UNOCAL AT 20: DIRECTOR PRIMACY
IN CORPORATE TAKEOVERS

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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.
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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

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\(^1\)Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).
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.

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

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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 resides 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”).


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”).


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

8 Id. at 954.

rather “the defender of the metaphorical medieval corporate bastion and the protector of the corporation’s shareholders.”

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

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 both values. 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. 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.

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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.
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.
Unocal’s academic critics typically err because they are preoccupied with accountability at the expense of authority. 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


21The Delaware Supreme Court has rejected the academic criticism of Unocal. See, e.g., Paramount Commc’n, 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).

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

23Other 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 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
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.

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.

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.
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 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

24The 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. Haneewicz, 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).


27Id. at 82-83.


29Id.

30Cf. 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”).
delegates such authority.\textsuperscript{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.”\textsuperscript{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,\textsuperscript{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.\textsuperscript{34} To facilitate this process of private ordering, the state’s corporation code offers a basic set of default rules that the parties are free generally to accept, reject, or modify as they see fit.\textsuperscript{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.\textsuperscript{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.\textsuperscript{37}

B. The Shareholders’ Contract

\textsuperscript{31}See infra notes 44-49 and accompanying text.
\textsuperscript{32}Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).
\textsuperscript{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.
\textsuperscript{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).
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 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

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”).


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
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. 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.” The vast majority of corporate decisions accordingly are made by the board of directors alone (or by managers acting under delegated authority). 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. Shareholders have virtually no power to initiate corporate action; indeed, they are entitled to approve or disapprove only a few board actions. The direct restrictions on shareholder power thus supplied by U.S. 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).

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).

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

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).

4For 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.

44Formal 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
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, 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

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49 See generally Bainbridge, supra note 35, at 512-14 (summarizing constraints).
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.
its subordinate officers—charged with seeking out the necessary inputs and bringing them together for productive labor.\textsuperscript{53}

Fiat can also lower costs associated with uncertainty, opportunism, and complexity.\textsuperscript{54} Given the limits on cognitive competence implied by bounded rationality,\textsuperscript{55} incomplete contracts are the inevitable result of the uncertainty and complexity inherent in ongoing business relationships.\textsuperscript{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.\textsuperscript{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.\textsuperscript{58}

\textsuperscript{53}Coase, supra note 50, at 392.

\textsuperscript{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),

\textsuperscript{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 relevance with respect to the organization for firms).

\textsuperscript{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”).

\textsuperscript{57}Coase, supra note 50, at 393.

\textsuperscript{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 \textit{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-
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.\footnote{59}

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.”\footnote{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.\footnote{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


\footnote{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, \textit{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, \textit{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. \textit{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 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, \textit{Board as Nexus, supra} note 24, at 24-25 (reiterating this argument).


\footnote{61}\textit{Id.} at 69.
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 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

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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.”).
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).
gather the information necessary to actively participate in decision making and thus are rationally apathetic.\footnote{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. \textit{Id.} at 392-93.}

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.\footnote{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, \textit{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, \textit{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}
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.” As we have seen, it is the board of directors that functions as that central office.

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. 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,” shareholders will require mechanisms to hold directors accountable for failing—whether through oversight or intent—to comply with that norm. Indeed, some claim that 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.

Arrow, supra note 60, at 68-69.

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).

See supra notes 40-43 and accompanying text.

“defining how agency costs can be controlled” is “the central problem of corporate law.”

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

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.

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.


73Cf. 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”).

74ARROW, supra note 60, at 78.
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

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

75Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).
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”).
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
rule therefore builds a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board’s decision. 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.

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.

Because approval by the target’s board of directors is a necessary prerequisite to most acquisition methods, 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. 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-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

managers sought “preferences for themselves” in surviving entity).

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).

(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 lockdown 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).
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.\textsuperscript{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.\textsuperscript{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 agreement embodying its decisions as to these matters.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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:

\textsuperscript{88}Id.
\textsuperscript{89}Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).
\textsuperscript{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).
\textsuperscript{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).
\textsuperscript{92}See Gilson, supra note 12, at 495-96 (summarizing the academic view of takeovers).
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. Propp94 that “[w]e must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to 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. Mathes96 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

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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).
95 Id. at 409.
96 199 A.2d 548 (Del. 1964).
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.

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

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

100Cheff, 199 A.2d at 555.
101Id.
(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.
103Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive
104Cheff, 199 A.2d at 554-55.
105See DOOLEY, supra note 48, at 549 (noting “the board’s burden [under Cheff] was more
apparent than real”).
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. Gilson was the leading early spokesman for what has been termed the auction model of management resistance. After arguing that Cheff failed adequately to constrain management’s conflict of interest in takeover contests, Gilson proposed a substantially more limited role for takeover defenses than Cheff had contemplated. 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. 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 \textit{ex ante} between defensive tactics that will promote a corporate auction and those that will preserve target board independence. In addition, because Gilson’s proposal only addressed incumbent tactics undertaken after an unsolicited offer is expected, it did not address the problem of pre-empting an offer before it can be responded to by the shareholders. 

\footnote{Dooley’s summary and analysis of the literature aptly sums it up as having “produced policy prescriptions running the gamut from A to B.” \textit{Id.}}\footnote{Id. at 551. See, e.g., Ronald J. Gilson, \textit{Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense}, 35 STAN. L. REV. 51 (1982) [hereinafter Gilson, \textit{Seeking Competitive Bids}]; Ronald J. Gilson, \textit{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, \textit{The Case for Facilitating Competing Tender Offers: A Reply and Extension}, 35 STAN. L. REV. 23 (1982) [hereinafter Bebchuk, \textit{Reply and Extension}]; Lucian A. Bebchuk, \textit{The Case for Facilitating Competing Tender Offers}, 95 HARV. L. REV. 1028 (1982) [hereinafter Bebchuk, \textit{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., \textit{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).\footnote{Gilson, supra note 103, at 827-29.}\footnote{Id. at 875-90.}\footnote{See Gilson, \textit{Seeking Competitive Bids}, supra note 107, at 64-65 (summarizing proposal).}\footnote{DOOLEY, supra note 48, at 555 (criticizing Gilson’s approach).}
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 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.

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114 Id. at 1169-74.

115 Easterbrook & Fischel, supra note 20, at 172.

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.
The Delaware Supreme Court never adopted either the auction or the passivity model. 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. If the court treated takeover defenses as a loyalty 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. 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. 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.

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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”).

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.
1. Unocal

In *Unocal Corp. v. Mesa Petroleum Co.*, 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.” Famed corporate raider T. Boone Pickens, whom the court referred to as having “a national reputation as a ‘greenmailer,’” 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 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. 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.

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

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121 493 A.2d 946 (Del. 1985).
122 Dooley, supra note 2, at 515.
123 *Unocal*, 493 A.2d at 956.
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.
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 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

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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.
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.

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

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.
negligence. Assuming the directors carry their first step, they next must prove the defense was reasonable in relation to the threat posed by the hostile bid. Both the decision to adopt a takeover defense and any subsequent decision to implement it are independently subject to challenge and judicial review.

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. 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.

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

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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 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.
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.
expectations . . .”139 As we shall see, intermittent accountability accomplished through “management by exception” is precisely what the Delaware standard has achieved.140

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

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139ARROW, supra note 60, at 78.
140See infra notes 160-63 and accompanying text.
141506 A.2d 173 (Del. 1986).
142Id. at 180-81.
Because the lockup ended the auction in return for minimal improvement in the final offer, it was invalidated.\footnote{Id. at 182 (emphasis added).}

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.”\footnote{Id. at 183-84.}

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.\footnote{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.} 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.\footnote{See, e.g., CRTF Corp. v. Federated Dep’t Stores, Inc., 683 F. Supp. 422, 441 (S.D.N.Y. 1988) (applying Delaware law).} Nonetheless, for many, the differences between Unocal and Revlon loomed large.\footnote{Cottle v. Storer Commc’n, Inc., 849 F.2d 570, 577 (11th Cir. 1988).}

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 decision was rendered.\footnote{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).} 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.”

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.

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

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’”).


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

\(^{152}\) *Newmont Mining Corp.*, 535 A.2d at 1338.


\(^{154}\) 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:

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
offers is, at best, a risky proposition for shareholders and, at worst, economically disastrous,\textsuperscript{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 \textit{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.\textsuperscript{157} Second, the board’s independence and decision-making process is subject to judicial scrutiny.\textsuperscript{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 tender offers.\textsuperscript{159} Admittedly, the form of review is unique, but so too is the demands that there shall be no conflict between duty and self-interest. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).\textsuperscript{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, \textit{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”).\textsuperscript{157}

\textsuperscript{158}See id. at 488-90.\textsuperscript{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 \textit{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.
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.\(^\text{160}\) 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.\(^\text{161}\) 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.\(^\text{162}\) 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.”\(^\text{163}\) 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 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.

\(^{160}\) *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.
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. 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. 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 Chancellor Allen’s opinion in TW Services, Inc. v. SWT Acquisition Corp. 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

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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.

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 plan at $68 to $70 per share.170 It is precisely because passive, widely

167Chancellor 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.
168551 A.2d 787 (Del. Ch. 1988).
169Id. at 793-94.
170Id. 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
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. 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 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. According to some, authority values are only appropriate in the negotiated acquisition context if the board is denied the ability to resist tender offers.

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).

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.”).
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. To the contrary, the incumbent board’s role is very active indeed because the incumbent board members remain in office and therefore also remain legally obligated to conduct the business, unless and until they are displaced. 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.” 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 “fundamental duty” to protect shareholders from harm, 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. 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.”

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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.


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. 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 matter, to sell his house. 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

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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.

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 determinant 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.
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.\textsuperscript{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.\textsuperscript{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 one of many accountability tools available, not as part of the firm’s decision-making system.\textsuperscript{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.”\textsuperscript{186}

\textsuperscript{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.

\textsuperscript{184}See supra notes 44-49 and accompanying text.

\textsuperscript{185}In light of the limitations to which those rights are subject, shareholder voting rights are not a very important accountability tool.

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. 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.

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.
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. Yet, almost 60% of public corporations now have staggered boards. Even more striking, the incidence of staggered boards has increased dramatically among firms going public (from 34% in 1990 to over 70% in 2001). Finally, activist shareholders have made little headway in efforts to “de-stagger” the board. 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. Indeed, if what investors do matters more than what they say, one must

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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.

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
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 examination of corporate legal rules will find plenty of evidence that courts value preservation of the board’s decision-making authority.195 The structural argument, however, ignores the authority values reflected in these rules. To the contrary, if accepted, the structural argument would necessarily undermine the board’s unquestioned authority in a variety of areas. Consider, for example, the board’s authority to negotiate mergers. If the bidder can easily bypass the board by making a tender offer, hard bargaining by the target board becomes counter-productive. It will simply lead the bidder into making a low-ball tender offer to the shareholders. This offer, in turn, would probably be accepted due to the collective action problems that preclude meaningful shareholder resistance.196 Restricting the board’s authority to resist tender offers thus indirectly restricts its authority with respect to negotiated acquisitions.197

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”).


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.

195 See supra Part II.E.


197 Many acquisitions are initiated by target managers seeking out potential acquirers. A no-resistance rule would discourage these takeovers, thus harming shareholders. No sensible seller would seek out potential buyers unless it is able to resist low-ball offers. Haddock et al., supra note 196, at 709-10. Note there is a subtle difference between the position advanced in the text and what might be called the “management as negotiator” model of takeover jurisprudence. Under this model, management can resist a tender offer in order to extract a better offer from the bidder. Suggestions of this model can be found in some of the Delaware cases. See, e.g., Mills Acq’n Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1989) (distinguishing between target board
Indeed, taken to its logical extreme, the structural argument requires direct restrictions on management’s authority in the negotiated acquisition context. Suppose management believes that its company is a logical target for a hostile takeover bid. One way to make itself less attractive is by expending resources in acquiring other companies. Alternatively, the board could effect a preemptive strike by agreeing to be acquired by a friendly bidder. In order to assure that such acquisitions will not deter unsolicited tender offers, the structural argument would require searching judicial review of the board’s motives in any negotiated acquisition.

To take but one more example, a potential target can make itself less vulnerable to a takeover by eliminating marginal operations or increasing the dividend paid to shareholders, either of which would enhance the value of the outstanding shares. Thus, a corporate restructuring can be seen as a preemptive response to the threat of takeovers. Although such transactions may aid incumbents in securing their positions, it is hard to imagine valid objections to incumbents doing so through transactions that benefit shareholders. Why should it matter if the restructuring occurs after a specific takeover proposal materializes? On the contrary, the structural argument not only says that it does matter, but taken to its logical defensive maneuvers that draw an otherwise unwilling bidder into the contest and those that end an active auction by effectively foreclosing further bidding. Ultimately, however, it proves unworkable. For example, how target directors are supposed to use takeover defenses as a negotiating tool never has been made entirely clear. Johnson & Siegel, supra note 3, at 375. Unless the directors can plausibly threaten to preclude the bid from going forward, their defensive tactics have no teeth and thus provide no leverage. Yet, in light of management’s conflict of interest, a board’s refusal to drop its defenses is necessarily suspect. Judicial review of such a refusal, moreover, requires courts to pursue some very thorny lines of inquiry: Is target management correct in believing they are better managers than the bidder? Or would the company, in fact, be better off with the bidder at the helm? Neither is the sort of question courts are comfortable asking about business decisions, including those involving self-dealing. As described below, my approach centers not on how the board used takeover defenses but on whether the board’s decisions were tainted by conflicted interests.

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199. Dooley, supra note 2, at 516-17.
201. See Dooley, supra note 2, at 517 (making this point); cf. Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 276 (Del. Ch. 1989) (upholding an employee stock ownership plan despite its anti-takeover effects, because the plan was “likely to add value to the company and all of its stockholders”).
extreme, it would require close judicial scrutiny of all corporate restructurings.  

Lastly, restrictions on the board’s authority to function as a gatekeeper with respect to unsolicited tender offers might have a multiplicative effect on the board’s authority generally. Because “the efficiency of organization is affected by the degree to which individuals assent to orders, denying the authority of an organization communication is a threat to the interests of all individuals who derive a net advantage from their connection with the organization.” Hence, by calling into question the legitimacy of the central decision-making body’s authority in this critical decision-making arena, a passivity rule might reduce the incentive for subordinates to assent to that body’s decisions in other contexts as well, thereby undermining the efficient functioning of the entire firm.

D. The Conflicted Interest Argument

The final and perhaps most important argument for treating negotiated and hostile acquisitions differently with respect to the scope of the target board’s authority comes down to the conflicted interests inherent in corporate takeovers. Put succinctly, accountability concerns are so severe in this context, they must trump authority values.

Unsolicited tender offers admittedly implicate accountability concerns in at least two ways, which might be referred to, respectively, as transactional and systemic. The former relates to the effect of a hostile takeover on the target in question, while the latter relates to the effect resistance to hostile takeovers can have on public corporations as a whole. Neither justifies wholly barring authority values from playing a part in developing the governing legal rules.

1. Transactional Accountability

No one disputes an unsolicited takeover offer poses a serious conflict between the interests of target managers and target shareholders. If the deal goes forward, shareholders stand to gain a substantial premium for their

\[202\] A related cost of shareholder choice is that it may encourage directors and managers to refrain from investments that have a positive net present value but also make the firm more attractive to potential hostile acquirers. See Richard E. Kihlstrom & Michael L. Wachter, Why Defer to Managers? A Strong-Form Efficiency Model, available at http://ssrn.com/abstract=803564.


\[204\] BAINBRIDGE, supra note 83, at 359.
shares, while managers face a substantial risk of losing their jobs. Any defensive actions by management are thus tainted by the specter of self-interest.

A key failing of the academic literature on takeovers is the almost universal conflation of the roles of corporate officers and directors. The legal literature speaks of management resistance and management defensive tactics, rarely recognizing any separate institutional role for the board. To the limited extent that it does differentiate between directors and managers, the literature tends to assume naively that even independent directors are in thrall to senior managers and will ignore shareholder interests if necessary to preserve their patrons’ jobs.

In contrast, the Delaware courts take the board of directors’ distinct role quite seriously, especially with respect to its independent members. As a doctrinal matter, the board’s burden of proof is more easily carried if the key decisions are made by independent directors. As a practical matter, the court’s assessment of the outside directors’ role often is outcome determinative.

Why have the Delaware courts insisted on drawing such sharp distinctions between the board’s role and that of management? While the conflict of interest unsolicited tender offers pose for the target company’s managers is inescapable, the independent director’s conflict of interest is merely a potential problem. Hence, it is error to claim the process of judicial review of takeover defenses “is inherently infirm because . . . all defensive

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205 For summaries of the empirical evidence, see BAINBRIDGE, supra note 83, at 359-60; Bebchuk, supra note 20, at 992-93. I am willing to assume arguendo that the evidence shows real losses to shareholders, as opposed to being an artifact of a downward sloping demand curve or mere wealth transfers from other stakeholders. Even so, while Bebchuk would be correct that allowing the board to function as a gatekeeper “makes shareholders worse off,” id. at 1004, I do not accept his implied proposition that this result has dispositive normative traction. The normative question remains whether shareholders have a right to be better off in this context. Property owners are subject to various legal regimes, such as zoning and regulatory takings, that can leave them worse off. Parties can enter into contracts they deem to be beneficial, even if the contract may leave them worse off in some settings. The empirical evidence on the premia paid in unsolicited bid thus cannot be a normative trump card.

206 See, e.g., Bebchuk, supra note 20, at 995; Easterbrook & Fischel, The Proper Role, supra 112, at 1199 n.108; Gilson, supra note 103, at 881.


actions have an entrenchment effect.210 For the independent directors, the conflicts posed by unsolicited tender offers are no different than those posed by freeze-out mergers, management buyouts, interested director transactions, or a host of similar situations. Corporate law neither prohibits these transactions nor requires complete board passivity in connection with them simply because they potentially involve conflicts of interest. Instead, it regulates them in ways designed to constrain self-interested behavior. Unless one makes a living on the buying side of corporate takeovers, it is not clear why hostile takeovers should be treated differently.211

Consider, for example, the somewhat analogous case of management-sponsored leveraged buyouts. Like unsolicited tender offers, these transactions inherently involve a strong risk of management self-dealing. While management is acting as the sellers’ agents and, in that capacity, is obliged to get the best price it can for the shareholders, it is also acting as a purchaser and, in that capacity, has a strong self-interest to pay the lowest possible price. Like unsolicited tender offers, management buyouts also create conflicts of interest for the independent directors. Just as an independent director may resist an unsolicited tender offer to avoid being fired by the hostile bidder, he may go along with a management buyout in order to avoid being fired by the incumbent managers.212 Alternatively, if an independent director is inclined to resist a hostile takeover because of his friendship with the insiders, should he not go along with a management-sponsored buyout for the same reason? Strikingly, the empirical evidence indicates shareholder premiums are essentially identical in management-sponsored leveraged buyouts and arm’s length leveraged buyouts.213 This evidence suggests the potentially conflicted interests of independent directors are not affecting their ability to successfully constrain management misconduct.214 Accordingly, while judicial review of management buyouts tends to be rather intensive, courts have allowed such transactions and have addressed the problem of conflicted interests by encouraging an active role for the firm’s independent directors in approving a management buyout proposal.215 Why should the same not be true of the

210Thompson & Smith, supra note 16, at 295 (emphasis omitted).
211BAINBRIDGE, supra note 83, at 361.
212Id. at 362.
214See Leo Herzel et al., Misunderstanding Lockups, 14 SEC. Reg. L.J. 150, 163-64 (1986) (arguing that various factors lead independent directors to assume control of takeover process).
board’s response to unsolicited tender offers? The legitimacy of the board’s active role seemingly is confirmed by the observation that boards have become “more willing than ever to accept takeover offers and, as important, to seek out strategic mergers that generate premia for their stockholders.”

In summary, the conflict of interest present when the board responds to an unsolicited tender offer differs only in degree, not kind, from any other corporate conflict. Although skepticism about board motives is appropriate, their conflict of interest does not necessarily equate to blameworthiness. Rather, it is simply a state of affairs inherently created by the necessity of conferring authority on the board of directors to act on behalf of the shareholders. To be sure, proponents of the no-resistance rule will respond that such a state of affairs could be avoided by declining to confer such authority on the board in this context. Yet, if the legal system deprives the board of authority here, it will be hard pressed to decline to do so with respect to other conflict transactions. As has been the case with other situations of potential conflict, we would expect the courts to develop standards of review for takeover defenses that are designed to detect, punish, and deter self-interested behavior. Because the risk may be greater in this context, stricter-than-normal policing mechanisms may be required, but this does not mean that we must set aside authority values by divesting the board of decision-making authority.

2. Systemic Accountability

Because the target board of directors’ transactional conflict of interest is neither so severe nor unusual as to justify a passivity requirement,
opponents of the target board’s gatekeeping function must find some other basis for denying in this context the board’s normal decision-making authority. For most critics of takeover defenses, such a basis is found in the systemic agency cost effects of target resistance.

The tension between authority and accountability arises because we need some mechanism for enforcing those rights for which shareholders and other constituencies have contracted. Recall that director primacy views the corporation as a vehicle by which directors bargain with factors of production. All corporate constituencies thus end up with certain bargained-for contractual rights, including the shareholders. Chief among the shareholders’ contractual rights is one requiring the directors to use shareholder wealth maximization as their principal decision-making norm. Agency cost economics, however, teaches that breaches of this contract by directors who shirk their responsibilities must be expected. Unfortunately, like many intra-corporate contracts, the shareholder wealth maximization norm does not lend itself to judicial enforcement absent self-dealing. Instead, it must be enforced indirectly through a complex and varied set of extrajudicial accountability mechanisms.

Disciplinary actions against employees and mid-level managers normally take the form of dismissals, demotions, or salary adjustments imposed by senior management. Where it is top management that must be disciplined, however, alternative mechanisms become necessary. According to the standard academic account, hostile takeover bidders provide such a mechanism. Making the standard efficient capital market assumption that poor corporate performance will be reflected in the corporation’s stock price, opponents of target resistance claim that a declining market price sends a signal to prospective bidders that there are gains to be had by acquiring the corporation and displacing the incumbent managers. The signal, of course, will not always be correct. Sometimes the firm’s market price may be declining despite the best efforts of competent management, such as where some exogenous shock like technological change or new government regulation has permanently altered the corporation’s

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221 See Bainbridge, Director Primacy, supra note 24, at 550.
222 For an argument that shareholders would not contract for a regime of undistorted shareholder choice, see supra notes 188-94 and accompanying text.
223 See BAINBRIDGE, supra note 35, at 419-29 (explaining why shareholder wealth maximization would emerge from hypothetical bargaining between directors and shareholders even in the director primacy model).
224 See id. at 422 (noting “the business judgment rule (appropriately) insulates directors from liability”).
225 See Henry Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110, 112 (1965)
fundamentals. If close examination by a prospective bidder reveals the declining market price is, in fact, attributable to shirking by the top management team, however, a disciplinary takeover could produce real gains to divide between the target’s shareholders and the successful acquirer. This prospect creates positive incentives for potential bidders to investigate when the market signals that a firm is in distress. Conversely, because keeping the stock price up is the best defense managers have against being displaced by this outside searcher, the market for corporate control—more specifically, the unsolicited tender offer—is an important mechanism for preventing shirking by top management. Indeed, some would argue, the market for control is the ultimate monitor that makes the modern business corporation feasible.

By making possible target resistance to unsolicited takeover bids, so the theory goes, takeover defenses undermine the very foundations of corporate governance. The first prospective bidder to identify a prospective target incurs significant search costs, which become part of the bidder’s overall profit calculation. Further, by announcing its offer, the first bidder also identifies the prospective target to all other potential bidders. Subsequent bidders thus need not incur the high search costs carried by the first bidder, perhaps allowing them to pay a higher price than is possible for the first bidder. If target resistance delays closing of the offer, additional bidders have an even greater opportunity to enter the fray. At the very least, target resistance may force the initial bidder to raise its offer, thereby reducing other bidders’ incentives to search out takeover targets. Reductions in bidders’ search incentives result in fewer opportunities for shareholders to profit from takeover premia. More important, a reduction in

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226 See generally id. at 119-20 (advancing this argument).
227 See, e.g., Bebchuk, supra note 20, at 993-94 (discussing ex ante effects of a board veto on takeover bids); see also id. at 996 (arguing “the possibility of a takeover provides a safety valve and source of discipline”). For a contrary argument, which posits that the potential conflicts of interest between managers and shareholders are less important than usually assumed and that takeovers generally do not produce value by displacing inefficient managers, see Richard P. Castanias & Constance E. Helfat, Managerial and Windfall Rents in the Market for Corporate Control, 18 J. ECON. BEHAV. & ORG. 153 (1992).
228 Easterbrook & Fischel, supra note 20, at 173-74; Alan E. Garfield, Paramount: The Mixed Merits of Mash, 17 DEL. J. CORP. L. 33, 50 (1992); Gilson, supra note 103, at 841-45.
229 Easterbrook & Fischel, The Proper Role, supra note 112, at 1178-79. I have argued elsewhere this phenomenon also helps explain the insistence on the grant of a lockup option made by many acquirers in negotiated acquisitions. Bainbridge, supra note 86, at 242. Fraidin and Hanson criticized this argument on the grounds that most of these costs are sunk, so they will not affect the behavior of rational acquirers. Stephen Fraidin & Jon Hanson, Toward Unlocking Lockups, 103 YALE L.J. 1739, 1814 (1994). While that is true from an ex post perspective, from an ex ante perspective potential bidders may not be willing to incur search costs in the first place without some expectation of realizing a return on that investment.
search incentives also reduces the effectiveness of interfirm monitoring by outsiders. In turn, that reduces the market for corporate control’s disciplinary effect. A rule prohibiting target resistance, therefore, is likely to decrease agency costs and increase stock prices, benefitting shareholders of all firms, even those whose companies are never targeted for a takeover bid.230

The difficulty with this line of argument is that a no-resistance rule, in effect, creates a kind of private eminent domain: bidders can effectively “condemn” target shares by offering even a slight premium over the current market price.231 Awarding the lion’s share of the gains to be had from a change of control to the bidder, though, only makes sense if all gains from takeovers are created by bidders through the elimination of inept or corrupt target managers, and none are attributable to the hard work of efficient target managers.232 Unfortunately for proponents of the no-resistance rule, the evidence is that “takeovers produce gains for a variety of reasons that are likely to differ from case to case.”233

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230 Easterbrook & Fischel, The Proper Role, supra note 112, at 1174. Some commentators who generally accept this account nonetheless have rejected the no-resistance rule. These critics concede the rule maximizes search incentives but question the amount of search activity that is socially desirable. Particularly, they assert the benefits of an increased search must be compared with the costs imposed on target companies if shareholders are coerced into selling at a price they do not perceive to be higher than the value of the target to them. See, e.g., Bebchuk, Reply and Extension, supra note 107, at 33-38. Alternatively, they posit the benefits of permitting corporate control auctions can outweigh the costs of doing so. See, e.g., Jonathan R. Macey, Auction Theory, MBOs and Property Rights in Corporate Assets, 25 WAKE FOREST L. REV. 85 (1990). I do not need to resolve this dispute within the ranks because both sides have missed the central point by focusing solely on accountability concerns and ignoring the equally important role of authority values.

231 Lucian Arye Bebchuk, The Sole Owner Standard for Takeover Policy, 17 J. LEG. STUD. 197, 200 (1988). As Bebchuk notes, the taking implications of the no-resistance rule are inconsistent with the passivity model’s chief proponents’ strong preference in other contexts for property rights and freedom of contract. Id. at 200-03. See generally DOOLEY, supra note 48, at 552-53 (discussing Bebchuk’s analysis).

232 See Haddock et al., supra note 196, at 709-10.

One of the principal reasons for protecting property rights in assets is to encourage ex ante investment by the owner. If the owner is unable to recapture the value created by ex ante investment upon sale of the asset, under investment [sic] will result. It follows that if the market standard results in coerced sales by target shareholders, there will be a suboptimal amount of investment in target companies, and a sole owner standard is to be preferred.

DOOLEY, supra note 48, at 553; see generally Bebchuk, supra note 231, at 210-11 (suggesting “synergistic gains” produced from mergers result from both bidder’s actions and any previously existing intrinsic value that prompted the merger in the first place); Haddock et al., supra note 196, at 708-19 (discussing a target firm’s rationale for both enhancing its marketability to and protecting its assets against potential bidders).

233 DOOLEY, supra note 48, at 553. Useful summaries of the empirical literature include Bernard S. Black, Bidder Overpayment in Takeovers, 41 STAN. L. REV. 597 (1989); Roberta

Dooley notes it would be naïve to assume “takeovers displace only ‘bad’ or ‘inefficient’ managers.” DOOLEY, supra note 48, at 561-63. While acknowledging that blamelessness does not eliminate the managers’ conflict of interest, he suggests that management resistance to unsolicited tender offers “may not deserve the opprobrium usually attached to self-dealing transactions.” Id. at 562. Indeed, Dooley observes, it may often be shareholders rather than managers who act opportunistically in the takeover context. Id. Much of the knowledge a manager needs to do his job effectively is specific to the firm for which he works. As he invests more in firm-specific knowledge, his performance improves, but it also becomes harder for him to go elsewhere. Thus, an implicit contract forms between managers and shareholders. Managers “promise to become more productive by investing in firm-specific human capital. They bond the performance of that promise by accepting long promotion ladders and compensation schemes that defer much of the return on their investment until the final years of their career. In return, shareholders promise job security.” Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, supra note 43, at 1004-08; DOOLEY, supra note 48, at 562.

Deciding “to terminate the managers’ employment by tendering [to a hostile bidder] seems opportunistic and a breach of implicit understandings between the shareholders and their managers.” DOOLEY, supra note 48, at 562. Shareholders can protect themselves from opportunistic managerial behavior by holding a fully diversified portfolio. By definition, a manager’s investment in firm-specific human capital is not diversifiable. Shareholders’ ready ability to exit the firm by selling their stock also protects them. In contrast, the manager’s investment in firm-specific human capital also makes it more difficult for him to exit the firm in response to opportunistic shareholder behavior. See Coffee, supra note 200, at 73-81.

Dooley concedes this analysis certainly helps explain the courts’ greater tolerance of conflicted interests in this context than in, for example, garden variety interested director transactions. Given the possibility that the shareholders’ gains come at the expense of the outgoing managers, it does not justify permitting them from blocking unsolicited tender offers. On the contrary, “the managers’ loss of implicit compensation benefits appears to be a particular dramatic form of transaction costs, which could be reduced by alternative explicit compensation arrangements,” such as shareholder payments to managers who lose their jobs following a takeover. DOOLEY, supra note 48, at 562. It may be that courts tolerate management involvement in the takeover process because they perceive management as having a right to compete with rival managerial teams for control of the corporation. By allowing management to compete with the hostile bidder for control, the courts provide an opportunity for management to protect its sunk cost in firm-specific human capital without adversely affecting shareholder interests. Id. at 562-63. Indeed, allowing them to compete for control will often be in the shareholders’ best interests. There is strong empirical evidence management-sponsored alternatives can produce substantial shareholder gains. See Jensen, supra note 200, at 324-26 (summarizing studies of shareholder gains from management-sponsored restructuring and buyouts). A firm’s managers obviously have significant informational advantages over the firm’s directors, shareholders, or outside bidders, which gives them a competitive advantage in putting together the highest valued alternative. Management may also be able to pay a higher price than would an outside bidder because to a firm’s managers, the company’s value includes both its assets and also the sunk costs in firm-specific human capital. Thus, shareholders have good reason to want management to play a role in
In order for a no-resistance rule to make sense, the unsolicited tender offer also must be the critical mechanism by which incumbents are disciplined. Unsolicited tender offers, however, are so rare and sporadic that a top manager who shirks his responsibilities by playing golf when he should be working is undoubtedly more likely to be struck by lightning while on the course than to be fired after a hostile takeover.234 As a result, the disciplinary effect of takeovers likely has been overstated by proponents of the no-resistance rule.235 Instead, as my analysis of Delaware’s takeover jurisprudence will suggest, the critical disciplinary mechanism is the board corporate takeovers, so long as that role is limited to providing a value maximizing alternative. DOOLEY, supra note 48, at 563.

It is certainly true that any management response to an unsolicited tender offer, other than pure passivity, triggers a competition between two or more rival managerial teams for control of the corporation. The competition is obvious when an unsolicited tender offer is made to the shareholders of the target of a locked-up negotiated acquisition. A competition also results, however, when management defends against a standard hostile takeover bid by putting forward a management-endorsed white knight bid, a management-sponsored leveraged buyout proposal, a restructuring of the corporation’s control structure transferring effective voting control to management and its allies, a restructuring preserving management’s incumbency by making the target unpalatable to hostile bidders, or even merely a management statement urging shareholder to reject the bid. Revlon’s progeny appear to encourage this sort of competition, so long as it is conducted fairly, by making it clear that the board, in conducting an auction, must have a very good reason for skewing the auction in favor of one of the competing bidders. Paramount Commc’n’s, Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1995); Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286-87 (Del. 1989); Mills Acq’n Co. v. Macmillan, Inc., 559 A.2d 1261, 1286-87 (Del. 1989).

Yet, to focus on competition between incumbent management and the outside bidder would obscure the critical role played by the board of directors. As described in Part V.A infra, the Delaware courts have rejected formalistic and formulaic approaches to takeovers. Instead, they have adopted a case-by-case search for conflicted interests. Where the facts suggest the directors have allowed self-interest to affect their decisions, they have lost, but where the directors pursued the shareholders’ interests, Delaware courts have deferred to their decisions, even where the reviewing court might not have made the same decision.

234BAINBRIDGE, supra note 83, at 365.
235It is generally agreed the value of a share of stock depends upon the market’s estimate of (1) the firm’s present and future performance under current management, (2) the likelihood the firm will be acquired in a negotiated acquisition times the expected premium, and (3) the likelihood the firm will be acquired in an unsolicited tender offer times the expected premium. See, e.g., Bebchuk, Case for Facilitating, supra note 107, at 1034; Easterbrook & Fischel, The Proper Role, supra note 112, at 1164 (not breaking out negotiated acquisitions). Even in the tender offer’s heyday, unsolicited tender offers were very rare events. Accordingly, the bulk of a stock’s value is comprised by the first two components. As we have seen, the corporate law decision-making structure with respect to those components strongly leans in the direction of authority rather than accountability, which suggests that the benefits of centralized decision-making power in these areas outweigh the costs of reduced management accountability. All of this suggests that the academic account of the tender offer’s corporate governance role rests on a flawed premises; namely, that greater management accountability is needed and that such accountability can be provided without infringing on the board’s authority elsewhere in the corporate governance system.
of directors, especially when these directors are independent. In turn, the tenure and reputation of outside board members are determined by the performance of the top inside managers, which gives independent directors further incentives to be vigilant in overseeing management’s conduct.

If independent directors were the sole bulwark against managerial shirking, concerns about structural and actual bias might be troubling, but they do not stand alone. Important accountability mechanisms are supplied by the product market in which the firm operates and the internal and external job markets for the firm’s managers. Top corporate managers do not get ahead by being associated with sub-par performance in the product markets. Indeed, as between shareholders and managers, it is the latter who have the greatest incentives to ensure the firm’s success. Shareholders can and should hold diversified portfolios, so that the failure of an individual firm will not greatly decrease their total wealth. Managers, on the other hand, cannot diversify their firm-specific human capital (or their general human capital, for that matter). If the firm fails on their watch, it is the top management team that suffers the principal losses.

For this reason, the capital markets also have a disciplinary function. Incompetent or even unlucky management eventually shows up in the firm’s performance. These signs are identified by potential debt or equity investors, who (if they are willing to invest at all) will demand a higher rate of return to compensate them for the risks of continued suboptimal performance. In turn, this demand makes the firm more likely to flounder and take the incumbent managers down with it.

The point here is not that the tender offer has no disciplinary effect but merely that the tender offer is only one of many mechanisms by which management’s behavior is constrained. Once we view corporate governance as a system in which many forces constrain management behavior, the theory of the second best becomes relevant. In a complex, interdependent system, it holds that inefficiencies in one part of the system should be tolerated if “fixing” them would create even greater inefficiencies elsewhere in the system as a whole. Accordingly, even if we concede the claim that a no-resistance rule would reduce agency costs, such a rule would still be inappropriate if it imposes costs in other parts of the corporate governance system. By restricting the board’s authority with respect to tender offers, the various academic proposals impose such costs by also restricting the

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237 See Dooley, supra note 2, at 525 (“[H]ow do managers get ahead, both in rising through a particular firm’s hierarchy or in obtaining a better position with another firm? The answer is surely not by being associated with failed projects, sub-par performance and personal venality.”).

238 Id.
board’s authority with respect to the everyday decisions upon which shareholder wealth principally depends. Therefore, it is not surprising that Delaware has rejected the academic approach to the unsolicited tender offer. Delaware’s takeover jurisprudence, like that regulating negotiated acquisitions, is best explained as implicitly concluding that the benefits of preserving authority outweighs the costs of doing so.

Evidence that Delaware made the right choice abounds. The director primacy-based system of U.S. corporate governance has served investors and society well. John Micklethwait and Adrian Wooldridge recently opined, for example, that the corporation is “the basis of the prosperity of the West and the best hope for the future of the rest of the world.”239 A comprehensive review of the evidence by Holmstrom and Kaplan is temperate only by comparison:

Despite the alleged flaws in its governance system, the U.S. economy has performed very well, both on an absolute basis and particularly relative to other countries. U.S. productivity gains in the past decade have been exceptional, and the U.S. stock market has consistently outperformed other world indices over the last two decades, including the period since the scandals broke. In other words, the broad evidence is not consistent with a failed U.S. system. If anything, it suggests a system that is well above average.240 It is difficult to imagine that the system of U.S. corporate governance would be functioning so well if the problem is as dire as the proponents of the systemic agency cost argument claim. Given the importance of Delaware to the U.S. corporate governance system, it is equally difficult to imagine that the system would be functioning so well if the critics of Unocal were correct.241

V. EVALUATING DELAWARE’S BALANCE


241As a distinguished Delaware jurist observes:

Although the jurisprudential landscape may not have been ideal for those who favored easy stockholder access to tender offers, the proponents of such access can hardly view the 1980s and 1990s as grounds for despair. With the sorts of swings one expects in any market, M&A transactions increased enormously during these decades.

Strine, supra note 107, at 874 (footnote omitted).
In its takeover jurisprudence, Delaware typically has balanced the competing claims of authority and accountability by varying the standard of review according to the likelihood that the target board of directors’ actions will be tainted by conflicted interests in a particular transactional setting and the likelihood that nonlegal forces can effectively constrain those conflicted interests in that setting. As a result, the Delaware cases tend to focus, albeit often implicitly, on the board’s motives.242

Former Delaware Chancellor Allen laid bare the concern with motive in discussing the closely related issues posed by management buyout transactions: “The court’s own implicit evaluation of the integrity of the . . . process marks that process as deserving respect or condemns it to be ignored.”243 Assuming that a special committee of independent directors would be appointed to consider the proposed transaction, Allen went on to explain:

When a special committee’s process is perceived as reflecting a good faith, informed attempt to approximate aggressive, arm’s-length bargaining, it will be accorded substantial importance by the court. When, on the other hand, it appears as artifice, ruse or charade, or when the board unduly limits the committee or when the committee fails to correctly perceive its mission—then one can expect that its decision will be accorded no respect.244

My claim is that the same is true with respect to board resistance to unsolicited tender offers.245 If the conflict of interest inherent in such

242See generally Dooley, supra note 2, at 517-24 (discussing the significance of board motives in Delaware’s takeover jurisprudence); see also Loewenstein, supra note 14, at 20-21 (noting the significance of the board’s conflicted interests to the analysis in AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986)).

243Allen, supra note 209, at 2060.

244Id.

245Hence, I disagree with Delaware Vice Chancellor Leo Strine’s characterization of my interpretation of the Unocal standard. Strine has suggested that “if all Professor Bainbridge thinks a board must do to satisfy Unocal is to prove (i) that a reasonable person could believe the bid was too low and (ii) that the board in fact holds that belief,” the Unocal standard will lack utility as an accountability device, “especially because courts might be reluctant to conclude that independent directors are misrepresenting their true beliefs about value.” Strine, supra note 107, at 879 n.45. As I understand it, however, the motive analysis under Unocal looks at the totality of the board’s conduct—not just the board’s beliefs about the value of the offer on the table—to determine whether the board acted disinterestedly, in good faith, and without improper entrenchment purposes. Hence, I would endorse the characterization of the Unocal standard offered by the federal district court in Southdown, Inc. v. Moore McCormack Resources, Inc., 686 F. Supp. 595 (S.D. Tex. 1988), which requires a reviewing court to ask “whether a fully informed, wholly disinterested, reasonably courageous director would dissent from the board’s act in any material
resistance has matured into actual self-dealing, the court will invalidate the defensive tactics. If the board acted from proper motives, even if mistakenly, the court will leave the defenses in place.

As evidence for this claim, I cite former Delaware Supreme Court Justice Moore’s argument that the court’s “decisions represent a case-by-case analysis of some difficult and compelling problems.” He later elaborated:

We did not approach [takeover] cases with the question of whether to allow the corporation to continue in its present form or to permit someone else to acquire the company. . . . [T]he question before the Court was whether the directors acted properly in accepting or rejecting the competing offers. . . . As long as the directors adhered to their fiduciary duties, it would have been most inappropriate for any court to intrude upon a board’s business decision. No court has a role in disciplining directors for the proper exercise of business judgment, even if it turns out to be wrong.

Former Delaware Chancellor Allen made much the same point in *RJR Nabisco*, where he indicated the basic question is whether the board acted with due care and in good faith:

Surely the board may not use its power to exercise judgment in [an auction of control] as a sham or pretext to prefer one bidder for inappropriate reasons. . . . But the board of directors continues, in the auction setting as in others, to bear the burden imposed and exercise the power conferred by Section 141(a). Assuming it does exercise a business judgment, in good faith and advisedly, concerning the management of the auction process, it has, in my opinion, satisfied its duty.

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Using a motive inquiry to balance authority and accountability concerns is the consistent theme throughout these summations of Delaware law.

This is not to suggest that motive is always dispositive. In *Omnicare, Inc. v. NCS Healthcare, Inc.*\(^{249}\) the Delaware Supreme Court invoked *Unocal* and its progeny to invalidate a lockup arrangement in a negotiated acquisition. In dissent, Justice Steele observed (correctly, in my view) that the target’s “board of directors acted selflessly pursuant to a careful, fair process and determined in good faith that the benefits to the stockholders and corporation flowing from a merger agreement containing reasonable deal protection provisions outweigh any speculative benefits that might result from entertaining a putative higher offer.”\(^{250}\) If motive were controlling, the court therefore should have upheld the merger agreement. Yet, if *Omnicare* illustrates that the motive-based analysis put forward herein is not a completely accurate positive account of Delaware law, at least the motive-based analysis provides a useful normative basis on which to critique opinions like *Omnicare*. Accordingly, it is not surprising that *Omnicare* is proving to be a highly controversial decision.\(^{251}\)

A. The Evolution Towards a Motive-Based Inquiry

As the *Unocal* standards evolved, two recurring questions arose. First, what threats to the corporation and its shareholders were legally cognizable under the first prong? Second, what defenses were proportional to a given threat?

At least for a time, the Delaware Court of Chancery defined the category of cognizable threats quite narrowly. Only threats to shareholder interests had any real analytical significance. Nor were all threats to shareholder interests cognizable. Rather, at least in the context of an offer for all of the target’s outstanding shares, the trend was towards limiting cognizable threats to inadequate value and structural coercion.\(^{252}\) Inadequate value refers, obviously enough, to a claim that the price offered by the bidder is too low. Structural coercion refers to bidder tactics creating a “risk

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\(^{249}\)818 A.2d 914 (Del. 2003).

\(^{250}\)Id. at 946 (Steele, J., dissenting).

\(^{251}\)See, e.g., David Marcus, *What’s Happening In Wilmington?*, AM. LAW., Mar. 2003, at 34 (“Since June 2002, the Delaware Supreme Court has issued five decisions that center on whether a company’s directors have acted properly. . . . The most controversial of the five rulings came in *Omnicare, Inc. v. NCS Healthcare, Inc.*”).

that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions."

The Delaware courts gave target directors a more-or-less free hand to deal with structurally coercive bidder tactics. Defenses designed to preclude such offers, minimize their coercive effect, or provide a more viable alternative to the shareholders were all deemed proportional. Indeed, when structural coercion was the identified threat, proportionality review usually was perfunctory at best.254

When inadequate value was the sole threat, however, proportionality review became more exacting. As most observers interpreted the so-called poison pill cases,255 Unocal permitted target management to use takeover defenses as negotiating leverage to obtain a better deal for the shareholders or, more realistically, to delay the hostile offer while an alternative transaction was arranged. In either case, target management supposedly had to let the shareholders make the ultimate decision.256 According to the conventional wisdom, once it became clear the best possible alternatives were on the table, the board was required to redeem the pill and permit the shareholders to choose between the available alternatives. The target board could neither “just say no,” nor could it structure the transaction in such a

253Gilson & Kraakman, supra note 124, at 267. See also supra notes 124-25 and accompanying text (discussing coercive effect of two-tier tender offers).

254In Unocal, for example, the court’s proportionality analysis can be described most charitably as concise. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d, 946, 956 (Del. 1985). Note that Delaware law on coercive bidder tactics is easily squared with my authority-accountability framework. On the one hand, corporate law grants sweeping powers to the board in part so the board can protect shareholder financial interests. If a coercive bid threatens those interests, authority values thus justify board resistance. On the other hand, giving the board power to resist coercive offers does not implicate significant accountability concerns. To be sure, the board’s decision to resist a structurally coercive bid may be motivated by personal considerations unrelated to shareholder welfare. So what? In the first place, the category of structurally coercive tactics is a well defined one, making it possible to determine objectively whether the board was responding to a true threat to shareholder interests. In the second, why should it matter incumbents get some protection if resistance also protects shareholder interests? The bidder, after all, controls its own fate in this regard. If the bidder drops the structurally coercive aspects of its offer, this justification for defensive tactics is no longer availing.

255The name refers to a group of cases in which targets used poison pills to protect a restructuring plan from interference by a hostile bidder. E.g., Grand Metro. PLC v. Pillsbury Co., 558 A.2d 1049, 1051 (Del. Ch. 1988); Interco, 551 A.2d at 791; see also BNS Inc. v. Koppers Co., 683 F. Supp. 458, 473-76 (D. Del. 1988) (applying Delaware law); CRTF Corp. v. Federated Dep’t Stores, Inc., 683 F. Supp. 422, 437-42 (S.D.N.Y. 1988) (same).

256Several cases have purported to stand for the proposition that the board must ultimately permit the shareholders to choose. E.g., Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 286 (Del. Ch. 1989); Pillsbury, 558 A.2d at 1058; Interco, 551 A.2d at 799-800; AC Acq’ns Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 113-14 (Del. Ch. 1986).
way as to force shareholders to accept a management-sponsored alternative.257

A superficial reading of these cases might lead one to conclude that the Delaware courts have embraced the structural argument described above. Proponents of the structural argument would insist that the critical doctrinal factor is whether shareholders were allowed to make the ultimate decision between the course of action proposed by management and that opposed by management. On close examination, however, this reading misses a subtle, but important nuance.

In City Capital Associates Ltd. Partnership v. Interco Inc.,258 the leading poison pill case, the target’s board of directors refused to redeem its poison pill. By doing so, the board prevented a hostile bid from going forward until a management-sponsored restructuring could be completed, which would make Interco an unattractive takeover target. Chancellor Allen enjoined the board’s obstructive tactics, using dicta that broadly endorsed the shareholder choice position.259 Tellingly, however, he concluded, “[R]easonable minds not affected by an inherent, entrenched interest in the matter, could not reasonably differ with respect to the conclusion that the [bidder’s] $74 cash offer did not represent a threat to shareholder interests sufficient in the circumstances to justify, in effect, foreclosing shareholders from electing to accept that offer.”260 If the right to decide belongs to the shareholders, however, what relevance do the board’s motives have? A motive analysis is only necessary—or appropriate, for that matter—if the board, in fact, has decisive authority in takeover battles.261


258 551 A.2d 787 (Del. Ch. 1988). See generally Dooley, supra note 2, at 519-21 (discussing Interco and emphasizing the role motive played in Chancellor Allen’s analysis).

259 Hence, Strine claims that: Interco seemed to point to a clear, bright-line limitation on the authority of directors to use a rights plan. While directors could deploy a pill to hold off a noncoercive offer for a discrete, if undefined, period of time, in the end they had to let the stockholders decide, even if the directors reasonably and in good faith believed that the offer was too low and should not be accepted. Strine, supra note 107, at 873. For the reasons set out below, I believe this interpretation imports too great a prophylactic intent (or, at least, effect) to Interco. See infra notes 260-61 and accompanying text (arguing Interco is based on an analysis of the target board’s motives).

260 Interco, 551 A.2d at 799.

261 Cf. Dooley, supra note 2, at 521 (analyzing Allen’s Interco opinion). This reading of Allen’s Interco opinion is supported by his subsequent TW Services decision, in which he distinguished Interco and the other poison pill cases from the case at bar on the ground that the former did not “involve circumstances in which a board had in good faith (which appears to exist here) elected to continue managing the enterprise in a long term mode and not to actively consider an extraordinary transaction of any type.” TW Servs., Inc. v. SWT Acq’n Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,181 (Del. Ch. Mar. 2, 1989), reprinted in 14 DEL.
The emphasis on motive is further confirmed by a Delaware Supreme Court case outside the line of poison pill decisions, in *Mills Acquisition Co. v. Macmillan, Inc.* In May 1987, Macmillan’s top management team recognized that the corporation was a likely takeover target. In response, top management began studying a restructuring plan that would effectively transfer voting control to their hands. Before the restructuring could be

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J. CORP. L. 1169, 1188 (1989). It is also confirmed by an article co-authored by Allen, in which he and two other distinguished Delaware jurists (Jacobs and Strine) took note of “the director-centered approach of American corporation law.” Allen et al., supra note 25, at 1087. They went on to reject “an approach mandating courts to issue injunctions that require boards to permit stockholders to choose between competing transactions in any and all circumstances would prevent informed, well-motivated boards from opposing transactions that they believe would injure the welfare of the corporations they serve.” *Id.* Note how in this passage, the authors emphasize respect for the board’s authority while implicitly contemplating an analysis of board motives, which is consistent with my interpretation of the Delaware case law.

Gilson claims *Interco* and the other poison pill cases required the Delaware Court of Chancery to decide between focusing on “judicial assessment of the wisdom of director decisions” and “allocating decision responsibility between shareholders and directors.” Gilson, supra note 12, at 497. He further asserts the chancery court opted for the latter. *Id.* In contrast, I argue *Interco* is to be understood as having opted for a third choice; namely, focusing not on the substantive merits of the board’s decision, but rather on an assessment of the target board of directors’ motives. *Cf.* Dooley, supra note 2, at 521 (inferring from Allen’s *Interco* opinion “the *Unocal* ‘reasonableness’ test is intended to function as a filter for conflicted interest, rather than as an objective measure of whether the board’s action was reasonably calculated to maximize shareholder wealth”). As such, my view of *Unocal* seems consistent with Rock’s perspicacious analysis of Delaware’s fiduciary duty law as a whole:

In the 1960s, when Delaware was revising its corporation law, Samuel Arsht, a leading figure of the Delaware corporate bar, is said to have proposed that the law be simplified to the following principle: Directors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith. This principle—which is, in my view, a completely accurate description of Delaware fiduciary duty law—conceptualizes Delaware fiduciary duty law in process terms (boards can do whatever they want as long as they follow the right process) and as setting standards as opposed to rules (boards must act in good faith). Most importantly, . . . the Delaware courts fill out the concept of “good faith” through fact-intensive, normatively saturated descriptions of manager, director, and lawyer conduct, and of process . . . .


Allen, Jacobs, and Strine have articulated a similar understanding of Delaware law as it existed pre-1985 (when *Fan Gorkom, Unocal, and Revlon* worked a purported revolution in the law): “Taken as a whole, therefore, the pre-1985 law had a somewhat simpler structure than Delaware corporation law presently has, and it operated primarily to protect stockholders from purposeful wrongdoing, self-dealing, or inequitable acts of entrenchment.” Allen et al., supra note 69, at 1291, *reprinted in 26 DEL. J. CORP. L. 863*. My claim here is *Unocal* did not fundamentally change that prior understanding.

262 559 A.2d 1261 (Del. 1989).
263 *Id.* at 1265.
264 *Id.*
implemented, however, the Robert M. Bass Group emerged as a potential bidder.\textsuperscript{265} The board then lowered the threshold at which its poison pill would become operative and took various other defensive steps designed to stave off the Bass Group until the restructuring could be completed.\textsuperscript{266} Unfortunately for Macmillan’s management, then-Vice Chancellor Jacobs found that the restructuring was not only economically inferior to the Bass Group bid, but also was designed to preclude the shareholders from accepting that bid.\textsuperscript{267} Concluding that \textit{Unocal} obliged Macmillan’s directors to give their shareholders “a choice,”\textsuperscript{268} Jacobs enjoined the restructuring.

Undaunted by their initial failure, the Macmillan board immediately began exploring a management-sponsored leveraged buyout.\textsuperscript{269} Shortly thereafter, a company controlled by Robert Maxwell entered the fray.\textsuperscript{270} Early negotiations with Maxwell were primarily conducted by Macmillan’s incumbent CEO,\textsuperscript{271} who misled Maxwell,\textsuperscript{272} while information about Maxwell’s bid was tipped to management’s leveraged buyout partner.\textsuperscript{273} The Macmillan board of directors failed to act to restrain management; instead, the board essentially abdicated its oversight function, which allowed management to skew the auction process in favor of their partner.\textsuperscript{274} Finally, the board granted a lockup option to management’s partner, effectively precluding Maxwell from presenting a competing tender offer to the target’s shareholders.\textsuperscript{275} The ultimate decision thus was made not by the disinterested board members or the shareholders, but by the same managers who were trying to buy the company.

Here we reach the point at which the conventional wisdom begins to unravel. In the course of invalidating the lockup, the Supreme Court distinguished between lockups that draw an otherwise unwilling bidder into the contest and those that end an active auction by effectively foreclosing further bidding.\textsuperscript{276} While neither type is unlawful per se, the court

\begin{itemize}
  \item \textsuperscript{265} Id. at 1266.
  \item \textsuperscript{266} See \textit{Macmillan}, 559 A.2d at 1266-71 (describing the board’s defensive maneuvers).
  \item \textsuperscript{267} Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1242 (Del. Ch. 1988).
  \item \textsuperscript{268} Id. at 1243.
  \item \textsuperscript{269} \textit{Macmillan}, 559 A.2d at 1272.
  \item \textsuperscript{270} Id. Although they lingered on stage for some time, by this point the Bass Group had more or less sung its swan song. \textit{Id.} at 1272 n.18.
  \item \textsuperscript{271} Id. at 1281.
  \item \textsuperscript{272} Id.
  \item \textsuperscript{273} \textit{Macmillan}, 559 A.2d at 1282-83.
  \item \textsuperscript{274} Id. at 1281.
  \item \textsuperscript{275} Id. at 1277-78.
  \item \textsuperscript{276} Id. at 1286 (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986)).
\end{itemize}
explained, the latter is subject to exacting judicial scrutiny. Where the target obtains only a minimal increase in the final bid in return for an auction-ending lockup, the agreement is unlikely to pass muster. On the other hand, where the favored bidder offers a significant price increase in return for an end to competitive bidding, judicial review will be more favorable.

If this distinction is to be taken seriously, Macmillan effectively permits the board to foreclose shareholder choice. Lockups can pose a severe threat both to free shareholder choice and to continued competitive bidding. While Macmillan holds bid preclusive lockups to a high standard, it also leaves open the possibility that the board can justify their use in appropriate cases. What then happened to the principle of free shareholder choice? The answer is that Macmillan rested on motive, not on shareholder choice. Macmillan implies the board retains full decision-making authority, including the authority to foreclose shareholder choice, unless it acted from improper motives.

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277 Macmillan, 559 A.2d at 1279.
278 Id. at 1286.
279 Id.
280 See supra note 197 (discussing the difficulty in distinguishing between lockups and other tactics that elicit bidding and those that preclude it).
281 Of course, shareholders, even in this context, retain some degree of choice. They can reject the favored bidder’s proposal by either voting down a merger agreement or refusing to sell into a tender offer, in the hopes that competing bids will then be made.
282 Bainbridge, supra note 86, at 287-89.
283 Fraidin and Hanson argue for a full-enforcement approach to lockups, in which courts would apply the business judgment rule to lockups. Fraidin & Hanson, supra note 227, at 1752-53. Part of the problem is that Fraidin and Hanson misconceive the nature of judicial review of lockups. Courts are not trying to identify lockups that are “foreclosing” and “supracompensatory,” as Fraidin and Hanson claim. Id. at 1784. Rather, as with other takeover deterrents, courts are seeking to identify lockups granted from improper motives.

Fraidin and Hanson offer an important insight, which suggests locked-up negotiated acquisitions implicate accountability concerns to a somewhat lesser extent than do takeover defenses used to defeat an unsolicited offer. I am not persuaded, however, that accountability concerns are so insignificant in this context to justify applying the business judgment rule to all lockups. The initial prong of their argument is that target boards have an incentive to sell to the highest valuing bidder because that bidder can pay the highest side payments to management. Id. at 1785-87. Similarly, in connection with their claim that lockups benefit shareholders, they argue target boards have strong motives to maximize share prices. Id. at 1804-06. From the perspective of the relationship between the board and shareholders of the target corporation, a locked-up negotiated acquisition is a final period transaction. This contrasts sharply to mergers of equals and to transactions in which the firm acts as the acquirer, transactions which Fraidin and Hanson use as foils for their argument. Because the latter are repeat transactions for purposes of the relationship between target shareholders and directors, we would expect the markets for capital and managerial jobs would exercise a greater degree of constraining influence on management than in the former. Management thus has more incentive to pursue self-interest in the context of a locked-up negotiated acquisition than in the latter situations. I also find their argument unpersuasive as an
This interpretation of Macmillan is confirmed by the contrast between that decision and an underappreciated gem of Delaware takeover jurisprudence, In re RJR Nabisco, Inc. Shareholders Litigation.\textsuperscript{284} Drawn with a broad brush, these cases appear to be quite similar. In both, the sequence of events opened with a proposal to give incumbent management control of the company. In both, a competing bid then emerged, an auction of corporate control developed, and the board ultimately had to select between two bids that were quite close in price. Yet, the results of both were quite different. In Macmillan, the board selected the nominally higher bid but was found guilty of breaching its fiduciary duties.\textsuperscript{285} In RJR Nabisco,
the board rejected the nominally higher bid, but its decision was protected by the business judgment rule. Why this disparity of result? As always, the answer is in the details.

In *RJR Nabisco*, a special committee of outside directors was formed as soon as the board was told that a group led by Russ Johnson, the President and Chief Executive Officer, wanted to take the company private in a management-sponsored leveraged buyout. The board carefully did not permit Johnson to have any role in the selection of the special committee, nor did the committee permit Johnson any role in selecting its financial or legal advisers. No member of the special committee had any direct or indirect financial interest in the transaction. The committee’s independence paid off handsomely in its insistence on fair competition. The management group’s role in the auction was limited to that of a bidder with no special advantages. Indeed, plaintiffs actually asserted that the committee and the board were biased against management, a claim Chancellor Allen found to be “baseless.” As a result, there was no basis for believing that the board’s decisions were motivated by self-interest.

In *Macmillan*, by contrast, there was a lengthy delay before a special board committee was formed. The special committee was “hand picked” by the incumbent chief executive officer, who along with Macmillan’s other senior managers was to receive up to a 20% equity stake in the firm if their leveraged buyout proposal succeeded. The supposedly independent committee, moreover, included a former college classmate of the CEO’s father. The committee’s financial and legal advisers were selected by the CEO. Not surprisingly, the committee failed to adequately oversee the competitive process, allowing management to skew the process in its favor.

Circumstantial evidence of the board’s motives thus proved critical to the outcomes of both cases. In *RJR Nabisco*, for example, Chancellor
Allen ultimately treated the plaintiffs’ complaint as “an attack upon a decision made by an apparently disinterested board in the exercise of its statutory power to manage the business and affairs of the corporation.” Finding no evidence undermining the appearance of disinterest, Chancellor Allen upheld the RJR Nabisco board’s conduct even though the two bids were substantially equivalent. He did so despite the board rejecting the nominally higher bid and despite the board expressly refusing to reopen the bidding. This latter point is particularly striking. The stated reason for the board’s refusal to reopen the bidding, despite the closeness of the two bids, was a concern that the nonmanagement bidder would drop out if the auction was extended. Although Allen believed that the nonmanagement bidder dropping out was unlikely, in light of the absence of any evidence that the board had acted from conflicted interests, he deferred to the board’s decision to endorse one of the bids, just as my analysis suggests he should have done. In contrast, the strong evidence of self-interested behavior by Macmillan’s officers and directors rendered the board’s decisions unworthy of deference. Thus, shareholder choice is not important in its own right, but it has significance only because attempts to foreclose it may suggest that the board of directors’ inherent conflict of interest has shifted from being a potential problem to an actual one.

14 DEL. J. CORP. L. at 1163-74 (commending the board’s conduct).


298 Id. at 91,715, reprinted in 14 DEL. J. CORP. L. at 1168.

299 Id. at 91,712-13, reprinted in 14 DEL. J. CORP. L. at 1162-63.

300 Id. at 91,713, reprinted in 14 DEL. J. CORP. L. at 1163.

301 The Delaware courts have examined this outcome determinative nature of motive in other cases as well. See, e.g., Gilbert v. El Paso Co., 575 A.2d 1131, 1146 (Del. 1990) (upholding settlement of a hostile takeover contest because “there is not a scintilla of evidence to intimate that this arrangement was the result of improper motives” on the board’s part); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) (upholding defensive tactics because the “board acted to maintain the company’s independence and not merely to preserve its own control”); Chesapeake Corp. v. Shore, 771 A.2d 293, 345 n.123 (Del. Ch. 2000) (noting the “ample evidence of entrenchment motives on the part of Shorewood’s management”); Henley Group, Inc. v. Santa Fe S. Pac. Corp., No. 9569, slip op. at 38 (Del. Ch. Mar. 11, 1988), reprinted in 13 DEL. J. CORP. L. 1152, 1178 (1988) (upholding corporate restructuring where the board’s “diligent efforts” to sell the company before embarking on the restructuring “deprive[d] the plaintiffs’ argument—that the defendants were motivated to entrench themselves—of its force”); Freedman v. Restaurant Assoc. Indus., Inc., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,220 (Del. Ch. Oct. 16, 1987), reprinted in 13 DEL. J. CORP. L. 651, 664 (1988) (board committee’s handling of management led leveraged buyout proposal to be reviewed under the business judgment rule because “[p]laintiffs [had] failed utterly to offer any legal justification for the court’s second-guessing [of] the decision of the special committee”).

To be sure, Delaware courts have laid considerable rhetorical emphasis on the importance of the shareholder franchise and, more importantly, have backed up that rhetoric by invalidating board of director actions that interfere with the free exercise of shareholder voting rights. See, e.g.,
B. The Merits of a Motive-Based Inquiry

An assessment of the balance struck by the Delaware courts between authority and accountability depends on the merits of the motive-based analysis those courts apparently have adopted. Some observers will concede that target managers and directors do not always pursue their own self-interest, but argue that the difficulty of distinguishing between proper and improper motives is so great in this context that courts should simply eschew a motive-based analysis.302 Granted, motive analysis is always difficult, but in every other conflicted interest context, the board’s authority to act depends upon the validity of the directors’ motives.303 Unless we are to accept the passivity model and strip the board of decision-making authority in the takeover context, a motive-based inquiry is inescapable.

The viability of a motive-based inquiry is perhaps most evident in multiple bidder settings because the board’s conduct in overseeing the competition between the management-sponsored alternative and the hostile bid provides more or less objective insights into the board’s motives. Suppose, for example, that the Macmillan board had conducted a fair auction, in which neither side had any special advantages. At the end of this

302 E.g., EASTERBROOK & FISCHEL, supra note 20, at 209; Thompson & Smith, supra note 16, at 294-96.
303 Dooley, supra note 2, at 518.
process, one of the competing bidders offered a substantial increase in price in return for a lockup option. On these facts, it seems unlikely that a board decision to grant the option is tainted by improper motives. As the Eleventh Circuit has noted:

All auctions must end sometime, and lock-ups by definition must discourage other bidders. The question therefore is not whether the asset lock-up granted to [the favored bidder] effectively ended the bidding process. The question is whether [the target] conducted a fair auction, and whether [the favored bidder] made the best offer.\(^{304}\)

If these questions can be answered in the affirmative, we more or less have objective evidence that the board acted from proper motives even though their actions effectively precluded anyone other than the favored bidder from acquiring the company. The use of a lockup or other defensive tactics to foreclose shareholder choice in such situations thus no longer raises a presumption of self-interest. The superiority of the prevailing proposal will have been demonstrated by the competitive process.

That the courts are able to similarly assess target board motives in a wide range of takeover contexts, including hostile takeovers in which only a single bidder is involved, is illustrated by *Henley Group, Inc. v. Santa Fe Southern Pacific Corp.*\(^{305}\) The defendant corporation adopted a poison debt plan pursuant to which pay-in-kind debentures were distributed to the company’s shareholders as part of a restructuring. A variety of anti-takeover provisions were built into the debentures, making the company a much less attractive takeover candidate.\(^{306}\) Vice Chancellor Jacobs, however, deemed the debentures to be valid under *Unocal*.\(^{307}\) Jacobs’ conclusion was driven in large part by the board of directors’ “diligent efforts” to sell the company prior to embarking upon the restructuring.\(^{308}\) These efforts “deprive[d] the plaintiffs’ argument—that the defendants were motivated to entrench themselves—of its force.”\(^{309}\)

C. The Pivotal Paramount Cases

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\(^{304}\)Cottle v. Storer Commc’n, Inc., 849 F.2d 570, 576 (11th Cir. 1988) (citations omitted).


\(^{306}\)Id. at 32-34, reprinted in 13 DEL. J. CORP. L. at 1174-75.

\(^{307}\)Id. at 40-41, reprinted in 13 DEL. J. CORP. L. at 1179.

\(^{308}\)Id. at 38, reprinted in 13 DEL. J. CORP. L. at 1198.

\(^{309}\)Henley Group, No. 9569, slip op. at 38, reprinted in 13 DEL. J. CORP. L. at 1178.
The ability of Delaware’s takeover doctrine to address cases in which improper motives tainted the board’s decision-making process is perhaps best illustrated by the pair of famous cases involving Paramount Communications. In the first, *Paramount Communications, Inc. v. Time, Inc.*, the Delaware courts addressed a takeover struggle between Time, Warner Communications, and Paramount. In the second, *Paramount Communications, Inc. v. QVC Network Inc.*, they addressed a takeover struggle between QVC, Viacom, and Paramount.

1. *Time*

After first developing a long-term strategic plan and searching for acquisitions that would advance this plan, Time’s board of directors agreed to a merger with Warner Communications in which former Warner shareholders would receive newly issued Time shares representing approximately 62% of the shares of the combined entity. As is typical in negotiated acquisitions, the parties also sought “to discourage any effort to upset the transaction” by agreeing to a lockup option giving each party the option to trigger an exchange of shares. In addition, the merger agreement included a no-shop clause that was supplemented by obtaining commitments from various banks that each party would not finance a takeover bid for Time.

Shortly before Time’s shareholders were to vote on the merger agreement, Paramount made a cash tender offer for Time. Time’s board rejected the offer as inadequate and chose not to enter into negotiations with Paramount. To forestall Paramount, the Time and Warner boards then agreed to a new structure for the transaction, under which Time would make

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311 637 A.2d 34 (Del. 1994).
313 Id. at 93,270, reprinted in 15 DEL. J. CORP. L. at 719.
314 Id. at 93,270-71, reprinted in 15 DEL. J. CORP. L. at 719-20. For a description of no-shop clauses and lockups, see Bainbridge, supra note 86, at 242-52.
315 The plan of merger called for Warner to be merged into a Time subsidiary in exchange for Time common stock. Although Time was not formally a party to the merger and approval by its shareholders therefore was not required under Delaware law, New York Stock Exchange rules required a vote of Time shareholders because of the number of shares to be issued. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,270, reprinted in 15 DEL. J. CORP. L. at 718.
316 Id. at 93,271-72, reprinted in 15 DEL. J. CORP. L. at 720-24. Paramount later raised its offer, which again was rejected outright. Id. at 93,275, reprinted in 15 DEL. J. CORP. L. at 728-29.
a cash tender offer for a majority block of Warner shares, to be followed by a merger in which remaining Warner shares would be acquired and thus obviating the need for shareholder approval. The new plan required Time to incur between $7 and $10 billion in additional debt. Finally, and perhaps most damningly from the perspective of a Time shareholder, the plan foreclosed the possibility of a sale to Paramount. If the new plan succeeded, Time’s shareholders would end up as minority shareholders in a company saddled with substantial debt and whose stock price almost certainly would be lower in the short run than the Paramount offer.

The substantial differences in shareholder wealth likely to result from a decision to merge with Warner rather than to sell to Paramount forcefully presented the question of who should make that decision. As Chancellor Allen put it, "[The] overarching question is where legally (an easy question) and equitably (more subtle problem) the locus of decision-making power does or should reside in circumstances of this kind." Paramount naturally insisted that Time’s board had an obligation to give the “shareholders the power and opportunity to designate whether the company should now be sold.” Chancellor Allen, however, squarely rejected that proposition. He acknowledged that reasonable people could believe the Paramount offer was the better deal for the shareholders, and many of Time’s shareholders undoubtedly so believed; thus, the Time directors’ preference for the Warner deal might turn out to be a terrible mistake. Having said all that, however, the board nonetheless had the authority to go forward with the Warner acquisition:

> [T]he financial vitality of the corporation and the value of the company’s shares is in the hands of the directors and management of the firm. The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a

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318 Id. at 93,274, reprinted in 15 Del. J. Corp. L. at 728.
319 This was so because Paramount conditioned its offer on, among other things, termination of the merger agreement with Warner. Time, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,271, reprinted in 15 Del. J. Corp. L. at 720.
320 As Chancellor Allen observed, "[Even Time’s] board understood that immediately following the effectuation of a Warner merger, the stock market price of Time stock was likely to be materially lower than the $175 then ‘on the table’ . . . ." Id. at 93,276, reprinted in 15 Del. J. Corp. L. at 731.
321 Id. at 93,278, reprinted in 15 Del. J. Corp. L. at 735.
322 Id.
majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm.\textsuperscript{324}

By now it should not be surprising that unlike proponents of the structural argument,\textsuperscript{325} I am not troubled by \textit{Time}’s emphasis on board prerogatives at the expense of shareholder choice.\textsuperscript{326} Because I regard shareholder choice as having little, if any, independent normative significance,\textsuperscript{327} the question is whether the \textit{Time} board’s foreclosure of shareholder choice was based on proper or improper motives. In other words, did the board exercise its prerogative in ways suggesting that the transaction was driven by management self-interest?

Granted, \textit{Time}’s decisions were made by a board comprised principally of outsiders with no readily apparent conflicts of interest.\textsuperscript{328} Once the Paramount bid emerged, however, the directors undertook a drastic course of action whose sole purpose was preventing their shareholders from accepting Paramount’s offer. As in \textit{Macmillan} and \textit{Interco}, the attempt to foreclose shareholder choice without first conducting

\textsuperscript{324}Id. The Delaware Supreme Court agreed: “Delaware law confers the management of the corporate enterprise to the stockholders’ duly elected board representatives. . . . That duty may not be delegated to the stockholders.” Paramount Commc’ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990). The court further observed that courts should not substitute their “judgment as to what is a ‘better’ deal for that of a corporation’s board of directors.” \textit{Id.} at 1153. In making this statement, the Delaware Supreme Court thereupon accused the chancery court of substituting its judgment in \textit{Interco} and its progeny, \textit{id.}, a conclusion that, unfortunately, is neither fair nor accurate. While Chancellor Allen observed in \textit{Interco} that the actual value of the restructuring was “highly debatable,” he did not attempt to resolve the valuation dispute. City Capital Assocs. Ltd. P’ship v. Interco Inc., 551 A.2d 787, 799 (Del. Ch. 1988). Instead, Chancellor Allen determined that the board of directors was disabled from acting because of their demonstrated conflict of interest. \textit{Id.} at 800-01. \textit{See supra} notes 258-61 and accompanying text. \textit{Interco}, thus, is not inconsistent with the authority values \textit{Time} reflects; rather, it brought into play accountability concerns \textit{Time} downplayed.

\textsuperscript{325}See discussion \textit{supra} Part IV.C.

\textsuperscript{326}Professor Gordon has offered an interesting twist on \textit{Time}. As I do, he recognizes that \textit{Time} was intended to emphasize the board’s prerogative at the expense of shareholder choice. \textit{See Gordon, supra} note 257, at 1940-41. He explains \textit{Time}, however, by a “socio-historical” argument in which the supreme court attempted to protect “solidaristic” values. \textit{Id.} at 1971-82. My thesis, in contrast, puts \textit{Time} (and, for that matter, the whole \textit{Unocal} line) much more firmly in the mainstream of the corporate law tradition of director primacy.

\textsuperscript{327}\textit{See supra} text accompanying note 301.

\textsuperscript{328}Chancellor Allen acknowledged that negotiated acquisitions present the potential conflicts of interest described \textit{supra} notes 84-86 and accompanying text. \textit{See Time}, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,268-69, \textit{reprinted in} 15 \textbf{DEL. J. CORP. L.} at 715. On the facts before him, however, Chancellor Allen found that there was not a sufficient basis to conclude “that such concerns have caused the [\textit{Time}] directors to sacrifice or ignore their duty to seek to maximize in the long run financial returns to the corporation and its stockholders.” \textit{Id.} at 93,269, \textit{reprinted in} 15 \textbf{DEL. J. CORP. L.} at 716.
a fair competition for control implicates accountability concerns because it provides circumstantial evidence from which one might reasonably infer the presence of self-interested decision making.

Both the chancery and the supreme court *Time* decisions responded at least implicitly to this concern. Both courts concluded that the Time board’s initial decision to merge with Warner was protected by the business judgment rule. Both courts also concluded that the lockup, the decision to recast the transaction as a tender offer for Warner, and the various other measures undertaken to stave off Paramount’s competing bid involved a conflict of interest sufficiently severe to require application of a more exacting standard of review. The preliminary question then was whether the *Unocal* or *Revlon* standard governed.

For somewhat different reasons both Chancellor Allen and the supreme court concluded that *Revlon* was not triggered. Chancellor Allen followed the poison pill cases by holding that *Revlon* applies to any transaction constituting a change in control, determining that the merger agreement would not result in a transfer of control because control of the combined entity “remained in a large, fluid, changeable and changing market.”

Although the Delaware Supreme Court indicated Allen’s analysis was “correct as a matter of law,” it rejected plaintiff’s *Revlon* claims “on different grounds”: Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, *Revlon* duties may also be triggered where, in response to a bidder’s offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company.

This passage is not exactly crystal clear. What are the other possibilities the court did not exclude? What is the difference between the first and second identified possibilities? If it were deciding the case on broader grounds than Chancellor Allen, can change of control transactions not involving a break-

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329 Id. at 93,279-80, reprinted in 15 DEL. J. CORP. L. at 739.
330 *Time*, 571 A.2d at 1150.
331 Id. (citation and footnote omitted).
up of the company still trigger Revlon? In particular, will Revlon apply when the target “initiates an active auction process seeking to sell itself” but the auction participants do not contemplate breaking up the company? What does the court mean by “a break-up of the company”?\(^{332}\) One could spin out such questions indefinitely, but the key point remains that the court appears to have used Time as a vehicle for sharply limiting Revlon’s scope, albeit in an unusually murky manner.

The court’s rejection of Revlon is curious because Revlon, as it had been interpreted before Time, seemed well-designed to address the problem at hand. There was a growing recognition that the Revlon “duties” were, in fact, simply the general Unocal standards applied to a special fact situation.\(^{333}\) Consistent with my analysis of Unocal and its progeny, there also was growing recognition that Revlon is principally concerned with capturing cases of conflicted interests.\(^{334}\) Revlon thus provided a useful

\(^{332}\)Presumably, the court had in mind the species of transactions commonly referred to as “bust up” takeovers, in which a bidder finances the transaction through highly leveraged debt securities and then sells substantial portions of the target’s assets in order to help finance the acquisition. If so, however, it also remains unclear what percentage of the firm must be sold off in order for the transaction to be regarded as a break-up. See Marc I. Steinberg, Nightmares on Main Street: The Paramount Picture Horror Show, 16Del. J. Corp. L. 1, 16-17 (1991).

\(^{333}\)See supra notes 152-154 and accompanying text.


[T]he Unocal “reasonableness” test is intended to function as a filter for conflicted interest, rather than as an objective measure of whether the board’s action was reasonably calculated to maximize shareholder wealth. From this perspective, Revlon and Interco can be seen as cases where the specific action approved by the board strongly suggests self-interest. Why else would a faithful agent refuse to permit a competing proposal to be put forward if not for fear that his own proposal is, in fact, not competitive? And why would the honest auctioneer ever seek other than the highest bid if not to seek side payments or otherwise indulge personal preferences? Note that in neither case did the court actually find that the board acted out of self-interest. But given Unocal’s recognition of the inherently conflicted nature of a tender offer defense, a mere inference of self-interest may suffice, unless it can be negated by the board.

Dooley, supra note 2, at 521.

In fact, it appears Revlon’s directors’ actions throughout the takeover fight were mainly concerned with protecting themselves from litigation by the company’s debt holders. See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). Fraidin and Hanson, however, argue that this “conclusion seems erroneous.” Fraidin & Hanson, supra note 227, at 1756 n.53. They assert there was no legal basis for directors to fear litigation from the note holders. Id. Their argument, however, overlooks two points. First, their analysis of the leading Delaware decision, Katz v. Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986), too easily dismisses the possibility Revlon’s directors might have faced liability. As Fraidin and Hanson acknowledge, Katz recognized corporate restructurings could “in effect transfer economic value from bondholders to stockholders.” Katz, 508 A.2d at 879. Fraidin and Hanson, however, fail to note Katz goes on to indicate that protection against such an eventuality would be available where there are appropriate indenture provisions. Id. Further, while it is true Delaware recognizes no fiduciary
vehicle by which the court might have determined whether the board had acted with improper motives. The *Time* court not only ignored this option, but it also limited *Revlon*’s doctrinal scope, thereby restricting the ability of Delaware courts to do so in future cases. This weakening of *Revlon* thus threatened to permit cases in which the board acted with improper motives to escape judicial review.

To be sure, the *Time* courts did not leave the lockup and other bid preclusive measures immune from challenge. Instead, both courts concluded that the lockup and *Time*’s subsequent recasting of the acquisition as a tender offer were defensive measures to be analyzed under *Unocal*. Relying on *Interco* and its progeny, Paramount argued that bid-preclusive defensive tactics were excessive in light of the minimal threat of inadequate value posed by a noncoercive tender offer at a substantial premium. Chancellor Allen distinguished those cases on the grounds the original decision to merge with Warner was motivated by *Time*’s long-term business plan. Unlike the poison pill cases, in which the management-sponsored transaction was principally intended to defeat an unsolicited tender offer, Chancellor Allen saw the revised structure of the *Time-Warner* transaction as being principally intended to facilitate accomplishment of the board’s

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336 Id. at 93,283; reprinted in 15 DEL. J. CORP. L. at 748.

337 Id.
long-term strategy.\textsuperscript{338} Given that the tender offer therefore arose out of preexisting legitimate, nondefensive business considerations, Time had a “legally cognizable interest” in going forward with the acquisition of Warner, which satisfied the first prong of \textit{Unocal}.\textsuperscript{339}

Chancellor Allen believed the second prong of the \textit{Unocal} analysis required him to evaluate, among other things, the importance of the corporate policy at stake and the impact of the board’s actions. With respect to the first point, he reiterated his view that pursuing the board’s long-term strategy was a legitimate and important corporate goal.\textsuperscript{340} As to the latter, he observed the offer for Warner “was effective but not overly broad.”\textsuperscript{341} Thus, Time’s board “did only what was necessary to carry forward a preexisting transaction in an altered form.”\textsuperscript{342}

As with Chancellor Allen’s \textit{Revlon} analysis,\textsuperscript{343} the supreme court affirmed his \textit{Unocal} analysis, but again did so with important differences.\textsuperscript{344} The supreme court expressly rejected Paramount’s argument that structural coercion and inadequate value were the only threats cognizable under \textit{Unocal}.\textsuperscript{345} Instead, \textit{Unocal} was to be applied on a case-by-case basis and in a flexible, open-ended manner.\textsuperscript{346} Among the flexible, open-ended threats the court identified in this case were the possibility that shareholders might incorrectly value the benefits of sticking with management’s long-term business plan, the difficulty of comparing Paramount’s bid to the benefits of the Warner acquisition, and the possibility that Paramount’s bid might “upset, if not confuse” the shareholder vote.\textsuperscript{347} Applying the proportionality prong of the \textit{Unocal} analysis, the court found that Time’s recasting of the transaction was a reasonable response to the identified threats.\textsuperscript{348}

As was the case with its analysis in \textit{Revlon}, the supreme court’s approach here marked a major turning point in the evolution of \textit{Unocal}. It expanded the list of cognizable threats and arguably weakened the proportionality standard. In doing so, it appeared to undermine the ability of

\begin{thebibliography}{9}
\bibitem{338} Id.
\bibitem{339} Id.
\bibitem{340} Id.
\bibitem{342} Id.
\bibitem{343} See supra notes 329-30 and accompanying text.
\bibitem{344} Paramount Commc’ns, Inc. v. Time Inc., 571 A.2d 1140, 1152-53 (Del. 1990).
\bibitem{345} Id. at 1153.
\bibitem{346} Id.
\bibitem{347} Id.
\bibitem{348} Time, 571 A.2d at 1154-55.
\end{thebibliography}
the *Unocal* framework to capture cases in which conflicted interests drove the board’s decision-making process.

Consider, for example, that many commentators concluded *Time* validated the so-called “just say no” defense, pursuant to which the target’s board simply refuses to allow the firm to be acquired, and backs up that refusal by a poison pill or other takeover defenses. I find this reading of *Time* unpersuasive. At the chancery court level, Chancellor Allen’s analysis hinged on his observation that Time’s acquisition of Warner “[did] not legally preclude the successful prosecution of a hostile tender offer” for the resulting entity. More importantly, he also indicated that defensive tactics used against a hostile offer by Paramount or some other bidder for the combined entity after Time’s acquisition of Warner would present a different issue.

The supreme court’s opinion is similarly limited. While it is true the court rejected any inference that directors are obliged to abandon a pre-existing business plan in order to permit short-term shareholder gains, Time’s plan was deemed reasonable and proportionate to the Paramount threat precisely because it was “not aimed at ‘cramming down’ on its shareholders a management-sponsored alternative,” but was only intended to carry forward “a pre-existing transaction in an altered form.” The supreme court also expressly affirmed Chancellor Allen’s finding that Time’s actions “did not preclude Paramount from making an offer for the combined Time-Warner company.”

These limitations on the court’s holding are important because they eliminate the “just say no” defense, as well as some of the other more apocalyptic interpretations of *Time*. The “just say no” defense does cram down a particular result—independence—on the shareholders, and also attempts to preclude anyone from making an offer for the combined

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349 See, e.g., David B. Hilder, *Ruling by Court on Time Inc.’s Merger Affirms the Power of Corporate Boards*, WAll ST. J., Feb. 28, 1990, at A3; The “Buzz-Off” Defense: A Play on the *Time* Ruling, 24 MERGERS & ACQUISITIONS, Mar./Apr. 1990, at 7-8; see generally Rock, *supra* note 261, at 1075 (noting *Time* “was widely viewed as the complete undermining of *Revlon* and as an endorsement of the ‘just-say-no’ defense”). Prior cases had at least implicitly rejected the “just say no” defense. In *Interco*, for example, Chancellor Allen indicated “in most instances” the use of takeover defenses was only legitimate in connection with attempts by the board to negotiate with the unsolicited bidder or to assemble an alternative transaction. City Capital Assocs. Ltd. P’ship v. Interco Inc., 551 A.2d 787, 798 (Del. Ch. 1988). In other words, the board could not simply “just say no.”


351 See id. at 93,284 n.22, reprinted in 15 DEL. J. CORP. L. at 749 n.22.

352 *Time*, 571 A.2d at 1154-55.

353 Id. at 1155.
company, both of which the court said management could not do. Therefore, *Time* does not necessarily compel one to conclude that the “just say no” defense will be deemed to be proportional to an adequate, noncoercive offer.

This limitation on *Time*’s scope is not sufficient because it creates its own problems. The court’s concern with the legal effect of *Time*’s actions appeared to signal a retreat from the use of *Unocal* to constrain target defensive measures. Consider, for example, the poison pill cases. Suppose management responds to an unsolicited tender offer by proposing a restructuring that effectively transfers voting control to the incumbent management team. The target’s board endorses this proposal and, to insure its success, refuses to redeem the target’s outstanding poison pill. Because of the substantial financial injury a pill would inflict on the bidding company and its shareholders, a bidder rarely seeks to complete its tender offer while an effective pill remains in place.354 Unless there has been a fair competition between the competing proposals, this course of conduct necessarily permits an inference of management self-interest. Yet, just as *Time*’s actions did not legally preclude Paramount from pursuing a bid for the combined Time-Warner entity, a poison pill does not legally preclude a bidder from going forward. Accordingly, one could have plausibly argued that it was proper under *Time*’s interpretation of *Unocal*.

Thus, although *Time*’s doctrinal implications are somewhat troubling, the actual result in that case is far less troubling. In most of the poison pill cases, for instance, the pill was deployed in order to delay a hostile bid while the target undertook a defensive restructuring intended to give management effective voting control or to otherwise make the target unpalatable to potential bidders.355 Such a restructuring’s deterrent effect is not dependent upon the target’s size; it works even for very small companies. In contrast, the success of *Time*’s defensive actions depended

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354 *Interco*, 551 A.2d at 795.

355 In a typical defensive restructuring, the target company pays a dividend consisting of cash (often borrowed) and debt securities, reducing the post dividend value of the target’s stock to the extent of the distribution. While the process is usually rather complex, target managers and/or the target’s employee stock ownership plan effectively receive the dividend in the form of stock, rather than cash or debt, at an exchange rate based on the stock’s post dividend value. *E.g.*, Black & Decker Corp. v. Am. Standard, Inc., 682 F. Supp. 772, 782 (D. Del. 1988); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344-45 (Del. 1987); Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1242 n.35 (Del. Ch. 1988). Alternatively, the target may conduct a tender offer in which public shareholders exchange their stock for cash and debt. *E.g.*, AC Acq’ns Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 104 (Del. Ch. 1986). In either case, management’s equity interest increases substantially vis-à-vis public shareholders. In *AC Acquisitions*, for example, the restructuring would have transferred 25% of the firm’s voting stock to a newly formed employee stock ownership plan. Coupled with management’s stock holdings, this would have created a formidable barrier for any post transaction bidder. *Id.* at 104-05.
almost wholly on the combined entity’s great size. While the extent of the combined entity perhaps made it unlikely a subsequent buyer would emerge to unwind the transaction, the possibility existed. Thus, the market for corporate control could exert some constraining influence on Time’s board, which reduced the likelihood that the board was acting for improper motives, especially in comparison to the defensive restructurings just described.

A variety of other factors could be cited to distinguish Time from Macmillan, Interco, and their progeny. Time’s business strategy was motivated by a desire to advance legitimate corporate interests. Particularly, it had not been cobbled together simply to justify takeover defenses. As a result, Paramount essentially was asking the court to enjoin Time’s board from continuing to operate the corporation’s business and affairs during the pendency of the takeover bid. The Delaware courts properly were reluctant to do so, as a hostile bidder has no right to expect the incumbent board of directors to stop an ongoing business strategy in midstream.

In summary, Time presented a highly unusual set of facts, which rebutted the inference that the board acted from improper motives and rendered the result—if not the reasoning—in that particular case relatively unobjectionable. Many fruitful avenues for limiting Time’s reasoning thus presented themselves. The question was whether the Delaware Supreme Court would avail itself of those options or would continue down the road of retreat Time’s reasoning appeared to mark out.

2. QVC

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356 According to Chancellor Allen, experience (such as the then-recent $25 billion RJR Nabisco leveraged buyout) suggested that an acquisition of Time-Warner was not impossible. See Time, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,284, reprinted in 15 DEL. J. CORP. L. at 749.

357 Id. at 93,283, reprinted in 15 DEL. J. CORP. L. at 748.

358 Time also was distinguishable from negotiated acquisitions in which the target board used a lockup to preclude competing bids. Time was the putative acquirer in what was really a merger of equals, unlike the typical fact pattern, in which the competing bid is directed to the shareholders of the merger target. As such, there is a lower than normal risk that the merger was motivated by side payments to Time’s managers. (While senior Time managers’ compensation increased after the merger, this was done to bring them more into line with the high compensation Warner executives received. Id. at 93,275, reprinted in 15 DEL. J. CORP. L. at 729.) Moreover, Time’s board could have structured the Warner acquisition as a tender offer from the outset, borrowing several billion dollars in the junk bond market to pay cash for Warner’s shares, and thereby complete the acquisition without ever having to get shareholder approval. Had they done so, Paramount would have been powerless to prevent the acquisition except by getting control of Time’s board before the Warner acquisition could be completed.
Ironically, the vehicle by which the Delaware Supreme Court revisited its *Time* decision was provided by Paramount in *Paramount Communications, Inc. v. QVC Network Inc.* 359 In *QVC*, Paramount now found itself playing Time’s role and advocating the very same arguments that had been its downfall in the prior case. Paramount, run by Martin Davis, entered into merger negotiations with Viacom, run and largely owned by Sumner Redstone. 360 The parties sought to preclude competing bids with an array of defensive measures, including a no-shop clause, a termination fee, and a stock lockup option. 361 First, the no-shop clause in their merger agreement prevented Paramount’s board from discussing any business combination with a third party unless (i) the third party could show its proposal was not subject to financial contingencies, and (ii) the Paramount board decided its fiduciary duties required it to talk to the third party. 362 Second, the termination fee obligated Paramount to pay Viacom $100 million if the Paramount-Viacom deal fell through. 363 Third, the stock lockup option gave Viacom the option of buying 24 million shares of outstanding Paramount stock at $69 per share (roughly 20% of the outstanding shares) if the Viacom deal fell through for any reason that triggered the termination fee. 364 Viacom could buy these shares with a senior subordinated note or could demand instead Paramount pay it the difference between $69 and the market price of the stock for 24 million shares. 365

Despite this seemingly formidable array of defenses, QVC made a competing offer. 366 Following several rounds of bidding, Paramount’s board announced it would recommend acceptance of the Viacom proposal and would continue to resist QVC’s offer. In the inevitable litigation, Paramount relied on *Time* to argue that the *Revlon* duties, whatever they may be, had not been triggered. 367 Given *Time*’s description of the requisite triggering events, this argument was not implausible.

359 637 A.2d 34 (Del. 1994).
360 *Id.* at 36-37. Redstone controlled roughly 85% of Viacom’s voting shares. *Id.* at 38.
361 *Id.* at 39.
362 *Id.*
363 *QVC*, 637 A.2d at 39. The termination fee was payable regardless of whether the deal created because Paramount terminated the Viacom deal to accept a competing offer or the Paramount stockholders voted down the Viacom deal. *Id.*
364 *Id.*
365 *Id.*
366 Hollywood egos and a desire for retaliation seem to have played some role in pursuing this offer, as QVC’s CEO and major shareholder, Barry Diller, had once been fired by Davis. See John Greenwald, *The Deal That Forced Diller to Fold*, TIME MAG., Feb. 28, 1994, at 50, 51.
367 *QVC*, 637 A.2d at 47.
QVC thus sharply illustrated the potential mischief done by Time. Assuming Revlon had not triggered, the issue would be whether Paramount’s defensive actions could be sustained under a Unocal-style analysis, which would have raised the distinction between legally and factually precluding competing bids. A successful Paramount-Viacom merger would not have legally precluded QVC from attempting to purchase the combined Paramount-Viacom entity. Accordingly, there was a strong argument Paramount’s actions should pass muster under Time’s reading of Unocal.

Even assuming QVC could have financed a bid for the combined entity, its efforts to acquire Paramount would have faced an insurmountable practical barrier; namely, the presence of Sumner Redstone. As controlling shareholder of Viacom, Redstone would have controlled the combined Paramount-Viacom entity. The presence of a controlling shareholder substantially changes the conflict of interest mix.

In theory, so long as acquisitions of publicly-held corporations are conducted by other publicly-held corporations, diversified shareholders will be indifferent as to the allocations of gains between the parties. Assume that the typical acquisition generates gains equal to 50% of the target’s pre-mid-market price. A fully diversified investor is just as likely to own acquiring company shares as target shares. Indeed, he may own both. Thus, allocation of the available gain between targets and acquirers is irrelevant to the diversified shareholder. Increasing the target’s share of the gains by increasing the premium the acquirer pays to obtain control necessarily reduces the acquirer’s share, which from the shareholder’s perspective, is simply robbing Peter to pay Paul. Worse yet, to the extent that gain allocation rules increase transaction costs, they leave a fully diversified shareholder worse off. In practice, of course, this argument is undermined by the implicit assumption that gains to the acquirer flow through to its shareholders.

Whatever one makes of the theory, however, situations like QVC unquestionably raise serious gain allocation concerns for target shareholders. If the acquiring entity is privately held, even a fully diversified shareholder by definition cannot be on both sides of the transaction. If the acquiring entity is publicly held but controlled by a single, very large shareholder, a fully diversified shareholder may not be able to fully share in the gains to be reaped by the acquiring company because the large shareholder’s control enables it to reap a non-pro rata share of any such gains. In the QVC situation, shareholders would not be

368Id. at 42-43.
indifferent to gain allocation. Instead, they would prefer to see gains allocated to the target.\textsuperscript{369} 

For this reason, QVC raised accountability concerns in a way that Time simply did not.\textsuperscript{370} There is special reason to fear the controlling shareholder’s positional and informational advantages will affect the allocation of gains. In particular, the controlling shareholder’s ability to reap a disproportionate share of post-transaction gains gives it an unusually high incentive to cause the acquiring entity to offer side payments to target directors in order to obtain their cooperation. Similarly, the controlling shareholder’s ability to reject acquisition proposals insulates the combined entity from the constraining influence of the market for corporate control.\textsuperscript{371}

\textsuperscript{369}As then-Vice Chancellor Jacobs observed:

[T]he shareholders’ continuing equity interest is far from secure, because once the Viacom transaction is complete Mr. Redstone will have absolute control of the merged entity and will have the power to use his control at any time to eliminate the shareholders’ interest by a “cash out” merger. In this case the board did not obtain, or even bargain for, structural protections that would ensure the continuity of Paramount’s current shareholders (or their successors) in any merged enterprise. Absent such protection, these shareholders can have no assurance that they will receive the long-run benefits claimed to justify the board’s decision to prefer Viacom over QVC. This is the only opportunity that Paramount’s shareholders will ever have to receive the highest available premium-conferring transaction. For this reason as well, fairness requires that the shareholders be afforded the fiduciary protections mandated by Revlon and Unocal.


\textsuperscript{370}Rock’s analysis of the distinctions between Time and QVC suggests additional reasons that the latter implicated significant accountability concerns:

In Time-Warner, fully informed directors acted deliberately pursuant to a well-thought-out long-term plan. Along comes Paramount, which tries to stop the Time board. In response, the directors reject Paramount’s efforts and determine to continue their long-term plan. In Viacom, a strong-willed CEO misleads the board, keeps crucial information from them, prevents them from discussing the terms of the bid with Barry Diller, and structures the transaction so that QVC is at a serious disadvantage because of personal antipathy for Diller. From this perspective, the cases are completely consistent with Delaware norms. Strong-willed CEOs who dominate directors are disfavored. Allowing personal antipathy for a bidder to interfere with the board’s serious consideration of the bid is wrong. Tilting the playing field towards management’s preferred bidder immediately raises questions.

Rock, \textit{supra} note 261, at 1081 (footnotes omitted). As he aptly summarizes it: “The principal difference between the two cases is that the managers and board behaved well in Time-Warner and badly in QVC.” \textit{Id.} at 1086.

\textsuperscript{371}While a controlling shareholder owes fiduciary duties to the minority, it would not be obliged to sell its shares to another bidder. Indeed, the Delaware Supreme Court has held that Revlon duties do not apply when a controlling shareholder effects a cash out merger with the subsidiary target corporation. Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 844-45 (Del. 1987).
As a result, the normal conflict of interest found in any acquisition is substantially magnified in the \textit{QVC} situation.

In \textit{QVC}, the Delaware Supreme Court demonstrated its sensitivity to this concern. Consider the otherwise obscure way in which the court described the nature of the shareholder interest that was imperiled by the Paramount board’s conduct:

At several points in the opinion, it is noted that voting control is generally achieved only at the price of paying a “premium” to the minority shareholders for the loss of their voting influence (fluid and dispersed though it is), and that public shareholders lose the expectation of receiving any such premium once control has been transferred to and consolidated in a majority shareholder.\footnote{DOOLEY, supra note 48, at 577.}

In addition, the \textit{QVC} court offered an equally curious explanation of why board action in a sale of control context is subject to enhanced judicial scrutiny:

Such scrutiny is mandated by: (a) the threatened diminution of the current stockholders’ voting power; (b) the fact that an asset belonging to public stockholders (a control premium) is being sold and may never be available again; and (c) the traditional concern of Delaware courts for actions which impair or impede stockholder voting rights.\footnote{\textit{QVC}, 637 A.2d at 45.}

If generalized to all takeovers, these references are rather puzzling. They have little to do with the conflicted interest focus of \textit{Unocal} and \textit{Revlon} and, in fact, might presage “some new analytic mode in which the principal emphasis will be on protecting shareholder ‘property rights’ in control premia.”\footnote{DOOLEY, supra note 48, at 577.} As applied to the specific facts of \textit{QVC}, however, references to the shareholders’ interest in the control premium makes perfect sense. They reflect the possibility that conflicted interests on the part of Paramount’s directors would lead them to take actions that transferred gains from their shareholders to Viacom and Redstone.\footnote{Instructively, Chancellor Allen in \textit{Time} had rejected plaintiffs’ argument that the acquisition of Warner precluded a future acquisition of Time-Warner in which former Time shareholders might receive a premium for their shares and, accordingly, triggered the \textit{Revlon} duties. Paramount Comme’ns, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH).}
Of course, it is not enough to recognize a conflict of interest; one must go on to do something about it. The QVC court not only recognized the enhanced conflict of interest present in this situation, but it also seemingly recognized the doctrinal limitations Time imposed on efforts to deal with this conflict. Granted, the court did not overrule Time, but it did limit Time to its unique facts and rejected Paramount’s reading of Time.376

Recall the relevant passage from Time: “Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate Revlon duties”377 the initiation of an active bidding process or the approval of a breakup of the company.378 In QVC, the court emphasized the phrase “without excluding other possibilities,” opining that one of the other possibilities was present; namely, a change of control.379 Accordingly, Revlon was triggered.

The QVC court’s analysis of Time arguably was somewhat disingenuous. In Time, the court had passed over the change-of-control test in favor of the breakup or self-initiated auction triggers. The “other possibilities” language was little more than judicial boilerplate. Yet, from a precedential perspective, that boilerplate became the mechanism by which the Delaware Supreme Court later was able to avoid the need to overrule its own Time decision while still repairing the damage that decision had done to Unocal and Revlon.

The end, however, perhaps justifies the means. By rehabilitating Chancellor Allen’s Time opinion, which the QVC court went out of its way to describe as “well-reasoned,” and by resurrecting the change-of-control test,380 QVC specifically addressed the potential for conflicted interests on

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376 QVC, 637 A.2d at 46.
377 Time, 571 A.2d at 1150 (emphasis added).
378 Id.
380 Id. at 47. An interesting problem is presented by the court’s failure to define the range of transactions that would constitute a change of control. Does a change of control occur in a triangular transaction, in which the target ends up as a wholly-owned subsidiary of the acquirer? Does a change of control occur when target shareholders receive cash or debt securities, rather than surviving company shares? In both cases, there has been a change in the ownership structure, but are these changes sufficient to trigger Revlon or Unocal?

QVC provides some support for finding a change of control in these situations. For example, the QVC court refers to the “diminution of the current stockholders’ voting power” and to the loss of future control premia. Id. at 45. Elsewhere in the opinion, the court notes the effect of the transaction would be “to shift control of Paramount from the public stockholders to a controlling stockholder, Viacom.” Id. at 48. Support for such an argument can also be found in Chancellor Allen’s Time decision, which found that the Time-Warner merger would not constitute a change of control because it was a merger of equals in which the existing Time shareholders’ interests were merely being diluted. Time, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at
the part of directors in transactions like the one at hand. Indeed, the court laid great stress on the fact that a transaction in which control changes hands to an identifiable owner leaves the target’s shareholders vulnerable to both ex ante and ex post misconduct by the incumbent directors and the new owner.\footnote{\textsuperscript{381}}

In addition to constraining Time’s interpretation of Revlon, the QVC court made an even more important doctrinal shift. Where Time had treated Unocal and Revlon as involving separate modes of inquiry directed at distinct issues, QVC restored the better view that they are part of a single line of cases in which the significant conflict of interest found in certain control transactions justifies enhanced judicial scrutiny. The QVC court, for example, reiterated that “the general principles announced in Revlon, in Unocal v. Mesa Petroleum Co., and in Moran v. Household International, Inc. govern this case and every case in which a fundamental change of corporate control occurs or is contemplated.”\footnote{\textsuperscript{382}}

Likewise, while Time had emphasized the formal tests announced in Unocal and Revlon, the QVC court struck out in a less rigid direction. As described in QVC, the enhanced scrutiny test is basically a reasonableness inquiry to be applied on a case-by-case basis:

The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including

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\textsuperscript{381} QVC, 637 A.2d at 43.

\textsuperscript{382} Id. at 46 (citations and emphasis omitted) (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989)).
the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors’ action in light of the circumstances then existing.  

The burden of proof is on the directors with respect to both issues. They need not prove they made the right decision but merely that their decision fell within the range of reasonableness. 

The reasonableness standard is a logical culmination of my argument that motive is what counts. Notice that the reasonableness test parallels the definition of fairness used in the former Model Business Corporation Act provisions governing interested director transactions, where the transaction in question falls “within the range that might have been entered into at arm’s length by disinterested persons.” Both standards seem designed to ferret out board actions motivated by conflicted interests by contrasting the decision at hand to some objective standard. The implicit assumption is that a reasonable decision is unlikely to be motivated by conflicted interest or, at least, that improper motives are irrelevant so long as the resulting decision falls within a range of reasonable outcomes. The operating norm appears to be “no harm, no foul,” which seems sensible enough. 

_QVC_, moreover, strongly indicated that a court should not second-guess a board decision that falls within the range of reasonableness, “even though it might have decided otherwise or subsequent events may have cast doubt on the board’s determination.” Recall in _Interco_, Chancellor Allen had warned that Delaware courts need to employ “the _Unocal_ precedent cautiously. . . . The danger that it poses is, of course, that 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.” Likewise, Justice Jacobs has observed that: “[a]lthough ‘enhanced scrutiny’ must be satisfied before business judgment rule presumptions will apply, that does not displace the

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383 Id. at 45. See also Veasey & Di Guglielmo, supra note 80, at 1456 (opining “a _Unocal_ review is essentially an objective, reasonableness review, as distinct from the minimalist rationality standard of the business judgment rule”).
384 _QVC_, 637 A.2d at 45.
385 Id.
386 My reading of _QVC_ is consistent with—and supported by—Rock’s conclusion that “_QVC_ makes clear that going through the motions without the right intention is legally risky in Delaware.” Rock, supra note 261, at 1087.
388 _QVC_, 637 A.2d at 45.
use of business judgment in the board room.” QVC acknowledged both of these concerns, making clear that so long as the board’s conduct falls within the bounds of reasonableness, Delaware courts will not second-guess the board’s decisions.


This conclusion is confirmed by then-Vice Chancellor Berger’s post-QVC decision in Rand v. Western Air Lines, Inc., No. 8632, at 8 (Del Ch. Feb. 25, 1994) (mem.), reprinted in 19 Del. J. Corp. L. 1292, 1300 (1994). As Paramount had done, Western Air Lines gave its prospective acquirer both a no-shop clause and a lockup. Id. at 5, reprinted in 19 Del. J. Corp. L. at 1298. As in QVC, there was a suggestion of self-interest on the part of Western Air Lines’ representatives. Western Air Lines’ chief negotiators were all employees of the firm who had large golden parachutes in their employment contracts. Id. at 9-10, reprinted in 19 Del. J. Corp. L. at 1300-01. Unlike QVC, however, judicial review elicited “no evidence from which one could reasonably infer that the negotiators were motivated by personal interests.” Id. at 10, reprinted in 19 Del. J. Corp. L. at 1301. The court therefore deferred to the board’s decisions, including the decisions to grant the no-shop clause and the lockup. Id. at 11, reprinted in 19 Del. J. Corp. L. at 1301.

Curiously, however, Fraidin and Hanson cited QVC in support of the proposition that Delaware recognizes the “just say no” defense. Fraidin & Hanson, supra note 227, at 1741. To be sure, in QVC, the court reaffirmed “the prerogative of a board of directors to resist a third party’s unsolicited acquisition proposal or offer,” while cautioning that such a decision “must be informed.” QVC, 637 A.2d at 43 n.13. But this does not signal approval of the “just say no” defense, in light of the court’s observation that the enhanced scrutiny test would be applied to “the adoption of defensive measures in response to a threat to corporate control.” Id. at 42. This is an important point because it is central to Fraidin and Hanson’s argument that all lockups should be upheld:

Delaware courts appear to intervene dramatically in board-room decision making when a board decides to sell a firm to a specific bidder at a substantial premium, but show near-complete restraint when a board decides (1) to reject any and all offers regardless of the premium being offered, (2) to authorize a “merger of equals” transaction in which their company merges with another and the shareholders receive no premium for their stock (and perhaps even receive less than market value for their stock), or (3) to purchase another firm at substantial premium (and perhaps overpaying). The “inherent” conflicts of interest which Delaware courts claim to find so troubling in the takeover context would appear to be most severe in the last three settings and . . . virtually non-existent in the first. If judicial restraint is appropriate in the last three settings, in which a board is rejecting or paying a substantial shareholder premium, it is surely appropriate in the first setting, in which a board of directors is accepting a substantial shareholder premium.

Fraidin & Hanson, supra note 227, at 1832-33 (footnotes omitted). The trouble I have with this argument is that it does not take adequate account of the case-by-case nature of Delaware’s takeover jurisprudence. Delaware courts do not routinely defer to board decision making in the first numbered setting. As this article has demonstrated, Delaware courts carefully examine the board’s decision-making process to determine whether the board acted from proper or improper motives. As to the second and third numbered settings, Fraidin and Hanson’s approach fails to take adequate account of the variety of nonlegal incentives that constrain the board’s exercise of its decision-making authority in these settings. In these settings, it is appropriate for authority values to take precedence in developing legal rules because accountability concerns are adequately addressed by nonlegal incentives.
D. Unitrin

If the point was insufficiently clear after QVC, it was driven home in unmistakable terms by the Delaware Supreme Court’s subsequent decision in Unitrin, Inc. v. American General Corp., a case in which the court approved an everything-but-the-kitchen-sink array of defensive tactics.\(^{392}\) Unitrin’s board adopted a poison pill, amended the bylaws to add some shark repellent features, and initiated a defensive stock repurchase. The chancery court found the latter tactic unnecessary in light of the poison pill.\(^{393}\) The supreme court reversed.

In so doing, the \textit{Unitrin} court held that “draconian” defenses, those defenses that are “coercive or preclusive,” are invalid.\(^{394}\) Non-preclusive or noncoercive defenses are to be reviewed under \textit{QVC}’s “range of reasonableness” standard.\(^{395}\) On the facts before it, the court concluded the shareholders were not foreclosed from receiving a control premium in the future and a change of control was still possible.\(^{396}\) Accordingly, the court concluded Unitrin’s defensive tactics were not coercive and might not be preclusive.\(^{397}\) More importantly, the supreme court determined that the chancery court had “erred by substituting its judgment” for that of the board.\(^{398}\) The supreme court explained this error:

\textit{The ratio decidendi} for the “range of reasonableness” standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors’ defensive response is not draconian (preclusive or coercive) and is within a “range of reasonableness,” a court must not substitute its judgment for the board’s.\(^{399}\)

\(^{392}\) 651 A.2d 1361 (Del. 1995).
\(^{393}\) Id. at 1377.
\(^{394}\) Id. at 1387.
\(^{395}\) Id. at 1387-88.
\(^{396}\) \textit{Unitrin}, 651 A.2d at 1388.
\(^{397}\) Id. at 1390. The court remanded for a determination of the latter question.
\(^{398}\) Id. at 1389.
\(^{399}\) Id. at 1388 (citing Paramount Commc’ns, Inc. v. QVC Network Inc., 637 A.2d 34, 45-46 (Del. 1994)). The Delaware Supreme Court continues to apply the \textit{Unitrin} formulation. \textit{See}, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003). Gilson, however, correctly cited Vice Chancellor Strine’s opinion in \textit{Chesapeake Corp. v. Shore}, 771 A.2d 293, 333-34, 344 (Del. Ch. 2000), as evidence at least one member of the chancery court “will not easily follow the
Note how the balance again tips towards authority values even in a context charged with conflicts of interest. Given the significant conflicts of interest posed by takeovers, courts recognize the need for some review. But the Delaware courts also seemingly recognize that their power of review easily could become the power to decide. To avoid this unhappy result, they are exercising appropriate caution in applying the *Unocal* standard.

VI. Conclusion

The search for conflicted interests reflects the Delaware courts’ solution to the irreconcilable tension between authority and accountability. Concern for accountability drives the courts’ expectation that the board will function as a separate institution independent from and superior to the firm’s managers. The court will inquire closely into the role actually played by the board, especially the outside directors, the extent to which they were supplied with all relevant information and used independent advisors, and the extent to which it was insulated from management influence. Only if the directors had the ultimate decision-making authority, rather than incumbent management, will the board’s conduct pass muster. But if it does, respect for authority values will require the court to defer to the board’s substantive decisions. The board has legitimate authority in the takeover context, just as it has in proxy contests and a host of other decisions that nominally appear to belong to the shareholders. Nor can the board’s authority be restricted in this context without impinging on the board’s authority elsewhere. Therefore, authority cannot be avoided anymore than accountability; the task is to come up with a reasonable balance. Properly interpreted, that is precisely what the Delaware cases have done.

400 The extent to which *Unitrin* tips the balance towards authority is highlighted by Gilson’s criticism of the decision:

> The court acknowledged that “[w]ithout the approval of a target’s board, the danger of activating a poison pill renders it irrational for bidders to pursue stock acquisitions above the triggering level.” Thus, a poison pill is preclusive of a tender offer. But under *Unitrin*, refusal to redeem the pill is not preclusive under *Unocal* unless a proxy fight is also precluded. 

Gilson, *supra* note 12, at 500-01 (quoting *Unitrin*, 651 A.2d at 1381). In other words, in the exercise of the target board’s gatekeeping function, the board may wholly foreclose the possibility of a successful unsolicited tender offer so long as it leaves the door open for a proxy contest. The board, however, need not leave the proxy contest gate wide open. Under *Unitrin*, the board apparently may “inhibit” proxy contests so long as it does not make them “mathematically impossible or realistically unattainable.” *Unitrin*, 651 A.2d at 1388-89.