa. Legis. Serv. 95, 98 (West) (to be codified as 15 PA. CONS. STAT. §§ 511(f), 1721(g) (1990)).

the country's preeminent management attorneys, was reported in the *Wall Street Journal* as saying that decisions like *Interco* might compel corporations to reincorporate outside of Delaware.[113]

Most likely, the court's action in *Paramount* had less to do with a "race to the bottom" or a "race to the top" and more with a heartfelt concern that a case-by-case, fact-based approach to takeovers was necessary. Takeovers are an extremely complex phenomenon, and, even now that takeovers have subsided, the jury is still out on whether the phenomenon is beneficial.

The *Paramount* court may have preferred a "mushy" test so that it could look at each case individually, assessing the relative merits of any given takeover versus its potential impact on the long-range plans of a company and the company's nonshareholder groups. Such discomfort with takeovers on the part of the court is perfectly reasonable, and need not be considered evidence of a "race to the bottom." Indeed, the United States Supreme Court, which is certainly not subject to the pressures of the chartering market, also reflected a growing suspicion of takeovers in its two decisions concerning state takeover statutes. In *Edgar v. MITE Corp.*,[114] the Court cited to the proponents of an open market for corporate control as if their theories were unassailable.[115] Five years later, in *CTS Corp. v. Dynamics Corp. of America*,[116] the Court emphasized how state corporate law need not subscribe to these very same theories.[117]

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113. Cohen, *Lipton Tells Clients that Delaware May Not be a Place to Incorporate*, Wall St. J., Nov. 11, 1988, § 2, at 7, col. 1.

114. 457 U.S. 624 (1982).

115. *Id.* at 643-44. The Court stated:

> The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1173-74 (1981) . . . .

Id.

116. 481 U.S. 69 (1987).

117. *Id.* at 92. The Court states:

> Appellee Dynamics responds to this concern by arguing that the prospect of coercive tender offers is illusory, and that tender offers generally should be favored because they reallocate corporate assets into the hands of management who can use them most effectively. *See generally* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender*

IV. CONCLUSION

This commentary has explored the mixed merits of *Paramount*'s "mushy," fact-based approach to target defensive actions. Although this commentary has critiqued the approach from a theoretical standpoint, it has also shown the practical benefits of the approach. Because the merits of takeovers are themselves so ambiguous, this commentary has suggested that it might be preferable for courts to approach takeover issues slowly and flexibly, through a case-by-case, fact-based analysis.

But even if a mushy, case-by-case approach is a good judicial strategy, that is not to suggest that takeover jurisprudence can replace the need for thoughtful planning at the legislative and executive levels. Policymakers must begin to grapple head-on with the big picture issues raised by the takeovers: Are our tax laws encouraging the use of too much debt? Do we need more active legislative intervention to help dislocated workers? Can our laws be changed to better promote long-term corporate planning? Mush might make good jurisprudence. It does not substitute for good economic and social policy.

> *Offer*, 94 Harv. L. Rev. 1161 (1981). As indicated *supra*, . . . Indiana's concern with tender offers is not groundless. Indeed, the potentially coercive aspects of tender offers have been recognized by the SEC . . . and by a number of scholarly commentators . . . . *The Constitution does not require the States to subscribe to any particular economic theory.* We are not inclined "to second-guess the empirical judgments of lawmakers concerning the utility of legislation . . . ."

Id. (emphasis added) (quoting Kassel v. Consolidated Freightways Corp., 450 U.S. 662, 679 (1981) (Brennan, J., concurring)). *See also id.* at 92 n.13.