UNOCAL AT 20: DIRECTOR PRIMACY IN CORPORATE TAKEOVERS

BY STEPHEN M. BAINBRIDGE*

ABSTRACT

In Unocal Corp. v. Mesa Petroleum Co., *the Delaware Supreme Court made clear that the board of directors of a target corporation "is not a passive instrumentality" in the face of an unsolicited tender offer or other takeover bid. To the contrary, so long as the target board's actions are neither coercive nor preclusive, the target's board remains "the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders."*

Unocal *is almost universally condemned in the academic corporate law literature. Building on his director primacy model of corporate governance and law, however, Bainbridge offers a defense of* Unocal *in this article. Bainbridge argues that* Unocal *strikes an appropriate balance between two competing but equally legitimate goals of corporate law: on the one hand, because the power to review differs only in degree and not in kind from the power to decide, the discretionary authority of the board of directors must be insulated from shareholder and judicial oversight in order to promote efficient corporate decision making; on the other hand, because directors are obligated to maximize shareholder wealth, there must be mechanisms to ensure director accountability. The* Unocal *framework provides courts with a mechanism for filtering out cases in which directors have abused their authority from those in which directors have not.*

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*Professor, UCLA School of Law. This article is based on the Francis G. Pileggi Distinguished Lecture in Law delivered by the author at Widener University School of Law, September 16, 2005. I thank Jack Jacobs and Leo Strine for their thoughtful comments on an earlier draft.

TABLE OF CONTENTS

I. INTRODUCTION

Who decides whether a transaction is beneficial for the corporation? Although questions of this sort pervade corporate governance, few transactions present it so starkly as does an unsolicited tender offer. Are such transactions mere "transfers of stock by stockholders to a third party" that do not "implicate the internal affairs of the target company"?[1] Or, as with most aspects of corporate governance, does the target company's board of directors have a gatekeeping function?[2]

In statutory acquisitions, such as mergers or asset sales, the target's board of directors' gatekeeping function is established by statute. If the board rejects a proposed transaction, the shareholders are neither invited to, nor entitled to, pass on the merits of that decision.[3] Only if the target's board of directors approves the transaction are the shareholders invited to ratify that decision.[4]

In nonstatutory acquisitions, such as tender offers, the answer is more complicated. A tender offer enables the bidders to go directly to the shareholders of the target corporation, bypassing the board of directors.[5] When the hostile tender offer emerged in the 1970s as an important acquirer tool, lawyers and investment bankers working for target boards responded by developing defensive tactics designed to impede such offers.[6] Takeover defenses reasserted the target board's primacy by extending the board's gatekeeping function to the nonstatutory acquisition setting.

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[1]Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).

[2]*See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 521 (1992) (suggesting "the fundamental governance question presented by unsolicited offers" is whether the "right to decide whether to accept or reject the offer reside[s] with the shareholders or is it, like all other important policy questions, initially a decision for the board to make until it reveals itself to be disabled by self-interest").

[3]*See* Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 321-22 (1987) (explaining corporate law vests the decision to reject a merger in the unilateral discretion of the target corporation's board of directors).

[4]*See, e.g.*, 3 MODEL BUS. CORP. ACT ANN. § 11.04 (b) (3d ed. Supp. 2000-2002) (providing that "*after* adopting the plan of merger . . . the board of directors must submit the plan to the shareholders for their approval") (emphasis added).

[5]*See* Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 844 (1993) (explaining "takeovers . . . , in contrast to mergers, are achieved by tender offers to the shareholders, and thus bypass incumbent management's approval").

[6]*See generally* PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 167-234 (3d ed. 2002) (tracing the development of takeover defenses).

The Delaware Supreme Court came down in favor of a target board gatekeeping function in *Unocal Corp. v. Mesa Petroleum Co.*[7] Although the court carefully refrained from giving target boards of directors *carte blanche* to preclude an unsolicited tender offer from going forward, the court made clear "a board of directors is not a passive instrumentality."[8] Later decisions confirmed that so long as the target board's actions are not "draconian," i.e., so long as the defensive measures undertaken are neither "coercive" nor "preclusive,"[9] the board remains not just a gatekeeper but rather "the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders."[10]

Over the last twenty years, academics and others have subjected *Unocal* to unrelenting criticism.[11] On *Unocal*'s fifteenth anniversary, writing in this *Journal*, Gilson deemed it "a failure."[12] Johnson and Siegel called it a "toothless standard," dismissing it as "fairly inconsequential."[13] Loewenstein likewise damned it as "a toothless tiger."[14] Regan claimed it gives target directors "a fairly forgiving, if not entirely free, pass."[15] Thompson and Smith view it as "a dead letter."[16] And so on.[17]

In contrast, my thesis herein is that *Unocal* and its progeny should be praised for having grappled—mostly successfully—with the core problem of corporation law: the tension between authority and accountability. A fully specified account of corporate law must incorporate

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

[8]*Id.* at 954.

[9]Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387-88 (Del. 1995).

[10]*Id.* at 1388.

[11]*Cf.* Burcham v. Unison Bancorp, Inc., 77 P.3d 130, 149 (Kan. 2003) (noting "despite criticism from outside sources, the Delaware courts, and with rare exceptions other jurisdictions, have continued to apply the *Unocal* test for over 20 years in a variety of fact patterns").

[12]Ronald J. Gilson, Unocal *Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 512 (2001).

[13]*See* Johnson & Siegel, *supra* note 3, at 330-31.

[14]Mark J. Loewenstein, Unocal *Revisited: No Tiger in the Tank*, 27 J. CORP. L. 1, 3 (2001).

[15]Paul L. Regan, *Delaware Court of Chancery Invalidates Limited Duration No-Hand Poison Pill*, 21 BANK & CORP. GOVERNANCE L. REP. 900, 904 (1999).

[16]Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 286 (2001).

[17]For a now somewhat dated summary of the academic literature on takeovers, along with a bibliography, see George Bittlingmayer, *The Market for Corporate Control (Including Takeovers)*, *in* 3 ENCYCLOPEDIA OF LAW & ECONOMICS 725 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000), *available at* http://users.ugent.be/~gdegeest/5640book.pdf.

both values.[18] On the one hand, corporate law must implement the value of authority in developing a set of rules and procedures providing efficient decision making. As we shall see, U.S. corporate law does so by adopting a system of director primacy. In this system, control is vested not in the hands of the firm's so-called owners, the shareholders, who exercise virtually no control over either day-to-day operations or long-term policy, but in the hands of the board of directors and their subordinate professional managers.[19] On the other hand, the separation of ownership and control in modern public corporations obviously implicates important accountability concerns, which corporate law must also address.

Unocal's academic critics typically err because they are preoccupied with accountability at the expense of authority.[20] In contrast, or so I will argue, Delaware's takeover jurisprudence recognizes that both authority and accountability have value.[21]

Achieving the proper mix between these competing values is a daunting—but necessary—task. Ultimately, authority and accountability cannot be reconciled.[22] At some point, greater accountability necessarily makes the decision-making process less efficient. Making corporate law therefore requires a careful balancing of these competing values. Striking such a balance is the peculiar genius of *Unocal* and its progeny.[23]

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[18]*See* Dooley, *supra* note 2, at 463 (arguing neither authority nor accountability standing alone "could provide a sensible guide to the governance of firm-organized economic activity because each seeks to achieve a distinct and separate value that is essential to the survival of any firm. Accordingly, any feasible governance system must and does contain elements of both . . . .").

[19]*See infra* Part II.

[20]Arguments that there are "systemic agency cost effects of management resistance" are a staple of the shareholder primacy-oriented academic literature. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 171-74 (1991) (invoking this argument to justify their management passivity rule); Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 993-94 (2002) (discussing the role of the hostile takeover as a constraint on agency costs).

[21]The Delaware Supreme Court has rejected the academic criticism of *Unocal*. *See, e.g.*, Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 n.18 (Del. 1990) (rejecting criticism by Johnson and Siegel). The court, moreover, has consistently reaffirmed the *Unocal* analysis. *See, e.g.*, Williams v. Geier, 671 A.2d 1368, 1371 (Del. 1996) (concluding, however, that *Unocal* did not apply on the facts of that case).

[22]*See* Dooley, *supra* note 2, at 464 (noting that authority and accountability "are also antithetical, and more of one means less of the other").

[23]Other explanations for Delaware's takeover jurisprudence are possible, but ultimately prove unpersuasive. According to some commentators, for example, this body of law is simply another instance of the so-called race to the bottom. *See* Bartley A. Brennan, *Current Developments Surrounding the Business Judgment Rule: A "Race to the Bottom" Theory of Corporate Law Revived*, 12 WHITTIER L. REV. 299, 314 (1991) (noting that "those who espouse a 'race to the bottom' theory see *Unocal* as another example of shareholders losing at the expense

Part II of this article resorts to first principles to lay out the argument both for the necessity of balancing authority and accountability and for according a presumption in favor of the former. Part III traces the origins of the *Unocal* standard. Part IV explains why *Unocal* was correct to reject the various forms of managerial passivity proposed by academic critics of Delaware law. Finally, Part V evaluates the further evolution of Delaware law, advancing an interpretation of that law in which motive is the critical inquiry.

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of management and lawyers"). As the race to the bottom theory goes, a significant proportion of Delaware's revenues come from corporation franchise fees, which gives Delaware strong incentives to attract incorporations. Because the state of incorporation will be selected by the firm's management, Delaware law will generally tend to favor management over shareholders. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 705 (1974) (coining the phrase "race for the bottom"). I am skeptical that the race to the bottom hypothesis explains *Unocal* or, for that matter, corporate lawmaking generally. In the long run, investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management. Nor will lenders lend to such firms without compensation for the risks posed by management's lack of accountability. Those firms' cost of capital will rise, while their earnings will fall. Corporate managers have many strong incentives to assure that their state of incorporation offers rules preferred by investors, not the least of which is that management compensation and wealth are often closely tied to firm earnings and performance. Excessively pro-management rules thus should fall gradually by the wayside. To be sure, the process functions neither smoothly nor flawlessly. It does work, though, and empirical research suggests that efficient solutions to corporate law problems win out over time. *See generally* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 64-73 (2002) (discussing the relevant studies and criticisms thereof). Admittedly, there are those who argue that takeovers are a special situation in which competition for incorporations does not lead to efficient rules. *E.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1486-88 (1992) (arguing that because takeovers involve significant externalities, state competition does not lead to efficient takeover rules). But is it not striking, to take an example from the legislative arena, that Delaware was one of the last states to adopt anti-takeover legislation and, when it did so, adopted a relatively weak statute? Romano, *supra* note 5, at 846. Unless one unrealistically expects the market for corporate charters to be perfectly efficient, the race for the top hypothesis still has more explanatory power than its converse.

Alternatively, perhaps courts tolerate defensive tactics because they perceive tender offers as affecting not only shareholders but also other corporate stakeholders. *Unocal* lent some support to this hypothesis when it permitted the target's board to consider "the impact [of the bid] on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)" in whether the bid posed a cognizable threat. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). In *Revlon*, however, the Delaware Supreme Court expressly forbade management from protecting stakeholder interests at the expense of shareholder interests; rather, any management action benefitting stakeholders must produce ancillary shareholder benefits. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). In certain corporate control auctions (sometimes referred to as *Revlon*-land), moreover, directors may not consider any interest other than shareholder wealth maximization. *Id.* If protecting nonshareholder constituencies was ever a motivating factor for the Delaware courts, their concern proved short-lived. For a critique of arguments seeking to justify target board of director resistance to takeovers on such concerns, see Bebchuk, *supra* note 20, at 1021-27.

II. WHO DECIDES? FIRST PRINCIPLES

If the corporation is properly conceptualized as a form of private property, answering this Part's titular question—who decides—would be trivial. Directors would be mere stewards of the corporation's owners; i.e., the shareholders. By what right could such stewards preclude their principals from selling the principals' property?

On the other hand, if the corporation is properly conceptualized as the nexus of a set of contracts among many different constituencies, the question becomes much more difficult. If efficient governance of this complex contractual construct required vesting some central authority with the power of fiat, moreover, it seems plausible that such an authority would have, at the very least, a gatekeeping function in determining the terms on which shareholders should be allowed to assign their contractual interests in the corporation to some outsider.

Deciding who decides thus requires an inquiry into first principles. What is the nature of the corporation? What is the nature of the shareholders' relationship to the corporation? What is the proper role and function of the board of directors? And so on.[24]

A. *Property or Contract?*

The notion the corporation is an entity owned by its shareholders long dominated American legal thought.[25] Berle and Means famously referred to the "[s]eparation of ownership and control,"[26] for example, observing that the owners of a public corporation—i.e., the

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[24]The analysis in this section draws heavily on my recent work on director primacy. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Director Primacy*]; Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002) [hereinafter Bainbridge, *Board as Nexus*]. Readers familiar with those articles likely may skip this Part without losing too much of the thread of the argument, although I trust this Part will not just recapitulate but also update and elaborate on my earlier work. For a constructive critique of my director primacy model, see Wayne O. Hanewicz, *Director Primacy,* Omnicare, *and the Function of Corporate Law*, 71 TENN. L. REV. 511 (2004). For an instructive application of the model to shareholder voting, see Harry G. Hutchison, *Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm*, 36 LOY. U. CHI. L.J. 1111 (2005).

[25]*See* William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1071 (2002) (noting "the 'property' and the 'entity' models that have dominated American corporation law scholarship and jurisprudence for the last one hundred years").

[26]ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4-5 (1933).

shareholders—exercised virtually no control over it.[27] More recently, Eisenberg explicitly argued shareholders possess most of the incidents of ownership, which he identified as including "the rights to possess, use, and manage, and the rights to income and to capital."[28] Accordingly, he claimed, shareholders own the corporation.[29]

In fact, however, it is error to conceptualize the corporation as a thing capable of being owned. Shareholders have no right to use or possess corporate property.[30] Management rights are assigned by statute solely to the board of directors and those officers to whom the board properly delegates such authority.[31] Indeed, to the extent that possessory and control rights are the indicia of a property right, the board of directors is a better candidate for identification as the corporation's owner than are the shareholders. As an early New York opinion put it, "[T]he directors in the performance of their duty possess [the corporation's property], and act in every way as if they owned it."[32]

Conceptualizing the corporation as a thing capable of being owned, moreover, requires one to reify the corporation as an entity separate from its various constituents. While reification provides a necessary semantic shorthand,[33] it creates a sort of false consciousness when taken to extremes. The corporation is not a thing. The corporation is a legal fiction representing the unique vehicle by which large groups of individuals, each offering a different factor of production, privately order their relationships so as to collectively produce marketable goods or services.[34] To facilitate this process of private ordering, the state's corporation code offers a basic

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[27] *Id.* at 82-83.

[28] Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 825 (1999).

[29] *Id.*

[30] *Cf.* W. Clay Jackson Enters., Inc. v. Greyhound Leasing & Fin. Corp., 463 F. Supp. 666, 670 (D.P.R. 1979) (stating "even a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation's property").

[31] *See infra* notes 44-49 and accompanying text.

[32] Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).

[33] On the uses and misuses of reification, see WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 117-18 (9th ed. 2004).

[34] *See generally* G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 894-95 (2000) (arguing that the corporation consists of a set of contracts among factors of production). The statement in the text is a slightly stronger version of the claim than I have offered elsewhere. For a more nuanced inquiry into the nature of the corporation, but one unnecessary to deploy in this context, see Bainbridge, *Board as Nexus*, *supra* note 24, at 16-17.

set of default rules that the parties are free generally to accept, reject, or modify as they see fit.[35]

To summarize, the corporation is properly understood as a legal fiction representing the nexus of a set of contracts among the multiple factors of production provided by the organization's various constituencies.[36] Because shareholders are simply one of the inputs bound together by this web of voluntary agreements, ownership is not a meaningful concept as applied to the corporation.[37]

B. *The Shareholders' Contract*

Jettisoning the notion that the corporation is a thing capable of being owned radically changes our understanding of the shareholders' relationship with the corporation. Rather than owning the corporation itself, the shareholders merely own the residual claim on the corporation's assets and earnings.[38] As a result, shareholders are not inherently privileged relative to other corporate constituents. Instead, as with the rights of other corporate constituents, the rights of shareholders are established through bargaining, even though the form of the bargain typically is a take-it-or-leave-it standard form contract provided off-the-rack by the default rules of corporate law and the corporation's organic documents.[39] In many respects, the interesting thing about the shareholders' contract is not the rights it confers but the very substantial limitations it imposes on those rights.

Consider, for example, the principal right that flows from the shareholders' status as the corporation's residual claimants; i.e., the requirement that corporate decisions be directed to the end of shareholder wealth. As the Michigan Supreme Court famously observed, "[I]t is not within the lawful powers of a board of directors to shape and conduct the

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[35]*See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 29-31 (2002) (discussing the role of default rules in corporate law).

[36]Bainbridge, *Board as Nexus*, *supra* note 24, at 16-17. As no less an authority than former Delaware Chancellor William Allen has acknowledged, contractarianism is now the "dominant legal academic view." William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993).

[37]Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980).

[38]*See generally* Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101, 102-03 (1985) (arguing that shareholders hold the residual claim and will prefer a rule maximizing the market value of that residual claim); *see also* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 184 (1996) (arguing that shareholders have residual claimant status with respect to both earnings and asset liquidation).

[39]*See* BAINBRIDGE, *supra* note 35, at 33 (noting that corporate law "rules function as a substitute for private bargaining").

affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefitting others."[40] The Delaware Court of Chancery has similarly opined that "[i]t is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders."[41] While the law clearly establishes shareholder wealth maximization as one of the default contractual rights of shareholders,[42] the business judgment rule effectively precludes courts from reviewing corporate decisions that allegedly further interests other than that of shareholder wealth maximization.[43]

The housekeeping rules of corporate governance likewise effectively preclude shareholders from using the voting process to discipline directors who deviate from the shareholder wealth maximization norm. Under all corporation statutes, the vast majority of corporate decisions are assigned to the board of directors or their subordinates acting alone.[44] As the Delaware code puts it, the corporation's business and affairs "shall be managed by or under the direction of a board of directors."[45] The vast majority of corporate decisions accordingly are made by the board of

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[40]Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919). For an interesting interpretation of *Dodge*, which argues that the shareholder wealth maximization norm originated as a means for resolving disputes among majority and minority shareholders in closely held corporations, see D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998). For my argument to the contrary, see Bainbridge, *Director Primacy*, *supra* note 24, at 575 n.143.

[41]Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

[42]*See generally* BAINBRIDGE, *supra* note 35, at 410-14 (reviewing the relevant case law).

[43]*See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 778-80 (Ill. App. 1968) (dismissing the plaintiff-shareholder's suit on business judgment rule grounds despite the plaintiff's uncontested allegations that the defendants had favored the interests of various nonshareholder constituencies). The principal exception to this rule is where directors rely on nonshareholder interests to justify takeover defenses, which do not necessarily get business judgment rule protection. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986).

Although Delaware has not done so, over half of the other states have adopted so-called nonshareholder constituency statutes, which expressly permit the board of directors to consider the effects of a corporate decision on nonshareholder interests. *See, e.g.*, 15 PA. CONS. STAT. ANN. § 1715(a) (West 1995). As I have argued elsewhere, these laws qualify traditional shareholder wealth maximization norm by allowing the board to make trade-offs between shareholder and stakeholder interests. *See* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 989-96 (1992) [hereinafter Bainbridge, *Interpreting Nonshareholder Constituency Statutes*]. As such, the statutes work an unfortunate change in the basic normative principles underlying corporate law. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993) (criticizing these statutes).

[44]All state corporate codes provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to further delegate power to subordinate firm agents. *See* 2 MODEL BUS. CORP. ACT ANN. § 8.01, 8-10 to 8-10A (3d ed. Supp. 2000-2002) (reviewing statutes).

[45]DEL. CODE ANN. tit. 8, § 141(a) (2001).

directors alone (or by managers acting under delegated authority).[46] The statutory decision-making model therefore is one in which the board acts and shareholders, at most, react. Control, put simply, is vested in the board, not the shareholders.[47] Shareholders have virtually no power to initiate corporate action; indeed, they are entitled to approve or disapprove only a few board actions.[48] The direct restrictions on shareholder power thus supplied by U.S. corporate law, moreover, are supplemented by a host of other economic and legal forces that prevent U.S. investors from exercising significant influence over corporate decision making.[49]

C. *Fiat by Contract*

If we think of corporate law as providing a set of off-the-rack default rules that lay out the terms of the contracts for which the corporation serves as a nexus, why do those rules provide shareholders with such limited control rights? Put another way, why is the corporate form seemingly designed to separate ownership (of the residual claim) from control?

The answer to that question starts with Coase's famous observation that when a corporate employee moves from department Y to department X he does so not because of change in relative prices, but because he is ordered to do so.[50] In other words, once the initial relationship is formed,

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[46]Of course, operational decisions normally are delegated by the board to subordinate employees. The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board's exclusive determination. *See, e.g.*, Lee v. Jenkins Bros., 268 F.2d 357, 370 (2d Cir. 1959); Lucey v. Hero Int'l Corp., 281 N.E.2d 266, 269 (Mass. 1972).

[47]For an analysis of why only shareholders and no other corporate constituents possess even these limited voting and control rights, see BAINBRIDGE, *supra* note 35, at 464-72.

[48]Formal shareholder control rights are so weak they scarcely qualify as part of corporate governance. Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 174-77 (1995) (summarizing state corporate law on shareholder voting entitlements). As a formal matter, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible. DEL. CODE ANN., tit. 8, §§ 109, 211 (2001). In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board. *See* Bayless Manning, *Book Review*, 67 YALE L.J. 1477, 1485-89 (1958) (reviewing J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958)) (describing incumbent control of the proxy voting machinery); *see generally* Michael P. Dooley, *Controlling Giant Corporations: The Question of Legitimacy*, *in* CORPORATE GOVERNANCE: PAST & FUTURE 28, 38 (Henry G. Manne ed., 1982) (observing "the limited governance role assigned to shareholders is intentional and is, in fact, the genius of the corporate form").

[49]*See generally* BAINBRIDGE, *supra* note 35, at 512-14 (summarizing constraints).

[50]R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 387 (n.s. 1937).

ongoing relationships within corporations are frequently determined by command-and-control rather than bargaining.

There are several reasons organizing economic activity via fiat may be preferable to bargaining. Where production requires some form of team effort, for example, bringing economic activity within the boundaries of the firm can reduce search and related bargaining costs.[51] Bringing together employees, creditors, equity investors, and other necessary factors of production requires on-going interactions too complex to be handled through a price mechanism.[52] The corporation solves that problem by creating a centralized contracting party—namely, the board of directors and its subordinate officers—charged with seeking out the necessary inputs and bringing them together for productive labor.[53]

Fiat can also lower costs associated with uncertainty, opportunism, and complexity.[54] Given the limits on cognitive competence implied by bounded rationality,[55] incomplete contracts are the inevitable result of the

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[51]The canonical example is Adam Smith's study of pin manufacturing. Smith observed that pin making requires eighteen distinct operations. A substantial synergistic effect resulted when a team was organized in which each operation was conducted by a separate individual: the team was able to produce thousands of pins a day, while an individual alone might produce one pin a day at best. ADAM SMITH, THE WEALTH OF NATIONS 4-5 (Modern Library ed. 1937). In theory, production teams of this sort can be organized through some form of decentralized price mechanism. *See* Sherwin Rosen, *Transaction Costs and Internal Labor Markets*, *in* THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 75, 78 (Oliver E. Williamson & Sidney G. Winter eds., 1991) (describing historical examples of quasi-assembly line production processes involving independent craftsmen transacting across a small local market).

[52]Rosen, *supra* note 51, at 84-85.

[53]Coase, *supra* note 50, at 392.

[54]Uncertainty arises in business relationships because it is difficult to predict the future conditions the parties will face. Opportunism arises because parties to a contract are inevitably tempted to pursue their own self-interests at the expense of the collective good, which in market transactions leads to contract breaches requiring resort to costly enforcement mechanisms. Complexity arises when the parties attempt to contractually specify how they will respond to a given situation. As the relationship's term lengthens, it necessarily becomes more difficult to foresee the needs and threats of the future, which in turn presents an ever-growing myriad of contingencies to be dealt with. *See generally* Dooley, *supra* note 2, at 471-512 (explaining how these costs relate to the theory of the firm). The three factors are not wholly independent. Uncertainty can result from opportunistic behavior, for example, where there is strategic nondisclosure or deliberate distortion of information. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 57 (1985).

[55]The term "bounded rationality" was coined by Herbert Simon. *See* HERBERT A. SIMON, MODELS OF MAN: SOCIAL AND RATIONAL 198 (1957). According to the theory of bounded rationality, economic actors seek to maximize their expected utility, but the limitations of human cognition often result in decisions that fail to maximize utility. Decision makers inherently have limited memories, computational skills, and other mental tools, which limit their ability to gather and process information. *See generally* Roy Radner, *Bounded Rationality, Indeterminacy, and the Theory of the Firm*, 106 ECON. J. 1360, 1362-68 (1996) (providing an especially detailed taxonomy of the various forms bounded rationality takes, with special emphasis on the theory's

uncertainty and complexity inherent in on-going business relationships.[56] In turn, incomplete contracts leave greater room for opportunistic behavior. According to the Coasean theory of the firm, firms arise when it is possible to lower these costs by delegating to a team member the power to direct how the various inputs will be utilized by the firm.[57] In the corporate setting, the board of directors effectively is empowered to unilaterally rewrite terms of many of the contracts between the corporation and its various constituents.[58]

In other words, while it is commonplace and correct to say that the corporation is a nexus of contracts, the corporation also must have a nexus for those contracts. After all, to say that the firm is a nexus is to imply the existence of a core or kernel capable of contracting. But kernels do not contract; people do. The necessity for a centralized decision maker capable of making adaptive changes by fiat thus emerges as the defining characteristic of the Coasean firm.[59]

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relevance with respect to the organization for firms).

[56]*See* WILLIAMSON, *supra* note 54, at 30-32, 45-46 (arguing that complete contracts are at best costly and may prove impossible under the specified conditions); *see also* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 23 (1975) (arguing that, under conditions of uncertainty and complexity, it becomes "very costly, perhaps impossible, to describe the complete decision tree").

[57]Coase, *supra* note 50, at 393.

[58]Oliver Williamson's transaction costs economics offers a more robust account of the costs associated with bargaining that can be reduced through hierarchical ordering of production within a firm, among which are informational asymmetries, bilateral monopolies, and incomplete contracting. Oliver E. Williamson, *Introduction*, *in* NATURE OF THE FIRM, *supra* note 51, at 3, 4. In particular, Williamson emphasizes that uncertainty and complexity do not provide a sufficient explanation for the emergence of *ex post* governance structures. Instead, one must also introduce some form of asset specificity, of which the most important for present purposes is the firm-specific human capital of the firm's agents. WILLIAMSON, *supra* note 54, at 30-32. For a critique of the transaction cost literature in this area, see Harold Demsetz, *The Theory of the Firm Revisited*, 4 J. L. ECON. & ORG. 141, 144-54 (1988).

[59]Obviously, fiat within firms has limits. Some choices are barred by contract, such as negative pledge covenants in bond indentures. Other choices may be barred by regulation or statute. Still other choices may be unattractive for business reasons, such as those with potentially adverse reputational consequences. Within such bounds, however, adaptation effected through fiat is the distinguishing characteristic of the corporation. Bainbridge, *Board as Nexus*, *supra* note 24, at 24.

In a classic article, Armen Alchian and Harold Demsetz rejected this understanding of the corporation. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972). They argued a firm has no power of fiat; instead, an employer's power to direct its employees does not differ from a consumer's power to direct his grocer. *Id.* at 777-78. Alchian and Demsetz may well be right that Coase erred in treating the firm as a nonmarket institution in which prices and contracts are of relatively little consequence, but there is no necessary contradiction between a theory of the firm characterized by command-and-control decision making and the contractarian model. The set of contracts making up the firm consists in very large measure of implicit agreements, which by

The Coasean central decision maker need not be an autocrat, however, as illustrated by the collegial decision-making processes of many small firms. Why then do large corporations tend to have hierarchical decision-making structures? Kenneth Arrow's seminal work on organizational decision making defined two basic decision-making structures: "consensus" and "authority."[60] Consensus is utilized where each member of the organization has identical information and interests and therefore will select the course of action preferred by all the other team members.[61] In contrast, authority-based decision-making structures arise where team members have different interests and amounts of information. They are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.[62]

It is very hard (if not impossible) to imagine a modern public corporation that could be effectively run using consensus-based decision-making mechanisms. The necessity of an actual nexus—a central decision maker capable of exercising fiat—thus follows in large part from the asymmetries of information and interests among the corporation's various constituencies. Shareholders care about the value of the residual claim on the corporation. Customers care about the quality and quantity of the goods produced by the corporation. Workers care about salary and conditions of employment. And so on. Under such conditions, efficient decision making demands an authority-based governance structure in which information is channeled to a central decision maker empowered to make choices binding on the firm as a whole.[63]

Consider the difficulties that would be faced by shareholders, who are conventionally assumed to be the corporate constituency with the best claim on control of the decision-making apparatus, if they were actually

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definition are both incomplete and unenforceable. As we have just seen, under conditions of uncertainty and complexity, the firm's many constituencies cannot execute a complete contract, so that many decisions must be left for later contractual rewrites imposed by fiat. It is precisely the unenforceability of implicit corporate contracts that makes it possible for the central decision maker to rewrite them more-or-less freely. The parties to the corporate contract presumably accept this consequence of relying on implicit contracts because the resulting reduction in transaction costs benefits them all. Thus, it is possible to harmonize the Coasean and contractarian models without having to reject a theory of the firm characterized by fiat. Bainbridge, *Board as Nexus*, *supra* note 24, at 24-25 (reiterating this argument).

[60]KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974).

[61]*Id.* at 69.

[62]*See id.* (providing examples of authority-based decision-making structures).

[63]*Cf. id.* at 69 ("Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success.").

asked to exercise control.[64] At the most basic level, the mechanical difficulties of achieving consensus among thousands of decision makers impede shareholders from taking an active role. Even if those collective action problems could be overcome, moreover, active shareholder participation in corporate decision making would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information. As to the former, while neoclassical economics assumes shareholders come to the corporation with wealth maximization as their goal (and most presumably do so), once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course will maximize share value.[65] As to the latter, shareholders lack incentives to gather the information necessary to actively participate in decision making and thus are rationally apathetic.[66]

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[64]I follow convention here without attempting to justify the limitation of voting rights to shareholders. For a defense of that convention, see Stephen M. Bainbridge, *Privately Ordered Participatory Management*, 23 DEL. J. CORP. L. 979, 1060-75 (1998).

[65]As my colleague Iman Anabtawi observes: "On close analysis, shareholder interests look highly fragmented." Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006). She documents divergences among investors along multiple fault lines: short-term versus long-term, diversified versus undiversified, inside versus outside, social versus economic, and hedged versus unhedged. *Id.* at 577-93. *Cf.* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 616 (1995) (stating that "in a world of costly and imperfect information, rational investors are likely to form heterogeneous expectations—that is, to make different forecasts of stocks' likely future performance").

[66]A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs. Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have any significant effect on the vote's outcome. ROBERT C. CLARK, CORPORATE LAW 390-92 (1986). The problem is compounded by the likelihood that a substantial number of shareholders will attempt to freeload on their fellow shareholders. *Id.* at 392-93.

The efficient capital markets hypothesis provides yet another reason for shareholders to eschew active participation in the governance process. This hypothesis claims that in an efficient market current prices always and fully reflect all relevant publicly available information about the commodities being traded. *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (discussing the "gulf" between the market efficiency theories in legal and economic scholarship). If the market is a reliable indicator of performance, as the efficient capital markets hypothesis claims, investors can easily check the performance of companies in which they hold shares and compare their current holdings with alternative investment positions. An occasional glance at the stock market listings in the newspaper is all that is required. Because shareholder apathy makes it easier to switch to a new investment than to fight the incumbent managers, a shareholder need not even know why one firm's performance is faltering. With the expenditure of much less energy than is needed to read corporate disclosure statements, he can simply sell his holdings in the struggling firm and move on to other investments. *But see infra* note 156 (citing authorities questioning the efficient capital markets hypothesis as it relates to takeover premia). For critiques of the hypothesis, see generally

Consequently, it is hardly surprising that the modern public corporation's decision-making structure precisely fits Arrow's model of an authority-based decision-making system. This must be so because neither shareholders, employees, nor any other constituency have the information or the incentives necessary to make sound decisions on either operational or policy questions.[67] Overcoming the collective action problems that prevent meaningful involvement by the corporation's various constituencies would be difficult and costly. Under these conditions, Arrow predicts, it is "cheaper and more efficient to transmit all the pieces of information [at] once to a central place" and to have the central office "make the collective decision and transmit it rather than retransmit all the information on which the decision is based."[68] As we have seen, it is the board of directors that functions as that central office.[69]

Donald A. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992) (outlining the various economic models offered to explain market efficiency and proposing that the capital market mechanisms and information markets cooperate to enable capital market efficiency); Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475 (1997) (finding the hypothesis useful in describing a rational investor's tolerance for risk versus return but incomplete in its theory that market price reflects intrinsic value).

[67]In large corporations, the desirability of authority-based decision-making structures is enhanced by the division of labor it makes possible. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize. CLARK, *supra* note 66, at 802. Managers specialize in the efficient coordination of other specialists. Directors specialize in the efficient coordination of managers. In order to reap the benefits of specialization, all other corporate constituents should prefer to specialize in functions unrelated to decision making, such as risk-bearing (shareholders) or labor (employees), and delegate decision making to managers. Put another way, economies of scale in the information transmission process can be achieved only by elite control of organizations. Kenneth J. Arrow, *Scale Returns in Communication and Elite Control of Organizations*, 7 J. L. ECON. & ORG. (SPECIAL ISSUE) 1, 1 (1991). This natural division of labor between capital and management, however, requires that the chosen managers be vested with discretion to make binding decisions. Thus, separating ownership and control by vesting decision-making authority in a centralized entity distinct from the corporation's various constituencies is what makes the large public corporation feasible.

[68]ARROW, *supra* note 60, at 68-69.

[69]*Cf.* William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1296 (2001), *reprinted in* 26 DEL. J. CORP. L. 859, 869 (2001) (endorsing "a corporate law regime which affords substantial freedom of action to disinterested, well-motivated directors"). The board of directors as an institution of corporate governance, of course, does not follow inexorably from the necessity for fiat. After all, an individual chief executive could serve as the hypothesized central coordinator. Yet, corporate law vests ultimate control in the board. Why? I have elsewhere suggested two answers to that question: (1) under certain conditions, groups make better decisions than individuals and (2) group decision making is an important constraint on agency costs. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 27-41 (2002).

D. *The Necessity for a Balance Between Authority and Accountability*

In its purest form, authority-based decision-making calls for all decisions to be made by a single, central decision-making body. If authority were corporate law's sole value, shareholders would have no voice in corporate decision making. Authority is not corporate law's only value, however, because we need some mechanism for enforcing those rights for which shareholders and other constituencies have contracted.

As we have seen, chief among the shareholders' contractual rights is one requiring the directors to use shareholder wealth maximization as their principal decision-making norm.[70] Given that the "separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge,"[71] shareholders will require mechanisms to hold directors accountable for failing—whether through oversight or intent—to comply with that norm. Indeed, some claim that "defining how agency costs can be controlled" is "the central problem of corporate law."[72]

The difficulty with all this rhetoric, however, is that a narrow focus on agency costs easily can distort one's understanding. Corporate directors operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. A variety of market forces provide important constraints. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents.

An even more important consideration is that agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant. Although we could substantially reduce agency costs by eliminating discretion but do not do so, it seems reasonable to infer that substantial efficiency gains follow from vesting the power of fiat in the board of directors. A complete theory of the firm therefore requires one to

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[70]*See supra* notes 40-43 and accompanying text.

[71]BERLE & MEANS, *supra* note 26, at 6. Modern scholars refer to this situation as the principal-agent or agency cost problem. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (setting out agency cost economics).

[72]Mark A. Sargent, *Lawyers in the Perfect Storm*, 43 WASHBURN L.J. 1, 1 (2003). *See also* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 740 (1997) (opining that the principal-agent problem between directors and shareholders is the central problem of corporate governance).

balance the virtues of discretion against the need to require that discretion be used responsibly.[73]

Thus, we cannot ignore either authority or accountability because both promote values essential to the survival of business organizations. Unfortunately, because the power to hold to account from the power to decide differs only in degree and not in kind, they are also antithetical. As Kenneth Arrow explained:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[74]

In other words, we cannot hold directors to account without undermining their discretionary authority. Establishing the proper mix of authority and accountability emerges as the real central problem of corporate governance.

E. *The Presumption in Favor of Authority*

One of the truly striking things about U.S. corporation law is the extent to which the balance between authority and accountability leans towards the former. Consider, for example, the central doctrine of corporation law; namely, the business judgment rule. The Delaware Supreme Court has explained that:

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors. . . . The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.[75]

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[73] *Cf.* Dooley, *supra* note 2, at 471 (arguing that the business judgment rule reflects a tension between "conflicting values" he refers to as "[a]uthority" and "[r]esponsibility").

[74] ARROW, *supra* note 60, at 78.

[75] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

In other words, the rule creates a presumption of deference to the board's authority as the corporation's central and final decision maker.[76]

The rule does so by establishing a limited system for case-by-case oversight in which judicial review of the substantive merits of those decisions is avoided. The court begins with a presumption against review.[77] It then reviews the facts to determine whether the decision-making process was tainted by self-dealing and the like.[78] The questions asked are objective and straightforward: Did the board commit fraud? Did the board commit an illegal act? Did the board self-deal? Whether or not the board exercised reasonable care is irrelevant, as well it should be.[79] The business judgment rule therefore builds a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board's decision.[80] This is precisely the rule for which shareholders would bargain because they would conclude that the systemic costs of judicial review exceed the benefits of punishing director misfeasance and malfeasance.[81]

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[76]*Cf.* Marx v. Akers, 666 N.E.2d 1034, 1037 (N.Y. 1996) (noting "shareholder derivative actions infringe upon the managerial discretion of corporate boards. . . . Consequently, we have historically been reluctant to permit shareholder derivative suits, noting that the power of courts to direct the management of a corporation's affairs should be 'exercised with restraint.'"); *see also* Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (noting "the derivative action impinges on the managerial freedom of directors").

[77]*See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining the rule creates a presumption that the directors or officers of a corporation "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

[78]*See, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811 (N.Y. Sup. Ct. 1976) (stating that absent "fraud, dishonesty or nonfeasance," the court would not substitute its judgment for that of the directors), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).

[79]*See, e.g.*, Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982):

> While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. . . . Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.

See also Brehm v. Eisner, 746 A.2d 244, 262-64 (Del. 2000) (rejecting plaintiff's contention that the business judgment rule includes an element of "substantive due care" and holding that the business judgment rule requires only "process due care") (emphasis omitted).

[80]BAINBRIDGE, *supra* note 35, at 269. I advanced this understanding of the business judgment rule in Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VANDERBILT L. REV. 83 (2004). Former Delaware Supreme Court Chief Justice E. Norman Veasey recently cited that article's analysis, deeming it to be "consistent with the Delaware doctrine that the rule is a presumption that courts will not interfere with, or second-guess, decision making by directors." E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1422 (2005).

[81]*See* BAINBRIDGE, *supra* note 35, at 253-69 (putting forward an economic analysis of the business judgment rule).

Strikingly, we observe what amounts to a presumption of deference even in settings where the board of directors faces potential conflicts of interest. Consider, as an example with particular relevance to the subject matter of this article, the role of the board in negotiated acquisitions.[82]

Because approval by the target's board of directors is a necessary prerequisite to most acquisition methods,[83] the modern corporate statutory scheme gives management considerable power in negotiated acquisitions. To purchase the board's cooperation, the bidder may offer side payments to management, such as an equity stake in the surviving entity, employment or noncompetition contracts, substantial severance payments, continuation of existing fringe benefits or other compensation arrangements.[84] Although it is undoubtedly rare for side payments to be so large as to materially affect the price the bidder would otherwise be able to pay target shareholders, side payments may affect management's decision making by causing them to agree to an acquisition price lower than that which could be obtained from hard bargaining or open bidding.[85]

Even where management is not consciously seeking side-payments from the bidder, a conflict of interest can still arise:

> There may be at work [in negotiated acquisitions] a force more subtle than a desire to maintain a title or office in order to assure continued salary or prerequisites. Many people commit a huge portion of their lives to a single large-

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[82]As another example, consider the rules governing interested director transactions. So long as the decisions are made by disinterested and independent directors, the net effect of the rules governing derivative litigation and the substantive standards governing such transactions is to insulate the board's substantive decisions from judicial review. Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1041-44 (1993); Dooley, *supra* note 2, at 486-91. Much the same is true of board decisions relating to management buyouts (MBOs), which involve a significant conflict of interest and therefore tend to get close judicial scrutiny, but which will receive judicial deference in appropriate cases. Bainbridge, *supra*, at 1075-79.

[83]*See* STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS 6-14 (2003) (setting out a typology of takeover mechanisms).

[84]*See, e.g.*, Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 625 (S.D.N.Y. 1987) (white knight offered target management equity stake); Singer v. Magnavox Co., 380 A.2d 969, 971 (Del. 1977) (target directors offered employment contracts); Gilbert v. El Paso Co., 490 A.2d 1050, 1053 (Del. Ch. 1984) (plaintiff alleged tender offeror modified bid to benefit target managers); Repairman's Serv. Corp. v. Nat'l Intergroup, Inc., No. 7811, slip op. at 2 (Del. Ch. Mar. 15, 1985), *reprinted in* 10 DEL. J. CORP. L. 902, 906 (1985) (plaintiff claimed target managers sought "preferences for themselves" in surviving entity).

[85]*See, e.g.*, Pupecki v. James Madison Corp., 382 N.E.2d 1030 (Mass. 1978) (plaintiff claimed that consideration for sale of assets was reduced due to side payments to controlling shareholder); Barr v. Wackman, 329 N.E.2d 180, 184 (N.Y. 1975) (plaintiff claimed target directors agreed to low acquisition price in exchange for employment contracts).

> scale business organization. They derive their identity in part from that organization and feel that they contribute to the identity of the firm. The mission of the firm is not seen by those involved with it as wholly economic, nor the continued existence of its distinctive identity as a matter of indifference.[86]

Thus, a negotiated corporate acquisition is a paradigmatic example of a final period problem.[87] In repeat transactions, the risk of self-dealing by one party is constrained by the threat that the other party will punish the cheating party in future transactions. In a final period transaction, this constraint—i.e., the threat of future punishment—disappears because the final period transaction is the last in the series.

As such, some of the various extrajudicial constraints imposed on management in the operational context also break down in corporate acquisitions. Target management is no longer subject to shareholder discipline because the target's shareholders will be bought out by the acquirer. Target management is no longer subject to market discipline because the target, by definition, will no longer operate in the market as an independent agency. As a result, management is less vulnerable to both shareholder and market penalties for self-dealing.[88]

Despite this well-known conflict of interest, Delaware corporate law definitively allocates decision-making authority to the board and, moreover, provides both substantive and procedural mechanisms ensuring a substantial degree of judicial deference to the board. The target's board possesses broad authority to determine whether to merge the firm and to select a merger partner. The initial decision to enter into a negotiated merger transaction is thus reserved to the board's collective business judgment, with shareholders having no statutory power to initiate merger negotiations.[89] The board also has sole power to negotiate the terms on which the merger will take place and to arrive at a definitive merger

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[86]Paramount Commc'ns, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,268-69 (Del. Ch. July 14, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 715 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990). While a potential conflict of interest therefore is present in all negotiated acquisitions, that conflict is usually constrained by the threat of competing bids. *See* Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 275 (1990). Where the target board of directors seeks to preclude competitive bidding by granting a lockup to the favored bidder, however, the conflict of interest becomes even more pronounced. *Id.* at 323.

[87]RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 720-21 (2d ed. 1995).

[88]*Id.*

[89]Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

agreement embodying its decisions as to these matters.[90] In general, while courts may inspect such decisions slightly more closely than they do standard operational decisions, the business judgment rule continues effectively to ensure that the considerable latitude conferred upon the board by statute may be exercised without significant risk of judicial intervention.[91]

In summary, perhaps the question should be framed not as whether courts should defer to board decisions respecting takeovers, but rather why courts should not do so. In any case, we will see that the academic analysis of management resistance to unsolicited takeover bids has almost uniformly exhibited nothing but disdain for the value of authority and deference thereto; to the contrary, the literature has been preoccupied almost exclusively with accountability concerns.[92] In sharp contrast, the Delaware courts have sought to balance authority and accountability.

III. DELAWARE STRIKES A BALANCE

Corporate takeovers undoubtedly raise significant accountability concerns. As Posner observed:

> 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.[93]

The Delaware Supreme Court recognized this conflict of interest early on, observing in *Bennett v. Propp*[94] that "[w]e must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to

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[90]DEL. CODE ANN. tit. 8, § 251(b) (2004). Shareholders have no statutory right to amend or veto specific provisions, their role being limited to approving or disapproving the merger agreement as a whole, with the statute requiring only approval by a majority of the outstanding shares. *Id.* § 251(c).

[91]*See* E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997) (drawing a distinction between "enterprise" and "ownership" decisions with respect to judicial review of board actions).

[92]*See* Gilson, *supra* note 12, at 495-96 (summarizing the academic view of takeovers).

[93]Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

[94]187 A.2d 405 (Del. 1962).

corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult."[95]

As we have seen, however, measures intended to promote accountability inevitably implicate the values of authority. Seeking to hold directors accountable for their decisions necessarily reduces the efficiency of corporate decision making. Conversely, of course, deference to the board's authority necessarily entails a risk of opportunism and even plain carelessness. Accordingly, as explained in Part II.D, choosing the appropriate balance between authority and accountability is the central problem of corporate law jurisprudence. In this Part, we trace the evolution of Delaware's balance between the two in the takeover arena.

A. Cheff v. Mathes: *Delaware's First Try*

Cheff v. Mathes[96] long was Delaware's leading case on the validity of takeover defenses. In *Cheff*, the Delaware Supreme Court laid down a set of rules that purported to restrict a target board's ability to resist hostile takeovers, but in fact, the rules did very little to do so. The target was a company called Holland Furnace, which marketed its products using a set of remarkably fraudulent tactics. Holland salesmen went door to door posing as government or utility inspectors. Once they had received access to the homeowner's furnace, the salesmen would dismantle it and refuse to reassemble it. The salesmen would inform the homeowner that the furnace was unsafe and that parts necessary to make it safe were unavailable. The homeowner would then be sold a replacement Holland furnace.[97] Because of government investigations into these unsavory practices, Holland's stock was performing poorly.

Arnold Maremont proposed a merger between Holland and Maremont's Motor Products Corporation. Holland's president, Cheff, rejected Maremont's overtures. Maremont then began buying Holland stock. When he announced his purchase publicly and demanded a place on the board, Cheff again refused. Holland claimed Maremont often bought corporations to liquidate them for a profit. Because of this reputation, Cheff claimed, Holland employees who were aware of Maremont's interest were beginning to show signs of discontent.

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[95] *Id.* at 409.

[96] 199 A.2d 548 (Del. 1964).

[97] Holland Furnace Co. v. FTC, 295 F.2d 302, 303-04 (7th Cir. 1961).

Having met resistance, Maremont offered to sell his stock to the firm at a premium over his purchase price and over the current market price.[98] Holland's board agreed, causing the corporation to repurchase Maremont's shares using corporate funds. Other shareholders then challenged that repurchase transaction in a derivative suit.

In *Cheff*, the Delaware Supreme Court announced the so-called "primary purpose test" for review of takeover defenses.[99] Under that standard, the court did not give the directors the immediate benefit of the business judgment rule's presumption of good faith. Rather, the directors had the initial burden of showing they had "reasonable grounds to believe a danger to corporate policy and effectiveness existed" and they had not acted for the primary purpose of entrenching themselves in office.[100] Only if the board could make such a showing would it be entitled to the business judgment rule's protection. The directors, however, merely had to show "good faith and reasonable investigation," otherwise they could not be held liable for an honest mistake of judgment.[101]

The *Cheff* court was well aware of the conflict of interest inherent in target resistance to unsolicited bids; hence, its imposition of the primary purpose test. In practice, however, the burden it placed on target directors

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[98]During the 1980s, the purchase by a corporation of a potential acquirer's stock, at a premium over the market price, came to be known as "greenmail." Buying off one person, however, provides no protection against later pursuers, except possibly to the extent that the premium paid to the first pursuer depletes the corporate resources and makes it a less attractive target. Such reduction in corporate resources could, of course, be achieved by managers simply by paying a dividend to all shareholders or by buying the corporation's shares from all shareholders wanting to sell. BAINBRIDGE, *supra* note 83, at 342 n.5. Section 5881 of the Internal Revenue Code, enacted in 1987, imposes a penalty tax of 50% on the gain from greenmail, which is defined as gain from the sale of stock that was held for less than two years and sold to the corporation pursuant to an offer that "was not made on the same terms to all shareholders." I.R.C. § 5881 (1987). Despite its many critics, greenmail actually may be beneficial in that it may allow the board to seek higher bids or to enhance value (above the greenmail bidder's price) by making changes in management or strategy. Essentially, the question whether greenmail deserves its bad reputation is an empirical one. The evidence supports the proposition that greenmail actually benefits nonparticipating shareholders overall and does not appear to be a device for entrenching incumbent management. Consequently, a greenmailer may be a catalyst for change from within or for a bidding war and may therefore deserve to make a profit. Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 15-16 (1985); Fred S. McChesney, *Transaction Costs and Corporate Greenmail: Theory, Empirics, and a Mickey Mouse Case Study*, 14 MANAGERIAL & DECISION ECON. 131, 133-34 (1993).

[99]*See Cheff*, 199 A.2d at 554; *see also* Royal Indus., Inc. v. Monogram Indus., Inc., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863, at 91,136-38 [1976 WL 860] (C.D. Cal. 1976) (applying Delaware law); Bennett v. Propp, 187 A.2d 405, 408 (Del. 1962) (recognizing the principle generally); Kors v. Carey, 158 A.2d 136, 140-42 (Del. Ch. 1960) (distinguishing the test from the facts in that case).

[100]*Cheff*, 199 A.2d at 555.

[101]*Id.*

proved to be minimal. Liability could be imposed only if entrenching the incumbent officers and directors in office was the primary motive for the defensive actions.[102] Management, therefore, simply directed its counsel to carefully scrutinize the bidder's tender offer documents to find some issue of policy as to which they differed. And, of course, it was always possible to find some policy disagreement between incumbent management and the outside bidder.[103]

Once found, such a policy difference was all that was necessary to justify the use of defensive tactics because the board could not be held liable for its actions, even if hindsight showed those actions to be unwise, so long as it was motivated by a sincere belief that defensive tactics were necessary to maintain proper business policy and practices.[104] The primary purpose analysis thus added little to the highly deferential treatment of board decisions mandated by the traditional business judgment rule and proved an ineffective response to the conflict of interest present when target boards and management responded to a takeover bid.[105]

B. *The Pre-*Unocal *Academic Critique of Delaware Law*

In the early 1980s, there came a veritable flood of academic writing on target board resistance to unsolicited takeover bids. Despite the voluminous debate, however, a relatively narrow set of policy proposals emerged.[106] Gilson was the leading early spokesman for what has been termed the auction model of management resistance.[107] After arguing that

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[102]*Royal Indus.* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,136-38 (applying Delaware law); Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 776 (Del. Ch. 1967). For a concise overview of *Cheff* and other pre-*Unocal* Delaware precedents, see Loewenstein, *supra* note 14, at 9-11.

[103]Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 829 (1981).

[104]*Cheff*, 199 A.2d at 554-55.

[105]*See* DOOLEY, *supra* note 48, at 549 (noting "the board's burden [under *Cheff*] was more apparent than real").

[106]Dooley's summary and analysis of the literature aptly sums it up as having "produced policy prescriptions running the gamut from A to B." *Id.*

[107]*Id.* at 551. *See, e.g.*, Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982) [hereinafter Gilson, *Seeking Competitive Bids*]; Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982). Professor Lucian Bebchuk was another early spokesman for a variant of the auction model. Unlike Gilson, however, Bebchuk was so concerned with the target incumbent's conflict of interest that he rejected allowing the incumbents to use defenses to promote an auction. Instead, he proposed statutory rules intended to allow an auction to develop on its own. *See, e.g.*, Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) [hereinafter

Cheff failed adequately to constrain management's conflict of interest in takeover contests,[108] Gilson proposed a substantially more limited role for takeover defenses than *Cheff* had contemplated.[109] Under Gilson's proposal, the incumbent board would be allowed to use only those tactics intended to secure a better offer for the shareholders, such as releasing information relevant to the offer's adequacy or delaying an offer while an alternative bidder is sought.[110] While Gilson's concern for management's conflict of interest is apparent, his approach did not effectively resolve that problem. It is very difficult to distinguish *ex ante* between defensive tactics that will promote a corporate auction and those that will preserve target board independence.[111] In addition, because Gilson's proposal only addressed incumbent tactics undertaken after an unsolicited offer is expected, it did nothing to prevent incumbent directors and managers from erecting defenses long before any offer is on the horizon.

Easterbrook and Fischel were the leading early spokesmen for what might be termed the passivity or no-resistance rule.[112] Easterbrook and Fischel would allow incumbent directors and managers of a target company no role in unsolicited offers; they argued for complete passivity on the part of target incumbents in the face of a hostile tender offer.[113] In their view, the tender offer presents not just a situational conflict of interest but also acts as the principal systemic constraint on unfaithful or inefficient corporate managers. In other words, they argued, the mere threat of

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Bebchuk, *Reply and Extension*]; Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) [hereinafter Bebchuk, *Case for Facilitating*]. Bebchuk's current position, however, is a variant on the managerial passivity rule:

> [Bebchuk] asks the courts to hold that a corporate board does not possess any equitable authority to impede the procession of a tender offer, once the directors have had the chance to develop another better alternative and inform the stockholders about their view that the offer is inadequate, and after they have channeled the initial stockholder referendum on the offer into the director election process.

Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 STAN. L. REV. 863, 864 (2002).

[108]Gilson, *supra* note 103, at 827-29.

[109]*Id.* at 875-90.

[110]*See* Gilson, *Seeking Competitive Bids*, *supra* note 107, at 64-65 (summarizing proposal).

[111]DOOLEY, *supra* note 48, at 555 (criticizing Gilson's approach).

[112]*See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter Easterbrook & Fischel, *The Proper Role*].

[113]Easterbrook & Fischel, *The Proper Role*, *supra* note 112, at 1201-04 (describing proposal).

corporate takeovers acts as an important check on agency costs that overcomes the collective action problems that plague shareholder oversight.[114] The company is most vulnerable to hostile bids when its stock price is low due to management incompetence and there is room for improving the company's value by displacing the incumbent management team. Put another way, a company will only appear attractive, and therefore will only be acquired, if the stock is undervalued compared to its potential. Knowing this, corporate managers will pursue superior performance and high stock prices to preserve their own jobs. Hence, Easterbrook and Fischel claim, "[i]nvestors benefit even if their corporation never becomes the subject of a tender offer."[115]

Given this analysis, Easterbrook and Fischel's hostility towards management resistance to takeovers is hardly surprising. They argued that defensive tactics make monitoring by outsiders less profitable and thus also less common.[116] Put another way, takeover defenses attenuate outsiders' incentives to play a monitoring role by eroding the expected return on identifying suitable takeover targets. Instead of being able to capture the returns of their monitoring activities, bidders are forced to share their gains with shareholders of the target company and with other bidders.

C. Unocal *and* Revlon: *Delaware Tries Again*

The Delaware Supreme Court never adopted either the auction or the passivity model.[117] At the same time, however, the court recognized the traditional doctrinal options were inadequate to the task at hand. Characterizing the action of a corporation's board of directors as a question of care or of loyalty has vital, potentially outcome determinative, consequences.[118] If the court treated takeover defenses as a loyalty

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[114] *Id.* at 1169-74.

[115] EASTERBROOK & FISCHEL, *supra* note 20, at 173.

[116] *Id.* In contrast to Gilson's preference for auctions, Easterbrook and Fischel contended that defensive tactics that induce auctions are especially problematic. *Id.* at 173-75. The first bidder expends time and effort monitoring potential targets. Second bidders essentially get a free ride on the first bidder's efforts. If the first bidder is unable to earn an adequate return on those efforts, however, the incentive to bid is reduced. *Id.*

[117] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 n.10 (Del. 1985) (acknowledging academic suggestions that "a board's response to a takeover threat should be a passive one" and dismissing them as "clearly . . . not the law of Delaware").

[118] *See* Mills Acq'n Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989) (observing that the choice of standard can be outcome determinative in this context); AC Acq'ns Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (same); *see also* DOOLEY, *supra* note 48, at 546-47 (noting the "doctrinal dilemma" facing courts in this area); Gilson, *supra* note 12, at 495 (describing a "yawning doctrinal chasm").

question, with its accompanying intrinsic fairness standard, takeover defenses would rarely pass muster. The defendant directors would be required, subject to close and exacting judicial scrutiny, to establish that the transaction was objectively fair to the corporation.[119] Because this burden is an exceedingly difficult one to bear and would likely result in routine judicial invalidation of takeover defenses, a duty of loyalty analysis makes sense only if we think all takeovers are socially desirable and that all takeover defenses are therefore bad social policy.

On the other hand, if the court treated takeover defenses as a care question, virtually all takeover defenses would survive judicial review. Before the target's directors could be called to account for their actions, plaintiff would have to rebut the business judgment rule's presumptions by showing that the decision was tainted by fraud, illegality, self-dealing, or some other exception to the rule.[120] Absent the proverbial smoking gun, plaintiff is unlikely to prevail under this standard. A duty of care analysis thus makes sense only if we think management resistance to takeovers is always appropriate.

1. *Unocal*

In *Unocal Corp. v. Mesa Petroleum Co.*,[121] the Delaware Supreme Court attempted to steer a middle course by promulgating what has been called an "intermediate" or "enhanced business judgment" standard of judicial review but is perhaps best described as a "conditional business judgment rule."[122] Famed corporate raider T. Boone Pickens, whom the court referred to as having "a national reputation as a 'greenmailer,'"[123] controlled Mesa, which in turn owned 13% of Unocal's voting stock. Mesa launched a hostile two-tiered tender offer, pursuant to which it initially offered to buy slightly over 37% of the remaining shares for $54 per share. According to Mesa, if the initial bid succeeded, Mesa would then eliminate

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[119]*See* Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1239 (Del. Ch. 1988) (observing where "fiduciaries charged with protecting the interest of the public shareholders have a conflicting self interest, those fiduciaries must establish the transaction's 'entire fairness' to the satisfaction of the reviewing court").

[120]*See id.*:

> [T]he transaction is approved by disinterested directors acting in good faith and pursuant to an appropriate deliberative process, the reviewing court will evaluate the transaction under the business judgment rule. . . . Under that standard, the transaction is presumed to be valid, and the directors' decision will not be disturbed, so long as it can be attributed to any rational business purpose.

[121]493 A.2d 946 (Del. 1985).

[122]Dooley, *supra* note 2, at 515.

[123]*Unocal*, 493 A.2d at 956.

the remaining shares by means of a freeze-out merger, in which the consideration would be junk bonds ostensibly worth $54 per Unocal share.

Two-tier offers like Mesa's are generally regarded as structurally coercive.[124] If shareholders believe the offeror is likely to obtain a controlling interest in the front-end transaction, they face the risk they will be squeezed out in the back-end for less money or a less desirable form of consideration. Thus, they are coerced into tendering into the front-end to avoid that risk, even if they believe the front-end transaction itself is undesirable.[125]

In hopes of fending off Mesa's bid, Unocal's board of directors authorized a discriminatory self-tender offer for Unocal's own stock. Under Unocal's counter offer, if Mesa's front-end tender offer succeeded in giving Mesa a majority of Unocal's stock, Unocal would then offer to repurchase the remaining minority shares with debt securities purportedly worth $72 per share. Unocal's self-tender offer was intentionally discriminatory in that any shares tendered by Pickens would not be accepted. If effected, the self-tender offer would drain Unocal of most of its significant assets and leave it burdened with substantial debt. What made the tactic especially clever, however, was that Unocal likely would never need to actually complete the self-tender offer. Its offer would only close if Mesa acquired more than 50% of Unocal's voting stock. Because Unocal was offering a higher price than Mesa, however, Unocal's shareholders were likely to tender to it rather than to Mesa. If no shareholders tendered to Mesa, Mesa

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[124]City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 797 (Del. Ch. 1988). In general, structural coercion refers to bidder tactics creating a "risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions." Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review*, 44 BUS. LAW. 247, 267 (1989).

[125]Suppose Target's pre-bid stock price was $50. Bidder 1 makes a two-tier offer with differing prices: $80 cash in the first step tender offer and $60 cash in the second step freeze-out merger. Assuming the first step tender offer seeks 50% of the shares plus one, the blended offer price is $70 with a blended premium of $20 per share (calculated by taking the weighted average of the two steps). Bidder 2 offers $75 in cash for any and all shares tendered, a premium of $25 per share. As a group, shareholders are better off with Bidder 2. Yet, Bidder 1's offer creates a prisoners' dilemma. Those shareholders who "cheat" by taking Bidder 1's front end offer end up with $80 rather than $75. With a large non-cohesive group in which defectors bear no cost—such as shame or reprisals—rational investors should defect. Because everyone's individual incentive is to defect, the shareholders end up with the offer that is worst for the group. Mesa's offer differed from this example by offering the same price in both steps, but the far less attractive form of consideration to be paid in the second step would have similarly coercive effects.

would not acquire 50%, and Unocal would be able to terminate its offer without taking down any of the tendered shares.[126]

Mesa sued to enjoin the self-tender offer, alleging Unocal's board of directors had violated its fiduciary duties to both Mesa and Unocal's other shareholders. In particular, Mesa objected to the discriminatory nature of the proposed self-tender offer. The Delaware Supreme Court rejected Mesa's arguments. Given the coercive nature of Mesa's bid, the bid's probable price inadequacy, and Pickens' reputation as a greenmailer, Unocal was entitled to take strong measures to defeat the Mesa offer.[127] Because excluding Mesa from the self-tender offer was essential to making the defense work, the directors could discriminate against Mesa without violating their fiduciary duties.[128]

In *Unocal*, the Delaware Supreme Court strongly reaffirmed the target board's general decision-making primacy, which includes an obligation to determine whether an unsolicited offer is in the shareholders' best interests:

> *The board has a large reservoir of authority upon which to draw.* Its duties and responsibilities proceed from the inherent powers conferred by . . . § 141(a), respecting management of the corporation's "business and affairs". [sic] Additionally, the powers here being exercised derive from . . . § 160(a), conferring broad authority upon a corporation to deal in its own stock. From this it is now well established that in the acquisition of its shares a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office.

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[126]When Unocal's shareholders complained about this aspect of the defense, Unocal agreed to buy 50 million of the shares tendered to it even if Mesa did not acquire 50%. *See Unocal*, 493 A.2d at 951 (noting the "partial waiver" of the Mesa purchase condition).

[127]*Id.* at 954-56.

[128]*Id.* at 957. After the *Unocal* decision, the SEC demonstrated its disapproval of discriminatory tender offers by amending its Williams Act rules to prohibit tender offers other than those made to all shareholders. *See* 17 C.F.R. § 240.13e-4(f)(8) (2005) (issuer self-tender offers); *id.* § 240.14d-10(a)(1) (third party offers).

Unocal and Mesa eventually negotiated an agreement that allowed Mesa to participate in Unocal's self tender. A Unocal shareholder then sued Mesa under the short swing profit provisions of Securities Exchange Act § 16(b). Mesa argued that the self tender qualified as an unorthodox transaction exempt from § 16(b). In *Colan v. Mesa Petroleum Co.*, 951 F.2d 1512, 1525 (9th Cir. 1991), however, the court rejected that argument, holding that Mesa's decision to tender to Unocal was voluntary and, therefore, subject to § 16(b) liability.

> Finally, the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source. . . . Thus, we are satisfied that *in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality.*[129]

In light of the board's potential conflict of interest vis-à-vis the shareholders, however, judicial review was to be somewhat more intrusive than under the traditional business judgment rule: "Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[130]

The initial burden of proof is on the directors, who must first show they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[131] The directors satisfy this burden "by showing good faith and reasonable investigation."[132] The good faith element requires a showing that the directors acted in response to a perceived threat to the corporation and not for the purpose of entrenching themselves in office.[133] The reasonable investigation element requires a demonstration the board was adequately informed, with the relevant standard being one of gross negligence.[134] Assuming the directors carry their first step burden, they next must prove the defense was reasonable in relation to the threat posed by the hostile bid.[135] Both the decision to adopt a takeover defense and any subsequent decision to implement it are independently subject to challenge and judicial review.[136]

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[129] *Unocal*, 493 A.2d at 953-54 (emphasis added; citations and footnotes omitted).

[130] *Id.* at 954.

[131] *Id.* at 955. Like the traditional business judgment rule, the conditional *Unocal* standard can be applied only to actions that are within the power or authority of the board. As a preliminary inquiry, one must ask whether the board had the authority to take this specific action under both the governing statutes and the corporation's organic documents. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350 (Del. 1985).

[132] *Unocal*, 493 A.2d at 955 (citing Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)).

[133] *Id.*

[134] *Moran*, 500 A.2d at 1356-57.

[135] *Unocal*, 493 A.2d at 955-56.

[136] In *Moran*, plaintiffs sued when the target first adopted a poison pill, before any takeover bid had been made. The court upheld the pill as valid, but explained:

> When the Household Board of Directors is faced with a tender offer and a

Not surprisingly, the board's "initial" burden of proof quickly became the whole ball game. If the directors carried their two-step burden, the business judgment rule applied, but if the directors failed to carry their initial burden, the duty of loyalty's intrinsic fairness test applied.[137] It is for this reason the *Unocal* test is more properly seen as a conditional version of the business judgment rule, rather than an intermediate standard of review lying between the duties of care and of loyalty. The *Unocal* standard solved the problem of outcome determination not so much by creating a different standard of review, but rather by creating a mechanism for determining on an individual basis which of the traditional doctrinal standards was appropriate for the particular case at bar.[138]

At the same time, by adopting a flexible standard rather than the prophylactic rules proposed by the academic critics of *Cheff*, Delaware struck a balance between authority and accountability. Arrow explains that "[t]o maintain the value of authority, it would appear that [accountability] must be intermittent. This could be periodic; it could take the form of what is termed 'management by exception,' in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations . . . ."[139] As we shall see, intermittent accountability accomplished through "management by exception" is precisely what the Delaware standard has achieved.[140]

> request to redeem the [pill], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the [pill]."

Moran, 500 A.2d at 1354. *See also* Hills Stores Co. v. Bozic, 769 A.2d 88, 106-07 (Del. Ch. 2000):

> Delaware case law has assured stockholders that the fact that the court has approved a board's decision to put defenses in place on a clear day does not mean that the board will escape its burden to justify its use of those defenses in the heat of battle under the *Unocal* standard.

[137]*See* Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 271 (Del. Ch. 1989).

[138]This aspect of *Unocal* has been criticized by three distinguished Delaware jurists, who argue that "once the target company board's defensive actions are found to satisfy or fail the *Unocal* test, any further judicial review of those actions under the business judgment or entire fairness standards is analytically and functionally unnecessary." Allen et al., *supra* note 69, at 1311, *reprinted in* 26 DEL. J. CORP. L. at 884. As a practical matter, the analysis in most cases in fact ends with application of the *Unocal* standard.

[139]ARROW, *supra* note 60, at 78.

[140]*See infra* notes 160-63 and accompanying text.

2. *Revlon*

Unocal established the legal ability of a target's board of directors to reinsert itself into the tender offer process as a gatekeeper, even though the tender offer seemingly had been designed to bypass the need for target board approval. To be sure, the extent to which the board could firmly close the gate—i.e., could a board "just say no"?—remained to be determined. Even so, the tender offer decisively was brought within the internal affairs of corporations. Within a year of the *Unocal* decision, however, the Delaware Supreme Court issued *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[141] a decision that threatened (and periodically still threatens) to eviscerate the target board of directors' gatekeeping role.

In response to an unsolicited tender offer by Pantry Pride, Revlon's board undertook a variety of defensive measures, culminating in the board's authorization of negotiations with other prospective bidders. Thereafter the board entered into a merger agreement with a white knight, which included a lockup arrangement, as well as other measures designed to prevent Pantry Pride's bid from prevailing. The Delaware Supreme Court reviewed (and upheld) Revlon's initial defensive tactics under the standard *Unocal* analysis.[142] In turning to the lockup arrangement, however, the court struck out in a new direction:

> The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. *The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.* This significantly altered the board's responsibilities under the *Unocal* standards. It 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. *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.*[143]

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[141] 506 A.2d 173 (Del. 1986).

[142] *Id.* at 180-81.

[143] *Id.* at 182 (emphasis added).

Because the lockup ended the auction in return for minimal improvement in the final offer, it was invalidated.[144]

If the *Revlon* decision's colorful metaphor is to be taken literally, the board's gatekeeping function would be substantially eviscerated. Instead of being empowered to decide whether an unsolicited offer would be allowed to go to shareholders or not, the target's board of directors would be relegated to mere facilitators and observers of the bidding process. Attempts to favor one bidder over another would be highly suspect, given that the board's objective "must remain the enhancement of the bidding process for the benefit of the stockholders."[145]

To be sure, even cases giving *Revlon* an expansive reading continued to reject Easterbrook and Fischel's notion that the target's board of directors should be mere passive observers of market competition.[146] For example, directors were not required to focus blindly on price to the exclusion of other relevant factors. Instead, the target's board could evaluate offers on such grounds as the proposed form of consideration, tax consequences, firmness of financing, antitrust or other types of regulatory obstacles, and timing.[147] Nonetheless, for many, the differences between *Unocal* and *Revlon* loomed large.[148]

If the balance struck in *Unocal* was not to be undone by *Revlon*'s seductive metaphor, two critical questions needed to be resolved in *Unocal*'s favor. First, when did directors stop being "defenders of the corporate bastion" and become "auctioneers"? Second, did the *Revlon* duties really differ from those imposed by *Unocal*?

The legal standard for determining whether *Revlon* had come into play repeatedly expanded and contracted during the first decade after the

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[144]*Id.* at 183-84.

[145]Mills Acq'n Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1989). Favored treatment of one bidder at any stage of the process was therefore subjected to close scrutiny under a modified version of the *Unocal* standards. *Id.* at 1288.

[146]*See, e.g.*, CRTF Corp. v. Federated Dep't Stores, Inc., 683 F. Supp. 422, 441 (S.D.N.Y. 1988) (applying Delaware law).

[147]Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 577 (11th Cir. 1988).

[148]*See, e.g.*, Loewenstein, *supra* note 14, at 3-4 (arguing that *Revlon* creates a standard of review far less deferential to target board actions than that promulgated by *Unocal*).

decision was rendered.[149] Ultimately, however, the Delaware Supreme Court appears to have settled on a standard with three triggers:

> The directors of a corporation "have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders," in at least the following three scenarios: (1) "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"; (2) "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company"; or (3) when approval of a transaction results in a "sale or change of control." In the latter situation, there is no "sale or change in control" when "'[c]ontrol of both [companies] remain[s] in a large, fluid, changeable and changing market.'"[150]

Outside those three situations, which do not even encompass all corporate control bidding contests, *Unocal* remains the defining standard. Indeed, in *Unitrin,* the Delaware Supreme Court emphasized the target board of directors' continuous gatekeeping function by flipping the *Revlon* metaphor around:

> When a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders. The fact that a defensive action must not be coercive or preclusive does not prevent a board from responding defensively before a bidder is at the corporate bastion's gate.[151]

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[149]*See* GILSON & BLACK, *supra* note 87, at 1073-80. *See, e.g.*, *Macmillan*, 559 A.2d at 1285 (holding the requisite "sale" could take "the form of an active auction, a management buyout, or a 'restructuring'"); *see also* Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1243 (Del. Ch. 1988) (suggesting a transfer of "effective control," not just a voting majority, may trigger duties under *Revlon*); *cf.* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) (*Revlon* not triggered where management ally had less than 50% voting control after defensive recapitalization); *accord* Black & Decker Corp. v. Am. Standard, Inc., 682 F. Supp. 772, 781 (D. Del. 1988) (reading Delaware law to require directors of a company "to maximize the amount received by shareholders once it is clear to them that the 'corporation is to be subject to a change of *control*'").

[150]Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1289-90 (Del. 1994) (citations and footnotes omitted).

[151]Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1388 (Del. 1995).

Even in the limited classes of cases for which *Revlon* is the controlling precedent, the Delaware Supreme Court has brought the relevant standard of review into line with *Unocal*. There was some initial waffling on the question of whether *Revlon* established special duties to govern control auctions or simply applied the general *Unocal* standards to a special fact situation. The latter interpretation ultimately prevailed. In 1987, for example, the Delaware Supreme Court drew a rather sharp distinction between the *Unocal* standard and what it then called "the *Revlon* obligation to conduct a sale of the corporation."[152] Two years later, the court indicated that "*Revlon* is merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders."[153] While subsequent cases and commentators still occasionally use phrases like "*Revlon* duties" or even "*Revlon*-land," the court has continued to indicate that *Revlon* is properly understood as a mere variant of *Unocal* rather than as a separate doctrine.[154]

In summary, then, *Revlon* has been safely contained. The target board of directors' prerogative to exercise some form of gatekeeping, even in a hostile takeover bid, has been consistently reaffirmed. The balance struck by *Unocal* remains intact.

IV. WHY NOT PASSIVITY?

Before evaluating the balance Delaware struck in *Unocal*, it will be helpful to dispose of the argument that there was no balance to be struck. In other words, we need to evaluate the argument—so forcefully rejected by the Delaware Supreme Court—for target board passivity.

Given the Delaware courts' "normal sensitivity to conflicts of interest[s],"[155] the evidence that target board resistance to unsolicited tender

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[152]*Newmont Mining Corp.*, 535 A.2d at 1338.

[153]Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989).

[154]*See, e.g.*, *Macmillan*, 559 A.2d at 1288 ("[Beyond getting] the highest value reasonably attainable for the shareholders . . . , there are no special and distinct 'Revlon [sic] duties.' "); *see also In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 730-31 (Del. Ch. 1999) ("'*Revlon* duties' refer only to a director's performance of his or her duties of care, good faith and loyalty in the unique factual circumstance of a sale of control over the corporate enterprise."); QVC Network, Inc. v. Paramount Commc'ns Inc., 635 A.2d 1245, 1267 (Del. Ch. 1993) ("The basic teaching of *Revlon* and *Unocal* 'is simply that the directors must act in accordance with their fundamental duties of care and loyalty.'"), *aff'd*, 637 A.2d 34 (Del. 1994).

[155]*See* Dooley, *supra* note 2, at 515 ("Given . . . the courts' normal sensitivity to conflicts of interest, many have been perplexed and some dismayed by the courts' refusal to ban or at least severely limit target board resistance."). Indeed, one is hard pressed to find more forceful judicial rhetoric than that used by Delaware courts in cases posing a conflict of interest:

offers is, at best, a risky proposition for shareholders and, at worst, economically disastrous,[156] and the undeniable fact the no-resistance rule does a more thorough job of removing management's conflicted interests from the tender offer process than does *Unocal*, it is not surprising Delaware courts adopted a standard that permits target resistance. The Delaware courts' consistent rejection of the no-resistance rule suggests the courts have perceived some dimension to the puzzle that has escaped the attention of academics.

Analysis should begin, then, with the proposition that all doctrinal responses to corporate conflict of interest transactions have two features in common. First, so long as the board of directors is disinterested and independent, it retains full decision-making authority with respect to the transaction.[157] Second, the board's independence and decision-making process is subject to judicial scrutiny.[158] Here, as ever, we see the competing influences of authority and accountability.

In a sense, Delaware's takeover cases do no more than simply bring this traditional corporate governance system to bear on target resistance to

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> While technically not trustees, [officers and directors] stand in a fiduciary relation to the corporation and its stockholders. 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 . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

[156]*See* DOOLEY, *supra* note 48, at 555-57 (summarizing data on wealth effects of takeovers and of target board resistance). On the other hand, it is now reasonably well-established that the demand curve for a corporation's stock slopes downwards and may even approximate unitary elasticity (i.e., buying 50% of a company's stock requires a price increase of 50%). *See, e.g.*, Laurie Simon Bagwell, *Dutch Auction Repurchases: An Analysis of Shareholder Heterogeneity*, 47 J. FIN. 71 (1992); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579 (1986). If so, little or no new wealth is created by takeovers. Instead, takeover premia are purely an artifact of supply and demand. In turn, this suggests that the conflict of interest posed by target board resistance is less serious than generally imagined.

On a related note, target board resistance to an unsolicited offer arguably can be justified if the market price of the corporation's stock underestimates the actual value of the firm and the board is unable to credibly convey this fact to the market. In other words, even where the bidder offers a substantial premium, which holders of a majority of the outstanding shares wish to accept, the offer is still "too low." Lynn Stout argues that heterogeneous expectations on the part of investors provides a theoretical basis for this line of argument. Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1244-52 (1990). *Cf.* Bebchuk, *supra* note 20, at 997 (opining "the stock market's informational inefficiency undermines the passivity approach of Easterbrook and Fischel").

[157]*See* Dooley, *supra* note 2, at 488.

[158]*See id.* at 488-90.

tender offers.[159] Admittedly, the form of review is unique, but so too is the context. Just as has been the case with all other corporate conflicts of interest, Delaware decisions in the unsolicited tender offer context strive to find an appropriate balance between authority and accountability. We see the courts' concern for accountability in, for example, *Unocal*'s explicit recognition of the conflict of interest that target directors and officers face in an unsolicited takeover bid.[160] It is, of course, one thing to recognize this conflict of interest and quite another to do something about it. As a doctrinal matter, the Delaware Supreme Court concretely demonstrated its sensitivity to management's conflicted interests by placing the preliminary burden of proof on the board.[161] This action demonstrated considerable judicial sensitivity to the board's conflicted interests because outside of areas traditionally covered by the duty of loyalty, putting the initial burden of proof on the board of directors is a very unusual—indeed, essentially unprecedented—step.

At the same time, however, we see the value of authority reflected in, for example, *Unocal*'s express rejection of the passivity model.[162] Even plainer evidence of the Delaware courts' concern for authority came when Chancellor Allen wrote that unless *Unocal* was carefully applied, "courts—in exercising some element of substantive judgment—will too readily seek to assert the primacy of their own view on a question upon which reasonable, completely disinterested minds might differ."[163] Is it not striking how precisely Allen echoes the point made above that one cannot make an actor more accountable without simultaneously transferring some aliquot of his decision-making authority to the entity empowered to hold him accountable.

In contrast, virtually all of the policy prescriptions to emerge from the academic accounts of the tender offer's corporate governance role would create an entirely new and radically different system of corporate

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[159]The point is made obvious by the Delaware Supreme Court's decision in *Williams v. Geier*, 671 A.2d 1368, 1371-74 (Del. 1996), in which an anti-takeover dual class stock plan received approval by the disinterested shareholders. In light of the shareholder action, the court held that the *Unocal* standard was "inapplicable here because there was no unilateral board action." *Id.* at 1377. As with all other conflicted interest transactions, shareholder approval provides substantial protection from judicial review for the board's decision. *See id.* at 1371.

[160]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[161]*See, e.g., id.* at 955.

[162]*Id.* at 955 n.10.

[163]City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 796 (Del. Ch. 1988). Chief Justice Veasey's *QVC* opinion likewise emphasized that a court should not second-guess a board decision falling within the range of reasonableness "even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination." Paramount Commc'ns, Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994).

governance, in which the board is stripped of some or all of its normal decision-making authority. The academic proposals not only reflect an overriding concern with accountability; they also reject the very notion that authority has any legitimate role to play in developing takeover doctrine. Deciding whether the judiciary or the academy has the better argument is the task to which the remainder of this Part is devoted.

The key to our inquiry is whether the unsolicited tender offer differs in kind, not just degree, from any other conflicted interest transaction. If so, perhaps a special governance scheme applicable only to unsolicited tender offers can be justified. If not, however, we would expect the law to treat unsolicited tender offers just as it treats other conflicted interest transactions. In other words, the law should develop mechanisms for policing the incumbent directors' conflict of interests, but it should not deny the incumbents a role in the process.

A. *The Question of Comparative Advantage*

According to most critics of Delaware's takeover jurisprudence, corporate law gives the board decision-making authority because in most situations the directors have a competitive advantage vis-à-vis the shareholders in choosing between competing alternatives.[164] Critics then argue that directors have no such competitive advantage when it comes to making tender offer decisions, and accordingly, they reject granting the board decision-making authority in the tender offer context.[165] Certainly it is true that even the most apathetic investor is presumably capable of choosing between an all-cash bid at $74 per share and an all-cash bid at $76. This analysis, however, obscures two important rationales for granting the board decision-making authority in the tender offer context.

At the outset, it is important to recognize that unsolicited tender offers and negotiated acquisitions have a good deal in common. From a practical perspective, it is often difficult to tell the two apart. In today's marketplace, most takeovers follow a fairly convoluted path. They start out quasi-hostile but end up quasi-friendly, or vice versa. They start out as a merger proposal, which is restructured as a tender offer for tax or other business reasons, or vice versa. The problem is usefully illustrated by

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[164]Easterbrook & Fischel, *The Proper Role*, *supra* note 112, at 1198. As explained in *supra* Part II.C, this is, of course, not the reason—or, at least, not the sole reason—corporate law vests decision-making authority in the hands of the board. Collective action concerns and disparate shareholder interests count for at least as much as information asymmetries.

[165]*Id.*

Chancellor Allen's opinion in *TW Services, Inc. v. SWT Acquisition Corp.*[166] SWT's unsolicited partial tender offer for TW Services was subject to a number of conditions, including a requirement that the transaction be approved by TW Services' board of directors. The TW Services' board saw the tender offer as a ruse designed to extort greenmail or to put the company into play. Accordingly, the board declined to redeem the company's outstanding poison pill. SWT filed a lawsuit seeking invalidation of the pill. Because SWT conditioned its offer on the TW Service board's support, the case presented a problem of characterization that the legal literature largely ignores. If the transaction is characterized as a merger, then most commentators would permit the board an active decision-making role. Conversely, if the transaction is characterized as a tender offer, they would preclude the board from exercising decision-making authority. Categorizing this transaction, however, is a nontrivial task.[167] Attempting to define the scope of the board's authority by the nature of the transaction at hand thus quickly proves an unsatisfactory resolution.

Even if one were wholly confident of one's ability to appropriately characterize transactions, however, the comparative advantage argument still would not justify precluding the board from exercising decision-making authority in tender offers. Consider transactions like the defensive restructuring at issue in *City Capital Associates Ltd. Partnership v. Interco, Inc.*[168] In the face of an all-cash hostile bid at $74 per share, Interco's board of directors proposed to sell certain assets and to borrow a substantial amount of money. The joint proceeds of those transactions would then be paid out to Interco's shareholders as dividends. The dividends would be paid in three forms: cash, bonds, and preferred stock. The dividends' total value was said to be $66 per share. Interco's investment banker opined that after this series of transactions, Interco's stock would trade at no less than $10 per share. The proposed defensive measures thus purportedly would give Interco's shareholders a total value of $76 ($2 more than the hostile bid).[169] In rebuttal, the bidder's investment bankers valued the defensive

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[166][1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,174 (Del. Ch. Mar. 2, 1989), *reprinted in* 14 DEL. J. CORP. L. 1169, 1174 (1989).

[167]Chancellor Allen treated the transaction as a merger proposal. *Id.* at 92,176, *reprinted in* 14 DEL. J. CORP. L. at 1177-78. This result makes sense. After all, the bidder controls the conditions to which the tender offer is subject. If SWT had wished to trigger *Unocal*-based review, for example, it could have done so by merely waiving the requirement for board approval. *Id.*

[168]551 A.2d 787 (Del. Ch. 1988).

[169]*Id.* at 793-94.

plan at $68 to $70 per share.[170] It is precisely because passive, widely dispersed shareholders have neither the inclination nor the information necessary to decide between these sort of alternatives that the corporate law in other contexts allocates the decision to the board.[171] Only compelling accountability concerns can justify treating tender offers differently. Thus, the comparative advantage argument collapses into a variant of the agency cost arguments discussed below.

B. *The Bypass Argument*

An alternative justification for treating the tender offer differently than negotiated acquisitions rests on the former's elimination of the need for target management's cooperation. As discussed above, the target board's gatekeeper role in negotiated acquisitions creates a conflict of

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[170]*Id.* at 799. If the reader is not fully persuaded by the Interco example, consider that of the well known Time-Paramount contest. Time received an initial bid from Paramount of $175, later raised to $200. Time's board was advised by its investment bankers, however, that if the company were to be sold it would likely command in excess of $250 per share. Time's shares had traded in a range of $103 5/8 to $113 3/4 in February and rose to a range of $105 to $122 5/8 in March and April, after the announcement of the Warner merger. The investment bankers further advised that the shares of the combined Time-Warner could be expected to trade initially around $150 and, based on projected cash flows, would steadily increase over the next three years until trading in the range of $208 to $402 per share in 1993. Paramount Commc'ns, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,271-74 (Del. Ch. July 14, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 720-24 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990). As Chancellor Allen dryly observed, the latter was "a range that a Texan might feel at home on." *Id.* at 93,273, *reprinted in* 15 DEL. J. CORP. L. at 724. Even a sophisticated institutional investor or hedge fund operator might have trouble sorting through all those claims. In any event, as Dooley has pointed out, such predictions are often preposterous, given that share price is a function of return and the return on any individual security is, in part, a function of the return on the market as a whole. Dooley, *supra* note 2, at 522 n.229. Any shareholder capable of predicting the return on the market four years hence would have comfortably retired long before the Time-Paramount fight began.

[171]*Cf.* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 254 (7th Cir. 1986) (explaining that shareholders "know little about the companies in which they invest or about the market for corporate control"), *rev'd on other grounds*, 481 U.S. 69 (1987). In addition, management often has information about the firm's value that is difficult to communicate effectively to shareholders in the middle of a takeover fight. *See, e.g.*, Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289-90 (Del. Ch. 1989) (explaining that target company had large, but unliquidated, asset in the form of a damage claim for patent infringement). In such cases, management does have a competitive advantage vis-à-vis the shareholders in making tender offer decisions.

Bebchuk concedes that directors may have information advantages relative to shareholders but rejects this as a ground for allowing the board to veto unsolicited takeover bids because, he claims, it would move "decisionmaking to a party that might be better informed but also has worse incentives." Bebchuk, *supra* note 20, at 1000. I disagree because I believe Bebchuk is conflating the incentives of managers and directors. *See* infra Part IV.D.1 (discussing the disparate incentives of managers and independent directors).

interest, which is constrained in part by the ability the tender offer gives a bidder to bypass the target's board by purchasing a controlling share block directly from the stockholders.[172] According to some, authority values are only appropriate in the negotiated acquisition context if the board is denied the ability to resist tender offers.[173]

This argument has a certain superficial appeal, but ultimately is unpersuasive. In the first place, it too ignores the problem of characterization alluded to in the preceding section. More importantly, tender offers are not the only vehicle by which outsiders can appeal directly to the shareholders. Proxy contests similarly permit a would-be acquirer to end-run management. Yet, nobody expects a board to be passive in the face of a proxy contest.[174] To the contrary, the incumbent board's role is very active indeed[175] because the incumbent board members remain in office and therefore also remain legally obligated to conduct the business, unless and until they are displaced.[176] Complete passivity in the face of a proxy contest would be inconsistent with the directors' obligation to determine and advance the best interests of the corporation and its shareholders.

The same is true of a tender offer. While the analogy between tender offers and proxy contests is unconvincing for most purposes, "the courts may have correctly sensed a fit at the most basic level."[177] As with a proxy contest, directors of a target of an unsolicited tender offer will remain in office unless and until the offer succeeds. Therefore, unless and until they are removed by a successful bidder, the board of directors has a

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[172]*See supra* notes 83-91 and accompanying text.

[173]*See, e.g.*, Easterbrook & Fischel, *The Proper Role*, *supra* note 112, at 1200 ("The performance of the board in its role as agent is policed by market forces. . . . The tender offer, therefore, is an essential safety valve to ensure that managers evaluate merger proposals in the best interests of the shareholders."); Gilson, *supra* note 103, at 850 ("Restricting management's role in a tender offer does not deny the value of management's expertise in evaluating and negotiating complex corporate transactions, but rather validates the unfettered discretion given management with respect to mergers and sales of assets.").

[174]*See* Dooley, *supra* note 2, at 516 ("No one would expect an incumbent management team to vacate their offices at the first hint of an election challenge.").

[175]Indeed, under state law, the board of directors may use corporate funds to pay for expenses incurred in opposing an insurgent, provided the amounts are reasonable and the contest involves policy questions rather than just a "purely personal power contest." Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 293 (N.Y. 1955).

[176]This principle follows from Delaware General Corporation Law § 141(b), pursuant to which a director's term continues until his successor is elected. DEL. CODE ANN. tit. 8, § 141(b) (2004).

[177]DOOLEY, *supra* note 48, at 563.

"fundamental duty" to protect shareholders from harm,[178] which can include resisting an unsolicited tender offer they truly believe is not in the shareholders' best interests. As *Unocal* recognized, complete board passivity in the face of such an offer would be inconsistent with the directors' fiduciary duties.[179] To the contrary, their fiduciary duty obliges them to seek out alternatives. At the bare minimum, it would be appropriate for the board to use takeover defenses to delay an inadequate bid from going forward while the board seeks out an alternative higher valued offer because until the board has time to arrange a more attractive alternative, there is a risk that the shareholders will "choose the inadequate tender option only because the superior option has not yet been presented."[180]

C. *The Structural Argument (a.k.a. Shareholder Choice)*

A related but more substantial argument against authority values in the unsolicited tender offer context contrasts the board's considerable control in negotiated acquisitions with the board's lack of control over secondary market transactions in the firm's shares.[181] Corporate law generally provides for free alienability of shares on the secondary trading markets. Mergers and related transfers of control, however, are treated quite differently. As shown in Part II.E, corporate law gives considerable responsibility and latitude to target directors in negotiating a merger agreement. The question has become whether unsolicited tender offers are more like secondary market trading or like mergers.

The so-called structural argument, also known as the shareholder choice argument, asserts that the tender offer is much more closely analogous to the former. According to its proponents, an individual shareholder's decision to tender his shares to the bidder no more concerns the institutional responsibilities or prerogatives of the board than does the shareholder's decision to sell his shares on the open market or, for that

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[178]MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1251 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

[179]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[180]Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289 (Del. Ch. 1989).

[181]The bypass argument discussed in the preceding section focuses on the outside bidder's ability to bypass the board of directors; the argument discussed here focuses on the target shareholders' ability to dispose freely of their shares. Obviously, there is considerable overlap between the two.

matter, to sell his house.[182] Both stock and a home are treated as species of private property that are freely alienable by their owners.

The trouble is that none of the normative bases for the structural argument prove persuasive. The idea that shareholders have the right to make the final decision about an unsolicited tender offer does not necessarily follow, for example, from the mere fact that shareholders have voting rights. While notions of shareholder democracy permit powerful rhetoric, corporations are not New England town meetings. Put another way, we need not value corporate democracy simply because we value political democracy.[183]

Indeed, we need not value shareholder democracy very much at all. As previously discussed, what is most striking about shareholder voting rights is the extensive set of limitations on those rights.[184] These limitations reflect the presumption in favor of authority. They are designed to minimize the extent to which shareholders can interfere in the board of directors' exercise of its discretionary powers. In fact, as noted in Part II.D, if authority were corporate law's sole value, shareholders would have no voice at all in corporate decision making. Instead, all decisions would be made by the board of directors or those managers to whom the board has delegated authority. Shareholder voting rights are properly seen as simply

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[182]*See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 254 (7th Cir.1986), *rev'd on other grounds*, 481 U.S. 69 (1987); Hanson Trust PLC v. ML SCM Acq'n Inc., 781 F.2d 264, 282 (2d Cir. 1986); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 258 (2d Cir. 1984); *see generally* Dooley, *supra* note 2, at 514 (explaining that a shareholder's decision to sell shares does not affect institutional responsibility). In addition to the normative arguments discussed in the text, Bebchuk advances two other justifications for shareholder choice: moving corporate assets to their highest valued user and encouraging optimal levels of investment in target companies. *See* Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1765-66 (1985). Neither of these legitimate goals requires shareholder choice; rather, they require only a competitive process that produces the highest valued bid. In other words, they require only fair competition for control.

Gilson criticizes *Unocal* for having created a regime under which shareholder choice, exercised collectively through voting rather than individually through selling, is determinative of the outcome of takeover fights. Gilson, *supra* note 12, at 502-06. In contrast, Thompson and Smith criticize *Unocal* for not creating a "sacred space" within which shareholders can exercise choice by voting and selling. Thompson & Smith, *supra* note 16, at 299. As developed below, I reject both critiques.

[183]The analogy between political and corporate voting rights is especially apt in light of the significant differences between the two arenas. First, voting rights are much less significant in the corporate than in the political context. Second, unlike citizens, shareholders can readily exit the firm when dissatisfied. Third, the purposes of representative governments and corporations are so radically different that there is no reason to think the same rules should apply to both. For example, if the analogy to political voting rights was apt, it would seem that the many corporate constituents affected by board decisions would be allowed to vote. Yet, only shareholders may vote. Bondholders, employees, and the like normally have no electoral voice.

[184]*See supra* notes 44-49 and accompanying text.

one of many accountability tools available, not as part of the firm's decision-making system.[185]

Nor is shareholder choice a necessary corollary of the shareholders' ownership of the corporation. As described in Part II.B, the nexus of contracts model visualizes the firm as a legal fiction representing a complex set of contractual relationships. Because shareholders are simply one of the inputs bound together by this web of voluntary agreements, ownership is not a meaningful concept under this model. A shareholder's ability to dispose of his stock is merely defined by the terms of the corporate contract, which in turn is provided by the firm's organic documents and the state of incorporation's corporate statute and common law. As Vice Chancellor Walsh observed, "[S]hareholders do not possess a contractual right to receive takeover bids. The shareholders' ability to gain premiums through takeover activity is subject to the good faith business judgment of the board of directors in structuring defensive tactics."[186]

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[185]In light of the limitations to which those rights are subject, shareholder voting rights are not a very important accountability tool.

[186]Moran v. Household Int'l, Inc., 490 A.2d 1059, 1070 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985). *Accord* Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 272 (Del. Ch. 1989) (observing "stockholders have no contractual right to receive tender offers or other takeover proposals"). I am using the term "corporate contract" here in the economic sense rather than the legal sense of the term. On the distinction between the legal and economic concepts of contract, see BAINBRIDGE, *supra* note 35, at 27-28. Thus, the "corporate contract" consists of a host of explicit and implicit understandings embodied in statute, judicial decisions, and the corporation's organic documents, not just of a single written document. *Cf. id.* at 29-31 (discussing the role and selection of default rules in corporate law). Those understandings certainly include a right of alienation, as reflected in the statutory restrictions on contractual prohibitions of alienation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 202 (2001). They do not, however, include the right to sell into a tender offer.

A distinguished Delaware jurist has criticized this argument:

> While Professor Bainbridge argues that stockholders who buy shares have opted for a contractual stew made up of statutory, charter, bylaw, and common law ingredients, he has not articulated which of those ingredients—before *Moran*—would have put a stockholder on notice that his right to sell his shares in a tender offer could be blocked by the board of his company. In the normal order, contractual and statutory restrictions on the alienability of shares tend to be specifically articulated; in the absence of such explicit restrictions, it can be argued that a reasonable stockholder buying shares would assume she was free to sell to whomever she wished whenever she wished without board interference. While Bainbridge's idea of the underlying "corporate law" contract has normative appeal as a justification for a director-centered approach to the exercise of corporate power, its accuracy as a positive description of the bargain stockholders think they make when they buy shares is less obvious.

Strine, *supra* note 107, at 869-70 n.15. In fact, the "contractual stew," taken as a whole, would put shareholders on notice the board likely had a gatekeeping function. In all change of control transactions, except tender offers and stock purchases, the board of directors has always acted as a gatekeeper. *See supra* notes 3-6 and accompanying text. When *Unocal* was decided, the use

Walsh's observation is given particular significance when considered in light of the nexus of contracts theory described in Part II.A, which posits that the law generally should provide default rules for which the parties would bargain if they could do so costlessly.[187] Walsh's dictum, therefore, suggests shareholders would bargain for rules allowing a target's board of directors to function as a gatekeeper even with respect to unsolicited tender offers.

The empirical evidence supports this hypothesis. It is well-established, for example, that the combination of a poison pill and a staggered board of directors is a particularly effective takeover defense.[188] Yet, almost 60% of public corporations now have staggered boards.[189] Even more striking, the incidence of staggered boards has increased dramatically among firms going public (from 34% in 1990 to over 70% in 2001).[190] Finally, activist shareholders have made little headway in efforts

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of an unsolicited tender offer as a mechanism for bypassing the board's gatekeeping function was still relatively new. *See* BAINBRIDGE, *supra* note 35, at 652 (noting that the tender offer emerged as an important takeover device in the 1960s). Almost from the outset of the tender offer's rise to prominence, efforts were made to restore the board's gatekeeping function through the use of takeover defenses and state takeover legislation. *See supra* text accompanying note 6. The Delaware Supreme Court endorsed that effort at least as early as *Cheff v. Mathes*, 199 A.2d 548, 556 (Del. 1964). Long before *Moran*, it was well-known *Cheff* effectively confined judicial review of target board actions that limit a shareholder's ability to sell into a tender offer to the highly deferential treatment of board decisions. *See supra* text accompanying note 105. In light of this history, it is difficult to believe shareholders' bargained-for rights have ever included the right to sell their shares into a tender offer without interference by the board of directors.

[187]For an overview of the nexus of contracts model, as well as a discussion of the conditions under which mandatory rules are preferable to defaults, see BAINBRIDGE, *supra* note 35, at 27-33.

[188]Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 931 (2002) (combining a staggered board and a poison pill almost doubled the chances of a target corporation remaining independent); Robert B. Thompson, *Shareholders As Grown-Ups: Voting, Selling, And Limits On The Board's Power To "Just Say No,"* 67 U. CIN. L. REV. 999, 1017-18 (1999) (using legal treatment of poison pill and classified board provisions as a measure of jurisdictional commitment to shareholder primacy); Neil C. Rifkind, Note, *Should Uninformed Shareholders Be a Threat Justifying Defensive Action by Target Directors in Delaware?: "Just Say No" After* Moore v. Wallace, 78 B.U. L. REV. 105, 111 (1998) (observing that "[w]hen poison pills and classified boards are used in tandem, the bidder either must mount two consecutive proxy contests to elect a majority of directors, or convince a court that the target directors' opposition to the offer constitutes a breach of the directors' fiduciary duties").

[189]Bebchuk et al., *supra* note 188, at 895. Another published estimate puts the figure even higher, at more than 70% of U.S. public corporations. Robin Sidel, *Staggered Terms for Board Members Are Said To Erode Shareholder Value, Not Enhance it*, WALL ST. J., Apr. 1, 2002, at C2.

[190]Bebchuk et al., *supra* note 188, at 889.

to "de-stagger" the board.[191] These findings are highly suggestive, as Easterbrook and Fischel observe:

> Although agency costs are high, many managerial teams are scrupulously dedicated to investors' interests. . . . By increasing the value of the firm, they would do themselves a favor (most managers' compensation is linked to the stock market, and they own stock too). Nonexistence of securities said to be beneficial to investors is telling.[192]

The existence of securities having certain features seems equally telling.[193] Indeed, if what investors do matters more than what they say, one must conclude that IPO investors are voting for director primacy with their wallets.[194]

Finally, and most importantly, the structural argument also ignores the risk that restricting the board's authority in the tender offer context will undermine the board's authority in other contexts. Even the most casual

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[191] *Id.* at 900.

[192] EASTERBROOK & FISCHEL, *supra* note 20, at 205.

[193] Bebchuk, Coates, and Subramanian argue shareholders could not have consented to the adoption of effective staggered boards because shareholders were unaware of their effectiveness when most such classification schemes were adopted. Bebchuk et al., *supra* note 188, at 941. If shareholders are that myopic, why do we want to give them the final say? In any case, Bebchuk, Coates, and Subramanian's own data confirm that increasingly, corporations making IPOs have a staggered board when they go public. *See supra* text accompanying note 190. They glide over that problem by claiming shareholder approval "was not necessary" in the IPO context. Bebchuk et al., *supra* note 188, at 942. This is technically true in the sense there was no vote of public shareholders, but it ignores the fact investors were willing to buy stock in the IPO despite the presence of a staggered board. In doing so, the shareholders effectively manifested their consent to the classification scheme through the working of the pricing mechanism. *Cf.* EASTERBROOK & FISCHEL, *supra* note 20, at 18 (stating "[t]he mechanism by which stocks are valued ensures that the price reflects the terms of governance and operation").

[194] Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 73 SO. CAL. L. REV. 1189, 1206 (2002) (summarizing evidence "shareholders display a revealed preference for rules that promote director primacy at early stages of a firm's development").

Bebchuk has argued shareholder attitudes cannot be inferred from the IPO data, offering as a counterfactual the declining number of attempts by established corporations to amend their articles to allow for a staggered board. Bebchuk, *supra* note 20, at 1017. As noted in his article with Coates and Subramanian, Bebchuk showed that almost 60% of public corporations now have staggered boards; however, they gave no data on the remaining 40%. Bebchuk et al., *supra* note 188, at 895. Perhaps the remaining public corporations lacking a staggered board do not need one as a takeover defense because they have other strong takeover defenses in place (such as the existence of a friendly controlling shareholder or dual-class stock). Consequently, contrary to Bebchuk's claim, the declining number of management-initiated staggered board proposals may be attributable to factors other than shareholder opposition to a gatekeeping role for the board of directors.