Toward a New Theory of the Shareholder Role: A sacred space in corporate transactions

Robert B. Thompson  
D. Gordon Smith

Follow this and additional works at: https://digitalcommons.law.byu.edu/faculty_scholarship

Part of the Business Law, Public Responsibility, and Ethics Commons, and the Business Organizations Law Commons

Recommended Citation

This Article is brought to you for free and open access by BYU Law Digital Commons. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of BYU Law Digital Commons. For more information, please contact hunterlawlibrary@byu.edu.
Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers

Robert B. Thompson* and D. Gordon Smith**

I. Introduction

Corporate law expresses a profound ambiguity toward the role of shareholders. Courts announce that the shareholder vote is “critical to the theory that legitimates the exercise of power... by some (directors and officers) over vast aggregations of property that they do not own.”1 At the same time, shareholders have a very difficult time actually making any corporate decisions. In this Article, we strive to define a new role for shareholders in publicly held corporations by drawing on economic theories of the firm and the structure of corporate law. More particularly, we examine the role of shareholders in hostile corporate takeovers, the area where the interests of shareholders and directors collide most dramatically, and highlight a necessary “sacred space” for shareholder self-help, free of directorial or judicial intrusion.

The dominant legal paradigm used to address the allocation of power between shareholders and directors in the hostile-takeover context is derived from the landmark Unocal case handed down in the midst of the 1980s takeover wave.2 Unocal provides a judge-centered process to resolve this conflict. When shareholders attack director-instituted defensive tactics that prevent shareholders from responding to a hostile takeover, courts are supposed to review the action under an “enhanced scrutiny” standard that is more intrusive than the notoriously deferential business-judgment rule. This proactive review is designed to ensure that directors are acting in the best interest of the corporation and its shareholders.3 The actual results of cases

---

* New York Alumni Chancellor’s Chair, Vanderbilt University Law School.
** Visiting Professor of Law, Vanderbilt University Law School; Associate Professor of Law, Northwestern School of Law of Lewis & Clark College. We are grateful to John Coates, Larry Hamermesh, Mitu Gulati, Curtis Milhaupt, Doug Moll, Rob Saunders, and Randall Thomas for insightful comments on early drafts of this article. We are particularly grateful to Vice Chancellor Leo Strine of the Delaware Court of Chancery for provocative insights regarding the Unocal standard. Thanks to Komelia Dormire for excellent research assistance.

3. To be precise, the Unocal court spoke of a board’s “enhanced duty” rather than the court’s “enhanced scrutiny.” Id. at 954. The court quickly modified its terminology in a subsequent case, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986), and has
decided under the *Unocal* standard reflect a much more passive judicial role that seems to distrust shareholder decision-making and to prefer that of directors. As the data in this Article show, *Unocal* and its progeny limit few defensive tactics by directors of target corporations, and shareholders get to decide very little. Judicial discontent with the current paradigm has risen noticeably, and academic commentary points out its deficiencies.

In this Article, we argue that the *Unocal* standard cannot resolve shareholder-director disputes in a satisfactory manner. *Unocal* asks judges to distinguish director-instituted takeover defenses that serve the interests of shareholders from those that merely entrench incumbent managers. Yet every successful takeover defense has an entrenchment effect, so this difference is not likely to be one that a third-party judge will be able to discern reliably. This is the kind of decision that the modern theory of the firm suggests will be brought inside the firm to be decided by a governance mechanism, not left to a third-party arbiter with insufficient information to get it right.

Ronald Coase's classic work on the theory of the firm asked why some economic activity was organized inside firms while other economic activity was organized across markets. Current scholarship—in law, economics, and finance—has coalesced around the idea that firms arise when contracts are incomplete. Particular corporate constituencies (including shareholders, employees, suppliers, and customers) are unable to write contracts that determine future payoffs under every possible contingency. In the world of incomplete contracts, third-party enforcement (for example, by judges) will be difficult. Consequently, the parties may turn to an internal-governance structure for making decisions when unanticipated contingencies arise, and that authority usually should rest in the hands of those with the most to gain (or lose).

---


4. *See discussion infra* subpart I(B).

5. *See, e.g.*, *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 475 (Del. Ch. 2000) ("Unocal's purpose and application have been cloaked in a larger, rather ill-fitting garment"); Chesapeake Corp. v. Shore, 771 A.2d 293, 317–45 (Del. Ch. 2000) (noting that "this case unavoidably brings to the fore certain tensions in our corporation law").


8. *See discussion infra* Part II.
Both in law and in economic theory, shareholders have a residual claim against the assets of the firm. But shareholders in a modern, publicly traded corporation may not always look like what theory assumes residual claimants would look like. Exit is easy, and incentives to invest in the management of the firm are low. As a result, it is often said that shareholders “delegate” their residual control over most business decisions to managers of the corporation and retain certain limited rights to constrain management by voting, selling, or suing. In turn, managers provide the hierarchy and centralized control to direct production and make an integrated assessment of the assets that define the firm.

What has been overlooked is that shareholders seeking to exercise their limited control over managers face a similar incompleteness of contract and ability to rely on judges that led to the initial decision to bring economic activity inside the firm. Contexts where directors lack a direct conflict of interest or are not in a final period make it particularly difficult for courts to respond to a shareholder’s claim that directors are not acting in the shareholders’ best interest. In those situations, it should not be surprising that shareholders would prefer a governance solution over a judge-centered solution.

In place of a judge-centered solution, we emphasize the part of the corporate-governance structure that permits shareholder self-help by voting or selling when director defensive actions reach too far. We call this part of corporate law “sacred space” in an effort to clearly carve out that part of the decision-making space in corporate governance that is left to shareholders. This approach not only provides a clearer way to address shareholder-director conflicts in current takeover controversies, but also acknowledges the change in the shareholder census since Unocal. With an increasing number of active institutional investors as shareholders, these shareholders are eager to decide for themselves whether a takeover is appropriate.9

By focusing on the role of shareholders, our sacred-space approach looks somewhat different from the current Delaware judicial paradigm that takes the directors’ role as its starting point, but the two approaches are necessarily related. In takeovers and other areas, corporate law allocates power between directors and shareholders in a reciprocal manner. To the extent that directors increase their decision-making authority, they reduce the range over which shareholders have authority—and vice versa. The implication of this insight, which is rarely made explicit in Delaware cases, is that questions about the proper scope of board power could just as easily be framed as questions about the proper scope of shareholder power.

9. As Vice Chancellor Strine asked in Chesapeake, “If stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded them?” Chesapeake, 771 A.2d at 328.
The Article proceeds as follows: We begin with a brief overview of the theoretical space that defines the roles of shareholders and directors in corporate governance (Part I) and provide a description of the statutory and common-law structure of corporate law, particularly as it applies to decisions in hostile takeovers (Part II). Part III focuses on fiduciary duty as the great judicial workhorse used to address shareholder-director conflict and explains why it has not worked in the takeover context. Part IV develops our alternative based on shareholder direct action as a means to resolve takeover disputes, a move we think is consistent with the current statutory structure and modern theory of the firm. In Part V, we discuss how this sacred-space approach would resolve current questions in takeover law, including issues such as the propriety of "just-say-no" action by directors and the reach of mandatory shareholder bylaws.

II. Shareholders' Role in the Theory of the Firm

In this section, we describe how the theory of the firm informs the role of shareholders in corporate law. Competing theories of the firm strive to answer several fundamental questions, as described by Hart and Moore: "What is a firm? Why do firms come into existence? How do transactions within a firm differ from those between firms?" For purposes of describing the role of shareholders in modern corporations, the boundaries of the firm have less relevance than the functions of the firm. With respect to the functions of firms, all theories of the firm hold that in certain circumstances firms produce efficiencies over arm's-length market transactions, either by economizing transaction costs or maximizing production. Our aim is to describe a role for shareholders within the firm that maximizes those efficiencies.

Our analysis draws primarily on three groups of sources: (1) agency theory, which is usually associated with the work of Michael Jensen and William Meckling; (2) transaction-cost economics, which has been most

10. Oliver Hart & John Moore, Property Rights and the Nature of the Firm, 98 J. POL. ECON. 1119, 1120 (1990) [hereinafter Hart & Moore, Property Rights]. Luigi Zingales writes of four "fundamental questions": (1) "[H]ow an organization devoid of unique assets succeeds in acquiring power that differs from 'ordinary market contracting between any two people'" (quoting Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777 (1972)); (2) "[H]ow is this power maintained and enhanced, and how is it lost?"; (3) "[H]ow this authority-based system operates in a way different from ordinary market contracting"; and (4) "[H]ow the surplus generated by the firm is allocated among its members." Luigi Zingales, In Search of New Foundations 3-4 (1999) (unpublished manuscript, on file with the Texas Law Review) [hereinafter Zingales, Search].

forcefully advanced by Oliver Williamson;\textsuperscript{12} and (3) property-rights theory, which was first articulated by Sanford Grossman, Oliver Hart, and John Moore,\textsuperscript{13} and has recently been enriched by the work of Raghuram Rajan and Luigi Zingales.\textsuperscript{14} Agency theory has dominated corporate-law scholarship,\textsuperscript{15} though not without substantial criticism.\textsuperscript{16} Transaction-cost economics has made significant inroads over the past decade, but the property-rights theory has only recently begun to attract significant attention.\textsuperscript{17}

While all competing theories of the firm trace their origins to Ronald Coase's provocative article, \textit{The Nature of the Firm},\textsuperscript{18} each offers unique


\textsuperscript{16} See generally Margaret M. Blair & Lynn A. Stout, \textit{A Team Production Theory of Corporate Law}, 85 VA. L. REV. 247, 259 (1999) (questioning whether agency theory affords any special insight into the nature of corporations).


\textsuperscript{18} Coase, \textit{supra note 7}. Williamson asserts that the origins of agency theory lie in the classic work of ADOLPH A. BERLE, JR. & GARDNER C. MEANS, \textit{THE MODERN CORPORATION AND PRIVATE PROPERTY} (1932). See \textit{WILLIAMSON, MECHANISMS, supra note 12}, at 172. Although agency theory speaks more directly to the separation of ownership and control than to other theories of the firm, its proponents were clearly attempting to tackle the issue identified by Coase—namely, why do firms exist and what are their boundaries? See Alchian & Demsetz, \textit{supra note 11}, at 783–84; Jensen & Meckling, \textit{supra note 11}, at 310–11; see also Thomas S. Ulen, \textit{The Coasean Firm in Law and Economics}, 18 J. CORP. L. 301, 311 (1993) ("[T]here is no doubt that [Alchian and Demsetz's] clarification of the essence of the firm would not have been undertaken but for Coase's \textit{The Nature of the Firm}."."
insights. Each of the primary theories of the firm relies on the contract metaphor, though to different effect. Agency theory developed the familiar "nexus-of-contracts" approach to firms. Both transaction-cost economics and property-rights theory recognize that the firm has a role in resolving the problems introduced by "incomplete contracts," but transaction-cost economics relies on governance structures to resolve those problems, while property-rights theory relies on ownership effects to resolve them. Before exploring these theories in more detail, a bit of background is in order.

Modern theories of the firm developed in reaction to the impoverished concept of the firm in neoclassical economics. Of course, prior to Ronald Coase, no one suspected that the theory of the firm was impoverished. As noted by Thomas Ulen, "If there was one topic that economists in the 1930s thought that they understood, it was the economic reasons for the existence of firms. Put briefly, the firm was a means of realizing economies of scale in the production of goods and services." Williamson describes the neoclassical firm as a production function, a "technology to which a profit maximization purpose was ascribed." Given profit maximization as the goal, firms would be forced to pursue strategies dictated by markets—or perish. Under this view, price theory was the only requirement for a theory of the firm.

Because neoclassical theory did not attempt to look inside the decision-making processes of the firm, commentators often refer to this conception of the firm as a "black box." In 1937, Ronald Coase opened the box and peered inside when he observed that some production is coordinated through firms rather than markets:

Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm these market transactions are eliminated, and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production. It is clear that these are alternative methods of co-ordinating production. Yet, having regard to the fact that, if production is regulated by price

---

19. See, e.g., Hart & Moore, Property Rights, supra note 10, at 1122 ("We... suppose that it is costly for agents to write detailed long-term contracts that precisely specify current and future actions as a function of every possible eventuality and that, as a result, the contracts written are incomplete and will be subject to renegotiation later on.").

20. Ulen, supra note 18, at 302.

21. WILLIAMSON, MECHANISMS, supra note 12, at 365.


movements, production could be carried on without any organization at all, well might we ask, Why is there any organization?\(^24\)

Coase's article was famously neglected for two decades. Once discovered, however, it led to startling new insights about the economics of organization. Those insights coalesced around two issues: (1) the purposes of firms and (2) the boundaries of firms. With respect to the first issue, Coase suggested that firms exist to economize on transaction costs. With respect to the second issue, Coase hypothesized that firms would integrate to the extent required to take advantage of savings in transaction costs.

The first attempt to deal systematically with the issues identified by Coase was the oft-cited article by Armen Alchian and Harold Demsetz, who argued that firms were designed to solve the "team-production" problem.\(^25\) Team production occurs when two or more people work jointly, and their respective inputs are "unobservable." In other words, an outsider would find it impossible to reward team members based on the quality or quantity of their inputs for the simple reason that direct observation of each team member's performance is impossible or prohibitively costly, or because the inputs of one team member are indistinguishable from the inputs of other team members.\(^26\) Alchian and Demsetz argued that shirking by team members could be reduced by subjecting the team to outside monitoring. Such monitoring would be performed by a principal, who specialized in monitoring. The "monitor's" incentives would derive from the fact that he was entitled to the residual earnings of the team.\(^27\)

While their description of the residual claimant offered a potentially powerful explanation for shareholders in the modern corporation,\(^28\) Alchian and Demsetz were criticized on at least two points. First, as noted by Masahiko Aoki, "it is vital for their argument to presume the principal's

\(^24\) See Coase, supra note 7, at 35–36.

\(^25\) See Alchian & Demsetz, supra note 11, at 783–84.

\(^26\) Id. at 780 ("In team production, marginal products of cooperative team members are not so directly and separably (i.e., cheaply) observable."); R. Preston McAfee & John McMillan, Optimal Contracts for Teams, 32 INT'L ECON. REV. 561 (1991) ("The synergy that is the reason for the team's existence may mean that an individual's contribution to the team's output is not distinguishable, so that it is impossible to pay him according to his own productivity.").

\(^27\) See Alchian & Demsetz, supra note 11, at 781–82.

\(^28\) This assertion is made with hindsight of nearly three decades. At the time it was written, the article by Alchian and Demsetz did not obviously describe the modern corporation. In that regard, Thomas Ulen has stated:

The modern corporation is, by and large, a publicly-held corporation, and it is not at all clear that the Alchian-Demsetz theory is an apt description of that corporation. Specifically, the residual claimant of the Alchian-Demsetz theory is most easily identifiable as an individual entrepreneur—for example, Andrew Carnegie or John D. Rockefeller—in a closely-held enterprise.... To relate the Alchian-Demsetz theory to those particular residual claimants requires another level of explanation, viz., how do common shareholders perform the monitoring function of the (individual) residual claimant theory?

Ulen, supra note 18, at 312.
perfect ability to observe the individual actions of team members, once properly motivated. The perfect observability assumption, however, renders the concept of teams almost meaningless.” 29 Second, Jensen and Meckling observed, “We sympathize with the importance they attach to monitoring, but we believe the emphasis which Alchian-Demsetz place on joint input production is too narrow and therefore misleading.” 30 In other words, Alchian and Demsetz overestimated the importance of team production. 31

A. Agency Theory

The emphasis on monitoring by Alchian and Demsetz places them firmly in the tradition of agency theory, though the most influential piece in this area was published four years later. Jensen and Meckling agreed with Alchian and Demsetz in holding that the firm was not (as Coase asserted) a pocket of productive activity where “market transactions are eliminated.” Instead, Jensen and Meckling viewed the firm as a “legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.” 32 From this standpoint, the boundaries of the firm are irrelevant because there is no firm in any meaningful sense. 33

This view of the firm dominated corporate legal scholarship for at least two decades and need not be examined in great detail here. For present purposes, it is sufficient to sketch the outlines of agency theory and describe its relationship to the law of fiduciary duties. The central focus of agency theory is the conflict created when one person acts on behalf of another. 34 In the context of corporate law, the directors are viewed as “agents” of the shareholders (“principals”). The probability that self-interested agents will deviate from the best interests of their principals will prompt parties in an agency relationship to provide incentives for loyalty. Principals may monitor

---

30. Jensen & Meckling, supra note 11, at 310.
31. Team production has recently enjoyed a renaissance in corporate legal scholarship. Blair & Stout, supra note 16.
32. Jensen & Meckling, supra note 11, at 311.
33. Jensen and Meckling argue that
   [i]t makes little or no sense to try to distinguish those things which are “inside” the firm... from those things that are “outside” of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.
   Id.
34. In the words of Jensen and Meckling, an agency relationship is “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.” Id. at 308.
agents, or agents may bond their own performance. In either event, the parties will not be able to align the agent's performance perfectly with the principal's preferences, and any divergences are referred to as residual loss. Taken together the monitoring costs, bonding costs, and residual losses are the total agency costs of the relationship.\textsuperscript{35}

For many, the function of corporate law is to minimize the total agency costs inherent in the relationship between directors and shareholders. Of course, corporate law would be unnecessary if directors and shareholders could write complete contracts.\textsuperscript{36} Some gaps in corporate "contracts" are filled by governance mechanisms (most importantly, shareholder voting), and other gaps are filled by the law of fiduciary duties.\textsuperscript{37} Our task in this paper is to distinguish between them.

B. Transaction-Cost Economics

The unit of analysis in transaction-cost economics is the transaction. The goal of transaction-cost economics is easily stated: align transactions with governance structures in a manner that minimizes transaction costs. Realization of this goal is a bit more complex, but the relevant features of transaction-cost economics are relatively accessible.

Transaction-cost analysis is founded on two behavioral assumptions: "bounded rationality" and "opportunism." Bounded rationality is the notion that actors strive to act rationally, but are simply incapable of fulfilling the requirements of strict rationality because of limited information and limited ability to process information. Opportunism is familiar from agency theory, but Williamson offers the most commonly quoted definition: "self-interest seeking with guile."\textsuperscript{38} He elaborates that this "includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit."\textsuperscript{39} Transactions are examined along three dimensions: asset specificity,\textsuperscript{40} frequency, and uncertainty. Where transaction costs are high, the relationships are brought inside the firm subject to its hierarchy and internal governance. Within the corporation, the board of directors is viewed as a governance instrument of shareholders, an instrument "whose principal purpose is to safeguard those

\textsuperscript{35} Id.

\textsuperscript{36} Although incomplete contracts are not central to agency theory, the existence of incomplete contracts suggests that monitoring and bonding will be accomplished by governance mechanisms, and agency theory does not reject that implication. As a result, agency theory and the other theories of the firm are complementary.

\textsuperscript{37} See, e.g., EASTERBROOK & FISCHER, supra note 15, at 90 ("If contracts can be written in enough detail, there is no need for 'fiduciary' duties . . . ").

\textsuperscript{38} WILLIAMSON, INSTITUTIONS, supra note 12, at 47.

\textsuperscript{39} Id.

\textsuperscript{40} Williamson has helpfully defined "asset specificity" to mean "[a] specialized investment that cannot be redeployed to alternative uses or by alternative users except at a loss of productive value." WILLIAMSON, MECHANISMS, supra note 12, at 377.
who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill-defined, and cannot be protected in a well-focused, transaction-specific way.\textsuperscript{41}

\textbf{C. Property-Rights Theory}

Property-rights theorists argue that the key to understanding the nature of firms is to focus on assets.\textsuperscript{42} Given the inevitability of incomplete contracts,\textsuperscript{43} ownership—defined as the residual right to control assets—\textsuperscript{44} will determine the decisions made in situations that are outside of any existing contracts. When ownership relates to specialized assets, it leads to control over human capital.\textsuperscript{45}

Under this view, decision-making within the firm is determined by ownership because owners have power. Firms are created when the exercise of such power produces efficiencies. Stated differently, firms solve the problems posed by incomplete contracts, but not by reducing transaction costs. Rather, firms solve those problems by encouraging the appropriate level of relationship-specific investment.\textsuperscript{46} As noted by Hart and Moore, “The driving force behind all our results is the idea that agents underinvest because some of the benefits from their investment are dissipated in future bargaining. Assets are allocated so as to mitigate this underinvestment.”\textsuperscript{47}

Recent work by Raghuram Rajan and Luigi Zingales follows in the tradition of Hart and Moore, but identifies a source of power distinct from ownership. Under this view, power emanates from the right to control access to assets, including human capital. “Access” is broadly defined to mean “the

---


\textsuperscript{42} Hart and Moore focused on physical assets, but noted that “the ideas may generalize to intangible assets such as goodwill.” Hart \& Moore, \textit{Property Rights}, supra note 10, at 1150. They conclude:

Some nonhuman assets are essential for the argument, however, and in fact we suspect that they are an important ingredient of any theory of the firm. The reason is that in the absence of any nonhuman assets, it is unclear what authority or control means. Authority over what? Control over what?

\textit{Id.}

\textsuperscript{43} As noted, if parties could negotiate complete contingent contracts, firms would be unnecessary. See supra notes 36–37 and accompanying text.

\textsuperscript{44} Hart \& Moore, \textit{Property Rights}, supra note 10, at 1120 (“[W]e identify a firm with the assets it possesses and take the position that ownership confers residual rights of control over the firm’s assets: the right to decide how these assets are to be used except to the extent that particular usages have been specified in an initial contract.”).

\textsuperscript{45} \textit{Id.} at 1121 (explaining that one’s bargaining position with laborers is strengthened through control of the assets that they use).

\textsuperscript{46} In describing the property-rights theory of the firm, Rajan and Zingales state that “[t]he role power plays within the firm is to foster and protect relationship-specific investments.” Rajan \& Zingales, \textit{Power}, supra note 14, at 387.

\textsuperscript{47} Hart \& Moore, \textit{Property Rights}, supra note 10, at 1151.
ability to use, or work with, a critical resource.\footnote{48} Why is access important? According to Rajan and Zingales, access determines how specific investments are made:

The agent who is given privileged access to the resource gets no new residual rights of control. All she gets is the opportunity to specialize her human capital to the resource and make herself valuable. When combined with her preexisting residual right to withdraw her human capital, access gives her the ability to create a critical resource that she controls: her specialized human capital.\footnote{49}

This "critical-resource" theory of the firm was partly inspired by shortcomings of the property-rights theory, including what Rajan and Zingales refer to as the "adverse effect of ownership."\footnote{50} They argue that ownership can actually reduce the incentive to make relationship-specific investments.\footnote{51} The intuition behind this conclusion is easy to understand—specialization may foreclose alternative uses of an asset, and these opportunity costs reduce the incentive to make the specialized investments that characterize the firm.\footnote{52}

Critical-resource theory provides a powerful explanation for the structure of modern, publicly traded corporations. Rajan and Zingales suggest that the adverse effects of ownership and the positive effects of access combine to argue for placing ownership in the hands of a "third party" who is not involved in the production process.\footnote{53} This largely passive owner "could delegate many of the powers of ownership that are unlikely to be misused to a managerial hierarchy [and] will retain the power to fire the production team (or the managing hierarchy) from the assets if it does not specialize."\footnote{54}

D. Comparing the Theories of the Firm

As noted by Oliver Williamson, agency theory and transaction-cost economics are "mainly complementary."\footnote{55} For example, both rely heavily on

---

\footnote{48} Rajan & Zingales, \textit{Power}, supra note 14, at 388. The authors elaborate on the basic definition as follows: "If the critical resource is a machine, access implies the ability to operate the machine; if the resource is an idea, access implies being exposed to the details of the idea; if the resource is a person, access is the ability to work closely with the person." \textit{Id.} at 388.

\footnote{49} \textit{Id.} at 388.

\footnote{50} \textit{Id.} at 406.

\footnote{51} \textit{Id.}

\footnote{52} Rajan and Zingales identify two other shortcomings. First, ownership by one agent may in some circumstances "crowd out" incentives to invest by other agents. Second, the property-rights theory involves a limited supply of ownership—if the number of agents who require incentives is great, there may not be enough ownership rights to go around. \textit{Id.} at 406-07.

\footnote{53} \textit{Id.} at 422.

\footnote{54} \textit{Id.}

\footnote{55} WILLIAMSON, \textit{MECHANISMS}, supra note 12, at 171. In his comparison of the two theories, Williamson notes that both come in two varieties. Formal work in agency theory is preoccupied
the concept of opportunism (often referred to as “moral hazard” in the agency literature). Moreover, both theories accept the notion of bounded rationality. Thus, the “behavioral assumptions” on which each theory is based are virtually identical.

According to Williamson, the primary difference between transaction-cost economics and agency theory lies in the unit of analysis. While the former examines transactions, the latter concentrates on agents. This difference in focus leads to a difference in approach that is crucial to our project, namely, that agency theory is primarily concerned with ex ante incentive alignment (of the agent and the principal) whereas transaction-cost economics is primarily concerned with ex post governance. This difference, in turn, has implications for the respective roles of private and court ordering. In Williamson’s words:

Rather than assume that disputes are routinely submitted to and efficaciously settled by courts, [transaction-cost economics] maintains that court ordering is a very crude instrument and that most disputes, including many that under current rules could be brought to a court, [can be] resolved by avoidance, self help and the like.

Like agency theory, property-rights theory and transaction-cost economics are “highly complementary.” According to Edward Rock and Michael Wachter, “[t]he critical insight shared by these approaches . . . is that contracting will inevitably be highly incomplete.” Nevertheless, the implications of incomplete contracts are dramatically different. In transaction-cost economics, the combination of incomplete contracts and opportunism leads to a focus on ex post contracting problems. Even if the

with questions relating to “mechanism design,” while less formal work focuses on monitoring and bonding in contracts organizations (“positive theory of agency”). Transaction-cost economics may be divided into “measurement” and “governance.” Williamson compares the positive theory of agency with the governance theory of transaction-cost economics. Id. at 172.

56. This is a more recent development in agency theory.

57. WILLIAMSON, MECHANISMS, supra note 12, at 175.

58. See id. at 176 (stating that reducing costs “through judicious choice of governance structure (market, hierarchy, or hybrid), rather than merely realigning incentives and pricing them out, is the distinctive . . . orientation” of transaction-cost economics).

59. Id. at 176–77 (citation omitted). This is not to suggest that courts are always counterproductive. To the contrary, Williamson acknowledges that the “availability of the courts to serve as a forum of ultimate appeal . . . serves to delimit the range of indeterminacy within which private ordering bargains must be reached.” Id. at 177.

60. Rock & Wachter, supra note 17, at 1630; see also Hart & Moore, Property Rights, supra note 10, at 1120 (stating that their analysis is consistent with Williamson’s prior work in transaction-cost economics).

61. Rock & Wachter, supra note 17, at 1630. In the interest of giving credit where credit is due, however, we note that on this point the theorists of the firms were inspired by the writings of a law professor, Ian Macneil, who pioneered the notion of “relational contracts.” See WILLIAMSON, MECHANISMS, supra note 12, at 355 (noting that Macneil’s treatment of contracts in his article The Many Futures of Contracts, 47 S. CAL. L. REV. 691 (1974) was “much more expansive, nuanced, and interdisciplinary (mainly combining law and sociology) than any I had seen previously”).
parties were not subject to information asymmetries, Williamson argues, "costly maladaptation and ex post bargaining" are possible. By contrast, the property-rights theorists assume costless bargaining will lead to efficient results ex post; therefore, property-rights theory focuses on ex ante contracting.

E. The Shareholders' Role in Corporate Law

For all of the attention that they receive, shareholders are still slighted by the theory of the firm. Whether because of "rational apathy" or lack of business expertise, shareholders are inevitably cast as passive constituents of the firm. While they nominally possess residual control rights of the publicly held firm, actual control is said to reside in the managers. Our task is to examine more closely the division of power between directors and shareholders. In this endeavor, generalizations about the "delegation" of control rights from shareholders to directors are inadequate.

Agency theorists leave surprisingly little to the shareholders. "Surprising" because agency theory is erected on the notion that a principal (the shareholders) monitors an agent (the managers). Nevertheless, agency theory routinely invokes the power of markets to "monitor" managers, thus supplanting the shareholders. For example, in their survey of corporate governance, Andrei Shleifer and Robert Vishny assert that "product market competition is probably the most powerful force toward economic efficiency in the world" and that "[t]akeovers are widely interpreted as the critical corporate-governance mechanism in the United States, without which

63. Hart & Moore, Property Rights, supra note 10, at 1152. Williamson argues that the "assumption of costless bargaining is a preposterous simplification." WILLIAMSON, supra note 62, at 6 n.5.
64. See Jensen & Meckling, supra note 11, at 337-38; see also ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 260-76 (1957) (discussing "rational apathy" in the context of an election within a democratic political system); MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION 55-56 (2d ed. 1971) (arguing that individual shareholders have no incentive to challenge inept or corrupt management).
65. See, e.g., Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance, 52 J. Fin. 737, 741 (1997). In the course of explaining how lack of business expertise renders shareholders passive and gives managers actual control, Shleifer and Vishny discuss the following hypothetical situation:
   In principle, one could imagine a contract in which the financiers give funds to the manager on the condition that they retain all the residual control rights. Any time something unexpected happens, they get to decide what to do. But this does not quite work, for the simple reason that the financiers are not qualified or informed enough to decide what to do—the very reason they hired the manager in the first place.
   Id.
66. Id. ("The fact is that managers do have most of the residual control rights.").
67. Id. at 738.
managerial discretion cannot be effectively controlled." When these market mechanisms fail, shareholders may sue. Voting is viewed as important, but not terribly effective in most contexts; therefore, the domain of shareholder self-help under this view is limited.

Property-rights theory provides less guidance than agency theory on the role of shareholders in corporate governance. Hart and Moore assert that shareholders have the residual right to control assets, which they define as "the right to decide how these assets are to be used except to the extent that particular usages have been specified in an initial contract." Within this definition lie the seeds of confusion for those attempting to delineate the respective roles of shareholders and directors. While it is widely accepted that shareholders have the residual right of control over a corporation, it is equally well-established that shareholders "delegate" some of those control rights to the board of directors. Incorporation subjects the assets of the firm to the default rules of the corporation statute, which empowers the board of directors with management authority over the firm. In many of the most difficult problems in corporate law (including the allocation of control rights when facing a hostile-takeover bid), the issue is whether directors or shareholders should have decision-making power. Suggesting that shareholders have decision-making power "except to the extent that particular usages have been specified in an initial contract" begs the question: what

68. Id. at 756 (footnote omitted).
69. Id. at 750–51 ("The most important legal right shareholders have is the right to vote on important corporate matters [but voting is] expensive to exercise and enforce.").
70. Hart & Moore, Property Rights, supra note 10, at 1120.
71. See, e.g., Blair & Stout, supra note 16, at 263 (noting that "the shareholder/owners at the top of the pyramid have been understood to be the residual claimants to all profits left over after all the corporation's contractual obligations have been met"); Zingales, Search, supra note 10, at 14; see also Hart & Moore, Property Rights, supra note 10, at 1121 n.3 ("It should be emphasized that the approach taken in this paper... distinguishes between ownership in the sense of possession of residual control rights over assets and ownership in the sense of entitlement to an asset's (verifiable) profit stream. In practice, these rights over assets will often go together, but they do not have to.").
72. Grossman & Hart, supra note 12, at 694 ("In a corporation the shareholders as a group have control and delegate this control to the board of directors (i.e., management)."). On the issue of delegation, see George Baker et al., Informal Authority in Organizations, 15 J.L. ECON. & ORG. 56, 56 (1999):

Authority is the defining feature of hierarchy. The boss can restrict the subordinate's actions, overturn his decisions, and even fire him (unless the boss's boss objects, in which case the boss herself may be fired). Tracing this chain of authority up the hierarchy, we eventually reach a person (sole proprietor) or group (shareholders) who can be thought of as owning all the decision rights in the organization. In short, formal authority resides at the top.

Of course, few organizations are run by tyrants who actively exercise their ownership of all the decision rights in the organization. To the contrary, many middle managers wield substantial authority. But we assert that such authority is always informal, in the sense that it can be retracted by those higher up the hierarchy, ultimately by those at the top who hold formal authority. That is, we see all subordinates' decision rights as loaned, not owned.
usages have been specified in the initial contract (that is, the statutory default rules)? On this issue, Hart and Moore provide no explicit guidance.\textsuperscript{73}

Transaction-cost economics appears more helpful in defining the shareholder role because of its emphasis on ex post governance of the firm. Under this view, the statutory default rules are not complete contingent contracts, but governance mechanisms. Even as governance mechanisms, however, the statutory default rules are incomplete because they do not precisely specify the decision-making roles of directors, shareholders, and courts. In the face of such uncertainty, we agree with Williamson that "court ordering is a very crude instrument" and that some disputes are best resolved by shareholder self-help.\textsuperscript{74} Yet unbridled shareholder decision-making can adversely affect the firm.\textsuperscript{75} As a result, we conclude that shareholders should act without interference from directors or courts in a narrowly defined range of circumstances, which we call "sacred space."

III. The Legal Structure: Corporate Governance and the Role of Judges

Corporate law is much more specific than most theory-of-the-firm discussions in detailing the relative roles of shareholders and directors within corporations. Yet the broad outlines of the statutory structure parallel one of the central teachings from the theory of the firm just discussed: some role for shareholders is essential, but too much shareholder control can adversely affect the firm. In this part we focus not just on the roles of these groups, but also on the central role of judges in resolving disputes between shareholders and directors. In the next two parts we explore how judge-centered shareholder litigation has failed in the takeover setting and suggest a focus on the other shareholder functions of voting and selling that have been overshadowed since Unocal.

Corporate law provides a business form that intentionally centralizes almost all corporate power in one subgroup of the enterprise, the board of directors. Section 141 of the Delaware Code is an explicit statement of this choice,\textsuperscript{76} and counterparts are found in the corporation statute of every other

\textsuperscript{73} Commenting on the decision by Hart and Moore to identify power inside the firm with ownership, Zingales rightly observes, "Not surprisingly this line of research has found it extremely difficult to deal with the separation between ownership and control." Zingales, Search, supra note 10, at 23.

\textsuperscript{74} See Rajan & Zingales, Power, supra note 14, at 424 ("[S]hareholders, precisely because of their remoteness from the production process, may be in a better position [than other stakeholders] to make decisions that are in the best interests of the firm.").

\textsuperscript{75} See Andrei Shleifer & Lawrence H. Summers, Breach of Trust in Hostile Takeovers, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (A.I. Auerbach ed., 1988). This may be particularly true in firms in which human capital is an important source of power. See Zingales, Search, supra note 10, at 37 ("[T]he major corporate governance problem [is] how to prevent conflicts among stakeholders from paralysis or destroying the firm.").

\textsuperscript{76} DEL. CODE ANN. tit. 8, § 141 (1991).
Such centralization promotes efficiency and facilitates an enterprise that can easily adapt to changing circumstances. These insights on the importance of centralized decision-making were formalized by Kenneth Arrow, one of the pioneers of transaction-cost economics. Directors' use of this centralized power—and with it, their ability to control other people's money—is subject to a variety of formal and informal constraints including regulatory laws, contracts, market behavior, and norms.

In contrast, the role for shareholders is limited. They vote, sell, or sue, each in carefully measured doses. Shareholders actually vote on very few things, including an annual election of directors and certain fundamental corporate changes after the board of directors has proposed them. Coordination costs and the rational passivity of most shareholders have meant that voting has traditionally provided weak practical limits on centralized director power. Voting to replace incumbent management was seldom successful in the time before the advent of hostile takeovers. Selling shares on the market has always been an option available to shareholders, given the longstanding corporate principle of free transferability of shares. The structure of markets and the dominance of passive, dispersed shareholders in most corporations made the collective use of this selling power a little-used means of changing corporate control prior to the widespread use of the cash tender offer in the 1960s and the rise in prominence of hostile takeovers in subsequent decades. The frenetic takeover activity during the early 1980s—fueled by the use of "junk-bond"
financing—transformed collective selling of shares into a real threat to directors’ control.85

Thus for most of the last century, it was the third area of shareholder rights—suing—that provided the greatest check on centralized board power. Courts necessarily played the key role in this mechanism, usually by developing and applying after the fact the broad concepts of fiduciary duty that limited the actions of directors. Indeed, the key regulatory move of the 1980s in corporate takeovers was the rise of fiduciary duties as the primary means to sort out legal claims regarding the ability of directors to limit or thwart the collective use of shareholder selling. Fiduciary duty held center stage, overpowering possible alternatives such as direct shareholder action to vote or sell shares, the regulatory provisions of the Williams Act,86 or the unfettered dictates of the market.87

Given the importance of a shareholder’s right to sue, some additional discussion of how fiduciary-duty litigation proceeds in corporate law is a necessary foundation for interpreting Unocal. A fiduciary-duty claim involves a shareholder’s request for a court to intrude into director decision-making. In this context there are both a common starting point and predictable paths by which a court will approach corporate claims alleging breach of fiduciary duty. The starting point is judicial deference, as expressed by the business-judgment rule. Courts presume that board actions are appropriate, and unless the court is moved from that position, it will defer to those actions and decline to intervene.88 The factors that will move a court off its initial position have been stated in different ways in different times, and they vary depending on the particular judicial context in which the question arises, but they revolve around four core issues: (1) good faith; (2)

---

85. For a useful historical account of the development of hostile takeovers, see Carol B. Swanson, The Turn in Takeovers: A Study in Public Appeasement and Unstoppable Capitalism, 30 GA. L. REV. 943, 958–81 (1996). John Coates recently offered the following observation, which seems particularly relevant to our discussion: “[F]rom the late 1950s, the tender offer mechanism has allowed bidders to package two relatively weak shareholder powers—the right to sell their shares and the right to vote for directors—into a powerful form of shareholder ‘voice.’” Coates, supra note 82, at 850.

86. 15 U.S.C. §§ 78m (d)–(f), 78n (d)–(f) (1994).

87. See Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target’s Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1194–95 (1981) (hereinafter Easterbrook & Fischel, Proper Role] (suggesting that a board’s response to a takeover threat should be passive).

88. This structure is implicit in many cases. For a particularly clear recognition of the business-judgment rule as the starting point, see In re IXC Communications, Inc. v. Cincinnati Bell, Inc., C.A. Nos. 17324, 17334, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999). The court explained that: Under Delaware law a breach of fiduciary duty analysis in the context of a merger begins with the rebuttable presumption that a company’s board of directors has acted with care, loyalty, and in “good faith.” Unless this presumption is sufficiently rebutted . . . this Court must defer to the discretion of the board and acknowledge that the board’s decisions are entitled to the benefit of the business judgment rule.

Id. at *4.
reasonable investigation; (3) conflict of interest; and (4) the substance or fairness of the transaction. Outside of hostile takeovers, the court's usual approach has been to require the plaintiff to show that the defendants acted inappropriately under at least one of those factors. In the absence of such a showing, the court will not proceed further and the challenged transaction will stand. Of the four, the last is the most controversial. Some believe it should not be there at all, while others believe that a decision could be challenged on this ground if it is egregious or not rational. In any event, such a challenge is very rarely successful.

89. Charles Hansen, The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, A Commentary, 41 BUS. LAW. 1237, 1239 (1986) ("[A]ny hint that such a standard be applied to the substance of a decision (apart from a review for egregious conduct) must be negated—and negated firmly—in the work of the Institute."). The Delaware cases offer some support for this position. Chief Justice Veasey recently weighed in on the issue in Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (citations omitted):

As for the plaintiffs' contention that the directors failed to exercise "substantive due care," we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is process due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.

We interpret this statement to be in harmony with our summary of the law above. When Chief Justice Veasey refers to "due care," he is focusing on the issue that we have labeled "reasonable investigation." When he asserts that there is no such thing as "substantive due care," he is not saying that the court will never consider the substance of a transaction. Rather, he is distinguishing that substantive aspect of the inquiry ("waste") from the procedural aspect of the inquiry ("due care"). Finally, he notes correctly that courts will sometimes use substance ("irrationality") as a proxy for determining good faith.

90. See In re Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed.").

91. In Gagliardi v. Tri-Foods Int'l, Inc., 683 A.2d 1049, 1051–52 (Del. Ch. 1996), Chancellor Allen wrote:

[In the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith. There is a theoretical exception to this general statement that holds that some decisions may be so "egregious" that liability for losses they cause may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in this jurisdiction.... Thus, to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary acting in a good faith pursuit of corporate purposes, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect.

Notable examples of contrary results exist in other jurisdictions. See, e.g., Joy v. North, 692 F.2d 880 (2d Cir. 1982) (reversing a lower-court dismissal of a derivative action based on a corporate decision, which put the bank in a classic "no-win" situation); Litwin v. Allen, 25
The most common method used by plaintiffs to overcome the business-judgment rule is to show a conflict of interest by the board of directors or other decision-makers. In such duty-of-loyalty cases, the court will review the substance of the transaction, usually shifting the burden of proof to the defendant to prove the entire fairness of the transaction. This analysis, of course, takes the court deep into the fourth factor, the fairness of the transaction, thereby drawing a stark contrast between duty-of-care cases and duty-of-loyalty cases in the law of fiduciary duty.

Although showing a conflict of interest is the most common means of overcoming the business-judgment rule, a deficiency as to one of the other factors can have a similar effect. For example, when directors fail to engage in an appropriate level of investigation, they lose the protection of the business-judgment rule. As demonstrated by the Cinerama decision of the Delaware Supreme Court, such a failing leads to judicial review of fairness.

Finally, before departing from our discussion of foundational principles, we note that the last two decades have seen important procedural developments relating to derivative litigation. These developments have been initiated by directors who would be unable to claim the full protection of the business-judgment rule. In an attempt to regain the protective deference of the business-judgment rule, they introduce internal corporate mechanisms to cleanse the taint of self-interest that stains the challenged transaction. These developments relate primarily to the demand requirement and the authority of special litigation committees. The result has been a complicated web of rules regulating derivative litigation, but the central policy question in most cases typically focuses on how intensive judicial review of various director decisions will be.
IV. The Limits of Fiduciary Duty

A. The Origins of Unocal

Defensive tactics to hostile takeovers fit uneasily within the corporate-governance structure just described. The absence of any direct conflict of interest in the sense usually associated with self-dealing—where directors cause the corporation to enter into a transaction involving either the directors or a party under their control on the other side—suggests that the stringent demands of the fairness standard are inappropriate. Indeed, in the years immediately before Unocal was decided, three federal appellate courts were asked to consider the duties owed by directors who adopt defensive tactics. Each found no conflict of interest and applied the deferential review of the traditional business-judgment rule. Significantly, one of the decisions was written by Collins Seitz, formerly Chancellor of Delaware, who was then sitting on the United States Court of Appeals for the Third Circuit. Together, these three opinions helped set the stage for Unocal.

At roughly the same time, several academics applying the budding principles of law and economics—and relying on the agency theory of the firm—argued for an interpretation of director duty that severely constrained the use of defensive tactics. These arguments were built largely on three premises: (1) defensive actions are suspicious because they entrench directors; (2) shareholders do not effectively monitor directors; and (3) the market for corporate control "automatically" monitors directors. The most provocative of these efforts was a proposal by now-Judge Frank Easterbrook and Professor Daniel Fischel that directors remain passive in the face of a hostile takeover bid. Although Easterbrook and Fischel were the most strident critics of incumbent-board defensive actions, they were not alone.

Against this backdrop, the Unocal court created a new approach that followed neither of the paths just described, but reacted to both of them. It expressly rejected the passivity principle and reaffirmed the ability of...
directors to take defensive action. The court recognized that directors fill an important role by acting as representatives of the shareholders, even if the directors are not completely free of conflicts. At the same time, the presence of inherent conflicts of interest made the court unwilling to jump immediately to the level of deference accorded by the business-judgment rule. Thus was born an intermediate standard of review—a level of scrutiny more intrusive than the business-judgment rule but less searching than fairness review. The animating force underlying this new standard was the “omnipresent specter” of conflict in a takeover defense, even though the conflict falls short of the express conflict in a self-dealing transaction.\(^\text{101}\)

The Unocal standard employs the same four factors described above that judges use to evaluate director action in other contexts, but Unocal assembled those factors in a new and curious way that has attracted some subsequent judicial criticism.\(^\text{102}\) The Unocal court presented its new approach as a “threshold” that lay before the business-judgment rule. As discussed above, a traditional fiduciary-duty claim requires the plaintiff to show an absence of good faith, a lack of reasonable investigation, the presence of a conflict of interest, or a lack of substantive rationality. By contrast, under Unocal, once the plaintiff is able to show that the context of the claim requires application of the Unocal standard, the court shifts the burden of proof to the defendant to show both (1) that the directors reasonably perceived a threat to the corporation, and (2) that the directors’ defensive responses were proportional to that threat.\(^\text{103}\)

100. *Unocal*, 493 A.2d at 955 n.10 (“It has been suggested that a board’s response to a takeover threat should be a passive one. However, that is clearly not the law of Delaware . . . .”) (citation omitted).

101. *Id.* at 954 (“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.”). *Unocal* does mention the ability of the shareholders to vote out the directors, but it does not develop the point. *Id.* at 959.


103. If the defendant carries this burden, the burden theoretically shifts to the plaintiff, and the business-judgment rule engages. However, as noted by Vice Chancellor Strine in *Gaylord*:

It is not at all apparent how a plaintiff could meet this burden in a circumstance where the board met its burden under Unocal. To the extent that the plaintiff has persuasive evidence of disloyalty (for example, that the board acted in a self-interested or bad-faith fashion), this would fatally undercut the board’s Unocal showing. Similarly, it is hard to see how a plaintiff could rebut the presumption of the business judgment rule by demonstrating that the board acted in a grossly careless manner in a circumstance where the board had demonstrated that it had acted reasonably and proportionately. Least of all could a plaintiff show that the board’s actions lacked a rational business purpose in a context where the board had already demonstrated that those actions were reasonable, i.e., rational.

*Gaylord*, 753 A.2d at 475–76.

In the converse situation, where the board fails to carry its initial burdens, the board is still allowed to proceed with an attempt to show the entire fairness of the transaction. *Unitrin*, 651 A.2d
The effect of the Unocal threshold would appear to provide the plaintiff with three additional opportunities for avoiding business-judgment review: the procedural hurdle of requiring the defendant to carry the burden of proof and the two prongs of the Unocal standard. But there is less to Unocal than meets the eye. Shifting the burden of proof, for example, might seem to be a promising means of increasing the likelihood of director liability. In this regard, the Unocal court took its cue from Cheff v. Mathes, a “greenmail” case from the early 1960s. As noted by Ronald Gilson, however, this type of burden shifting in the wake of Cheff had no perceptible effect on the outcome of cases that would distinguish them from cases subject to the traditional business-judgment rule. Likewise, it seems unlikely that the mere shifting of burdens would have a significant impact on the outcome of Unocal litigation.

The first prong of the Unocal standard is similarly uninspiring to a hopeful plaintiff. While the defendants are nominally required to show that “they had reasonable grounds for believing there was a danger to corporate policy and effectiveness,” the Unocal court (again following Cheff) stated that this burden of proof was “satisfied by a showing of good faith and reasonable investigation.” In other words, the parties would be debating the same issues that would arise under the business-judgment rule.

The second prong of the Unocal standard—the proportionality part of the review—was the most controversial aspect of the case and the most promising basis for extricating the court from the business-judgment rule. The cause of the excitement (for those on both sides of the issue) was that the

---

at 1377 n.18. This, too, seems fairly implausible. See Gaylord, 753 A.2d at 476. All of this awkwardness surrounding Unocal has prompted Vice Chancellor Strine to call for a reformulation of the Unocal standard:

[O]ne wonders whether it might also be clearer to reformulate the Unocal test so that it incorporates the concept of due deference to board judgment articulated in Unocal and Unitrin without the confusing burden-shifting required to tie everything to the business judgment and entire fairness standards of review. . . . That is, if Unocal is the standard of review in a case, perhaps it ought to be the exclusive standard of review.

One tentative approach to such a formulation might be to simply place the burden on the plaintiffs to prove that the directors’ defensive actions were a disproportionate and unreasonable or an improperly motivated response to the threats faced by the corporation, based on all of the circumstances (which would include the interests of and care used by the directors who made the decision). . . . Such a test could incorporate the requirement that directors’ actions be sustained if they are not draconian and are within the range of reasonable defensive responses. This test would give plaintiffs the opportunity to attack the board’s decision directly (a chance plaintiffs do not get in the normal case) and yet preserve for boards a realm of reasonable discretion protected from judicial intrusion.

Gaylord, 753 A.2d at 476 n.46.

104. 199 A.2d 548 (Del. 1964). Greenmail is “the act of buying enough stock in a company to threaten a hostile takeover and then selling the stock back to the corporation at an inflated price.” BLACK’S LAW DICTIONARY 709 (7th ed. 1999).


second prong seemed to require a substantive judgment by the court, something completely missing from most cases decided under the business-judgment rule.

Requiring the court to perform a substantive review as a threshold test is a bit jarring. In simplest terms, the court said that defendants who wish to reach the promised land of no substantive review (under the business-judgment rule) must first cross a threshold that required substantive review! Of course, whether this is as dramatic as it sounds depends on how substantive the review under Unocal is, a topic we address in the next section.

The decision in Unocal was accompanied by much fanfare and speculation about the willingness of Delaware courts to insert themselves into hotly contested battles for corporate control. In an early effort to apply the Unocal framework, Chancellor William Allen called Unocal “the most innovative and promising case in our recent corporation law.” Regardless of one’s predilections about the initial decision, however, the subsequent development of the Unocal standard has failed to live up to its early billing. In the following sections, we describe our survey of all Delaware cases applying the Unocal framework to demonstrate that Unocal almost never results in judicial invalidation of takeover defenses. We also find a dramatic decrease in the number of Unocal claims decided in the Delaware courts. We then look at the reasoning of Unocal’s progeny in an effort to explain our results and conclude that Unocal, as currently structured, does not provoke judicial scrutiny of director defensive tactics that is at all “enhanced,” as compared to the review provided under the traditional business-judgment standard. Finally, in the normative aspect of our Unocal

107. In his recent analysis of the relationship between Unocal and the business-judgment rule, Vice Chancellor Strine observed:
   In itself, the Unocal test is a straightforward analysis of whether what a board did was reasonable. But Unocal’s purpose and application have been cloaked in a larger, rather ill-fitting doctrinal garment. Once the court applies the Unocal test, its job is, as a technical matter, not over. If, upon applying Unocal, the court finds that the defendants have met their burden of demonstrating the substantive reasonableness of their actions, the court must then go on to apply the normal review appropriate in cases that do not implicate Unocal. In essence, the court must reimpose on the plaintiffs the burden of showing “by a preponderance of the evidence” that the business judgment rule is inapplicable. Of course, the business judgment rule exists in large measure to prevent the business decisions of a board of directors from being judicially examined for their substantive reasonableness—an eventuality that has, in the Unocal context, already taken place.

Gaylord, 753 A.2d at 474-75 (citations omitted).


analysis, we explain why this standard—or any other standard based on fiduciary duty—is incapable of policing management entrenchment.

B. Empirical Results of Unocal Cases, 1985–2000

Between the issuance of Unocal in 1985 and the end of 2000, a Westlaw search shows that the Delaware Court of Chancery issued 141 opinions citing Unocal and that the Delaware Supreme Court issued 33 opinions citing Unocal. Of course, many of these citations were merely incidental references to the case. Only 34 Court of Chancery opinions and 8 Supreme Court opinions work through the entire Unocal analysis and reach a conclusion in the case. Very few cases are decided exclusively on the first prong of Unocal. In almost every case raising this issue, the courts find a cognizable threat.110

The most dramatic evidence of Unocal's feebleness is revealed in the outcomes of proportionality review, the second prong of Unocal analysis. Since Unocal was decided in 1985, the Delaware Supreme Court has not found defensive tactics to be disproportionate outside of a Revlon context.112 The Court of Chancery has been more aggressive in finding disproportionality,113 but in every such case that has reached the Delaware Supreme Court, the finding of disproportionality has been reversed or pushed to the side.114


111. The structure of enhanced scrutiny suggests that if a threat were not found, a board would not have carried its burden. In contrast, the absence of a threat has sometimes been used to explain why director action does not trigger any scrutiny beyond the deference of the business-judgment rule, a use that seems inconsistent with the reasoning set forth in Unocal. See, e.g., Kahn ex rel. DeKalb Genetics Corp. v. Roberts, 679 A.2d 460, 466 (Del. 1996), which held that Unocal should not apply when the corporation repurchased its shares in the absence of a hostile bidder.

112. See, e.g., Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1993) (striking down various board-instituted defensive tactics where the board's primary duty had become that of being an auctioneer).


114. The most recent Court of Chancery opinion striking down defensive actions is Chesapeake Corp. v. Shore, 771 A.2d 293 (Del. Ch. 2000). The appeal of that case was dropped after a subsequent business transaction. See Shorewood Agrees to International Paper Acquisition, WALL ST. J., Feb. 17, 2000, 2000 WL-WSJ 3018437. The Delaware Supreme Court affirmed the Court of
What effect has the inhospitable reception given to *Unocal* claims by the Delaware Supreme Court had on the takeover market? Causal connections of this type are impossible to forge with confidence, but we venture a few speculative remarks. First, we suspect that the weakened *Unocal* standard probably accounts—at least in part—for the limited litigation in this area.115 Despite several recent decisions by Vice Chancellor Strine,116 litigation in the Delaware courts over issues relating to hostile takeovers has slowed considerably. From 1985 through 1990, the Delaware courts decided an average of 3.5 cases per year in which they employed the *Unocal* analysis.117 From 1991 through 2000, the Delaware courts decided just over one such case per year.118

Chancery’s condemnation of the “no-hand” poison pill in *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), but did so on non-*Unocal* grounds. The Delaware Supreme Court reversed the Court of Chancery in *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995). The Court of Chancery’s opinions in *Pillsbury, Interco*, and *AC Acquisitions* were never appealed, but the Delaware Supreme Court went out of its way to discredit their reasoning in *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1152–53 (Del. 1989) (“To the extent that the Court of Chancery has recently [substituted its judgment regarding what would be a more attractive deal for that of a corporation’s board of directors] in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis.”). The Court of Chancery’s opinion in *Carmody v. Toll Bros.*, 723 A.2d 1180 (Del. Ch. 1998), was not appealed, but the Delaware Supreme Court cited it with seeming approval in *Quickturn*, 721 A.2d at 1291. The interlocutory appeal in *Evans* was dismissed for mootness after the target company’s board decided to sell the company. *Macmillan, Inc. v. Robert M. Bass Group, Inc.*, 548 A.2d 498 (Del. 1988). The Court of Chancery decisions in *Staley Continental* and *Instiiform* were not appealed, and there have been no references to the cases by the Delaware Supreme Court.

115. Perhaps it should go without saying, but there are other possible explanations for the decrease in litigation. For example, the extensive litigation in the late 1980s may have provided all of the guidance that most companies needed to erect takeover defenses capable of passing judicial review. More specifically, by allowing the adoption of poison pills, the Delaware courts have enabled incumbent boards with staggered terms to effectively preclude hostile takeovers, thus obviating the need for more innovative defenses.


117. We only considered opinions where the court worked through the *Unocal* standard, eliminating cases that cited *Unocal* only peripherally and cases—such as *Davis Acquisition, Inc. v. NWA, Inc.*, No. Civ.A.10761, 1989 WL 40845 (Del. Ch. Apr. 25, 1989)—where the facts implicated a *Unocal* analysis but the court postponed an ultimate decision under *Unocal* for procedural considerations. Where a single set of facts generated opinions by the Court of Chancery and the Delaware Supreme Court, we counted only one case. For example, in 1985 and 1986, the Delaware courts issued two opinions in the well-known *Revol* litigation. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239 (Del. Ch. 1985). In such instances, we counted only one unique case. Under these terms, we found 21 unique cases from 1985 to 1990. If we had counted opinions instead of cases, we would have found an average of 4.83 opinions per year as follows: 1985—five opinions; 1986—two opinions; 1987—three opinions; 1988—seven opinions; 1989—six opinions; 1990—six opinions.

118. We found only 12 unique *Unocal* cases from 1991 through 2000. with only one case in which a single set of facts generated *Unocal* opinions by both the Court of Chancery and the Delaware Supreme Court. *See Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1993); *QVC Network, Inc. v. Paramount Communications Inc.*, 635 A.2d 1245 (Del. Ch. 1993). This may seem surprising, but several notable cases illustrate why many cases did not
The decline in Unocal litigation might be thought to be related to a decline in hostile-takeover activity. This explanation might explain litigation patterns in the early 1990s. But from 1994 through 1998 there were an average of 40 hostile bids per year. Moreover, there were 68 hostile bids in 1995, "nearly as many as any year in the 1980s." The bottom line is that during the 1990s the number of hostile transactions returned to levels nearly equal to those of the 1980s, and the number of Delaware corporations remains as high as ever, but neither participants in those takeover battles nor target-company shareholders seem to be going to court. In the absence of a change in the legal standards, this result would seem particularly puzzling because success rates for hostile bidders have declined over time, suggesting that the need for litigation is stronger than ever. In the next section, we explore a common-sense explanation to that puzzle.

C. The Death of Unocal

What explains the death of Unocal in the Delaware Supreme Court? In this section, we explore that question by analyzing the evolution of takeover defenses and their treatment in the Delaware courts. We describe how Unocal became a dead letter and propose that the dearth of current litigation over the Unocal standard stems from the simple fact that outcomes in hostile produce dual opinions. Mentor Graphics Corp. v. Quickturn Design Systems, Inc., 728 A.2d 25, 52 (Del. Ch. 1998) decided the fate of a "no-hand" poison pill under Unocal, but the Delaware Supreme Court decided the appeal under "fundamental Delaware law." Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1290 (Del. 1998). In Williams v. Geier, the Court of Chancery examined a recapitalization plan under Unocal, but the Delaware Supreme Court subsequently held that Unocal does not apply in the absence of unilateral board action. Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996). The Court of Chancery held that a stock repurchase plan violated Unocal in In re Unitrin, Inc. Shareholders Litigation, 1994 WL 698483, at *4 (Del. Ch. Oct. 13, 1994), but the Delaware Supreme Court clarified the Unocal standard and reversed and remanded for further proceedings. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1389–91 (Del. 1995).

During the time period in question, three years (1992, 1996, and 1999) show no Unocal cases. The busiest years were 1994 and 2000, each with three Unocal cases—less than an average year in the late 1980s.

119. Coates, supra note 82, at 855.
120. Id.
121. Unocal claims are often brought by the hostile bidder during the contest for control. Delaware courts are extremely accommodating of litigants' need for expedited process, and the lag between the underlying board action and written court opinions is often short, usually a few months. In other circumstances, claims are brought by derivative plaintiffs, and the lag between the underlying board action and written court opinions is often measured in years. In some situations, the target board may initially oppose a takeover but agree to a plan before a judicial hearing is held or a decision rendered. See, e.g., Robert Langreth, Behind Pfizer's Takeover Battle: An Urgent Need, WALL ST. J., Feb. 8, 2000, 2000 WL-WSJ 3017104 (reporting Pfizer's success in acquiring Warner-Lambert over American Home Products's opposition). If there has been an increase in that activity, that would not be picked up in the data we have.

122. See Coates, supra note 82, at 856 (noting that 'total bidder 'win' rates have... fallen only modestly, from 32% in the peak hostile bid year of 1988, to 24% in 1998').
takeover litigation have become so predictable that the combatants choose to avoid the effort. Although Delaware fiduciary-duty law is notoriously indeterminate,123 *Unocal* has become well-settled in the sense that directors win except in extreme cases.124

The story behind *Unocal* begins with an understanding of the rationale for tolerating defensive actions that is consistent with the theory and statutory structure arguments discussed in the previous sections. Why not simply prohibit directors of target corporations from acting defensively or permit directors to make all takeover decisions? In their well-known endorsement of director passivity, Easterbrook and Fischel argued that takeovers should be encouraged and concluded that courts should structure director fiduciary duties accordingly.125 The problem with this form of argument is twofold: (1) the issue of whether takeovers create social wealth has never been fully resolved,126 and (2) whether a board in a particular situation should act

---


124. Consider the three most recent cases in which plaintiffs prevailed in a *Unocal* claim. In *Carmody v. Toll Bros.*, 723 A.2d 1180, 1195 (Del. Ch. 1998), the board adopted a “dead-hand” poison pill as a planning device, and Vice Chancellor Jacobs found the device could be both coercive and preclusive under *Unitrin*. Jacobs’s conclusion rests on the finding that the continuing-director provision is a “show stopper” in the sense that “if only the incumbent directors or their designated successors could redeem the pill, it would make little sense for shareholders or the hostile bidder to wage a proxy contest to replace the incumbent board.” *Id.* at 1187.

*Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25 (Del. Ch. 1998), involved a poison pill with a “delayed redemption provision” that prevented any directors from redeeming Quickturn’s poison pill for six months following the election of a new board. Vice Chancellor Jacobs held that the delayed redemption provision was neither coercive nor preclusive under *Unitrin*, but that it was outside the range of reasonableness because “the board has failed to show why the additional six month delay imposed by the DRP is necessary to achieve the board’s stated purpose for its adoption.” *Id.* at 49, 52.

In *Chesapeake Corp. v. Shore*, 771 A.2d 293, 296-97 (Del. Ch. 2000), the directors of Shorewood Packaging Corporation amended the bylaws to increase the vote required for amendment from a majority to two-thirds. The action was designed to protect the corporation’s staggered board, which was created by the bylaws. Because the managers owned nearly 24% of the company’s outstanding shares, the bylaw amendment “made it mathematically impossible for Chesapeake to prevail in a Consent Solicitation without management’s support, assuming a 90% turnout.” *Id.* at 297.

These cases each involve actions that appear designed to test the edges of acceptable board behavior. The actions at issue in *Carmody* and *Chesapeake* were viewed by the judges as completely disabling to shareholder choice. In *Quickturn*, the action was not extreme enough to be considered coercive or preclusive by Vice Chancellor Jacobs, but the Delaware Supreme Court subsequently held that it violated “fundamental Delaware law” by preventing a future board from redeeming the pill. See *Quickturn Design Sys.*, Inc. v. Shapiro, 721 A.2d 1281, 1290 (Del. 1998).


defensively and whether there should be a blanket prohibition against defensive action are separate issues. Obviously, internal-governance rules may dramatically affect the role of hostile takeovers in a macroeconomic sense. Nevertheless, in light of the ambiguity surrounding the desirability of hostile takeovers, courts have implicitly concluded that internal-governance rules should not be crafted in a way that is designed to encourage such transactions, but rather should be crafted to maximize value to the target corporation’s shareholders in the event that a hostile transaction is proposed.

Because the Delaware courts have soundly rejected the view that defensive actions by boards of directors should be prohibited, the battle now rages around a different issue: given that defensive actions are sometimes appropriate, when do boards cross the line between serving the shareholders’ interests and serving their own interests? According to Unocal, that line was to be drawn based on the existence of the threat to a corporate purpose (first prong), and the magnitude and proportionality of the directors’ response to that threat (second prong).

In cases after Unocal, courts have interpreted threats so broadly that almost any threat—no matter how trivial—suffices under the first prong of the analysis. The facts in Unocal present what appeared to be a severe threat, as conveyed by the multiple adjectives that Justice Moore used to describe the tactic: a two-tiered, front-end loaded, coercive takeover. In a typology first suggested by Professors Ronald Gilson and Reinier Kraakman, and later used by judges, this would be labeled “structural coercion,” but for a variety of reasons such bids are largely a historical relic. The last time a court applying Unocal found an actual bid that was structurally coercive was in 1990.

---

127. In reference to Easterbrook and Fischel’s proposal, the Unocal court observed, “that clearly is not the law of Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures.” Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 n.10 (Del. 1985).

128. Unocal, 493 A.2d at 957 (1985); see also Andrew G.T. Moore II, The 1980s, Did We Save the Stockholders While the Corporation Burned?, 70 WASH. U. L.Q. 277, 284 (1992) (asserting that “the Court’s decision in Unocal ... signaled the end of the coercive two-tier junk bond fueled tender offer”).


130. The defensive action taken by Unocal’s board of directors is also a historical relic. In the wake of Unocal, the SEC adopted Rule 14d-10 to prohibit selected tender offers. 17 C.F.R. § 240.14d 10(a) (1987). The Rule has withstood a challenge on grounds that it exceeded the SEC’s authority. See Polaroid Corp. v. Disney, 862 F.2d 987, 995 (3rd Cir. 1988).

131. Gilbert, 575 A.2d 1131; Tomczak, 1990 WL 42607. In a recent decision, the court allowed the board of directors to consider the possibility of a structurally coercive bid despite the...
The language in *Unocal* permits threats broader than those apparent from the facts in that case, and subsequent courts have embraced contexts that would come within the other two legs of the Gilson and Kraakman typology: opportunity loss and substantive coercion. In opportunity loss situations, managers seek to intervene to protect the shareholders against the loss of an opportunity; for example, to give shareholders more time to become fully informed or to allow management to construct an alternative transaction. As interpreted by the Delaware courts, substantive coercion is potentially the broadest form of threat. In its most mundane form, substantive coercion results merely from a bid that is perceived by the board to be inadequate. Such bids are said to be “coercive” to the extent that target shareholders, if left to their own devices, might accept an inadequate offer. It is not immediately obvious how shareholders are “threatened” by inadequate offers. Nevertheless, it is relatively easy to imagine how a

---

absence of “record evidence to support a finding that any such offer was imminent.” *In re Gaylord Container Corp. S’holders Litig.*, 753 A.2d 462, 478 (Del. Ch. 2000). *Cf.* Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 48 n.18 (Del. 1993) (noting that the two competing tender offers in that case were “two-tiered, front-end loaded, and coercive” and “should be expected to receive particular careful analysis by a target board”).

132. The court listed the following as examples of the types of threats the board could consider: “inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.” *Unocal*, 493 A.2d at 955.

133. The Delaware Supreme Court expressly adopted Gilson and Kraakman’s typology in *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1384 (Del. 1995).

134. Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1123 (Del. Ch. 1990) (holding that the decision to delay an annual shareholders’ meeting was a reasonable response to a perceived threat to the shareholders’ interests).


136. Ronald Gilson recently noted that “[u]nfortunately, only the phrase and not the substance captured the attention of the Delaware Supreme Court; the mere incantation of substantive coercion now seems sufficient to establish a threat under *Unocal* without any inquiry into the facts or management’s explanation for the market’s under pricing of the company’s shares.” GILSON, supra note 6, at 9 n.22.


138. Gilson and Kraakman noted that substantive coercion requires more than inadequate price:

The only threat posed by a non-coercive offer that management considers unfair, ill-timed, or underpriced, is the threat that something will lead shareholders to accept it. But since such a threat is not structurally coercive, it will warrant a defensive response only if the offer is substantially coercive in that shareholders might somehow be led to accept unfavorable substantive terms voluntarily. Put another way, substantive coercion posits a likely mistake by target shareholders who would not accept the terms of an acquirer’s offer if they knew what management knew about their own company, about the acquisitions market, or about management itself. In addition, since target management can be expected to tell shareholders, loudly and often, what it knows,
board of directors with the authority to reject an inadequate offer might use that authority to improve the position of shareholders.

Early Court of Chancery opinions that used Unocal to strike down defensive tactics propounded a remarkably broad conception of so-called substantive coercion. In his recent exegesis of substantive coercion, Vice Chancellor Leo Strine followed the spirit of these early opinions:

As a starting point, it is important to recognize that substantive coercion can be invoked by a corporate board in almost every situation. There is virtually no CEO in America who does not believe that the market is not valuing her company properly. Moreover, one hopes that directors and officers can always say that they know more about the company than the company's stockholders—after all, they are paid to know more. Thus, the threat that stockholders will be confused or wrongly eschew management's advice is omnipresent.

Each of these cases striking down defensive tactics admitted the existence of a threat, even if minimal. The outcomes of the cases ultimately hinged on the defensive tactic failing the proportionality prong of the Unocal analysis. Importantly for our purposes, the outcomes of the early cases

---

139. In AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del Ch. 1986), which involved a self-tender defensive response to a tender offer, Chancellor Allen finessed the first prong of Unocal, reasoning that

[there is no evidence that the . . . offer—which is non-coercive and at a concededly fair price-threatening injury to shareholders or to the enterprise. However, I take this aspect of the test to be simply a particularization of the more general requirement that a corporate purpose, not one personal to the directors, must be served by the stock repurchase . . . .]

The [target company board's] creation of . . . an alternative [of creating an option for stockholders], with no other justification, serves a valid corporate purpose (certainly so where, as here, that option is made available to all shareholders on the same terms). That valid corporate purpose satisfies the first leg of the Unocal test.

Id. at 112. Later, in City Capital Associates, he reasoned that, even where an offer is not structurally coercive, "it may represent a 'threat' to shareholder interests in the special sense that an active negotiator with power, in effect, to refuse the proposal may be able to extract a higher or otherwise more valuable proposal, or may be able to arrange an alternative transaction or a modified business plan that will present a more valuable option to shareholders." City Capital Assoc., 551 A.2d at 797-98.


141. AC Acquisitions Corp., 519 A.2d at 112-14 (contending that it is unreasonable for a company to take steps to preclude its shareholders from selling shares of stock to a competitor); City Capital Assoc., 551 A.2d at 799-800 (holding that it is unreasonable for a board of directors to prohibit its shareholders from accepting a noncoercive offer for their stock by using "poison pill" rights). Retired Justice Duffy, sitting by designation, followed Chancellor Allen's reasoning in Grand Metropolitan Public Ltd. v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988). In that case, Justice Duffy repeatedly emphasized that the threat posed by the hostile tender offer did not threaten the target corporation, but only the shareholders of that corporation, and even then, the only threat was inadequate price. Id. at 1056-59. According to Justice Duffy, the directors of the target
were later criticized by the Delaware Supreme Court in the well-known *Time* decision.\textsuperscript{142} As a result, the Delaware Supreme Court sanctioned the use of defensive mechanisms in the face of an offer at a price perceived to be inadequate. By approving substantive coercion as a rationale for defensive action, the court ensured that directors would always carry their burden of proof on the first prong of the *Unocal* framework.\textsuperscript{143}

The more innovative aspect of *Unocal* was its requirement that a defensive measure “must be reasonable in relation to the threat posed.”\textsuperscript{144} This “proportionality” requirement requires an examination of the substantive effects of the board’s actions,\textsuperscript{145} but it was intended to be something less than “fairness” review.\textsuperscript{146} In perhaps the strongest argument made in favor of the potential of proportionality review, Ronald Gilson and Reinier Kraakman asked a simple question: “[I]s proportionality review likely to have substance?”\textsuperscript{147} In their view from an early vantage point, proportionality review might evolve into nothing more than a “threshold test” that “serves chiefly to signal judicial concern and to invite planners to proceed with their defenses only after constructing a record that demonstrates reasonableness and that articulates a ‘threat.’”\textsuperscript{148} Alternatively, they envisioned proportionality review as a “regulatory test” under which “management would be forced to justify its choice of defensive actions by

---

142. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989) (holding that the Delaware Court of Chancery’s prior opinions improperly allowed the court to substitute its business judgment for that of a corporation’s board).


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

145. Marcel Kahan has argued that *Unocal* focuses on process alone: “*Unocal* subjects a decision to reject an offer to an enhanced review of the process by which this decision is arrived at, but not to an independent review of the substantive merits of the decision.” Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court’s Takeover Jurisprudence*, 19 J. CORP. L. 583, 588 (1994). We disagree. The *Unocal* court said that determining proportionality “entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise.” *Unocal*, 493 A.2d at 955. The court’s review of that analysis is also substantive. In *Unocal*, the court validated the board’s decision to adopt a selective exchange offer (excluding Mesa) for the purpose of “defeat[ing] the inadequate Mesa offer or, should the offer still succeed, [to] provide the 49% of its stockholders, who would otherwise be forced to accept ‘junk bonds’, with $72 worth of senior debt.” *Id.* at 956. By holding that the *Unocal* board’s actions were reasonable, the court necessarily affirmed the board’s determination that the threat existed, made a judgment about the magnitude of the threat, and concluded that the response to the threat was “fair” to shareholders. *Id.* at 955–56. This is quintessential substantive review.

146. The court firmly rebutted Mesa’s arguments that the actions of *Unocal*’s board were taken by interested directors, thus meriting fairness review. *Id.* at 957–58.


148. *Id.* at 252.
reference to the amount of coercion associated with a particular bid.\textsuperscript{149} Although it seems unlikely that the \textit{Unocal} court began with the minimalist "threshold" construction in mind, the subsequent development of the \textit{Unocal} standard has shown the standard to be just that.

One reason is that courts simply are not very good at proportionality review. Gilson and Kraakman note that effective proportionality review requires a court to "exercise its independent judgment in weighing whether management's plans present a plausible story: a goal that improves on the value of the hostile offer and a means that is reasonably likely to achieve the goal."\textsuperscript{150} Even Gilson and Kraakman recognize that courts would not be very effective at this type of inquiry.\textsuperscript{151} Nevertheless, they argue that proportionality review serves a valuable "screening" function quite apart from the outcome of the cases.\textsuperscript{152}

The perverse effects of \textit{Unocal}—with no meaningful first prong and a second prong requiring substantive review by reluctant judges—became apparent in \textit{Unitrin v. American General Corp.},\textsuperscript{153} where the Delaware Supreme Court refined the \textit{Unocal} proportionality standard. The Delaware Supreme Court reversed a Court of Chancery decision that had held a repurchase program was not reasonably related to the threat.\textsuperscript{154} In doing so, the Delaware Supreme Court emphasized its view that a proxy contest was still a viable option to oust incumbent management in the wake of the repurchase program, and suggested that the standard for proportionality was whether the defensive measures were (1) coercive or preclusive or (2) outside the range of reasonableness.\textsuperscript{155}

The court said that a defensive measure would be considered "coercive" if it were "aimed at 'cramming down' on its shareholders a management-sponsored alternative"; a defensive measure would be considered "preclusive" if it prevented a bidder from making an offer.\textsuperscript{156} In short, defensive measures that are coercive or preclusive represent only the most

\begin{flushleft}
\textsuperscript{149} Id. at 254.
\textsuperscript{150} Id. at 270–71.
\textsuperscript{151} Gilson and Kraakman explain that [t]o this point, our development of an effective proportionality test remains subject to the same criticism that we leveled at the \textit{Cheff} test. Particularly in the common case where management alleges substantive coercion because of price inadequacy, we would be hard pressed to demonstrate a necessary benefit from the proportionality test as we have developed it thus far. A deceptively clever story about future values might seem to be as capable of validating preclusive defensive tactics under the proportionality test as a clever story about policy conflicts was able to do under the old \textit{Cheff} test.
\textsuperscript{152} Id. at 271.
\textsuperscript{153} 651 A.2d 1361 (Del. 1995).
\textsuperscript{155} \textit{Unitrin}, 651 A.2d at 1386–88.
\textsuperscript{156} Id. at 1387.
\end{flushleft}
extreme assertions of director power, cutting off shareholders completely from the opportunity to choose their own course. Anything short of that would be evaluated by the "range of reasonableness" standard, which the court described in terms that echo descriptions of the business-judgment rule:

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.\(^{157}\)

Collectively, the reformulated standards in *Unitrin* seem to have lost the skepticism of incumbent managers that animated *Unocal*, opting instead to consolidate power over takeover decisions in those incumbent managers despite the "omnipresent specter" of self-interest.\(^{158}\) In light of our prior observations regarding the *Unocal* standard, however, the extreme position taken by the *Unitrin* court seems almost inevitable.\(^{159}\) Given the expansive notion of "threats" adopted by the Delaware courts, managers can hardly fail (and rarely do) in the first prong of *Unocal*.\(^{160}\) Additionally, when the courts come around to the second prong, they are forced into the uncomfortable position of speculating about the relative harm posed by the threat as compared to the benefits promised by the defensive action. In lieu of bald speculation, and in harmony with a tradition of deference to directors, courts are driven to seek markers that signal abuse. Short of completely foreclosing

\(^{157}\) Id. at 1388 (citing Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45–46 (Del. 1993)).

\(^{158}\) Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, 954 (Del. 1985).

\(^{159}\) In *Chesapeake*, Vice Chancellor Strine reads *Unitrin* narrowly:

*But I do not read *Unitrin* as a reformulation of *Unocal*'s focus on the actual substantive reasonableness of defensive measures and whether a board in fact made a good faith and informed business judgment in adopting those measures. *Chesapeake Corp. v. Shore*, 771 A.2d 293, 333–34 (Del. Ch. 2000).

\(^{160}\) Even where courts are skeptical of the existence of a threat, they will usually give the defendants the benefit of the doubt. See, e.g., Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289 (Del. Ch. 1989) ("While I am skeptical about the general proposition that a non-coercive inadequate tender offer constitutes a cognizable threat, the unusual circumstances of this case appear to justify some level of defendant response."). Interestingly, courts outside Delaware that adopt the *Unocal* standards seem more inclined to take the first prong seriously. See, e.g., Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1347–48 (D. Nev. 1997); AHI Metnall, L.P. by AHI Kan., Inc. v. J.C. Nichols Co., 891 F. Supp. 1352, 1356–57 (W.D. Mo. 1995); Air Line Pilots Ass'n, Int'l v. UAL Corp., 717 F. Supp. 575, 586–87 (N.D. Ill. 1989) (all holding that the respective defendants' perceptions of threats were unreasonable).
shareholder action, there are no such markers. Thus, it is quite understandable for the court to gravitate toward a "preclusive or coercive" standard. Of course, Unitrin retained the "range of reasonableness" inquiry, in the event that an action that is not quite preclusive or coercive might still be objectionable. This standard has been employed only twice (both times by the Court of Chancery) in striking down a defensive action. In one of those cases, the Delaware Supreme Court subsequently affirmed on alternative grounds, and the other case ended prior to any hearing by the court.

D. Why Fiduciary Duties Cannot Effectively Curb Entrenchment

When faced with a hostile-takeover attempt, managers of a target corporation are naturally inclined to act defensively. After all, if they were enthusiastic about the bidder's attentions, the deal would be friendly, not hostile. When courts are asked to review defensive measures approved by the target managers, they focus quite rightly on the possibility of management entrenchment. No widely accepted definition of entrenchment exists, but in the broadest sense, entrenchment occurs whenever managers hinder the ability of shareholders to replace them. If this were the notion of entrenchment accepted by the courts, however, every defensive measure would be invalidated because takeover defenses necessarily create obstacles to the ouster of incumbent managers.

Courts do not employ this expansive notion of entrenchment, but instead strive to distinguish inappropriate defensive actions (that is, defensive actions that serve the interests of the managers) from appropriate defensive actions (that is, defensive actions that serve the interests of the shareholders). But as Easterbrook and Fischel have observed, "There is no signal that separates intransigent resistance from honest efforts to conduct an auction for the shareholders' benefit." In the end, courts are left to evaluate the substantive impact of the defensive action: What effect does this action have on the corporation's shareholders? Courts do not relish the task of evaluating the impact of business decisions. Judges would rather focus on the decision-making process. If the process is structured in a manner designed to produce good results for shareholders—that is, if the decision makers are disinterested and acting in good faith and with complete information—then courts will defer, even when the decision seems


163. Easterbrook & Fischel, Proper Role, supra note 87, at 1175.

164. Ronald Gilson properly identified the primary tension in this area: "The difficulty... has been the courts' inability to distinguish defensive tactics from neutral corporate action, particularly where dual effects are present." Gilson, Structural Approach, supra note 99, at 875.
illogical. This is the essence of the business-judgment rule. Generally speaking, only where the process is infirm do judges turn to a substantive inquiry into the fairness of the action.

The difficulty courts face in evaluating defensive actions is that the process is inherently infirm because, as noted above, all defensive actions have an entrenchment effect. Despite this inherent defect in the process, courts have been unwilling to impose the same level of scrutiny that is imposed in other cases involving a conflict of interest. Courts before Unocal applied the business-judgment rule to defensive mechanisms by target managers, and even when Unocal recognized the inherent conflicts facing target managers, the Delaware Supreme Court was reluctant to impose the rigid substantive review (the "fairness" standard) that normally accompanies cases involving self-interested action. Although Unocal and other cases are less than clear on the rationale for this reluctance, perhaps courts were concerned that the "fairness" standard would be outcome determinative in favor of the plaintiffs, or perhaps they were simply baffled about how to judge the "fairness" of a defensive action, a problem that Ronald Gilson has

---


Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any "upside" gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky! you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on "negligence," "inattention," "waste," etc., could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.

166. Ronald Gilson described the reasoning of a 1969 federal district court case as follows: "Where dual motives are present—maintaining control and furthering a legitimate corporate interest—the conflict of interest is eliminated and the appropriate standard ... is the business judgment rule." Gilson, Structural Approach, supra note 99, at 830 (discussing Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969)).

167. See, e.g., AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) ("Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation. Perhaps for that reason, the Delaware Supreme Court recognized in [Unocal] that where a board takes action designed to defeat a threatened change in control of the company, a more flexible, intermediate form of judicial review is appropriate."); see also Gilson & Kraakman, supra note 129, at 248 (stating, with respect to the fairness standard, "invoking this rigorous standard would simply condemn most defensive tactics without any justification beyond the standard itself").
called the "fairness dilemma." In any event, courts have viewed entrenchment as less likely to influence managerial action than more direct conflicts. This view led to the search for new standards to evaluate defensive actions, which the court articulated in *Unocal*.

The challenge facing the *Unocal* court, therefore, was to create a standard that would distinguish "good" takeover defenses from "bad" takeover defenses without using either the business-judgment rule or the fairness standard. It is often said that "[p]eople who are only good with hammers see every problem as a nail." In the context of hostile takeovers, the Delaware judiciary's hammer is fiduciary-duty law, and every question regarding the propriety of board action looks like a nail. In creating the new standard of review, therefore, the court naturally turned to fiduciary duty. As suggested by this metaphor, the failure of *Unocal* discussed above cannot be wholly attributed to faulty execution, but rather to the decision to use fiduciary-duty law to address a problem for which it can provide an inadequate solution. In short, fiduciary-duty law is incapable of addressing the "omnipresent specter" of self-interest identified in *Unocal*.

Fiduciary duties in corporate law are designed primarily to address conflicts between managers and shareholders. Modern corporations statutes allocate managerial power over the corporation to the board of directors. In making decisions, directors are obliged to act in the interests of the shareholders. At root, fiduciary obligation is best conceived in terms of loyalty. Given our emphasis on the theory of the firm, it is worth

---

168. Ronald Gilson noted that fairness review is inapt for defensive actions. In reference to *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964), an early Delaware "greenmail" case, Gilson wrote: "A conflict of interest existed which, in the court's view and, I think, in fact, was not subject to a traditional fairness review." Gilson, *Structural Approach*, supra note 99, at 828.


170. Park McGinty also concludes that fiduciary duties are not suited to protecting shareholder interests in the hostile-takeover context, but he limits his explanation to institutional incapacity. Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 261–70 (1997) (pointing out that the process of valuing a target company requires a degree of financial sophistication that courts are unable to apply).


173. Although directors typically delegate authority over ordinary business decisions to executive officers, directors remain primarily responsible for decisions regarding fundamental transactions. See MODEL BUS. CORP. ACT § 8.01(b) cmt. (1999) ("[D]elegation does not relieve the board of directors from its responsibility of oversight . . . ."); see, e.g., N.Y. BUS. CORP. LAW § 701 (McKinney 1986) ("[T]he business of a corporation shall be managed under the direction of its board of directors . . . ."); 15 PA. CONS. STAT. ANN. § 1721 (West 1995) ("[T]he business and affairs of every business corporation shall be managed under the direction of a board of directors.").

174. DeMott, *supra* note 172, at 882 ("If a person in a particular relationship with another is subject to a fiduciary obligation, that person (the fiduciary) must be loyal to the interests of the other person (the beneficiary).")
pausing to note that the duty of loyalty fits comfortably within any theory of the firm. This duty is most prominent in agency theory,175 but any theory (including both transaction-cost economics and property-rights theory) that relies on delegation of control rights from shareholders to managers must contemplate a duty of loyalty. Even if contracts are incomplete, the duty of loyalty performs the useful function of ensuring that managers strive to serve the shareholders.

The problem here is that proportionality review is incapable of measuring loyalty in this context. As discussed above, the usual method of evaluating loyalty in the face of conflict is to inquire after the fairness of the transaction at issue. While Gilson’s “fairness dilemma” offers a reasonable account of why a court might reject this approach, the courts in fact offer an alternative explanation. They simply doubt whether directors are truly self-interested. These doubts are manifested through attempts to focus on director motivation as a means of separating “good” defensive actions from “bad” defensive actions. For example, in Cheff v. Mathes, the Delaware Supreme Court reasoned:

"If the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course. On the other hand, if the board has acted solely or primarily because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper."176

This approach to the problem was carried over to Unocal, where the Delaware Supreme Court referred to an “omnipresent specter” of self-interest.177 Implicit in this phrasing is doubt about whether the self-interest has actually taken hold. Like a specter, self-interest hovers over all defensive actions, but it seems to take hold only occasionally. In addition, the structure of the court’s argument suggests that it is trying to separate cases of self-interest from other cases.

This approach is ill conceived. We believe that the primary difficulty in this area revolves around the fundamental ambiguity of defensive actions when viewed by a judge. Because every defensive action has an entrenchment effect, distinguishing “good” defensive actions from “bad” defensive actions ultimately requires courts to consider whether the incumbent managers are too fixed in their positions. Of course, entrenchment may be consistent with shareholder welfare, so the inquiry must be quite nuanced.

175. See, e.g., Shleifer & Vishny, supra note 65, at 751–53.
Unfortunately, as noted above, there are no useful market transactions against which to compare levels of entrenchment. The only thing we know for sure is that directors who act in a coercive or preclusive manner have crossed the line. Thus, the *Unitrin* standard is an accurate reflection of the best we can do under fiduciary duties.

Still, we suspect that some defensive actions that fall short of being coercive or preclusive are nevertheless problematic. This explains *Unitrin's* retention of the "range-of-reasonableness" inquiry. That inquiry suffers, however, from the same ambiguity problem that pushed us toward "preclusive or coercive" in the first place. The result is that we approach the inquiry with some trepidation, much like our approach to director actions under the business-judgment rule, because courts lack the kind of information that would permit them to verify whether this line has been crossed. In the end, it appears that the best that fiduciary-duty law has to offer is prevention of coercive or preclusive behavior, and that limited constraint is inconsistent with the "omnipresent specter" of self-interest that hangs over these transactions.

Facing uncertainty about the primary effect of the director action on the shareholders' interests, the court seems to use improper motivation as a surrogate for harm to shareholders. In many instances, assuming the ability to discern director motives, this form of rough justice could yield correct results; after all, self-serving directors often confer benefits on themselves at the expense of shareholders. On the other hand, even the best boards often act out of a desire to perpetuate themselves in office (albeit through superior performance rather than by erecting barriers to their ouster). The key distinction between good boards and bad boards, therefore, is not motivation but whether the boards effectively serve the interests of the shareholders. Moreover, judges will not be able to obtain and verify information on that issue sufficient to overcome the deference with which courts approach any shareholder litigation alleging a breach of fiduciary duty. Like the incomplete contracts that prompted the formation of a firm in the first place, the board's performance in this context is not susceptible to effective judicial oversight. Thus, shareholders will be propelled toward a nonjudicial method of resolving the conflict.

---

180. Interestingly, in *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25, 44 (Del. Ch. 1988), Vice Chancellor Jacobs found that the board of directors' adoption of the delayed redemption provision (DRP) was "motivated by a good faith belief that their actions were in the company's best interests." He reached this conclusion despite the fact that their stated justification for adopting the DRP was "at war with how the DRP . . . would actually operate." *Id.* at 50.
V. Creating “Sacred Space” for Shareholder Action

The limits inherent in the existing judge-centered approach to resolving shareholder-director disputes in takeovers make this an appropriate time to reexamine voting and selling as shareholder functions that can act as alternatives to suing based on fiduciary duty. The change in the shareholder census—that is, the increased number of institutional shareholders who are able (and willing) to play a more active role in corporate governance—strengthens the case for pursuing alternatives to shareholder litigation as the primary means of resolving takeover disputes. In this Article, we propose an alternative standard based on the notion of “sacred space” for shareholder action. In simplest terms, sacred space is an area within which shareholders can vote or sell their shares without interference from incumbent managers. This approach is limited and nuanced. It is not the broad, general preference for shareholder decision-making that frightened judges in the aftermath of the director passivity discussions of the early 1980s. It anticipates that directors may use defensive tactics to protect other constituencies or to gain higher returns for shareholders, and it reflects fears that shareholders are capable of using their power to prefer themselves over other corporate constituencies.

The concept of sacred space emanates from the shareholders’ statutorily defined role in a market-enclosed corporate-governance system. Under every theory of the firm discussed above, shareholder oversight is viewed as crucial to the legitimacy of director power, and the most important medium for shareholder expression is the right to vote. Although state corporate law allocates to directors the power to manage the corporation, shareholders have the ultimate power to determine the direction of the corporation because they are entitled to elect the directors. The importance of this power has sometimes been discounted on grounds that atomized shareholders have little incentive to rise up and assert themselves collectively. Nevertheless, the importance of the shareholder franchise should not be measured by the

---

181. For an example of a current paper continuing the earlier debate, see MARTIN LIPTON & PAUL K. ROWE, PILLS, POLLS AND PROFESSORS: A REPLY TO PROFESSOR GILSON 5 (N.Y. Univ. Center for Law and Business, Working Paper #CLB-01-006, 2001), available at http://www.stern.nyu.edu/clb/, which noted that the underlying struggle between the two polar points of view have hardly changed in the past twenty years.

182. See generally Blair & Stout, supra note 16 (introducing a “team production theory” to explain how public corporations reconcile such potential conflicts).

183. See, e.g., Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) (“The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”).

184. MODEL BUS. CORP. ACT § 7.28(a) (1999) (“Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting when a quorum is present.”).

185. Frank Easterbrook and Daniel Fischel described this phenomenon as “rational passivity.” EASTERBROOK & FISCHEL, supra note 15, at 197.
frequency of proxy contests alone. Instead, the full importance of voting requires recognition of the potential to aggregate votes by purchasing shares, usually through a tender offer.

In this section we first identify the core components of shareholder voting and selling under state corporate law and focus particularly on the interactive aspect of these two functions. In a legal system such as ours that values private ordering, new transactions will expose gaps in the permissible structure. We offer three maxims that should govern judicial questions that arise regarding sacred space. In the next section we apply those maxims to active issues arising in a takeover setting.

**A. The Interaction of Voting and Selling to Create Sacred Space**

The role for shareholder decision-making in corporations is decidedly complex. Two sets of interactions are discussed here. First, effective shareholder decision-making necessarily depends on the ability of shareholders to vote and to sell their shares. In a typical publicly held corporation, a vote to displace management rarely happens without the impetus of an offer to purchase made via the market. Further, the selling option through such a tender offer will not occur without the real possibility of an effective voting channel to implement the control purchased via the market. In defining sacred space for shareholder action, therefore, we consider both voting and selling, first separately and then as they interact.

Second, within each function there is another layer of complexity. Corporate law provides default rules that are the starting point for analysis, but various defensive tactics can be employed to constrict the space afforded shareholders under the default rules. Depending on the nature of the action, defensive actions may be imposed by directors alone or implemented with the approval of shareholders. More importantly for purposes of this analysis, there are antidotes—that is, there are ways available to remove those defenses. One final bit of complexity is introduced by the fact that the outcome of a takeover struggle will turn on the order in which the defenses are imposed and the antidotes attempted, so that there is no single equilibrium that will result from this process.

1. **Shareholder Voting.**—The structure of corporate law calls for only intermittent shareholder oversight in the form of director elections, shareholder approval of fundamental corporate changes, and similar actions, but these actions—like the occasional votes of the electorate in representative democracies—are fundamental to the corporate-governance system. As Chancellor Allen noted in an eloquent defense of shareholder voting:

   It has, for a long time, been conventional to dismiss the stockholder vote as a vestige or ritual of little practical importance. . . . Whether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory
that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.\footnote{186}{Blasius, 564 A.2d at 659.}

The effectiveness of shareholder voting power requires that shareholders be allowed to vote on certain transactions at specified occasions. In the sections that follow, we discuss both the timing and the subject matter of shareholder votes.

\begin{itemize}
\item \textit{a. The Statutory Starting Point.}—Delaware corporate law requires an annual meeting of shareholders for the purpose of electing directors.\footnote{187}{Del. Code Ann. tit. 8, § 211(b) (1991).} The Delaware statute also allocates to shareholders (on their own initiative) the power to remove directors and make changes to the corporation’s bylaws.\footnote{188}{Id. §§ 141(k), 109(a).} In addition, shareholders have the responsibility of voting on certain fundamental transactions—such as amending the corporation’s certificate of incorporation or approving a merger—if first recommended by the board of directors.\footnote{189}{Id. §§ 242, 251(c); see also id. § 271(a).}

In addition to acting at an annual meeting, shareholders can vote at a special meeting. Under the Delaware statute, however, the only persons authorized to call a special meeting are the board of directors and other persons specified in the certificate of incorporation or in the bylaws.\footnote{190}{Id. § 211(d).} A third forum for shareholder action is the written consent.\footnote{191}{Id. § 228.} The default rule as to written consents is more favorable to shareholder action, providing that shareholders holding a majority of the outstanding shares have a right to act without a meeting.\footnote{192}{Id. § 228(a). Of course, this default rule may be changed by a provision in the certificate of incorporation.}

\item \textit{b. Limitations and Defenses That Constrain Shareholder Decision-Making.}—The default rules just described can be circumscribed to severely limit the powers of shareholders seeking to act against the wishes of a recalcitrant board of directors. For example, while it would be possible for the certificate of incorporation to provide that a special meeting could be called by a majority of shareholders (or even 10\% of shareholders as provided by the Model Business Corporation Act),\footnote{193}{Model Bus. Corp. Act § 7.02(a)(2) (1999) (stating that the articles can change the percentage required but cannot raise it higher than 25\%).} such a provision does not exist in the charters of many publicly held corporations.\footnote{194}{Cf. Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J.L. Econ. & Org. 83, 85 (2001) (sampling 310 firms—approximately two-thirds of which were controlled by venture capitalists or leveraged buyout} Many
corporations also have charter provisions eliminating the power of shareholders to act by written consent.195

With their ability to act thus restricted to the annual meeting, shareholders may find additional obstacles in the way of change. Perhaps the most potent deterrent to a change of control is the staggered board. Under such a provision, the board of directors is typically divided into three classes with a roughly equal number of directors in each class. One class is elected at each annual meeting so that directors serve a staggered three-year term.196 By an unusual tying arrangement in the Delaware Code, a corporation that chooses to have staggered terms also automatically changes the default rule regarding removal of directors.197 Instead of the usual default rule permitting shareholders to remove directors for any reason, directors on a staggered board can only be removed for “cause,” a difficult and time-consuming process in a public corporation that effectively blocks the use of the removal power.198 As a result, where the corporation’s charter contains a staggered-board provision, a forced change of control would typically require action at two annual meetings to elect new directors in two classes.199

These defensive provisions are often contained in the certificate of incorporation when the company goes public.200 Alternatively, they may be added by amendment of the certificate of incorporation, which shareholders must approve after a recommendation by the directors.201 In addition to these limitations, which the shareholders either have notice of or participate in, the shareholders’ ability to act under the statutory default rules might also be constricted by actions of the directors alone, such as by delaying or conditioning the use of written consents or acting at special or annual

specialists—that went public over a two-and-a-half-year period (not limited to firms incorporated in Delaware) and concluding that 24.5% of the firms precluded shareholders from calling a special meeting and acting by written consent).

195. Id.
196. Del. Code Ann. tit. 8, § 141(d) (1991) (providing that “the directors of any corporation organized under this Chapter may, by the certificate of incorporation or by an initial bylaw, or by a bylaw adopted by a vote of the stockholders, be divided into 1, 2 or 3 classes; the term of office of those of the first class to expire at the annual meeting next ensuing; of the second class 1 year thereafter; of the third class 2 years thereafter; and at each annual election held after such classification and election, directors shall be chosen for a full term, as the case may be, to succeed those whose terms expire”).
197. Id. § 141(k).
198. See Campbell v. Loew’s, Inc., 134 A.2d 852, 861 (Del. Ch. 1957) (finding directors whose removal was sought were not given a reasonable opportunity to be heard by the stockholders on the changes made).
199. See, e.g., Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545 (D. Del. 1995); Essential Enters. Corp. v. Automatic Steel Prods., Inc., 159 A.2d 288 (Del. Ch. 1960) (holding that shareholders could not remove at one meeting board members who had staggered terms that were set up in the corporation’s charter).
200. Daines & Klausner, supra note 194, at 85.
meetings. Such board actions are reviewed not necessarily under Unocal (although these actions may well be a defensive tactic), but under the Blasius line of cases that limit the board's ability to interfere with the shareholder franchise.

c. Antidotes to the Defensive Tactics.—The effectiveness of efforts by the board of directors to resist shareholders depends not only on the nature of the defensive tactic but also on the inability of the shareholders to modify or remove the defensive provisions. Most of the limitations on voting described above are contained in the certificate of incorporation, which may be amended only at the initiation of the board of directors. Thus, an election ousting a majority of the directors is a precondition to changing the offending provision, but replacing a majority of the board is practically impossible as long as the defensive provision is in place. It is a Catch-22. An even more insulated defense can occur in situations where changing the offending provisions requires not just a majority of the shareholders but a supermajority.

2. Shareholder Selling.—Like the power to vote, the power to sell is a fundamental right cherished by shareholders. It is not specifically articulated in corporate codes but, rather, is a part of underlying property rights on which the corporation statutes rest. In this regard, as in many others, the law is building on the foundation provided by markets, without the need to duplicate what the market provides. Thus, the right to sell shares in a corporation is inherent in the investment, which contemplates the ability to transfer both control rights (that is, voting rights) and financial rights, without seeking the permission of other shareholders. Historically, the right to sell has been discussed in the context of a shareholder's individual sale, an action that—as already discussed—had little governance effect. As the market for shares has evolved to provide opportunities for sales in

202. See, e.g., Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (invalidating a director action to change the date of the annual meeting); Aprahamian v. HBO, 531 A.2d 1204, 1208 (Del. Ch. 1987) (finding inequitable a board’s postponement of its annual meeting).

203. The Delaware Supreme Court has blurred the distinction between Unocal and Blasius suggesting that “[i]n certain circumstances, [the judiciary] must recognize the special import of protecting the shareholders’ franchise within Unocal’s requirement that any defensive measure be proportionate and ‘reasonable in relation to the threat posed.’” Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1397 (Del. 1995) (quoting Stroud v. Grace, 606 A.2d 75, 92 (Del. 1992)). Yet in Stroud, the court concluded that a Blasius analysis was inappropriate absent a showing of a primary purpose to impede exercise of shareholder franchise. Stroud, 606 A.2d at 79.

204. See Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

205. See Centaur Partners, IV v. Nat’l Intergroup, Inc., 582 A.2d 923, 924 (Del. 1990) (deciding that the corporate charter clearly and unambiguously requires an 80% supermajority vote in order to enlarge the board of directors).

206. Partnership law, on the other hand, has the opposite default rule. UNIF. P'SHIP ACT § 25(2)(b), 6 U.L.A. 700 (1995).
collective transactions, the selling function's role in corporate governance has grown. In this section, we address the right of an individual minority shareholder of a public corporation to sell shares into the market and the rights of shareholders as a group to sell their shares in a collective transaction, both rights being part of the market-produced property rights available to shareholders, but not always equally recognized by Delaware courts.  

a. The Statutory Starting Point.—Under the corporate law of Delaware and other states, the usual rule is that shares of stock are freely transferable. State corporations codes do not see the need to specify this basic right of property, but it is implicit in statutory provisions regulating restrictions on share transfer. The right to freely sell shares includes the possibility of a collective sale by a group of shareholders to a third party desiring to take over the corporation.

b. Defenses and Limitations.—The default rule of free transferability has been limited in several ways since the growth of hostile takeovers. First, federal law (the Williams Act) regulates the conduct of bidders seeking to purchase shares, mostly by requiring disclosure, but also by some substantive regulation. Second, state antitakeover statutes, refined after the Delaware Supreme Court struck down the first generation of statutes, seek to impose prohibitive costs on what a bidder could do if

207. A recent Delaware Supreme Court case held that certain decisions—such as voting for directors and making individual buy-sell decisions are for the stockholder, not the court, to make. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000). The reference to voting for elections does not negate the other shareholder voting rights inherent in the collective structure. Neither should the reference to individual selling exclude other means by which shareholders sell. To draw a line between individual selling decisions and selling decisions made in the context of one bidder offering to buy the shares of many shareholders fails to give full recognition to the market for shares. Delaware statutory and common law has never been considered a closed system that ignores or denies the incentives and effects provided by markets. That underlying foundation evolves just as the Delaware statutes evolve. See Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW. U. L. REV. 913, 915-16 (1982).


209. The statute does not prohibit shareholders from selling collectively and does not assign the board of directors an intermediary role in such transactions. Id. States' initial antitakeover efforts to regulate collective sales did not survive constitutional attack. See Edgar v. MITE Corp., 457 U.S. 624, 630-34 (1982). Second-generation state antitakeover statutes therefore focused on business combinations with a person who has engaged in collective purchases. See DEL. CODE ANN. tit. 8, § 203 (1991). These antitakeover statutes were more successful in surviving constitutional attack. See CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987) (deciding that it is within a state's role as the overseer of corporate governance to offer an opportunity to protect shareholders from takeovers).


211. See, e.g., Edgar, 457 U.S. 624 (finding an Illinois statute to have unduly burdened interstate commerce).
successful. Third, and most effective, the unilateral action by the board of a target company to implement a poison pill makes a hostile takeover so prohibitively expensive that potential acquirors are unwilling to proceed without its removal.

c. Antidotes.—The Williams Act and state antitakeover statutes are beyond our focus, but the poison pill lies at the heart of our concern. The prohibitive expenses of the poison pill can be avoided by the redemption of the pill prior to its being triggered. The Delaware Supreme Court, in approving the initial use of the pill, left open the possibility that a board's failure to redeem the pill would be judged by the enhanced-scrutiny standard of Unocal. This seemed to open up the possibility that poison pills would be removed by judicial use of fiduciary duty; indeed, some early Court of Chancery decisions held that the refusal to redeem a poison pill was a breach of duty. Yet in a subsequent decision, the Delaware Supreme Court criticized those decisions, and the federal court in Delaware has applied Delaware law to suggest that Unocal does not reach so far as to require redemption of the poison pill.

3. Interaction of Selling and Voting, Defenses, and Antidotes.—Any explanation of the decision-making role of shareholders can be brought into focus only if both selling and voting are in view and their interaction is observed. As noted above, either selling or voting by itself results in no significant role for shareholders. Consider the most potent antitakeover defense available to most corporations: the combination of a staggered board, which limits the effectiveness of a vote to remove the board, and a poison pill, which limits the use of selling to transfer control. If either mechanism were removed, shareholders desiring to accept an offer against the wishes of

212. See, e.g., CTS Corp., 481 U.S. at 73–75 (upholding Indiana's Control Share Acquisition Act, which conditions voting rights of block shares acquired in hostile transactions on a vote of remaining shareholders).

213. See Moran v. Household Int'l, 500 A.2d 1346, 1348–49 (Del. 1985) (involving a rights plan giving shareholders—but not a hostile bidder—the right to purchase additional shares from the corporation at half-price upon the occurrence of a hostile takeover).

214. Moran, 500 A.2d at 1356.


216. See Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989) (“Plaintiffs' position represents a fundamental misconception of our standard of review under Unocal principally because it would involve the court in substituting its judgment as to what is a ‘better’ deal for that of a corporation’s board of directors. To the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper Unocal analysis. See e.g., Interco, 551 A.2d 787, and its progeny . . . .”)

the board could quickly, probably within weeks, accomplish their goal. With both mechanisms in place, the time required to oust the incumbent managers would instead be measured in months or years.

B. The Core Attributes of Sacred Space

The complexity made possible by the interaction among the various rules, possible defensive tactics, and antidotes emphasizes the likelihood of gaps that litigants can exploit and that judges may be asked to fill. If sacred space is to have staying power, its core attributes must be understandable and capable of being applied over a range of transactions. We provide three maxims that seek to capture such attributes, and in the Part that follows we discuss how they might be applied in several settings that present open questions in corporate law.

First, sacred space embodies the structure established by positive corporate law that shareholders participate directly in core governance decisions. Corporate law gives shareholders the power to vote and sell even while it gives directors the overall power to manage the business and affairs of the corporation. Our first maxim highlights the need to recognize the space within which a well-functioning corporate-governance system requires shareholder action, the space where directors cannot have absolute authority. This is readily visible in the statutory provisions specifying large corporate decisions like mergers that are not left to the directors alone, but must have the approval of shareholders.218 Statutes also provide the possibility of a shareholder role when directors have a conflict of interest.219 More central than either of these is shareholder action that does not depend on director initiative—the shareholders' power to vote for directors and to sell their shares. Hostile takeovers reflect transactions that are large and important and that pose the potential for director conflict such that some shareholder role would be expected given the policies just described. These transactions came of age only with the growth and maturity of an active and developed takeover market, including the dramatic growth in the role of institutional shareholders. They exist mostly within markets that corporation statutes have never addressed in detail. Viewing statutes as if in a vacuum floating free of the markets in which they are embedded, courts sometimes understate the power of our first maxim or confine it only to voting.

We emphasize two more specific points that follow from this maxim in a hostile-takeover setting: (a) shareholders must be allowed to exercise the decision-making authority given to them by statute at least annually and (b)

218. For example, see mergers, sale of substantially all of the corporate assets, and changes to the certificate discussed supra in note 189 and the accompanying text.

219. See DEL. CODE ANN. tit. 8, § 144(a)(2) (1991) (permitting shareholder action to remove the taint of a director when that director is also a director for—or has a financial interest in—a competing company).
shareholders should be able to use their antidote power even earlier than the annual meeting to remove director-installed defensive tactics that would block the shareholders' right to exercise their power to vote or to sell their shares.

An important feature of Delaware corporate law is its emphasis on providing shareholders with an annual opportunity to vote. Chancellor Allen provided a stalwart defense of that principle in *Hoschett v. TSI International Software, Ltd.*:

The annual election of directors is a structured occasion that necessarily focuses attention on corporate performance. Knowing that such an occasion is necessarily to be faced annually may itself have a marginally beneficial effect on managerial attention and performance. Certainly, the annual meeting may in some instances be a bother to management, or even, though rarely, a strain, but in all events it provides a certain discipline and an occasion for interaction and participation of a kind. Whether it is welcome or resented by management, however, is in the end, irrelevant under Section 211(b) and (c) of the DGCL and similar statutes in other jurisdictions.220

A more difficult question is whether the annual meeting is the only time that shareholders should be seen or heard.221 That would be a very narrow definition of the oversight role, which is not compelled by the statutory structure. If the right to vote is to mean anything, particularly against the panoply of defensive tactics that can be implemented by directors alone, shareholders should be able to act by the statutorily prescribed means of meetings or consents to take action that removes the director-instituted defensive tactics and restores the space for shareholder decision-making that the statute intended.222 Shareholders should be able, either at an annual or at a special meeting or by written consent, to pass a mandatory bylaw that removes a defensive tactic interfering with the shareholders' right to vote or sell. Alternatively, shareholders—acting either by resolution or mandatory bylaw—should be able to trigger the duty of the board of directors to auction the company to the highest bidder.223 In the *Revlon* opinion, which first


221. See, e.g., *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 469–70 (Del. Ch. 2000) (holding that the Charter and Bylaw Amendments proposed by the Gaylord board served a rational business purpose when their net effect was to limit shareholders' opportunities to vote in a single annual meeting). As set out below, we argue that sacred space requires that shareholders be able to remove director defensive tactics that interfere with their right to vote and to sell. See infra text accompanying notes 223, 250.

222. As previously mentioned, Delaware permits constraints on shareholder-called special meetings and action by written consent and permits the use of staggered boards that slow down shareholder action. These actions can constrict shareholder space, but the default structure suggests the change should be clear and uncoerced. See supra text accompanying notes 190–204.

223. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (holding that when it had become apparent that the breakup of the company was inevitable, "the
described the duty to auction, the directors had taken the necessary steps to put the corporation up for sale. In a subsequent opinion, however, the Delaware Supreme Court specified that the directors' duty to auction arises "when a corporation undertakes a transaction" that will cause a change in control or a breakup of the corporate entity.224 Consistent with a view of sacred space, shareholders should be able to initiate action that would put the company up for sale, leaving it to the board to conduct the auction.225

Second, sacred space does not mandate unrestrained shareholder power. The first maxim recognizes that shareholder decision-making is a necessary counterbalance to possible deficiencies in director decision-making, and that shareholder decision-making has a venerated place in corporate governance alongside judicial constraints based on directors' fiduciary duties. Yet the particularity of shareholder power and the breadth of directors' management power will necessarily leave room for director action that tempers the means by which shareholders act. Sacred space does not mean that shareholders should be entitled to make an immediate and direct decision regarding every proposed change in control. For example, shareholder protection does not require that shareholders be given the opportunity to accept a tender offer in any time frame specified by the bidder.226

Limiting shareholders' ability to force a quick decision reflects two sets of concerns. First, the board as a unified bargaining agent for shareholders can secure a better deal than shareholders would obtain by acting independently. Chancellor Chandler recently made the point that shareholders are better off having limits on their power. He pointed to two prominent examples in which "institutional investors were eager to cash out on the terms offered by a hostile tender offer" and were opposed by the corporation's board of directors.227 In both cases, AMP and Quickturn, the board subsequently secured a substantially better offer from a "white knight."228 As the Chancellor put it, "shareholders were better off under the 

226. Easterbrook & Fischel, Proper Role, supra note 87, at 1161-63 (arguing that when shareholders must decide quickly whether to accept a tender offer, the target company has insufficient time to enact antitakeover strategies that hurt the shareholders in the long run).
stewardship of their board's business judgment. He suggested that these examples "should give commentators reason to think twice before decrying a board's wisdom in holding out (or even rejecting an offer) when it seems that even the most sophisticated of investors are in total disagreement."

Restraints on shareholder power sometimes reflect skepticism of shareholder primacy and a concern for other groups who have an interest in the corporation, a concern that powered the stakeholder movement in the 1980s. Margaret Blair and Lynn Stout have suggested an approach to corporate law based on the notion that boards act as "mediating hierarchs." They suggest that corporate law partially frees directors from direct accountability to shareholders, allowing them to act as disinterested trustees representing the interests of all members of the corporate "team." According to this view, shareholders (and others contributing to team-specific assets) would be willing to give up control in the hopes of sharing in the benefits that can flow from team production.

Sacred space differs somewhat from either of these views. While acknowledging that director action will sometimes delay or shape shareholder action, we expressly recognize that shareholders always retain the ability to vote or sell and to implement antidotes for defensive tactics so that shareholders have the ability to determine the result of a takeover in a real sense, not just in a remote theoretical sense. Our proposal is not one that says that shareholders and markets should always determine the results of takeovers. We expressly recognize director ability to temper or delay shareholder action for the benefit of shareholders or other constituencies. We believe that this follows naturally from the fact that sacred space builds on fundamental conceptions of power allocation drawn from corporate statutes. In other words, sacred space recognizes that shareholders have a specific role in corporate decision-making, but it also recognizes that this role is limited by the statutorily assigned functions of voting, selling, and suing.

Third, sacred space embodies a concept of shareholder self-help, even when directors are acting in good faith. This maxim most clearly distinguishes sacred space from the current dominant approach that relies on judicial constraints via fiduciary duty to address deficiencies in director decision-making. Sacred space comes from a recognition that judicial intervention has gone as far as it can go. In the place of judicial intervention, sacred space offers shareholder self-help. This self-help—while limited as described in the second maxim—is not concerned with whether the directors were acting in good faith. Shareholders are entitled to act and directors are

229. Chandler, supra note 227, at 1095.
230. Id. at 1095–96.
232. Id. at 276–79.
prohibited from significantly infringing upon sacred space, regardless of
good faith or motives of the directors. Although sacred space might be said
to fit within a structure described by reference to fiduciary duty, in the sense
that it defines the scope of fiduciary action, it is distinctive in that claims
based on sacred space will be accompanied by a presumption that favors the
shareholders’ right of action.

The Delaware courts have some experience, albeit limited, with judicial
review of defensive tactics separate from issues of good faith and motive. In
Blassius Industries, Inc. v. Atlas Corp., for example, Chancellor Allen
observed that defensive actions taken “for the primary purpose of thwarting
the exercise of a shareholder vote” must be supported by a “compelling
justification.” Most importantly for our purposes, Allen held that the
Blassius board had acted in good faith, but noted that the real question was

whether . . . the board, even if it is acting with subjective good faith
(which will typically, if not always, be a contestable or debatable
judicial conclusion), may validly act for the principal purpose of
preventing the shareholders from electing a majority of new directors.
The question thus posed is not one of intentional wrong (or even
negligence), but one of authority as between the fiduciary and the
beneficiary.

Delaware courts have been reluctant to apply the Blassius standard,
perhaps because the “compelling justification” standard is largely outcome-
determinative. The judicial analysis usually focuses on whether disenfran-
chisement is the directors’ sole or real purpose, and courts usually find
some other meaningful purpose and thus evade Blassius. Sacred space, on the
other hand, calls for shareholder action, which may or may not strike down
director action. In short, we believe that sacred space will provide more
meaningful shareholder protection than Blassius.

233. 564 A.2d 651 (Del. Ch. 1988).
234. Id. at 660.
235. Id. at 661.
236. Id. at 658.
237. See Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996) (“Blassius’ burden of
demonstrating a ‘compelling justification’ is quite onerous, and is therefore applied rarely.”).
238. Consider the most recent and very narrow description of the reach of Blassius by Vice
Chancellor Strine in Chesapeake: “Because the test is so exacting—akin to that used to determine
whether racial classifications are constitutional—whether it applies comes close to being outcome-
(footnote omitted).
239. In Chesapeake, Vice Chancellor Strine analyzed the relationship between Blassius and
Unocal/Unitrin, observing:

[T]he preclusion question [under Unitrin] and the issue of the board’s "primary
purpose" are not easily separable. The line between board actions that influence the
electoral process in legitimate ways (e.g., delaying the election to provide more time
for deliberations or to give the target board some reasonable breathing room to identify
alternatives) and those that preclude effective stockholder action is not always
Arguably, the Delaware Supreme Court has begun to move to an “authority-based” review of defensive actions. In *Quickturn Design Systems, Inc. v. Shapiro,* the court declined to apply *Unocal* to a defensive mechanism, even after the Court of Chancery held that the “delayed redemption provision” at issue in the case was a disproportionate response to the threat perceived by Quickturn’s board. For the first time, the Delaware Supreme Court held that a defensive mechanism was invalid because it violated “fundamental Delaware law.” The most intriguing aspect of *Quickturn* is the court’s conclusion that the delayed redemption provision violates section 141(a) of the Delaware code because a board’s authority to manage the business and affairs of a corporation has inherent limits. Although the court’s reasoning suggests only that the current board cannot restrict the power of a future board, it would also support a conclusion that a board’s authority to manage the business and affairs of a corporation is inherently limited by the power of the stockholders to exercise decision-making authority for the voting and sale decisions assigned to them.

In the wake of *Unocal* and *Moran v. Household International, Inc.,* such limits were largely imperceptible. When the *Unocal* court was considering the authority of the board to adopt a discriminatory exchange offer, it reasoned, “The board has a large reservoir of authority upon which to draw.” The court cited this aspect of *Unocal* in *Moran,* where the parties famously battled over the validity of a “flip-over” poison pill. The focal point of the case was section 157 of the Delaware code, which authorizes the creation and issuance of “rights,” but once the court had rejected all of luminous. Absent confessions of improper purpose, the most important evidence of what a board intended to do is often what effects its actions have.

In reality, invocation of the *Blasius* standard of review usually signals that the court will invalidate the board action under examination. Failure to invoke *Blasius,* conversely, typically indicates that the board action survived (or will survive) review under *Unocal.*

Given this interrelationship and the continued vitality of *Schnell v. Chris-Craft,* one might reasonably question to what extent the *Blasius* “compelling justification” standard of review is necessary as a lens independent of or to be used within the *Unocal* frame. . . . Stated differently, it may be optimal simply for Delaware courts to infuse our *Unocal* analyses with the spirit animating *Blasius* and not hesitate to use our remedial powers where an inequitable distortion of corporate democracy has occurred.

---

240. 721 A.2d 1281 (Del. 1998).
241. Id. at 1290.
242. Id. at 1292. At this point, the reasoning takes on the flavor of the silly theological arguments about whether an omnipotent God can create a boulder that is too heavy for that God to lift.
243. 500 A.2d 1346 (Del. 1985).
244. *Unocal,* 493 A.2d at 953.
plaintiffs’ arguments that section 157 could not possibly mean rights like these, it stated:

Having concluded that sufficient authority for the Rights Plan exists in 8 Del. C. § 157, we note the inherent powers of the Board conferred by 8 Del. C. § 141(a), concerning the management of the corporation’s “business and affairs” (emphasis added), also provides the Board additional authority upon which to enact the Rights Plan.

Moran dismissed the possibility of nonfiduciary limits under section 141(a) so curtly and so thoroughly, the issue has barely arisen since. Just because a board has a “large reservoir of authority,” however, should not give the board omnipotence. Quickturn implicitly recognized this fundamental principle. The concept of sacred space contemplates that the primary remedy for shareholders is self-help by initiating their right to vote and to sell. The actions shareholders may take are limited, but include shareholders’ ability to initiate such actions. Shareholders should be able to act annually or during an interim period by special meeting or written consent if defensive actions threaten their ability to vote or to sell. In some circumstances, however, self-help may be impractical. When director action threatens immediate and irreparable harm to sacred space, therefore, shareholders should be allowed to bring a claim for injunctive relief against the directors.

VI. Implications of Sacred Space

We seek to define the appropriate balance between shareholder power and board authority in corporate takeovers—perhaps the most difficult question in corporate law. In our presentation, the emphasis is on the reciprocal nature of the two realms: an increase in one necessarily reduces the reach of the other. As a framework for addressing core questions of corporate governance, sacred space necessarily differs from today’s dominant paradigm of fiduciary duty, where the focus is on the board’s authority to make corporate decisions and the limits that should be placed on the board because of loyalty or care concerns. The primary constraint in this paradigm

246. Moran, 500 A.2d at 1351–53.
247. Id. at 1353 (citing Unocal, 493 A.2d at 953) (footnote omitted).
248. Unocal, 493 A.2d at 953.
249. See Quickturn, 721 A.2d at 1291–92.
250. By invoking the notion of “threat,” we intentionally invite comparisons to the first prong of the Unocal standard, where the Delaware courts have allowed directors to take defensive action based on an expansive interpretation of potential threats from bidders. Unocal, 493 A.2d at 954–55. Similarly, we believe that shareholders should be allowed to challenge director defensive actions any time they threaten shareholder action in the limited areas assigned to shareholders. Obviously, when discussing actions by the board of directors—the group assigned to protect shareholders—potential threats assume a different form than threats from an outsider. In the Unocal context, the Delaware courts uphold director actions that are not “draconian.” Id. at 955.
results from judicial interpretations of fiduciary duty. When approached in this way, the tradeoff is between the efficiency value of centralized board decision-making versus the effectiveness of judicial constraints on self-interested or careless board action.

The instincts of the court in *Unocal* were the right ones. The specter of entrenchment requires something other than the traditional deference of the business-judgment rule. For the reasons set out in Part III, however, judicial interpretations based on fiduciary duty have produced results that look remarkably like those we would expect under the business-judgment rule. The resulting constraints on director decision-making do not live up to the aspirations of the *Unocal* court, and they leave shareholders preferring a governance alternative that does not require courts to depend on unverifiable information. As described in Part IV, we believe that shareholder action within the narrow realm provided for shareholders has a greater potential to achieve the proper balance of power sought by *Unocal*.

Of course, relying on shareholder action to constrain directors has its own costs. Until now, the focus on fiduciary duty in the takeover context has meant that courts and commentators have not explored this trade-off very thoroughly. The primary costs of shareholder action result from (1) the inefficiencies inherent in decentralized decision-making and (2) the potential that selfish shareholder action would inflict harm on other constituencies of the corporation. The inefficiency of decentralized decision-making is readily apparent when one considers the costs that would be associated with having a large number of investors with attenuated involvement with the business making numerous ordinary decisions. Courts also seem to have some concern that shareholders, if left to their own devices, would sometimes go their own way, preferring their own interests to those of the corporation as a whole. For these two reasons and perhaps others, shareholder decision-making has been limited to a small class of voting decisions and some decisions to sell or sue.

The rise of a developed market for corporate control created new space and new questions as to the relative rights of shareholders and directors. Chancery Court decisions—such as those in *Interco* and *Grand Metropolitan*—recognized that shareholders should be trusted to decide core questions such as whether to accept a hostile tender offer. Later Delaware Supreme Court decisions—such as *Unitrin* and *Time Warner*—took a narrower view of shareholder decision-making, holding that the only required channel of expression was the ability to turn directors out in a proxy contest, not to sell via accepting a hostile tender offer. Because of the


focus on director authority in these cases, the justification for the distinction between shareholder authority in selling as contrasted to shareholder authority in voting was not well developed and indeed has been criticized by commentators and judges. The reality of takeover transactions in the last decade has been that proxy contests most often occur when they are backed by a hostile tender offer. In that setting, a shareholder decision to oust directors via a proxy action so that a hostile tender offer will go forward seems little different in substance than a shareholder decision to respond to a hostile tender offer.

Limiting shareholder decision-making to election of directors permits shareholders only indirect control over corporate policy. Such a limit might, in form, be supported by a distrust of direct shareholder action that parallels concern for direct decision-making by the populace under the United States Constitution. But given the reality of current transactions, that seems like a charade. When shareholders decide to give a proxy to a director slate supporting a pending tender offer, it is little different from deciding to tender their shares in response to the offer. While shareholder action is limited, the baseline rights include both voting and selling that is made possible because of the presence of a market. We prefer a focus on sacred space that permits shareholders to take substantially similar acts and recognizes that if there is concern about shareholder excess, the limited realm for shareholder action provides a sufficient limit. To draw on an analogy used by the court in Unitrin, an effective overview role for shareholders would permit them to lower the gates erected by the directors to defend the corporate bastion if the shareholders believed that the overture was indeed favorable, but it would not authorize the shareholders to seek out its own barbarian.

To illustrate how sacred space would resolve concrete issues in the takeover setting, we offer two examples, one—the “just-say-no” defense—that arises from a challenge to the board’s authority to take defensive action, and the other—shareholder-adopted bylaws—that is framed by the shareholders’ authority to act. By looking at the same issue from these two different perspectives, we hope to highlight the common threads in sacred space. Moreover, the validity of the “just-say-no” defense and shareholder-adopted bylaws are both open questions in Delaware. We believe these difficult issues can be usefully examined based on sacred space. This section concludes with a general discussion of issues that lie between these two.

253. In commenting on a draft of this paper, Professor Lawrence Hamermesh rightly noted that a proxy vote is different from a share tender in that the latter results in the end of any opportunity to secure a higher price. By contrast, when shareholders elect a board of directors, that board is obligated to maximize the value of the corporation, even if that means seeking a higher bid from some other party. This clarification is useful in thinking about voting generally, but we believe that voting in most hostile takeover contexts relates exclusively to the merits of the proposed transaction and that only in the most exceptional circumstances would an insurgent board of directors seek a different transaction after taking office.
A. "Just Say No"

"Just say no" is a label used to describe a context in which a board of directors attempts to stonewall a hostile takeover bid indefinitely. The acceptability of the "just-say-no" defense under Delaware law is uncertain. Although several decisions rendered by the Delaware Supreme Court and numerous commentators seem to support its use, Unitrin's condemnation of "preclusive" actions would suggest that "just saying no" is an unacceptable response to a hostile bidder. The Delaware Supreme Court has never directly decided the issue, but the federal district court in Delaware relied on precedent from the court to authorize a "just-say-no" defense in Moore Corp. v. Wallace Computer Services, Inc. The fact that some courts and commentators consider the "just-say-no" defense a plausible approach to corporate governance reflects how far we have strayed from the notion that shareholders should have a meaningful voice in corporate affairs. Under the concept of sacred space, "just say no" is not a close case.

Moore involved a claim that the board of directors of Wallace Computer Services breached its fiduciary duties by refusing to redeem a poison pill in the face of an all-cash tender offer representing a substantial premium over the market price. The directors of Wallace rejected the offer from Moore Corporation as "inadequate" after considering the views of Wallace's investment bankers, even though Wallace's shareholders had tendered over 73% of the outstanding shares. Moore was unable to proceed immediately with its takeover bid because Wallace had a lethal combination of defensive mechanisms: a poison pill (which would be triggered upon the purchase of 20% of the outstanding shares) acted to bar shareholder action by selling, and a staggered board—created in the corporate charter and dividing the

254. For an excellent discussion of Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989) and Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995), see Gordon, supra note 6, at 522–27. See also Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.11 (Del. 1993) (protecting stockholder rights from "unwarranted interference"); Stroud v. Grace, 606 A.2d 75, 82–83 (Del. 1992) (holding that the Unocal heightened standard of review did not apply when a board's defensive actions were later ratified by a shareholder vote); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (holding that using "corporate machinery and the Delaware law" to obstruct "legitimate" efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management was "contrary to the established principles of corporate democracy").


256. The initial offer was at a 27% premium to the market price as of the date of the announcement of the offer. Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545, 1551 (D. Del. 1995). After the initial offer was rejected, Moore raised it, offering a premium of over 35%. See id. at 1553 (stating that the offer price rose from $56 to $60).

257. Id. at 1551 n.4.
board into three classes—blocked any immediate shareholder control action by voting.\textsuperscript{258}

Wallace’s recalcitrance would force Moore to challenge the incumbent directors in two annual meetings to obtain majority control of the board of directors. And of course, Moore would need majority control of the board before redeeming the poison pill. Despite these obstacles, the district court held that retention of the pill was not “preclusive” under \textit{Unitrin} because the bidder still had the option of replacing incumbent management through a proxy contest. Strangely, the court did not mention the fact that the board of directors of Wallace was classified, so that a successful proxy challenge would need to stretch over two annual elections.

We find the \textit{Moore} court’s unwillingness to order the redemption of the poison pill completely understandable when framed solely by \textit{Unitrin}, looking only at the impact on voting and seeking reasons not to trust the directors’ action. After all, the defensive mechanisms employed by Wallace did not \textit{preclude} a takeover.\textsuperscript{259} Yet viewed in the larger frame, director action effectively blocked shareholder oversight.

\begin{flushright}
\textsuperscript{258} \textit{WALLACE COMPUTER SERVS., INC., FORM 8-K} § 3.2 (June 14, 1995), available at http://www.sec.gov/Archives/edgar/data/104348/0000104348-95-000008.txt.

The court also discussed whether the refusal to redeem the poison pill would fall outside the range of reasonableness. In this aspect of the opinion, the court does not weigh the relative burden of the defensive mechanism against the seriousness of the threat. Instead, the court assumes the deferential posture normally associated with business-judgment review:

The evidence demonstrates that the Wallace Board reasonably believed that the shareholders were entitled to protection from what they considered to be a “low ball” offer. After substantial capital investment spanning several years, Wallace had finally begun to reap the financial benefits from its WIN system. These benefits, however, were reflected in data which remained peculiarly within the province of the Wallace Board. Shareholders, at the time of the Moore offer, were unable to appreciate the upward trend in Wallace’s earnings which have been set forth in detail above. Given this situation, the Wallace Board’s response can hardly be deemed unreasonable.

\textit{Moore}, 907 F. Supp. at 1563 (citations omitted). This deferential attitude was encouraged by the Delaware Supreme Court in \textit{Unitrin}, where it wrote: “The ratio decidendi for the ‘range of reasonableness’ standard is a need of the board of directors for latitude in discharging its fiduciary
In contrast with Moore, the recent Delaware Chancery Court decision in *Carmody v. Toll Brothers*,260 provides an example of when *Unitrin*'s preclusive/coercive standard would work to preserve space for shareholder action. In *Carmody*, the court invalidated a "dead-hand" poison pill, which with its cousin the "no-hand poison pill" has been one of the most discussed takeover innovations over the past decade. Both arose in response to a fatal shortcoming in traditional poison pills (viewed from the perspective of the target): the ability of hostile bidders to use the one channel remaining open for shareholder action after *Unitrin* to wage a proxy contest to replace incumbent directors with new directors who would then redeem the pill. In the absence of a charter provision creating a classified board, every corporation whose shares are widely held is susceptible to attack in this manner. Indeed, waging a proxy contest in conjunction with a tender offer has become standard practice for hostile bidders. Imposing a classified board, if not already in place, requires an amendment to the charter and thus a vote of shareholders. Institutional shareholders have become more reluctant to support such changes.261

To close this gap in a target's defensive armada in a way that could be achieved by directors alone, corporate boards began adding "continuing-director" provisions to their poison pills. These provisions typically proscribe the removal of the poison pill by anyone other than the current directors or their approved successors and have been aptly named "dead-hand poison pills." In *Carmody*, the only Delaware case addressing dead-hand poison pills, Vice Chancellor Jacobs found both statutory and fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint." *Unitrin*, 651 A.2d at 1388. 260. 723 A.2d 1180 (Del. Ch. 1998).

261. See John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEXAS L. REV. 271, 325 (2000) ("Charter amendments to install such defenses are increasingly rare, mainly because amendments require shareholder approval. Since the institutional shareholder community organized in the late 1980s, such approvals became increasingly difficult (if not impossible) to obtain.").

262. Vice Chancellor Jacobs concluded that the dead-hand pill was preclusive because it made the "bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'" *Carmody*, 723 A.2d at 1195. He also held that the dead-hand poison pill "purposefully disenfranchises" shareholders and violates the "compelling justification" standard from *Blasius*. Id. at 1193 (citation omitted). Two other courts have addressed the validity of dead-hand pills. *Bank of New York Co. v. Irving Bank Corp.*, 528 N.Y.S.2d 482, 485 (Sup. Ct. 1988) was an early case in which a New York court held that the continuing-director provision produced an "illegal discrimination" between the incumbent board and any board consisting of newly elected, insurgent directors. In *Invacare Corp. v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997), a federal district court in Georgia upheld a dead-hand poison pill under Georgia law, reasoning that incumbent directors possessed the authority to define the terms of the rights and that references to "continuing directors" in two sections of the Georgia statute provided evidence that "the concept of continuing directors is an integral part of a takeover defense and is not contrary to public policy in Georgia." *Id.* at 1581 (citing GA. CODE ANN. §§ 14-2-1111, 14-2-1133 (1994)).
Prior to *Carmody*, several commentators had criticized dead-hand poison pills on the grounds that they infringe impermissibly on shareholder suffrage.263 Jeffrey Gordon, for example, characterized these pills as a "just-say-never" defense.264 Vice Chancellor Jacobs relied heavily on these commentators in concluding that dead-hand poison pills are a "show stopper."265 His assumption was that dead-hand poison pills are insurmountable, even if a hostile bidder is able to obtain control of the board of directors through a proxy contest. Yet Peter Letsou has identified a channel that remains open to shareholders even in the face of a dead hand: after a successful proxy fight and election of new directors, the new board would not act to redeem the pill, but rather could propose a merger or similar transaction.266 This is not to argue that dead-hand poison pills should be permitted, but is intended to illustrate the fragility of a legal standard that requires judges to draw a line based on evaluating director actions. By contrast, shareholders have the power of self-help under sacred space. The implicit policy judgment underlying *Moore* and *Carmody* appears to be that director defensive action is permitted as long as one voting channel remains


265. *Carmody*, 723 A.2d at 1187 ("If only the incumbent directors or their designated successors could redeem the pill, it would make little sense for shareholders or the hostile bidder to wage a proxy contest to replace the incumbent board. Doing that would eliminate from the scene the only group of persons having the power to give the hostile bidder and target company shareholders what they desired: control of the target company (in the case of the hostile bidder) and the opportunity to obtain an attractive price for their shares (in the case of the target company stockholders).")

266. See Peter V. Letsou, *Are Dead Hand (And No Hand) Poison Pills Really Dead?*, 68 U. CIN. L. REV. 1101 (2000). He suggests a pill could be rewritten to apply to corporate transactions that follow a successful proxy solicitation but no subsequent acquisition of shares by the bidder: Accordingly, if dead-hand and no-hand poison pills are to be made effective, the triggering provisions of those pills must be changed so that they apply to all acquisition techniques. In other words, the flip-over provisions of the current generation of poison pills, which only apply to mergers and assets sales occurring after a person or group acquires the specified percentage of the target firm’s shares, must be made applicable to all mergers and asset sales. Only then will no-hand and dead-hand provisions achieve their goal of preventing bidders from using proxy contests and consent solicitations to attain the power necessary to acquire the corporation’s business without the consent of incumbent managers.

*Id.* at 1155.
open for shareholder activity—no matter how narrow that channel might be. The result is that there is no effective shareholder oversight of director action in a situation where there is the possibility of entrenchment. This violates the first maxim of sacred space.

Section 141 neither mandates nor forbids such action. Any answer should be informed by the shareholder and director roles as contemplated by the statutory structure, one that provides ample room for director action, as long as it is accompanied by shareholder oversight. Sacred space moves the focus away from preclusion to recognizing space for shareholder action to protect shareholder rights to vote or to sell as the explicit policy base, providing the balance that Unocal sought and subsequent cases have been unable to provide.

B. Shareholder-Adopted Bylaws

Shareholder-adopted bylaws, which have only recently become prominent in corporate-governance debates, provide a second setting illustrating shareholder-director conflict. This setting focuses more on the affirmative role of shareholders in the corporate structure. Most legal discussions of shareholder-adopted bylaws begin with a comparison of section 109(b)267 (describing the permissible scope of corporate bylaws) and section 141(a)268 (describing the management role of the board of directors) of the Delaware statute, which create what Professor Jeffrey Gordon calls a "recursive loop."269 As a result of the statutory ambiguity, any final resolution regarding the validity of shareholder-adopted bylaws will require the intervention of the Delaware courts. We believe that preservation of sacred space requires the use of mandatory shareholder bylaws, and that the proper scope of such bylaws follows naturally—if not always unambiguously—from this purpose.

The Delaware corporation statute authorizes shareholders to adopt bylaws "not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."270 On the other hand, the statute charges the directors with management of the "business and affairs" of the corporation, "except as may be otherwise provided in this chapter or in its certificate of incorporation."271 When the statute authorizes shareholder-adopted bylaws only to the extent

268. Id. § 141(a).
271. Id. § 141(a).
that they are "not inconsistent with law," does that "law" include the provision granting managerial authority to directors? Similarly, when the statute authorizes directors to manage the firm subject to limitations "otherwise provided in this chapter," does that include limitations imposed by the shareholders through bylaw?

Most commentators who have considered these questions have concluded that the two sections of the Delaware statute cannot be reconciled without appeal to policy arguments. Two recent commentators have peered into the statutory abyss and professed to see more clearly the intention of the Delaware legislature, but the fact that they reached opposite conclusions supports our view that the plain words of the statute are too contradictory to be interpreted without employing external policy considerations.

Professor Jonathan Macey finds authorization for shareholder-adopted bylaws in the exceptions clause of section 141(a) ("except as may be otherwise provided in this chapter") and in the "clear and unequivocal language of section 109(b)." While we agree with Professor Macey's conclusion that shareholder-adopted bylaws can limit director power to some extent—and we recognize that his conclusion is not based on his reading of the statutory language alone, but also on his views regarding the proper role of target shareholders—we find the foregoing reasoning too facile. The language of section 109(b) is not "clear and unequivocal," and Macey's reading of it completely ignores the requirement that bylaws be "not inconsistent with law"—a phrase that presumably includes section 141(a).

An alternative reading of the statute was provided in a thoughtful article by Professor Lawrence Hamermesh, who offers this resolution of the apparent conflict in the code:

When section 141(a) refers to limitations on board authority "provided in this chapter," it does not refer to all by-laws that could conceivably be adopted pursuant to the general authority conferred by section 109(b). Rather, section 141(a) is more naturally read to refer to statutes which address its specific subject matter—the allocation of managerial power to the board of directors—and which clearly and explicitly depart from that allocation by providing for management by

272. Id. § 109(b).
273. Id. § 141(a).
274. See, e.g., Coffee, supra note 269, at 607–10 (describing the alternative readings of the provisions, then turning to the common law and SEC no-action letters for interpretive guidance); Gordon, supra note 6, at 547 (arguing that "statutory formalism really runs out").
277. Macey, supra note 275, at 868.
persons other than directors. These statutes explicitly permit court-appointed trustees, custodians and receivers to manage the affairs of the corporation in lieu of the board of directors.278

While this reading seems plausible, it leaves unanswered the crucial question with respect to shareholder-adopted bylaws. By providing for limitations on director authority, section 141(a) certainly “does not refer to all by-laws that could conceivably be adopted pursuant to the general authority conferred by Section 109(b),” but does it refer to any shareholder-adopted bylaws? In other words, may shareholders in some circumstances limit director power through bylaws? Presumably, any bylaw adopted by shareholders would limit director power in the matter addressed, unless directors are allowed to amend the bylaw to undo the shareholder action. Professor Hamermesh would permit shareholder-adopted bylaws on matters where there is “specific statutory authorization,” such as for calling a special meeting of shareholders.279 While his approach has some appeal, we find no language in section 109(b) that limits the use of shareholder-adopted bylaws to actions for which there is independent statutory authorization. Indeed, the statute, which allows action on “the business of the corporation” and “the conduct of its affairs,” is conspicuously broader than that interpretation.280 In the last analysis, we find Professor Hamermesh’s reading incongruous with our understanding of the statutory scheme, and it is certainly inconsistent with sacred space.

Rather than attempting to rationalize two provisions that are facially inconsistent, we side with Professor Gordon, who concludes that the “Delaware court needs a theory to explain the appropriate boundary between shareholder power and the board’s authority—a theory presumably richer in normative appeal than ‘management wins.’”281 A federal district court in Oklahoma faced exactly this issue in International Brotherhood of Teamsters

278. Hamermesh, supra note 269, at 431.

279. He notes that his reasoning does “not imply that the nearly universal power of stockholders to adopt bylaws is merely nominal and without consequence. There are numerous fields in which bylaw regulation is of nearly unchallengeable validity, due to specific statutory authorization.” Id. at 479–80. For example, Professor Hamermesh argues that bylaws permitting shareholders to call special meetings are authorized by § 211(d) and would not “contravene[] the more general allocation of corporate authority to the board of directors.” Id. at 481. He uses similar reasoning with regard to bylaws establishing director qualifications, bylaws affecting board governance, and bylaws affecting corporate offices. Id. at 482–86.


281. Gordon, supra note 6, at 547. Gordon proposes a theory of shareholder choice under which courts would ask, “[W]hat would shareholders choose to have initiative power over?” Id. While we are sympathetic to Gordon’s approach, we are skeptical that courts would engage in such an open-ended inquiry in a matter of such fundamental importance to the corporate-governance system. By contrast, sacred space provides a more grounded starting point because it is tied to statutory norms.
Under a statute very similar to Delaware’s, the court reasoned:

In the scheme of corporate governance the role of shareholders has been purposefully indirect. Shareholders’ direct authority is limited. This is true for obvious reasons. Large corporations with perhaps thousands of stockholders could not function if the daily running of the corporation was subject to the approval of so many relatively attenuated people. However, the authority given a board of directors under the Oklahoma General Corporation Act, [citing the Oklahoma equivalent of Delaware’s section 141(a)] is not without shareholder oversight, [citing the Oklahoma equivalent of Delaware’s section 109(b)].

In this reasoning, we see the foreshadowing of sacred space. Unable to resolve the issue from the plain words of the statute, the court appealed to the respective governance roles of shareholders and directors, as prescribed in the statute.

Despite the foregoing, the issue of whether shareholders are allowed to adopt bylaws is not difficult because the statute expressly grants shareholders that authority. Instead, the difficult issue relating to shareholder-adopted bylaws is defining the point at which the shareholders cross the line that divides shareholders and directors. Several commentators have ventured proposals to resolve this issue, but these efforts are hobbled by the need to import artificial distinctions into the statute.

Sacred space not only provides a rationale for validating the use of shareholder-adopted bylaws, but it provides the limiting principle. Because sacred space derives from the limited role assigned to shareholders under the statute, shareholder-adopted bylaws justified by sacred space are not open to

282. 975 P.2d 907 (Okla. 1999). A federal district court in Georgia faced a similar issue in Invacare Corp. v. Healthdyne Technologies, 968 F. Supp. 1578 (N.D. Ga. 1997). The court rejected a bylaw that would have required the board of directors to remove the dead-hand feature of a poison pill. Id. at 1582. However, the statute in that case is substantially different from the Delaware statute.

283. See Okla. Stat. Ann. tit. 18, § 1013(A) & (B) (West 1999) ((A). . . [T]he power to adopt, amend or repeal bylaws shall be in the shareholders entitled to vote . . . . (B) The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its shareholders, directors, officers or employees.").

284. Int’l Bhd. of Teamsters, 975 P.2d at 911.

285. Del. Code Ann. tit. 8, § 109(a) (1991) ("After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote. . . .").

286. See Coffee, supra note 269, at 613–16; Gordon, supra note 6, at 547–50.

287. Cf. Hamermesh, supra note 269, at 444 (concluding that "the efforts to distinguish by-laws that permissibly limit director authority from by-laws that impermissibly do so have failed to provide a coherent analytical structure, and the pertinent statutes provide no guidelines for distinction at all").
the same type of abuse that would follow more open-ended authorizations. In other words, allowing shareholders to limit director authority through bylaws based on self-protection of shareholder sacred space does not give the shareholders carte blanche to manage the corporation.

Sacred space also addresses the thorny issue of whether directors should be allowed to amend or repeal shareholder-adopted bylaws to undo the reforms. The Delaware statute is silent on these issues. It vests the power to adopt, amend or repeal bylaws in the shareholders, and allows the certificate of incorporation to confer that power on the directors. The fact that directors are given such power, however, “shall not divest the stockholders... of the power, nor limit their power to adopt, amend or repeal by-laws.” One might argue that this last clause empowers shareholders to override directors, but not vice versa, but this reading seems like a stretch. Moreover, as Professor Hamermesh observes:

If the board of directors derives unqualified authority to amend the bylaws from the certificate of incorporation, as it almost invariably does, and the by-laws may not contradict the superior provisions of the certificate of incorporation, a by-law purporting to limit authority conferred upon the directors by charter provision should be suspect, to say the least.

We are left, then, as we were before, with an ambiguous statute and the need for policy to resolve the ambiguity. Again, we lean on sacred space. We need not—like the Model Business Corporation Act—construct rules that preclude amendment when (and only when) the shareholders specifically include a protective statement in the bylaws. Instead, we would propose that shareholder-adopted bylaws be protected from subsequent amendment by directors if that subsequent amendment would infringe on sacred space. Where no such infringement would occur, the directors are free to amend. Note that this solution would allow for the tailoring of bylaws when shareholders are overly aggressive, but would not allow directors to undo shareholder efforts to protect sacred space.

288. The Model Business Corporation Act prohibits the board of directors from amending a bylaw when the shareholders “expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw.” MODEL BUS. CORP. ACT §10.20(b)(2) (1999).
290. Id.
291. Professor Hamermesh describes a similar argument under the New York statute. See Hamermesh, supra note 269, at 468–69.
292. Id. at 470.
293. MODEL BUS. CORP. ACT § 10.20(b) (1999) (“A corporation’s board of directors may amend or repeal the corporation’s bylaws, unless: (1) the articles of incorporation or section 10.21 reserve that power exclusively to the shareholders in whole or in part; or (2) the shareholders in amending, repealing, or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw.”).
C. Questions at the Edges

Regulating takeover defense requires broad standards rather than targeted rules. The high stakes in many control contests—when combined with the broad leeway for private ordering in the American legal system and the breadth of action permitted directors under corporate statutes—means that directors and their lawyers have both the incentive and the means to develop innovative defensive tactics that push the boundaries of traditional practice. Even with sacred space, we acknowledge that difficult questions will remain—particularly as to antitakeover defenses implemented by directors in which shareholders would normally not participate. Corporations utilize numerous antitakeover defenses. Golden parachutes, which are contracts between the corporation and certain of its employees, are one such example. Corporations have also made use of Employee Stock Ownership Plans ("ESOPs"), which are contracts between the corporation and its shareholders, and termination fees or lockups, which are contracts between the target corporation and a preferred bidder. Existing law based on fiduciary duty arguably provides some constraint as to those actions, but the constraints are spotty. Our preferred solution focuses on shareholder self-help; it could also guide judicial response to these director actions in settings where director action occurs as part of a board-proposed alternative to an announced proxy fight or tender offer. In such a setting a board's contracts with third parties cannot trump the shareholders' right to take action within their reserved space. Existing authority reflects such a principle in merger cases where board contracts with a preferred bidder

294. Golden parachutes provide generous payments to managers and sometimes to other employees if control of the corporation changes. They do not directly block takeovers, but can make them more expensive. See, e.g., Richard A. Lambert & David F. Larcker, Golden Parachutes, Executive Decision-Making, and Shareholder Wealth, 7 J. ACCT. & ECON. 179 (1985) (describing a study of 90 firms with golden parachutes).

295. The use of an employee stock-ownership plan may permit stock to be placed in friendly hands. Such a plan is often funded with borrowed money and provides cover to directors while purporting to be justified by general compensation goals. Compare Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989) (sustaining an ESOP under an entire fairness standard) with NCR Corp. v. Am. Tel. & Tel. Co., 761 F. Supp. 475 (S.D. Ohio 1991) (invalidating an ESOP).

296. Lockups have produced a vigorous academic debate. Cf. Ian Ayres, Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions, 90 COLUM. L. REV. 682 (1990) (noting that stock lockups alone will not preclude a bid or prevent a rival from outbidding); Marcel Kahan & Michael Klausner, Lockups and the Market for Corporate Control, 48 STAN. L. REV. 1539 (1996) (stressing the importance of close judicial scrutiny of lockups due to the potential for negative effects on the incentive structure); Stephen Fraidin & Jon Hinson, Toward Unlocking Lockups, 103 YALE L.J. 1739 (1994) (arguing that all lockups should be enforced subject only to business-judgment-rule scrutiny).

297. See, e.g., Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1993) (holding that lockups are permitted in some situations, although they are not permitted when they are inconsistent with directors' fiduciary duties).
cannot foreclose shareholder action on a competing bid. The Delaware Supreme Court has held that a preferred bidder’s contract with a target in violation of the board’s fiduciary duty is invalid and unenforceable. Sacred space suggests similar protection for other shareholder actions, and the presence of an announced proxy fight or tender offer is a particularly strong signal announcing such space for shareholder decision-making.

This idea is reflected in a federal decision enjoining a “comprehensive plan” taken by the board of ITT Corporation to fend off a hostile bid from Hilton Hotels that would have split ITT into three new entities, the largest one with a staggered board requiring a shareholder vote of 80% to remove the provision. The court noted that shareholders have two forms of action: “They may sell their stock or vote to replace incumbent board members.” It held that “the Comprehensive Plan would violate the power relationship between ITT’s board and ITT’s shareholders by impermissibly infringing on the shareholders’ right to vote . . . .” Where shareholders seek to exercise their right to vote or sell, this precedent supports enjoining director action.

Similarly, sacred space will help define the boundary of other fiduciary-duty concepts such as the Revlon duty to auction. Not surprisingly for a doctrine based on fiduciary duty, Revlon focuses entirely on the directors’ realm. Subsequent opinions such as Paramount v. Time that severely limited the reach of the Revlon duty also focus only on the director’s role in the corporations. What would happen if this approach were linked with a recognition of shareholder space? In that setting, it is relevant not only that the directors of Time had a plan for their business, but also that the shareholders had been asked to vote on that plan, and that the actions of the directors in the face of a higher offer from Paramount excluded the shareholders from that role. In that setting, the shareholders should be able to seek relief in order to preserve their opportunity to vote.

There remains a more difficult context of director-implemented defensive tactics outside of a pending proxy fight or tender offer that signals

---

298. See, e.g., Belden Corp. v. Internorth, Inc., 413 N.E.2d 98, 102 (Ill. App. Ct. 1980) (stating that bidders who make an agreement with management “do not, however, have an unequivocal right to the benefits of the merger, since the power to approve the merger lies with the [target] shareholders . . . .”); cf. Great W. Producers Coop. v. Great W. United Corp., 613 P.2d 873 (Colo. 1980) (holding that a “best efforts” clause in a merger agreement was tempered by the directors’ duties under the general corporation law of the state).

299. Paramount Communications, 637 A.2d at 51.


301. Id. at 1351.

302. Id. at 1346.


305. New York Stock Exchange rules required the approval of the original transaction by Time shareholders. Delaware corporate law required the approval of Warner shareholders. Id. at 1146.
shareholder action.\textsuperscript{306} A target board, having no other effective defensive tactic, might be willing to take actions that would make the target so unattractive to a potential bidder that shareholders would end up with a company that was not worth very much. Shareholder self-help in sacred space could address prospective harm, but there would be some possible director actions that would be neither within that space nor tied to an alternative offer discussed above. And to the extent that sacred space forecloses some director defensive tactics currently permitted, such as poison pills, some directors may be more tempted to pursue such distasteful options. Here there is no better alternative to judicial review, but what we are asking judges to do in this setting should still be somewhat easier than what currently occurs under the \textit{Unocal} standard. A scorched-earth action may well be severe enough that it comes within a traditional waste standard under which courts have been willing to intrude into director action.\textsuperscript{307}

VII. Conclusion

Directors possess broad powers to make corporate decisions, including decisions related to a takeover. Yet corporate law and theory require a role for shareholders in fundamental changes and transactions in which the directors may have a conflict. Even accounting for reasons not to prefer shareholder decision-making for operational and other matters, there remains a space for shareholder action. In \textit{Unocal}, the Delaware Supreme Court went in a different direction, focusing instead on a regime of enhanced judicial scrutiny as the primary shareholder protection against director action taken in a takeover setting to thwart shareholder selling or voting. It has not worked as it was intended, primarily because of the difficulty of a third-party judge separating director actions that may have an entrenchment motive from those that could benefit the shareholders. The result is that defensive tactics are almost never overturned by a court. A better alternative—based on insights from the theory of the firm—is to permit direct shareholder action to vote and to sell, and to enact antidotes to director actions that frustrate such shareholder action within the space provided for them by corporate law.

\textsuperscript{306} \textit{See} Larry Gurwin, \textit{The Scorched Earth Policy}, \textit{THE INSTITUTIONAL INVESTOR}, June 1979, at 35 (highlighting alternative defensive tactics such as mud-slinging campaigns).

\textsuperscript{307} \textit{See} Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) ("Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.").