SETTLING THE DEBATE: A RESPONSE TO PROFESSOR BEBCHUK'S PROPOSED REFORM OF HOSTILE TAKEOVER DEFENSES*

The news today is filled with stories of corporate malfeasance and calls for corporate governance reform. With the rise of activist shareholders who no longer stand idly by and let management have free reign, corporate boards are facing increasing pressure to clean up their acts and govern in a responsible, transparent way that clearly benefits shareholders.

One major battleground for reform is the appropriate scope of takeover defenses. These defenses emerged during the hostile takeover heyday of the 1980s and have evolved over time to meet the threats that companies face from hostile bidders. Though boards of directors claim that these takeover defenses can benefit shareholders by allowing the company to remain independent, investors continue to question whether these defenses are really a way for corporate boards to gain greater power for themselves. Two common defensive mechanisms, staggered boards and poison pills, are in the crosshairs of investor-rights groups and activist shareholders. When a company uses these two defenses in tandem, they may provide a powerful, almost impenetrable barricade against hostile takeovers, as evidenced by the recent battle between Oracle and PeopleSoft.[1] This staggered board/poison

* The author gratefully acknowledges the guidance and assistance of Professor George S. Geis and Professor Kenneth Rosen, both of the University of Alabama School of Law. The author also wishes to thank Mr. Steven M. Haas for his suggestions on an earlier draft of this Comment.

1. On June 6, 2003, software giant Oracle Corporation announced a $5.1 billion ($16 per share) offer for its competitor PeopleSoft Corporation. David Marcus et al., *What Might Have Been—Or Might Be*, CORP. CONTROL ALERT, Apr. 23, 2004. PeopleSoft enacted a poison pill in 1995, and in response to the takeover bid, it also enacted a customer assurance program whereby customers would be refunded as much as five times their licensing fees on PeopleSoft software should a takeover occur and the product not be supported thereafter. Rita K. Farrell, *PeopleSoft Chief's Remarks Cited as Cause of Dismissal*, N.Y. TIMES, Oct. 5, 2004, at C4. Oracle sued PeopleSoft on June 18, 2003, seeking to force the redemption of the poison pill and the invalidation of the customer assurance program. *See* Laurie Flynn & Andrew Ross Sorkin, *Oracle's Campaign to Take Over PeopleSoft Heats Up*, N.Y. TIMES, June 19, 2003, at C1. The case was the first time in fifteen years that a Delaware court has taken up the legality of a poison pill, and from the outset, it was agreed that Oracle would have difficulties ahead in convincing the court to do something it had never done—force the redemption of a pill. *See* David Marcus, *Oracle-PeopleSoft Dispute Lands in Chancery Court's Lap*, DEL. L. WKLY., Oct. 6, 2004, at D3. As the courtroom drama progressed, Oracle raised and lowered its bid depending on PeopleSoft's market performance. On November 1, 2004, in a self-proclaimed "final offer," Oracle raised its offer from $21 per share to $24 per share. Laurie Flynn, *Oracle Raises its Hostile Bid for PeopleSoft by $3, to $24*, N.Y. TIMES, Nov. 2, 2004, at C1. Two weeks later, Oracle celebrated as a majority of PeopleSoft shareholders tendered their shares in nonbinding agreements. Laurie J. Flynn, *Shareholders Favor Oracle, But PeopleSoft Board Says No*, N.Y. TIMES, Nov. 21, 2004, § 1, at 37. However, even though a majority of shares were tendered, Oracle could not complete the purchase of those shares until the PeopleSoft board removed the poison pill—an unlikely move considering that the board again voted unanimously to reject the bid despite the shareholder tender. *Id.* The intense speculation on how Vice Chancellor Leo Strine

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pill combination almost guarantees that a hostile bidder will have to wait a minimum of two years before it can gain control of the target board and possibly complete the takeover. But is this good for shareholders? Is it always to the shareholders' benefit that a hostile takeover fail? When a company's board puts these provisions in place, is it protecting its own position of power within the company at the expense of the shareholders? Courts continue to grapple with these questions. While the takeover defenses generally are legally acceptable, the current legal issue is at what point in the takeover process do these provisions go too far. When does a board cross the line from protecting the company's best interests to actually harming shareholders by preventing a takeover that would be very profitable for those shareholders?

Several proposals have been offered over the last few years regarding Delaware's treatment of poison pills, including ending effective staggered boards by requiring annual election of directors,[2] rejecting the doctrine of substantive coercion as a sufficient threat to justify a takeover defense,[3] and instituting a tougher *Unocal* proportionality review than currently exists.[4] However, the most noted criticisms of effective staggered boards and poison pills as well as proposed remedies for their effect on shareholders come from Professors Lucian Bebchuk, John Coates, and Guhan Subramanian.[5] In order to combat the decreased shareholder value that poison pills purportedly cause and to protect the ballot box safety valve (the right of shareholders to make decisions in the takeover context), Bebchuk proposes that "[c]ourts should not allow managers to continue blocking a takeover bid after they lose one election conducted over an acquisition offer."[6] Under this proposal, after the incumbent target board loses one election that is effectively a referendum on the hostile bidder's offer, the board would be required to redeem the poison pill and allow the takeover to proceed.[7] Bebchuk argues that his approach should be adopted for several reasons: it is true to existing Delaware corporate jurisprudence, legislative intervention

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would rule came to an abrupt halt on December 13, 2004, when lawyers for both PeopleSoft and Oracle called Chancellor Strine and announced that a tentative deal had been reached after Oracle raised its bid to $26.50 per share. Rita K. Farrell, *As Suits End, Judge Says Deal Was Only Way to Resolve Fight*, N.Y. TIMES, Dec. 14, 2004, at C3. Thus, a new ruling on the legality of the poison pill will have to wait until another day, but as seen through this example, the debate over poison pills and their effect on shareholders is not going away any time soon.

2. *See* Patrick S. McGurn, *Classification Cancels Corporate Accountability*, 55 STAN. L. REV. 839 (2002).

3. *See* Paul L. Regan, *What's Left of* UNOCAL?, 26 DEL. J. CORP. L. 947, 970-72 (2001).

4. *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 266-73 (1989); *see also* Regan, *supra* note 3, at 972-74.

5. Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

6. *Id.* at 944.

7. *Id.* at 944-45.

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is not required, and substantial benefits will result to shareholders with only minor disruptions to the Delaware corporate landscape.[8]

While Professor Bebchuk has extensively researched this issue and has made a valuable contribution to the debate, his proposal to drastically reform the poison pill should not be adopted by Delaware. For the reasons discussed below, the current approach of the Delaware courts in allowing directors to make the ultimate decisions, while simultaneously requiring directors to act in the best interest of shareholders, is preferable to Bebchuk's suggested change to the regulation of Delaware companies and the nature of their corporate decisionmaking process. First, corporate directors, not shareholders, should have the ultimate decisionmaking authority in the takeover context. Second, Professor Bebchuk's proposal would create an unjustified judicial carve-out for hostile takeover situations. Third, the poison pill provides much needed protections for target company shareholders. Finally, the Bebchuk proposal is fundamentally inconsistent with existing Delaware takeover law jurisprudence.

Part I of this Comment provides a basic overview of staggered boards and poison pills along with the relevant caselaw regarding the standard of review applied by Delaware courts to defensive mechanisms. Part II sets forth the basic framework and reasoning behind Bebchuk's proposal. In Part III, I offer a critique of the Bebchuk proposal and argue that the existing approach of the Delaware courts is the preferable option.

I. STAGGERED BOARDS AND POISON PILLS

A. *Staggered Boards*

The successful takeover of a corporation often rests on one's ability to gain effective control of the company's board of directors. This renders the method for electing board members potentially critical. A staggered board of directors is a board grouped into classes, usually two or three, with only one class of directors elected each year. The number of classes depends on the size of the board and any applicable statutory restrictions. For example, Delaware and thirty-eight other states permit a maximum of three classes,[9] while New York permits up to four.[10] A staggered board may either be specified in the corporation's charter or established through the bylaws, again depending on state law.[11] In Delaware, a staggered board may be created either through the charter or through the bylaws,[12] while the Revised

8. *Id.* at 945.

9. Richard H. Koppes et al., *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023, 1029 n.21 (1999).

10. N.Y. BUS. CORP. LAW § 704(a) (McKinney 2003).

11. Bebchuk et al., *supra* note 5, at 894.

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

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Model Business Corporation Act (RMBCA) limits the method of establishment to the charter only.[13]

As a takeover defense, a staggered board established through the charter is generally more effective because in order to dismantle it, approval by both the board and the shareholders is required.[14] By contrast, to dismantle a staggered board initiated through the bylaws generally requires only a vote of either the board or the shareholders.[15] In his study of the use of staggered boards as takeover defenses, Bebchuk distinguishes and focuses on "'effective staggered board[s],'" which he defines as situations where the staggered board is established by charter, the directors may only be removed for cause, and the shareholders may not increase the size of the board and then effectively "pack" the board by filling those vacancies.[16] Roughly 50% of U.S. public companies have effective staggered boards.[17]

Standing alone and absent a poison pill, a staggered board is not a perfect defense mechanism.[18] In the event of hostile takeover bid, a staggered board has the theoretical effect of delaying the takeover until after two annual elections have taken place. Even if the bidder owns a majority of the target's stock and the corresponding voting rights, it will take two election cycles for it to gain control of a majority of seats on the board of directors. There are two main weaknesses, however, to the staggered board as a defense mechanism.[19] First, while a staggered board does delay a hostile bidder from gaining control of the board and pushing through the acquisition, it does not prevent the takeover.[20] If the bidder is dead set on acquiring the target and is willing to wait out two election periods, a staggered board generally has no power to stop the takeover.[21] However, in the real world of

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13. MODEL BUS. CORP. ACT § 8.06 (2005).

14. Bebchuk et al., *supra* note 5, at 894.

15. *See id.* However, this is not always the case:

> A staggered board specified in the bylaws might be as difficult to dismantle as a staggered board specified in the charter if the charter specifies that the board must approve any modifications to board structure, effectively making the staggered board provision in the bylaws equivalent to a charter provision. . . . In addition, a supermajority voting requirement for shareholder bylaw amendments may make a staggered board in the bylaws equivalent to a charter provision, which can be such a hurdle to dismantling as to be practically akin to an outright ban.

Id. at 894 n.18 (citations omitted).

16. *Id.* at 894.

17. Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 627 (2003).

18. *See* ROBERT CHARLES CLARK, CORPORATE LAW 576 (1986).

19. Bebchuk et al., *supra* note 5, at 903.

20. *Id.*

21. However, during the 1990s there were three prominent examples to the contrary. Three hostile takeover bids involving Delaware corporations with effective staggered boards (Younkers, Wallace Computer, and Circon) all failed, even though the bidder won the first election and gained a third of the board's seats. Subramanian, *supra* note 17, at 627 n.33. U.S. Surgical Steel made its bid for Circon in August 1996 and won the first election in October 1997, but it was forced to withdraw from the bid in May 1998 when it was taken over by Tyco International, which had a policy against hostile bids. *Id.* Carson Pirie Scott announced its bid for Younkers in October 1994 and elected the first third of the directors in May 1995, but Younkers responded by expanding its board and reelecting the directors who had been voted out. *Id.* Moore announced its bid for Wallace Computer in July 1995 and won the first

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business decisions, it is unlikely that a company will postpone its strategy and sit atop a pile of cash for two years waiting out the election period. Second, the general view is that if a hostile bidder acquired a majority of the shares of the target and won the first election, the remaining board members would probably come to terms with the buyer.[22] By remaining on the board after the first election, the directors potentially hurt their personal reputations because they are basically powerless to prevent the eventual takeover.[23]

Even though staggered boards may not be powerful anti-takeover devices by themselves, with the increased emphasis on corporate governance reform, there is growing opposition by shareholders toward staggered boards, with some even going so far as to press to de-stagger existing boards.[24] As a result of shareholders' increasing awareness of the power of staggered boards and the threat of entrenchment, efforts to classify boards have dwindled since the 1990s.[25]

B. Poison Pills (a.k.a. Shareholder Rights Plans)

1. Overview

Poison pills were developed as a means for corporations to defend against hostile takeover bids by making the cost of the takeover prohibitively expensive and forcing the bidder to work with the target's board to complete the deal.[26] There are two main effects of this defensive mechanism: first, it slows down the hostile takeover process and allows the target board to consider an auction or other options;[27] second, it can be used to

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election in December 1995, but it withdrew its bid in August 1996. *Id.*

22. *See* CLARK, *supra* note 18.

23. Bebchuk et al., *supra* note 5, at 904.

24. *Id.* at 900. McGurn notes:

> The 2002 proxy season was a high watermark [for shareholder actions to repeal classified boards]. Average voting support for the fifty-six proposals that made it to corporate ballots was a whopping 58.1% of the votes cast. Thirty-nine proposals calling for repeal of staggered terms received support from holders of at least a majority of the votes cast at the firms' 2002 annual meetings. A dozen boards witnessed holders of more than half of their companies' shares support the precatory proposals.

McGurn, *supra* note 2, at 840-41 (footnotes omitted).

25. *See* Bebchuk et al., *supra* note 5, at 900. In 1986, there were eighty-eight proposals to classify boards among companies covered by the Investor Responsibility Research Center, while in 2000, there were only ten such proposals. *See id.*

26. MARTIN LIPTON ET AL., MERGERS AND ACQUISITIONS AND TAKEOVER PREPAREDNESS C-I-1 (1995).

27. BRUCE WASSERSTEIN, BIG DEAL–2000 AND BEYOND 791 (2000). For example, in 1989 Coastal Corporation decided to pursue a hostile takeover of Texas Eastern. On January 17, 1989, Coastal made an offer of $42 per share, totaling $2.5 billion. The market bid up the share price to $48. Texas Eastern realized that it could not remain independent, so its board became determined to achieve the highest share price possible. The board kept its poison pill in place but stated that it would be removed on March 15 to allow for an auction. In the end, Panhandle Eastern exceeded Coastal's bid with an offer of $53 cash per share for 80% of Texas Eastern's stock. The poison pill that Texas Eastern had adopted bought enough time to arrange for the auction, which ultimately benefited the shareholders. *Id.* at 795-96.

preclude hostile takeovers altogether.[28] The power of these shareholder rights plans, as they are commonly known, has caused the widespread adoption of these plans in the years since their creation.[29] These plans come in two main varieties: "flip-in" plans and "flip-over" plans.[30] The "flip-in" provision gives target shareholders, other than the hostile bidder, the right to purchase special shares of the company's stock at a discount from market price.[31] The plan is triggered when a hostile bidder acquires 10% to 20% of the company's stock, depending on the plan. The rights are generally issued as a dividend on the common stock, such that they are traded together until the triggering event.[32] Once the triggering event occurs, however, the rights can be traded separately from the common stock.[33] The "flip-in" plan also usually includes an exchange provision that grants the target board the power to exchange one share of common stock for each outstanding right held by shareholders.[34] This would occur after the plan has been triggered and allows the target to continue diluting the hostile bidder's stake but without the costs to the shareholders of exercising their rights.[35] The "flip-over" provision grants shareholders the right to buy shares of the acquiring company at a market discount if the takeover succeeds, thereby diluting the value of the acquiring company if they go ahead with the takeover—the "poison pill" that the bidder must swallow.[36] Due to corporate governance concerns associated with rights plans, some companies have succumbed to investor demands and weakened their rights plans such that they would not apply to an all-cash offer for all of the outstanding shares of the company.[37] While these "chewable pills" may satisfy investors, they are ineffective in most situations and "may create an artificial 'target price' for a company that does not maximize shareholder value."[38]

Generally poison pills have a ten-year lifespan and the renewal of a pill, unless specified in the plan itself, does not require shareholder approval.[39] Some companies choose to make modifications or fundamentally change the structure of the plan when renewal comes due.[40] In contrast to the renewal of a plan is the redemption of a plan—when a company ends the

28. *Id.* at 791.
29. LIPTON ET AL., *supra* note 26, at C-I-1 ("The efficacy of the rights plan has made it a common feature among U.S. corporations. Over 1,700 companies have adopted a rights plan, including approximately half of the Business Week 1000 companies and Fortune 500 companies and approximately two-thirds of the Fortune 200 companies.").
30. *Id.*
31. *Id.*
32. WASSERSTEIN, *supra* note 27, at 795.
33. *Id.*
34. LIPTON ET AL., *supra* note 26, at C-I-2-3.
35. *Id.*
36. *Id.* at C-I-1.
37. WACHTELL, LIPTON, ROSEN & KATZ, TAKEOVER LAW AND PRACTICE 55 (2003) [hereinafter WACHTELL].
38. *Id.*
39. *Id.* at 57.
40. *See id.*

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rights plan. Often the rights can be redeemed by the issuing board at any time before the triggering event for a minute amount, such as $0.02 per right.[41] Some companies redeemed their plans voluntarily after takeover activity cooled in the early 1990s.[42] Other companies, in response to investor pressure, have redeemed their plans after three or four years or have agreed to put the issue to a shareholder vote.[43] Above all, if a board finds a takeover offer acceptable, it has the power to redeem the pill to allow the deal to go forward.

2. *Standard of Review Caselaw Development*

A brief review of the major Delaware caselaw regarding defensive mechanisms is necessary for a full understanding of the current debate over the poison pill/staggered board combination. Central to the debate is Delaware's view of where shareholders fit into the corporate decisionmaking process and the duties that directors owe to shareholders in the hostile takeover context. The following discussion examines five cases that provide guidance on poison pills and the shareholder primacy versus director primacy debate.

In *Unocal,* the Delaware Supreme Court established a new standard of review for defensive mechanisms—an "enhanced scrutiny" analysis.[44] Under this analysis, if the plaintiff shareholder makes a showing that the board adopted a defensive mechanism without shareholder approval, the deference normally given to directors' decisions is suspended and a two-part test is applied.[45] If the board can meet the test, the business judgment rule protection is then restored.[46] Under the first prong of the analysis, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."[47] The second prong of the test is one of balance: "If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the

41. WASSERSTEIN, *supra* note 27, at 794.

42. WACHTELL, *supra* note 37, at 57 ("Time Warner, which had redeemed its rights plan in response to institutional pressure, reinstituted a rights plan with a 15% threshold in response to open market purchases by Seagram.").

43. *Id.*

44. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985). The facts in the *Unocal* case involved the threat of a two-tiered cash tender offer by Mesa Petroleum, the hostile bidder, seeking to gain a majority of shares of Unocal Corporation. *Id.* The first tier was a regular tender offer whereby shareholders could sell their shares to Mesa at the bid price. *Id.* The shares that were not tendered to Mesa after the first round could be exchanged by Mesa for junk bonds in a second round, the second tier of the offer. *Id.* at 949-50. The Unocal board of directors, after consulting with its investment banker, found that the offer was inadequate and coercive. *Id.* at 950-51. The board agreed that if the hostile bidder reached a certain level of ownership, Unocal would make an offer to buy the remaining shares of its own stock from all shareholders except Mesa through an exchange of debt securities. *See id.* at 949-51.

45. *Id.* at 954.

46. *Id.* at 955.

47. *Id.*

directors of the nature of the takeover bid and its effect on the corporate enterprise."[48]

In *Moran*, the Delaware Supreme Court moved to an examination of poison pills, in particular, finding them legal under Delaware corporate law.[49] The court first addressed the plaintiffs' claim that the Household board lacked the authority under Delaware law to adopt a rights plan because Delaware General Corporation Law only authorizes rights plans for corporate finance purposes, not for takeover defense means.[50] The court found that there was no evidence that the legislature meant to limit the scope of 8 Del. C. § 157 (DATE) to only corporate finance, thus the pill could be employed for takeover defense purposes.[51] The plaintiffs' second claim was that the rights plan usurped shareholders' rights to receive tender offers by changing the structure of Household.[52] The court rejected this argument, finding:

> [The poison pill was] not absolute. When . . . faced with a tender offer and a request to redeem the Rights, [the board] will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in . . . originally approving [the poison pill].[53]

In addition, the court found that the rights plan caused little or no change in the governance structure of the company and certainly caused no greater structural change than any other defensive measure the company could have adopted.[54] Because Household's board did have the authority under Delaware law to adopt the rights plan, the court reviewed the board's actions under the *Unocal* standard. Under *Unocal*'s first prong, the court found the board met the standard because it was concerned with the threat of a two-

48. *Id.*

49. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1348 (Del. 1985). Household's board of directors adopted a rights plan that was triggered upon an announcement for 30% of Household's stock or upon the acquisition of 20% of Household's stock by a single entity. *Id.* The plan also had a flip-over provision that allowed rights holders to purchase $200 of the common stock of the acquirer company for $100. *Id.* at 1349. Household's board took this action to prevent future takeover attempts, and the company was not engaged in a takeover battle when the measure was adopted. *Id.* Moran, one of Household's directors, was chairman of a corporation that was interested in possibly acquiring Household, and he filed suit following the adoption of the plan. *See id.* at 1348-49.

50. *Id.* at 1351.

51. The statute provides in part:

> Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to acquire from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

DEL. CODE ANN. tit. 8, § 157(a) (Supp. 2004); *see also Moran*, 500 A.2d at 1351 n.7.

52. *Moran*, 500 A.2d at 1353-54.

53. *Id.* at 1354.

54. *Id.*

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tiered tender offer.[55] As to the second prong, the court found that "the Directors reasonably believed Household was vulnerable to coercive acquisition techniques and adopted a reasonable defensive mechanism to protect itself."[56]

As *Moran* left the *Unocal* approach intact, the question of when a takeover might involve a breach of fiduciary duty received significant attention. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* presented a situation in which the defensive measures taken by a corporation's board crossed the legal line of fiduciary duty.[57] The court found that the Revlon board had instituted the shareholder rights plan in response to Pantry Pride's takeover bid of $45 per share, which Revlon's investment bankers had found to be substantially below value.[58] The board had "protected the shareholders from a hostile takeover at a price below the company's intrinsic value, while retaining sufficient flexibility to address any proposal deemed to be in the stockholders' best interests."[59] Thus, the court found that the board acted in good faith using reasonable investigation in approving the rights plan that was reasonable in relation to the threat posed by the undervalued hostile bid.[60]

The second stage of the defensive plan undertaken by the board in response to Panty Pride's increased bid of $47.50 was the share exchange offer for ten million of its own shares.[61] The court again found that the board acted with reasonable investigation and good faith in approving the plan that was reasonable in relation to the threat posed by the inadequate offer of Pantry.[62] As Pantry increased its bid to $50 and then to $53, however, the Revlon board responded by authorizing management negotiations for a buyout or merger with a third party.[63] The court found this action to be a clear indication that the company was up for sale and breakup was inevitable.[64] This change in status significantly affected the board's duties under *Unocal*: "The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[65] So once it becomes clear to directors, either through their own actions or through the actions of the bidder, that the company will not remain independent, the board cannot continue to posture and hold out; it must work in the shareholders' best interest—either through recommending the hostile bid or through negotiation.

55. *Id.* at 1357.
56. *Id.*
57. 506 A.2d 173 (Del. 1986).
58. *Id.* at 180.
59. *Id.* at 181.
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.* at 182.
64. *Id.*
65. *Id.*

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In *Paramount Communications, Inc. v. Time, Inc.*,[66] the Delaware Supreme Court confronted another question of defensive measures—more specifically, under what circumstances must a board abandon a strategy of growth and development in order for shareholders to recognize an immediate gain.[67] The court began its analysis by stating two key principles of Delaware corporate law: first, the board of directors has a duty to manage the business of the corporation, and this duty "includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability";[68] second, with the exception of those situations set forth in *Revlon*, "a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[69] Under these principles, the court then examined the two instances in which the *Revlon* duties attach to directors. The first situation is when the corporation initiates an auction to sell itself or undertakes a reorganization plan that involves the breakup of the corporation.[70] The second situation is when, in reaction to a bidder's offer, the board seeks out a transaction with a third party that will involve the breakup of the company and the abandonment of the board's long-term strategy for the company.[71] The court made clear, however, that if the board's response to a hostile tender offer is solely defensive and not an abandonment of the corporate existence, then *Revlon* duties do not attach to the board.[72]

In applying the *Unocal* standards to Time's actions, the court explicitly rejected a rigid and narrow interpretation of *Unocal* in which the court effectively substitutes its own judgment for that of the board as to what is the best deal for shareholders.[73] Under a flexible *Unocal* standard, in analyzing the threat posed by a takeover bid, directors may consider the "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders . . . the risk of nonconsummation, and the quality of securities being offered in the exchange."[74] Under the proportionate response prong of the test, Paramount claimed that Time's actions constituted an unreasonable response because Time's shareholders were not given the opportunity to accept the tender offer. The court found that Paramount's claim was "a fundamental misun-

66. 571 A.2d 1140 (Del. 1989).

67. *Id.* at 1149. The case involved the stock-for-stock merger of Time and Warner, which was disrupted when Paramount made an all-cash offer for Time just as Time and Warner were taking their proposed merger to their respective shareholders. *See id.* at 1146-47.

68. *Id.* at 1150.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.* at 1153.

74. *Id.* (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)) (ellipsis in original).

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derstanding of where the power of corporate governance lies."[75] As the court noted in the outset of its discussion, the management of the corporation is delegated to the board of directors, and "[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."[76]

Finally, the *Unocal* standard of proportionate review was refined in *Unitrin, Inc. v. American General Corporation.*[77] In response to a takeover bid by American General, Unitrin enacted various takeover defenses, including a poison pill and a stock repurchase agreement.[78] The court identified three categories of threats that are posed by hostile takeovers: opportunity loss, structural coercion, and substantive coercion.[79] The threat of inadequate price falls under the substantive coercion category. The court found that the chancery court applied the wrong standard, stating:

> [A] court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision. . . . Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.'"[80]

In expanding and clarifying the proportionality review, the court stated that a defensive measure may not be draconian: that is, it may not be preclusive or coercive.[81] Using a colorful analogy, the court stated that the board has a duty to protect the corporation and its shareholders:

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75. *Id.* at 1154.
76. *Id.*
77. 651 A.2d 1361 (Del. 1995).
78. *Id.* at 1376. Unitrin's board found that American General's bid posed two threats (antitrust and inadequate price) that justified defensive actions. The chancery court found that the board acted reasonably in identifying the threats, satisfying the first prong of *Unocal*, but the court found that the share repurchase program failed the proportionality prong of the test because the plan went further than was necessary to protect the Unitrin shareholders. *See id.* at 1375-77. On appeal, the Delaware Supreme Court remanded the decision back to the chancery court with much guidance. *See id.* at 1389-90.
79. *Id.* at 1384. The court defined the three types of threats as follows:

Commentators have categorized three types of threats:

> (i) *opportunity loss* . . . [where] a hostile offer might deprive target shareholders of the opportunity to select a superior alternative offered by target management [or, we would add, offered by another bidder]; (ii) *structural coercion*, . . . the risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions; and (iii) *substantive coercion*, . . . the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value.

Id. (quoting Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153 n.17 (Del. 1989)) (alterations and ellipsis in original).
80. *Id.* at 1385-86 (quoting Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 45-46 (Del. 1994)).
81. *Id.* at 1388.

> When a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders. The fact that a defensive action must not be coercive or preclusive does not prevent a board from responding defensively before a bidder is at the corporate bastion's gate.[82]

Thus, the court remanded the case back to the chancery court with instructions to determine whether the repurchase plan was preclusive, whether the repurchase plan would only inhibit American General's hostile bid, or whether the plan would make the success of American General's proxy fight "mathematically impossible."[83]

II. A DRASTIC REFORM PROPOSAL

In his study of "effective staggered board[s],"[84] Bebchuk focuses on the ballot box "safety valve" that has been established through Delaware jurisprudence and whether that safety valve really exists in the case of an effective staggered board.[85] Bebchuk identifies several impediments to the effective operation of the safety valve, including the delay problem and the two-election problem. Bebchuk argues that the delay imposed on hostile bidders who attempt to acquire targets with effective staggered boards leads many bidders to give up the fight.[86] When a target has a staggered board/poison pill combination, even after winning one proxy contest, a bidder will have to stay in the game for another year until a second annual election will allow it to take control of the board. This gives the target an incentive to stand firm and wait it out instead of immediately capitulating, while the acquiring company must decide whether it can afford to wait or must let the deal die.[87]

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82. *Id.* at 1388. The court continues its corporate protection metaphor:

> [I]f a board reasonably perceives that a threat is on the horizon, it has broad authority to respond with a panoply of individual or combined defensive precautions, e.g., staffing the barbican, raising the drawbridge, and lowering the portcullis. Stated more directly, depending upon the circumstances, the board may respond to a reasonably perceived threat by adopting individually or sometimes in combination: advance notice by-laws, supermajority voting provisions, shareholder rights plans, repurchase programs, etc.

Id. at 1388 n.38.

83. *Id.* at 1388-89.

84. Bebchuk et al., *supra* note 5, at 894.

85. *Id.* at 908. Bebchuk explains the ballot box safety valve as follows:

> In the current legal regime, then, if the board wants to maintain the pill and not sell to a hostile bidder, the only way to gain control passes through the ballot box. The bidder will have to replace the board with one willing to redeem the pill. Such a ballot box victory is required for a bidder whose offer is attractive to shareholders to overcome incumbents' opposition.

Id.

86. *See id.* at 919.

87. *Id.* at 917. If the target has an effective staggered board, it may refuse to submit to the hostile bidder. "The target's share price may increase through the bid price (as was the case with Wallace Computer), a white knight may appear (Younkers), the bidder may lose interest or its ability to pursue the bid (Circon), or other unforeseeable circumstances may intervene . . . ." *Id.* The effective staggered board,

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Closely related to the delay problem, Bebchuk argues, is the two-election problem. When a hostile bidder has to endure only one election to take control of the target's board of directors, the bidder will launch a proxy fight around the time of the election, and concurrently, it will announce the acquisition price such that the stockholders of the target company know exactly what the bidder wants to do with the target going into the election and how much it will pay.[88] When two elections are required, Bebchuk suggests, the bidder is put in an awkward position. Unless the bidder announces an acquisition price at the time of the first election proxy fight, the shareholders are unlikely to vote for the new board; however, if the bidder does announce an acquisition price at the first election, he is locked in for a year and "will be providing the target shareholders with a year-long put option for their shares."[89]

When the delay and two-election problems are combined with the fact that no bidder has ever successfully completed two proxy contests in order to take control of a target, Bebchuk asserts that the ballot box as a safety valve is illusory in situations with effective staggered boards.[90] In order to ensure that the ballot box is a safety valve even in companies with effective staggered boards, Bebchuk proposes a new approach for Delaware courts: "Courts should not allow managers to continue blocking a takeover bid after they lose one election conducted over an acquisition offer."[91] After the incumbent target board loses one election, which is effectively a referendum on the bidder's offer, that board would be required to redeem the poison pill and allow the takeover to proceed.[92]

This proposal claims to have three major advantages. First, Bebchuk argues that the proposal is consistent with the principles of Delaware's takeover jurisprudence.[93] Delaware law has consistently required the availability of a safety valve through the ballot box. Because this safety valve, it is argued, does not exist in the case of effective staggered boards, this proposal brings this situation back in line with existing Delaware law.[94] Under *Unocal*, the defense response must be proportional to the threat posed, but maintaining a poison pill after shareholders have effectively voted against it by supporting the alternate slate of directors is a disproportionate response.[95] Further, under *Unitrin*, the defensive measures must be reasonable and non-preclusive, but Bebchuk asserts that it is clearly unreasonable for a board to maintain a pill after losing an election that was effectively a referendum on the bid.[96] The second advantage claimed is that it does not require action by

therefore, has led to directors no longer resigning after the first proxy contest is lost. *Id.*

88. *Id.* at 920.
89. *Id.*
90. *Id.* at 914.
91. *Id.* at 944.
92. *Id.* at 944-45.
93. *Id.* at 945.
94. *See id.* at 945-47.
95. *See id.*
96. *Id.* at 946.

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the Delaware legislature because it is in line with existing Delaware caselaw.[97] Third, this proposal claims to have a substantial effect on Delaware takeover situations while imposing minimal disruption.[98] The proposal would reinvigorate the ballot box safety valve and ensure that the board cannot pursue a course of action in the takeover context unless it has the support of its shareholders.[99]

In a subsequent publication, Bebchuk refined his proposal into that of a standard:

> [C]ourts should give much weight in deciding whether a pill should be maintained to whether or not there has been a shareholder vote. If such a vote has been cast and lost, . . . there should be a strong judicial presumption that maintaining the pill would be disproportionate or preclusive. But even under [this new, clarified] proposal, the target board should have an opportunity to persuade a court that its reasons for maintaining a pill were justified by unusual facts or circumstances.[100]

Bebchuk refined his proposal after criticism that there are situations in which the court should not force the redemption of the pill following the loss of an election, such as when a new bidder enters the scene immediately after the vote, or the court discovers that the bidder had lied about its financing or the health of its business.[101] Before and after this refinement, however, Bebchuk's proposal has been the subject of intense criticism. This Comment, for the reasons explained below, shares such skepticism.

III. THE PILL SHOULD BE SAVED

A. *Director Primacy is the Preferable Corporate Decisionmaking Model*

A fundamental battle in corporate law jurisprudence exists between shareholder primacy and director primacy. Investor representatives and corporate governance reform advocates seek to place more of the decisionmaking authority in the hands of shareholders, while other scholars, business leaders and management consultants seek to allow the board of directors to retain fundamental control over the decisions of the corporation, while acting in the best interest of the shareholders. This overarching corporate law policy question has spilled into the debate over poison pills and when corporations should be allowed to maintain defensive measures in the face of a takeover bid that is supported by the target's shareholders. This Comment

97. *Id.* at 947.
98. *Id.*
99. *Id.* at 948.
100. Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 910 (2002).
101. *Id.*

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concludes that directors, while under a fiduciary duty to their shareholders, should be given the ultimate decisionmaking authority in the takeover context.

The director primacy model detailed by Professor Stephen Bainbridge offers a sharp contrast to Professor Bebchuk's model of shareholder decisionmaking. The premise behind his model is that the firm has a nexus of contracts with individuals and entities—of which shareholders are only a subset—which is managed by the board of directors.[102] The director primacy model "accepts shareholder wealth maximization as the proper corporate decisionmaking norm, but rejects the notion that shareholders are entitled to either direct or indirect decisionmaking control."[103] This theory asserts that the centralized decisionmaking ability given to the board—the fiat—is the vital element of an effective and efficient corporate governance philosophy.[104] Bainbridge argues that there is an inherent tension between authority and accountability under the director primacy model—when shareholders provide capital to a corporation they implicitly contract for the directors to pursue shareholder wealth maximization.[105] Thus, the limits placed on the board's actions are accountability measures derived from the contract between shareholders and the corporation and by common law fiduciary duties, not a manifestation of shareholder primacy. However, any accountability measures imposed on the board inevitably decrease the board's decisionmaking authority.[106] It is this tension between accountability and authority, where the court draws the line, that threatens the efficient management of a corporation.[107] As the non-reviewable decisionmaking authority of the board is reduced, the increased shareholder activism "contemplates that shareholders will review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel. . . . [G]iving investors this power of review differs little from giving them the power to make management decisions in the first place."[108]

Bainbridge argues that while Delaware courts have not explicitly endorsed the director primacy model, the courts' decisions in takeover cases are more easily explained under that model than under the Bebchuk share-

102. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547, 560 (2003). Bainbridge explains the nexus of contracts idea as follows:

> [W]e can think of the corporation as a vehicle by which the board hires capital by selling equity and debt securities to risk bearers with varying tastes for risk. The board of directors thus can be seen as a sort of Platonic guardian—a *sui generis* body serving as the nexus for the various contracts making up the corporation and whose powers flow not from shareholders alone, but from the complete set of contracts constituting the firm.

Id.

103. *Id.* at 563.

104. Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 795 (2002).

105. *Id.* at 805.

106. *Id.*

107. *Id.* at 807.

108. *Id.*

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holder model. First, while Bebchuk proposes a rule that courts should require a board to redeem the pill after the loss of one election, as discussed above, Delaware prefers standards to rules, which is consistent with the view that directors decisionmaking authority should not be subject to review unless certain factors are present.[109] Bainbridge finds that Delaware takeover law is based on three central assumptions: an understanding that a conflict of interest may arise when a target board resists a takeover bid, an understanding that judicial review of board decisions can undermine the board's decisionmaking authority, and an attempt to find a middle ground in the accountability versus authority conflict.[110] This balance between accountability and authority has resulted in the reasonableness standard, whereby a board's decisionmaking process and resulting actions are judged on a case-by-case basis.[111] This case-by-case analysis allows for the examination of the board's motive for its decision, an examination that is not feasible were the court to apply a rule as Bebchuk advocates.[112] The reasonableness standard is more exacting than the traditional business judgment rule because of the potential for conflicts of interest, yet it recognizes and even endorses the board's broad decisionmaking authority by refusing to substitute the court's judgment for that of the board so long as the decision was within the range of reasonableness.[113] This standard, while infringing on the board's authority to some extent, is certainly more deferential to the board and in line with the director primacy jurisprudence than Bebchuk's rule.[114] The situation boils down to "a very basic question: Who decides? [Bainbridge's] answer is: The board decides. Delaware's post-*Unocal* standard of review is consistent with that basic proposition."[115]

B. *What Makes This Situation Special?*

A central question arises after entertaining Professor Bebchuk's proposal: What makes the decision to redeem a poison pill, or more broadly the decision to allow a takeover to occur, different from other major decisions when shareholders want a change in corporate policy but must wait two election cycles to get the directors they want? In a response to Bebchuk's proposal, Delaware Vice Chancellor Leo Strine asked just this question.[116] He presents the example of a company in which the board decides to expand the business line and change the company's name. The corporation has a nine-member staggered board. A large shareholder decides that the changes

109. *Id.* at 814.
110. *Id.* at 815.
111. *Id.* at 816.
112. *See id.* at 816-17.
113. *Id.*
114. *Id.* at 817.
115. *Id.* at 818 (footnote omitted).
116. Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 STAN. L. REV. 863, 866-68 (2002).

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are a bad idea and launches a proxy fight to elect a slate of three directors that will vote to reverse the changes. The annual election effectively becomes a referendum on the changes, and the shareholder's slate is elected. When the three new directors are unsuccessful in getting the other six directors to vote to revoke the changes, they file suit, claiming that the other directors breached their fiduciary duties because the shareholders, through the proxy contest and referendum, supported the revocation of the changes. As Strine notes, the business decisions involved in this example could have an equivalent impact on shareholder wealth as a decision to accept or reject a takeover bid.[117] Yet, "[b]y statute, the board—and not the stockholders—manages the corporation and makes these strategic decisions. Until the stockholders can elect a new board majority that actually changes corporate policy, they must live with the strategy pursued in good faith by the incumbent board majority."[118]

This example illustrates the fundamental conflict that Bebchuk's proposal presents. Where do you draw the line between a shareholder decision and a director decision? Although there are many decisions that a board can make that will have great impact on the corporation and its shareholders, Bebchuk chooses the takeover decision as the dividing line. Delaware has created a statutory system of corporate governance that gives directors the power to manage the corporation and make the strategic decisions, but under the Bebchuk proposal, there would be a carve-out where this statutory scheme would not apply. Bebchuk does not adequately set forth a rationale for why the decision to redeem the pill deserves special treatment apart from other fundamental policy and strategy decisions of the board that would not get special treatment.

The basic argument is that the directors are breaching their fiduciary duty if they fail to redeem the pill after the incumbent slate loses a proxy election which effectively serves as a referendum on the issue. Bebchuk argues that to maintain the pill would be unreasonable in this situation.[119] If this is the case, then activist investors can make the case that this should be the standard of review for any corporate decision. If a classified board makes a decision that the shareholders do not like, as long as the shareholders can win a proxy contest to elect a minority of directors, the board must change its decision. Instead of a business judgment rule, there would effectively be a shareholder ratification rule; if a proxy contest became effectively a referendum on a board decision and the incumbent board lost, then the board's decision loses as well. While this scenario is unlikely to occur anytime soon, the point is that Bebchuk's argument gives no reason *why* it should happen. There is no basis offered upon which to limit shareholder primacy to just the takeover situation, versus opening up all major board decisions to shareholder review and change. Shareholders can currently turn

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117. *Id.* at 868.
118. *Id.* (footnote omitted).
119. *See supra* Part II.

a proxy contest into a vote of confidence in the board or a vote on a certain decision, but until the shareholders can elect a majority of directors that agree with their position, the existing board decision remains. A majority of the board must make the decision, not a majority of the shareholders.

C. *The Current Approach Protects Shareholders*

The intermediate scrutiny analysis developed under *Unocal* protects shareholders by preventing a board from arbitrarily resisting a takeover. While most board decisions are analyzed under the business judgment rule, the lowest level of scrutiny, the Delaware courts have decided that because of the inherent tension involved in the employment of a defensive measure—tension between the board maximizing shareholder wealth and the board members holding on to their jobs—heightened judicial scrutiny should apply to these situations. While Bebchuk argues that the current situation harms shareholders in that bidders are forced to endure delays and the two-election problem, the *Unocal* test ensures that, although the takeover process may be slowed, the board is acting to protect shareholders. Before the board can implement or continue to employ a defensive measure, it must have sufficiently studied the situation and found that a threat to the corporation *and the shareholders* exists and that the defensive measure to be taken is proportional to the threat presented.[120]

Further, the adoption of a poison pill does not, in any way, relieve the board of its fiduciary duties to the shareholders. In fact, it is more likely that the drastic reforms proposed for the poison pill would actually lead to the board violating its fiduciary duty by preventing it from protecting shareholders from inferior proposals. Fiduciary duties are a key check on the powerful force of a poison pill. As noted above, there is an inherent tension between a board acting in the best interest of shareholders and the board pursuing self-interested ways to save their jobs. Under the *Unocal* analysis, the court will look first to ensure that the board actually found that there was a threat to the corporation and that the adoption was not just the self-interested action of the board.[121] Even if there was a threat, the response must not harm shareholders—it must not be more than a proportionate response. This scrutiny works to ensure that the board continues to abide by its fiduciary obligations. When the board is faced with a tender offer and must decide whether to redeem the rights plan, the board cannot arbitrarily reject the offer. The same fiduciary duty to the shareholders in effect at the time the pill was adopted also applies in the decision to maintain or redeem the pill.[122] As Mark Gordon explains:

120. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985).
121. *See id.*
122. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985).

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> [T]akeover defenses, including [effective staggered boards], are tools that a board may or may not employ when confronted with a takeover attempt, but they do not determine *how* a board should act in any particular circumstance, and they do not relieve a board of its obligation to act in the best interests of stockholders. Delaware law says directors *can* "just say no" if they believe doing so is in the best interests of stockholders, but it does not say that they *should* "just say no" in every circumstance just because they can.[123]

While there may be delays and inconveniences to the hostile bidder and the shareholders due to the board's use of a pill, shareholders are not at the mercy of an arbitrary and capricious board of directors. The language of *Unocal* and *Moran*, and long-established fiduciary duties are all intertwined in the intermediate scrutiny that a Delaware court undertakes when evaluating a defensive measure, which ensures that shareholders are protected. Under Bainbridge's director primacy model, which suggests maintaining the status quo on this intermediate scrutiny, shareholders get the benefits of the poison pill along with the assurance that there are sufficient checks on the board's power to prevent the pill's abuse.[124]

One of the key justifications of the poison pill is that it forces a hostile bidder to deal with the target board directly instead of trying to go straight to the shareholders. The ultimate goal for the target board is, theoretically, to maximize shareholder wealth through either obtaining the highest price from the bidder, finding a white knight[125] that will be even better, or convincing the shareholders that current management can do better than either of the other two options. The director primacy model protects shareholders by forcing the bidder to deal with the board, which can act as a negotiator for the shareholders. As Mark Gordon, a mergers and acquisitions practitioner at Wachtell, Lipton, Rosen & Katz noted, the effect of Professor Bebchuk's proposal would be thus:

> [It] would essentially require the board to accept a deal at whatever price the raider had put on the table at the time of the stockholder vote[. His proposal] does not appear to be particularly well designed to maximize returns to target stockholders, and may in fact be a significant step in the wrong direction."[126]

123. Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 830 (2002) (footnote omitted).
124. *See supra* Part III.A.
125. A "white knight" is "a friendly corporate acquirer who 'saves' a takeover target from a hostile suitor, usually by buying a controlling interest in the company or buying the company itself." STANLEY FOSTER REED, THE M&A DESKBOOK 348 (2001).
126. *Id.* at 836.

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Therefore, the board would no longer be able to act as a negotiator for shareholders if it was forced to redeem its pill as soon as shareholders consented to the takeover.[127]

Under the director primacy model, directors can utilize the poison pill as a way to extract a higher premium for the target company. If there is a proxy contest and the one-third of the incumbent board is replaced, the target board could then give the hostile bidder the option to either raise its bid, in which case the target board agrees to support the takeover, or wait another year until the next annual election to take control of the board. The cost of having to wait another year to complete the takeover might very well induce the bidder to increase its price substantially in order to get the deal done now. A real life example of this phenomenon can be seen in Weyerhaeuser's year-and-a-half struggle to takeover Willamette.[128] In November 2000, Weyerhaeuser made an offer for Willamette at $48 per share. This bid was increased to $50 a share, and in May 2001, Weyerhaeuser conducted a proxy contest and removed one-third of the Willamette board. The remaining incumbent directors persisted in their opposition to the bid but ultimately agreed to a deal at $55.50 per share in January 2002. Through this effective use of the defensive measures, the target board was able to ultimately extract a 16% premium over Weyerhaeuser's first bid and $5.50 more per share than what the shareholders implicitly agreed to during the proxy contest.[129] Had the Bebchuk proposal been in effect, the takeover struggle would have ended in May 2001 with shareholders receiving more than $5 per share less than they would have received just a few months later. Removing this protection, as Bebchuk would do, defeats a key purpose of the poison pill and removes a vital tool for maximizing shareholder wealth from the directors.

The Delaware Supreme Court's recognition of substantive coercion as a justifiable threat in *Unitrin* demonstrates a further way in which poison pills protect shareholders. As defined by the court, substantive coercion is "'the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value.'"[130] The court recognized that the board has a right to protect shareholders from making the wrong choice in a takeover bid.[131] As Martin Lipton has noted, the court's recognition that a board of directors "can respond to the threat of 'substantive coercion' is essentially a recognition that shareholders may 'get it wrong' because information about a company's value may not either be fully available or fully understood by all shareholders, and that avoiding such a result is an appropriate goal for directors."[132] Though the argument

127. *Id.*
128. *Id.* at 834-35.
129. *Id.*
130. Unitrin v. Am. Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995) (quoting Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990)).
131. *See id.* at 1384-86.
132. Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27

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can be made that the court's recognition of substantive coercion greatly decreases shareholder choice, as seen in the Weyerhaeuser-Willamette example, shareholders sometimes do make the wrong choice, or more frequently, make their choice too early. By recognizing substantive coercion as a threat, Delaware has empowered the board to try to prevent shareholders from tendering their shares at an inadequate price. By delaying the bid, the board can negotiate or strong-arm the hostile bidder into raising its offer price such that the board fulfills its duty to maximize shareholder wealth. Vice-Chancellor Strine summed up the importance of substantive coercion as follows:

> [T]he substantive coercion doctrine gave the Delaware courts a method of reconciling the Delaware approach of giving a strong hand to directors, with the principle that the primary duty of corporate directors is to advance the best interests of stockholders. . . . Substantive coercion thus provided a stockholder-focused rationale . . . for upholding the primacy of decisionmaking by directors . . . , even in the tender offer acceptance context.[133]

Were the courts to adopt Professor Bebchuk's proposal, the board would be unable to protect shareholders from substantive coercion because they would be required to let the takeover proceed immediately after the proxy fight. There could be no stalling, no negotiation, and no arm twisting by the board to try to extract a higher and more adequate price for shareholders. The current approach protects shareholders in a way that the Bebchuk proposal cannot.

D. The Director Decision Model Is Consistent with Delaware Jurisprudence

Delaware jurisprudence favors director primacy in terms of the definitive decisionmaking power, while simultaneously requiring directors to be ultimately concerned with the shareholders' interest.[134] Beginning in *Unocal,* the court has tried to balance the competing director and shareholder interests.[135] The resolution in *Unocal* was the creation of the intermediate scrutiny standard of review, whereby directors were given the ultimate decisionmaking authority and great deference so long as they acted in good faith and responded in a proportionate manner to the threat.[136] The court further endorsed this view in *Moran* when it passed favorable judgment on the use of the poison pill so long as the board could withstand the *Unocal* intermediate scrutiny. The Delaware jurisprudence, while not explicitly affirming

DEL. J. CORP. L. 1, 29 (2002).

133. Strine, *supra* note 116, at 876.

134. *See supra* Part III.A.

135. *See supra* Part I.B.2.

136. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985).

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"director primacy," does implicitly leave the directors to make decisions with shareholders expressing their views only in specific and limited situations.[137] As Professor Gilson has noted, "'[s]hareholder choice' is not a paramount value in Delaware. . . . There is one critical place in the statutory scheme for 'shareholder choice[,]' as both *Unocal* and *Household* pointed out. 'Shareholder choice' is exercised in elections for corporate directors . . . ."[138] As the court stated in *Unocal*, "[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out."[139] Shareholder primacy is the exception, not the rule.

Further, Delaware jurisprudence has emphasized that a board must not depart from a long-term business strategy in order to satisfy shareholder short-term wealth. As seen in *Time*, Delaware has recognized the responsibility of the board to direct the long-term strategy of the company and ensure long-run returns for shareholders.[140] The court found that the board's duty "includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability,"[141] and, with the exception of those situations set forth in *Revlon* when a company is put up for auction, "a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[142] As emphasized in this case, Delaware jurisprudence recognizes that the board is charged with setting corporate policy and directing the long-term growth of the company, including in the takeover and merger context. Thus, boards of directors are not beholden to the short-term whims of shareholders, and directors are not required to subordinate the long-term growth of the company and long-term interests of investors to the short-term desires of shareholders for a takeover.[143]

The line of cases from *Unocal* through *Unitrin* demonstrates that Delaware jurisprudence recognizes that the board must make the ultimate decisions, including in the takeover context.[144] While shareholders are given a voice in some contexts, such as approving a merger or sale of a large portion of a company's assets, the board ultimately guides and directs the corporation through these fundamental issues. The approach suggested by Professor Bebchuk would be a marked and unwarranted departure from this deference to the directors. It would take the ultimate decision on the takeover away from the board and give it to the shareholders because once the shareholders replaced a portion of the incumbent board in a proxy contest,

137. *See supra* Part I.B.2.
138. Lipton, *supra* note 132, at 27.
139. *Unocal*, 493 A.2d at 959.
140. *See* Paramount Commc'ns, Inc., v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989).
141. *Id.*
142. *Id.*
143. *See supra* Part I.B.2. (discussing *Paramount*, 571 A.2d 1140).
144. *See supra* Part I.B.2.

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the board would be forced to redeem the pill and let the takeover go through. They would not have the ability to stop the takeover. Even if the board was acting reasonably, proportionately, and in the shareholders' best interest in opposing the takeover, Bebchuk's approach would require the board to let the takeover occur and effectively put aside their fiduciary duties to the corporation and its shareholders. That approach is inadvisable and incompatible with the well-developed and long relied upon corporate law policies of Delaware.

CONCLUSION

A shareholder vote to replace one-third of a company's directors should not force the redemption of that company's poison pill. Although the staggered board/poison pill combination provides a powerful anti-takeover defense, this great power is not boundless. While the Delaware courts have sanctioned this combination, the board must still fulfill its fiduciary obligation to the shareholders. While directors may act to protect the long-term strategy of the corporation, even if that means sacrificing short-term gain to shareholders, defensive measures that are draconian or serve only to entrench the directors will not be upheld by the courts. Despite these inherent protections and limitations of the poison pill/staggered board, Professor Bebchuk has proposed a rigid rule that would effectively gut the poison pill's effectiveness as a takeover device. The proposal would create a judicial carve-out for hostile takeover situations that is unnecessary and unjustified. The proposal would take away the right of a company to employ a valid and legal defensive measure that protects shareholders. Most troubling, Bebchuk's proposed rule would take the decisionmaking power away from the board of directors and place it in the hands of shareholders, giving them the power to decide the fate of the company through only one election, despite the company's use of a staggered board and poison pill. For these reasons, Delaware should reject the Bebchuk proposal and continue to follow the director decisionmaking model.

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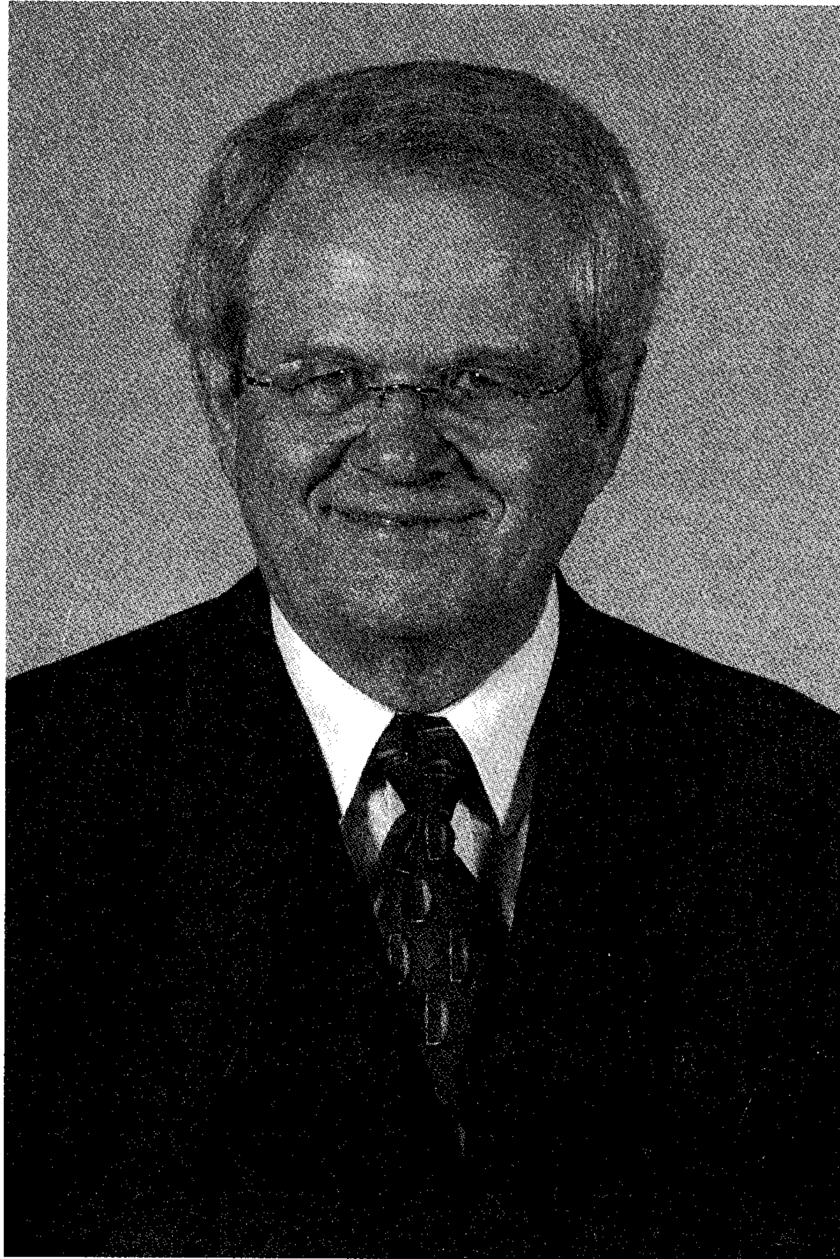

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