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**Lipton and Rowe's Apologia for Delaware:  
A Short Reply**

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## Lipton and Rowe's Apologia for Delaware: A Short Reply

Ronald J. Gilson\*  
(December, 2001)

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I am flattered that Martin Lipton and Paul Rowe have written so lengthy and thoughtful a response<sup>1</sup> to my reprise of the fifteen-year history of *Unocal*.<sup>2</sup> Martin Lipton has a strong claim to having devised the most important innovation in corporate law since Samuel Dodd invented the trust for John D. Rockefeller and Standard Oil in 1879.<sup>3</sup> Paul Rowe is an active and experienced practitioner who has also contributed to the debate over Delaware takeover law. Thus, if nothing else, it is an enormous, if perhaps somewhat backhanded, compliment<sup>4</sup> that they thought my essay had sufficient potential for influence to warrant their substantial effort to challenge it.

To set the stage for purposes of this short reply, my essay offered a respectful, but in the end quite negative, assessment of the Delaware Supreme Court's post-*Unocal* effort in trying to walk a middle road between managerialists like Mr. Lipton, who thought defensive tactics in tender offers were properly reviewed under the business judgment rule, and those, mostly academics, who thought that the ultimate decision concerning a tender offer belonged to the shareholders. This middle road – the *Unocal* intermediate standard -- contemplated a regulatory role for the courts in that they would

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\* Charles J. Meyers Professor of Law and Business, Stanford University, and Marc and Eva Stern Professor of Law and Business, Columbia University. I appreciate the editors of the Delaware Journal of Corporate Law giving me the opportunity to offer this reply. I am also grateful to William T. Allen, Jeffrey Gordon and Michael Klausner for helpful comments on an earlier version.

<sup>1</sup> Martin Lipton & Paul K. Rowe, Pills, Polls and Professors: A Reply to Professor Gilson, \_\_ Del. J. Corp. Law \_\_ (2002)(hereinafter referred to as "A Reply to Professor Gilson").

<sup>2</sup> Ronald J. Gilson, *Unocal* Fifteen Years Later (and What We Can Do About It), 26 Del. J. Corp. L. (4912001)(hereinafter referred to as "*Unocal* Fifteen Years Later").

<sup>3</sup> See Ron Chernow, Titan 224-225 (1998).

themselves determine whether a particular defensive tactic was reasonable in relation to the threat, if any, posed by the offer. In *Unocal Fifteen Years Later*, I argued that the Supreme Court's subsequent development of the intermediate standard, culminating in *Unitrin*,<sup>5</sup> has devolved into an unexplained preference that control contests be resolved by elections rather than through the market. Unless a successful proxy fight by the bidder to remove the incumbent board "would either be mathematically impossible or realistically unattainable,"<sup>6</sup> it appears that the board may decline to redeem a poison pill and thereby prevent shareholders from having the opportunity to accept a tender offer. I suggested that the Court's path was set by a well meaning but, with the benefit of hindsight, plainly incorrect fear that the hostile takeovers represented a macroeconomic threat, and that, correctly in this respect, only the Delaware courts were in a position to act.

Fifteen years of experience, as exemplified by *Unitrin*'s unexplained electoral bias, counsels in favor of repositioning Delaware takeover law for the future. To that end, I offered a quite modest proposal. I did not suggest overturning *Household International*'s validation of a board's power to adopt a poison pill, nor did I suggest that the Delaware Supreme Court recant its post-*Unocal* doctrine. Rather, I recommended only that shareholders be allowed to amend or repeal an existing poison pill by adopting a bylaw to that effect.

Lipton and Rowe rather exaggerate the impact of this proposal. "If shareholders can tell the board that directors' fiduciary duties do not allow for adoption of a pill,"

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<sup>4</sup> Thus the tone of my response will reflect that compliment, and largely (but not completely) ignore the hyperbole that from time to time appears in the Lipton & Rowe essay.

<sup>5</sup> *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

<sup>6</sup> *Id.* at 1388-89.

Lipton and Rowe inform us, “then there is nothing left of the teaching of *Unocal*, *Household*, and *Quickturn* ... .”<sup>7</sup> For better or worse, however, sanctioning a shareholder-adopted bylaw to amend or redeem a pill hardly puts Humpty Dumpty back together again. Repealing *Household International* would require the board to secure shareholder approval before adopting a pill. My modest proposal leaves board adopted pills (and the Supreme Court’s unfortunate post-*Unocal* jurisprudence) in place, except in those circumstances when shareholders overcome the not insubstantial costs of defeating management in a proxy contest over adopting the redeeming bylaw. This hardly merits Lipton and Rowe’s characterizing it as the “wholesale rejection of the framework of Delaware law regarding takeovers.”<sup>8</sup>

But whether my proposal is modest or downright subversive, Lipton and Rowe certainly offer a different view of the doctrinal history, and a rather different assessment of the role of takeovers in corporate governance. Quite plainly, they have sought to offer the reasoned analysis of how the Delaware Supreme Court got to *Unitrin* that the court has not itself provided. Readers can assess our competing accounts of Delaware takeover doctrine without further assistance from any of the authors.

What does warrant further comment, however, are three themes that animate Lipton and Rowe’s argument. The first is that affording shareholders a primary role in the governance of takeovers depends on an unequivocal commitment to the stock market’s informational efficiency. The second is that allowing shareholders to repeal a poison pill ignores empirical evidence showing that the adoption of a pill increases takeover premiums. The third is that the Delaware General Corporation Law (“DGCL”),

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<sup>7</sup> A Reply to Professor Gilson, at 3.

<sup>8</sup> *Id.* at 1.

although silent with respect to target directors power to block offers not directed to them, nonetheless incorporates an unstated meta-principle that privileges directors over shareholders with respect to all forms of takeovers. Part I of this reply takes up Lipton and Rowe's misunderstanding of the role of market efficiency in the shareholders' role in assessing the governance of takeovers. Part II takes up the poison pill issue, suggesting that the pill is itself an empty vessel whose impact, transactionally and on share prices, depends on what standard governs its redemption. Finally, Part III complicates Lipton and Rowe's neat construction of the DGCL as reflecting an unstated meta-principle that allocates control over takeovers to management.

### **I. Market Efficiency and the Corporate Governance of Takeovers**

The most puzzling aspect of Lipton and Rowe's criticism of my assessment of Delaware takeover law is their sharp focus on market efficiency. This concept, in their view, seems to separate the forces of darkness and light: "[o]n the one side are the partisans of efficient market theory. ... On the other side are a variety of other participants in the debate, who do not accept the efficient market theory as the only, or the best, guide for corporate law decision making."<sup>9</sup> Lipton and Rowe then complete their syllogism by arguing that efficient market theory has been discredited of late and, therefore, so too has the position of those who view shareholders as the ultimate decision makers in tender offers. The problem with this neat two-step is that it misstates the role of market efficiency in the analysis and, I think, also misstates or misunderstands the impact of recent criticism of market efficiency on the corporate governance role of takeovers.

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<sup>9</sup> Id. at 2. Elsewhere, Lipton and Rowe identify "the primacy of the outcomes defined as optimal by the efficient market theory" as one of the "false premises" underlying my theses. Id. at 23.

The role of takeovers in corporate governance is by now a familiar story. Some forms of corporate underperformance may prove difficult to remedy internally. The product market often does not act with sufficient speed or intensity to police poor strategy or implementation. As well, the need for industry-wide restructuring – as, for example with the failure of the conglomerate experiment – may be difficult to perceive from within the industry and the corporation. Under these circumstances, traditional legal rules are ill suited to resolve concerns about these kinds of underperformance. Courts cannot distinguish with precision whether underperformance results from bad luck on the one hand, or bad judgment on the other. The business judgment rule properly serves to allocate that assessment to the market.<sup>10</sup> If underperformance persists, the value gap may come to exceed the costs of mounting a hostile tender offer. The issue of defensive tactics arises in this context. Target management's efforts to block a takeover may reflect a good faith effort to secure a better price for shareholders, or it may reflect entrenchment, a preference of target management to maintain the status quo.

So far, we have only an agency problem. Market efficiency now comes into play in two different ways. First, one might take the position that the target company's current market price is a sufficiently good metric of the company's value that even a very small premium is an advantage to target shareholders. In this view, advanced originally by Judge (then Professor) Frank Easterbrook and Professor Daniel Fischel, one could argue that target management should be entirely passive in the face of a hostile tender offer, foregoing even an effort to secure a better price.<sup>11</sup> From the perspective of target

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<sup>10</sup> This analysis is developed in Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Takeovers, 33 Stan. L.Rev. 819 (1981).

<sup>11</sup> Frank Easterbrook & Daniel Fischel, The Proper Role of a Target's Management in Responding to a Takeover, 94 Harv. L.Rev. 1161 (1981).

company shareholders, this argument places significant reliance on the target company's stock price being an accurate measure of value because the attractiveness of a small premium is sensitive to small differences in underlying value.

In contrast, one might take the position that target management should be permitted to deploy defensive tactics to provide sufficient time to secure a better offer or to persuade shareholders that remaining independent would result in greater long term value. This position recognizes that share prices may not reflect information known only within the corporation and that target management can enhance the corporation's share price by disclosing that information. It further recognizes that management can use delay to negotiate a higher price for shareholders or to attract a competing bid. In the end, however, shareholders would decide whether to accept the offer.<sup>12</sup> This position is significantly less dependent on the relative degree of market efficiency, because the process of seeking an alternative offer and informing shareholders of previously private information will improve the market's pricing. I should also note a point to which I will return shortly. This position is not inconsistent with Mr. Lipton's poison pill.<sup>13</sup> Indeed, the pill is an effective way of securing sufficient time for management to seek out an

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<sup>12</sup> See, e.g., A Structural Approach to Corporations, supra note 10. The *Interco* standard reflects a similar allocation of role. The difference between these two positions is substantial – can target managers seek to increase value for shareholders or must they be completely passive? It generated a long running argument between Easterbrook & Fischel and Alan Schwartz, on the side of passivity, and myself and Lucian Bebchuk on the side of active but non-defensive target management activity. For a sense of the debate, compare Easterbrook & Fischel, supra note 11, Frank Easterbrook & Daniel Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982), and Alan Schwartz, Search Theory and the Tender Offer Process, 2 J.L.Econ. & Org. 229 (1986), with Ronald J. Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L.Rev. 51 (1982), Lucian Bebchuk, The Case for Facilitating Competing Tender Offers, 95 Harv. L.Rev. 1028 (1982), Lucian Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension, 35 Stan. L.Rev. 23 (1982)

<sup>13</sup> Lipton & Rowe complain about the labeling of Lipton's innovation with the term "poison pill." They prefer "Shareholders' Rights Plan." It is hard to see how this label is more descriptive, especially since the thrust of their position in this debate is that shareholders should not have the "right" to forgo a shareholders' rights plan. See Ronald J Gilson, Just Say No to Whom?, 25 Wake Forest Law Review 121 (1990).

alternative bid or communicate with shareholders. The position is inconsistent only with Mr. Lipton's preferred construction of the pill – that the pill allows blocking shareholders from *ever* having the opportunity to accept the offer.

It is at this point that agency theory and market efficiency intersect. Management may have nonpublic information concerning the value of the corporation that convinces them that the tender offer price is too low. Nothing in efficient market theory is inconsistent with this circumstance. The shareholder choice position does not depend on the stock market being *strong* form efficient; i.e., that share prices reflect information that only management knows.

That leaves us with a balance. On the one hand, as Lipton and Rowe want to emphasize, management may know something that the market doesn't. On the other, as they are inclined to ignore, management may resist a tender offer out of either self-interest or error. How do we trade off the absence of strong form market efficiency – the reason for giving management discretion – and the potential for agency costs, the reason for restraining discretion? The shareholder choice position gives target management the opportunity to reduce the informational inefficiency by seeking alternatives and by making disclosure. Lipton and Rowe's position leaves the agency cost problem untouched and without doing anything about the claimed mispricing of a target company's stock.

Neither Lipton and Rowe's position nor my shareholder choice position perfectly solves both problems. Target management may be right that long-term value is maximized by independence even though it cannot credibly demonstrate it.

Alternatively, shareholders may be better off accepting the offer because management's opposition is in error or is self-interested. How do we choose the best rule for target shareholders?

The question can be posed empirically. Take two samples: one composed of companies that successfully defeated hostile tender offers and remain independent; the second composed of companies that either were taken over by the initial bidder or secured a better offer. Lipton and Rowe's managerialist position would find support if returns to shareholders of the "stay independent" sample exceed those of the "taken over" sample. Alternatively, the shareholder choice position finds support if returns to shareholders of the "taken over" sample are higher.

Lipton and Rowe should find this framing of the issue familiar. In Lipton's 1979 article, he undertook a similar empirical test, announcing that a "quasi-*stay independent*" sample experienced greater returns: better than "50% of the targets are either today at a higher price than the rejected offer price or were acquired after the tender offer was defeated at a price higher than the offer price."<sup>14</sup> The problem was that Lipton's sample included companies that were subsequently acquired at a higher price not long after blocking the hostile offer – an outcome entirely consistent with a shareholder choice regime. If instead one focuses on the subsequent share values of only those companies in Lipton's sample that remained independent, his data reveal that target shareholders who continued to hold their shares as a result of management's preventing them from tendering in the hostile offer earned an average compounded rate of return on the money that would have received had they been allowed to tender of negative 5.48

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<sup>14</sup> Martin Lipton, *Takeovers in the Target's Boardroom*, 35 *Bus. Law.* 101, 106 (1979).

percent. This is hardly a testimonial to the value of target management's private information.<sup>15</sup>

A more recent example of just this phenomenon is set out in Figure One (although it is only one data point it is a familiar one) – the impact on shareholders of Time Inc.'s ability to stay independent as a result of the Delaware Supreme Court decision that Paul Rowe has described as “a promise to corporate America.”<sup>16</sup> Figure One compares actual post-transaction returns to Time shareholders with the returns they would have had if they had been allowed to accept Paramount's \$200 per share offer and invested the proceeds in either the less risky New York Stock Exchange index or in a debt instrument paying 10 percent. It took eleven years for Time shareholders to get even for the first time, although this condition did not last. Time shareholders were not wrong in preferring the Paramount offer.

[Figure One here]

This analysis suggests that agency cost problems in takeovers are more serious than problems of strong form market inefficiency. This is hardly surprising because a shareholder choice regime acts to constrain the extent of market inefficiency while the Lipton and Rowe position does nothing to alleviate the agency cost problem.<sup>17</sup>

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<sup>15</sup> Gilson, A Structural Approach to Corporations, supra note 10.

<sup>16</sup> Paul K. Rowe, The Future of the “Friendly Deal” in Delaware (unpublished paper, 2001)

<sup>17</sup> Of course, it need not have worked out that way. If one makes strong enough assumptions, any result is possible. For example, Andrei Shleifer and Robert Vishny recently offered a model in which takeover

There is no need to go into detail here in responding to Lipton and Rowe's misstatement of the empirical evidence on takeovers. For present purposes it is sufficient to note that the most recent and extensive empirical investigation, which takes into account the econometric lessons learned from earlier studies, supports the proposition that takeovers result in net shareholder gains, with the lion's share of the gain going to target shareholders. I am aware of no study that shows other than large positive gains to target shareholders from takeovers.<sup>18</sup>

I will pause, however, to assess Lipton and Rowe's claim that recent economic challenges to the concept of market efficiency, namely that anomalies like the January effect, events like the October 1987 market crash, and developments like behavioral economics, render market efficiency as an unreliable basis for takeover policy. First, Lipton and Rowe's presentation of this material is strikingly unbalanced.<sup>19</sup> More important, however, their reliance on behavioral economics to undermine the relevance of market efficiency is quite odd. While Lipton and Rowe point to applications that

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activity in the 1970s, 1980s and 1990s can be explained by market inefficiency. The model, however, has some Rube Goldberg-like characteristics. First, the stock market is assumed to be dramatically inefficient – either badly over or undervaluing a company's stock – while managers are assumed to be completely rational and understand precisely the way in which the market is inefficient and are also able to predict precisely the long-term value of their companies and the companies they purchase. Next, managers are assumed to maximize their personal objectives given their own time horizons. In effect, the model requires *both* market inefficiency and enormous agency costs. The result is acquisitions that have no economic purpose other than exploiting the particular mispricing of the moment given the self-interest of managers. Andrei Shleifer & Robert Vishny, *Stock Market Driven Acquisitions*, NBER Working Paper 8439 (August 2001).

<sup>18</sup> Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and New Perspectives on Mergers*, 15 *J.Econ.Perspec.* 103 (2001). Lipton and Rowe get a little carried away with their effort to debunk empirical studies supporting shareholder gains from takeovers. They characterize the empirical evidence supporting gains to *target* shareholders as “weak and inconsistent.” A Reply to Professor Gilson at 26. Here Lipton and Rowe simply misstate the facts.

<sup>19</sup> I take some pride in Lipton and Rowe's repeated reference to my discussion of the limits to existing empirical studies of market efficiency. The point is that the evidence on any complex economic phenomenon will be mixed and require analysis. It would have been better had they exhibited similar balance. For an accessible and skeptical discussion of the persuasiveness of recent research on market efficiency, including especially the October 1987 crash and behavioral economics, see Mark Rubenstein, *Rational Markets: Yes or No? The Affirmative Case*, 57 *Fin. An. J.* 15 (2001).

predict circumstances where the aggregation mechanisms that drive market efficiency may fail, they ignore the fact that the role of shareholders in the governance of takeovers is a tradeoff between agency costs and strong form market inefficiency. To evaluate the impact of behavioral economics on that tradeoff requires that we consider its impact on the level of agency costs as well.

Behavioral economics finds its roots in biases identified by cognitive psychologists, especially Amos Tversky and Daniel Kahneman.<sup>20</sup> These biases are rooted in failures in individual, not market decision-making, and thus apply more directly to the decision processes of management. For example, suppose we apply cognitive dissonance theory to target management's reaction to a hostile bid that calls into question management's performance. It suggests that target managers would reduce the dissonance they experience as a result of the hostile bid and its explicit criticism of their performance, by deriding the bidders' motives and skills, and acclaiming the bright future under target management's leadership. While target management might in good faith believe its comments, behavioral economics suggests that the comments grow out of a cognitive bias.

Thus, behavioral economics may in some circumstances predict that the stock market may fail to regress out inaccurate beliefs, but it also predicts dysfunctional defensive behavior by target management in takeovers based on cognitive biases, and in this setting without market aggregation mechanisms to temper them. In the end, behavioral economics speaks to both sides of the tradeoff between agency costs and market inefficiency. The necessary judgment remains the same: which failing is

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<sup>20</sup> See, e.g., *Judgments Under Uncertainty: Heuristics and Biases* (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982).

systematically worse. My judgment is that behavioral economics will increase the agency cost problem more than it will the strong form market inefficiency problem, thereby reinforcing the shareholder choice position. However, Lipton and Rowe never consider the problem.

## **II. The Value of the Poison Pill**

Not surprisingly given Martin Lipton's role as alchemist behind the poison pill, Lipton and Rowe take issue with my proposal that shareholders be allowed to adopt bylaws amending or repealing board adopted poison pills. They refer to John Coates' careful evaluation of event studies of pill adoptions,<sup>21</sup> and to a number of studies showing that target companies with a poison pill receive higher premiums than target companies without one, both of which are said to show that a company's adoption of a poison pill does not reduce shareholder value.

John Coates work levels an important criticism of event studies that try to measure the impact on share price of a company's adoption of a poison pill. Because the board of directors can adopt a pill at any time, its stock price will already incorporate the pill's expected impact. Its actual adoption is therefore not an event. Coates insight, however, says nothing about whether the pill's impact is beneficial to target shareholders; it speaks only to the unreliability of using event studies to measure it.

The premium studies make a stronger claim – that pills are beneficial to target shareholders because they increase the size of takeover premia. With respect to assessment of this data, the critical fact is that a poison pill is not self-defining. It depends entirely on what the courts allow management to do with it. Suppose a pill only

allows management time to secure an alternative transaction and persuade shareholders that the bid price is too low, but does not allow management ultimately to block the offer – call it an *Interco* pill. The effect of such a pill, then, is to allow management the means to shop the company. In turn, the premium studies would suggest that auctions provide a benefit to target shareholders, an outcome that is precisely what is predicted by the shareholder choice model. If this is what a pill means, as I suggested earlier, it is a useful mechanism to implement a shareholder choice regime, and Lipton and Rowe and I have no quarrel (although we all may have a quarrel with Easterbrook, Fischel and Schwartz)..

Of course, I understand Lipton and Rowe to have a quite different view of how target management should be able to use a poison pill. In their view, I assume, management can decline to redeem a pill – to just say no – provided they “show through detailed presentations and expert testimony that their assertion was reasonable and based on appropriate information.”<sup>22</sup> *Unitrin* put the matter somewhat differently. A pill need not be redeemed if the refusal is not preclusive; that is, as long as a proxy fight is not “mathematically impossible or realistically unattainable.”<sup>23</sup>

The real problem in assessing the impact of the poison pill is framing a clear hypothesis concerning what a pill can accomplish. If companies in fact are adopting *Interco* pills, one would expect one result; if they are adopting Lipton and Rowe just say no pills, one would expect a different result; and if the substance of pills have changed

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<sup>21</sup> John C. Coates IV, Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence, 79 Tex. L. Rev. 271 (2000); John C. Coates, Empirical Evidence on Structural Defenses: Where Do We Stand?, 54 Miami L. Rev. 83 (2000).

<sup>22</sup> A Reply to Professor Gilson at \_\_\_. While it would be refreshing for Lipton and Rowe to acknowledge that such a showing was necessary, the reality is that the showing sets a low bar provided that the target company has competent counsel and is actually acting in good faith. Of course, it is possible to trip over even a low bar, as demonstrated by Vice Chancellor Strine’s careful opinion in *Chesapeake Corporation v. Shore*, 2000 WL 193119 (Del.Ch. 2000).

<sup>23</sup> *Unitrin*, 651 A.2d at 1388-89.

over time because of judicial decisions, and if uncertainty remains over the substance of a pill fifteen years after *Household International* because the Delaware Supreme Court has declined to clearly state what a pill authorizes management to do, then one would have no idea what to expect. The outcome would depend on the chronological distribution of the sample and on the degree of uncertainty at any point in time. Any result would necessarily reflect a mix of all these factors, and therefore reveal little about the impact of pill adoption. In the absence of being able to specify the substance of the pills making up the samples of the premium studies, they tell us little about whether a particular version of a poison pill is a good thing or a bad thing for shareholders.<sup>24</sup>

What does this analysis add to the debate about shareholder choice and shareholder adopted bylaws? It reveals, I suggest, what Lipton and Rowe expect shareholders would do if they had the opportunity to act. As I explained in *Unocal Fifteen Years Later*, I believe that institutional investors will approve sensibly drafted – say *Interco* style – pills and likely will approve even not so sensibly drafted pills proposed by trusted, well-performing management. I also believe, and the vigor of Lipton and Rowe’s response suggests they share this belief, that institutional investors will resist pills that give unimpressive management the power to block a tender offer. Since that position seems perfectly sensible behavior by rational investors, the question is why Lipton and Rowe object to it. The answer, I think, is a managerialist view of corporate governance that appears to me out of the mainstream but, of course, they make the very same claim with respect to my views.

In the end, then, the debate comes back to where it started some twenty years ago – to the allocation of responsibility among shareholders and directors. And this brings

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<sup>24</sup> Bernard Black and I made this point sometime ago. See Gilson & Black, *supra* note 19, at 781-83.

me to the final point of this response: Lipton and Rowe's claim of a managerialist meta-principle in Delaware corporate law.

### **III. Lipton and Rowe's Managerialist Meta-Principle**

Lipton and Rowe ultimately transcend their attack on market efficiency and their rigorous defense of the poison pill, to thoughtfully confront a serious question: just how managerialist is the DGCL? And whether one views their analysis as a careful apologia for what the Delaware Supreme Court has done but not articulated, or as a road map for what they hope the Delaware Supreme Court will do, this certainly is the right question.

What makes the analysis difficult is the same issue that made it difficult when Lipton first wrote in 1979 and when I responded two years later. The DGCL requires board approval of mergers and sales of assets, thereby giving the board blocking power. The statute was, and remains, silent about tender offers because a tender offer does not require corporate level action. Lipton in 1979, and now with Rowe, fill that supposed gap by arguing that a tender offer has the same functional effect as other fundamental transactions and therefore should be treated the same way: directors should be able to block a tender offer of which they do not approve. As I suggested in *Unocal Fifteen Years Later*, this is a strange argument for the court that invented the equal dignity doctrine to rationalize different processes for functionally similar acquisition techniques. The statute's silence with respect to tender offers, now many years after their emergence, just dictates a different process for tender offers. In 1981, and now, I argue that tender offers provide a critical safeguard that supports board control over every other acquisition technique (and the protection of the business judgment rule). If the board improperly or mistakenly declines an acquisition offer, the shareholders can

go over their heads by accepting a tender offer. In this analysis, tender offers are treated differently precisely because they are the functional equivalent of a merger or sale of assets.

Here, then, is where the issue is joined. In Lipton and Rowe's view, the role of safety valve that I ascribe to tender offers, they ascribe to elections: "'Shareholder choice' is exercised in elections for corporate directors."<sup>25</sup> And we then confront the comparative advantage of markets and elections at resolving control contests, which I addressed in *Unocal Fifteen Years Later*.

For present purposes, I will not rehearse the differences in statutory analysis that both sides to this debate offer to support their positions. While I think Lipton and Rowe significantly overstate the coherence of the Delaware statute in this regard and the structural exegesis that has been offered by the Delaware courts, readers can judge the persuasiveness of the competing analyses without further assistance from the participants. Rather, I want to close by briefly exploring how pervasive Lipton and Rowe's managerialism is. I suggest that their commitment to elections runs less deep than they acknowledge, and that their position ends up threatening the legitimacy of the very system they (and I) seek to support.

In *Unocal Fifteen Years Later*, I argued that a critical problem with elections serving as the only safety valve in the system is that defensive pressure then shifts to elections, and begins degrading the election process itself. We have already seen the progression begin – target management is no less threatened by an election whose campaign theme is to pull the pill than by the tender offer itself – so that the dynamic we have already observed with defensive tactics is being repeated with elections. Counsel

devises dead hand and slow hand pills, recommends staggered boards, and formulates tactics, like eliminating the right of shareholders to call special meetings and giving the board the right to delay shareholder meetings, which have the unmistakable purpose of shifting the outcome of the election to favor management irrespective of the merits.

With the welcome exception of *Mentor Graphic's* dispatch of dead and slow hand pills, the courts have really not policed this process. Lipton and Rowe refer to Chancellor Allen's strict formulation in *Blasius* – that the “board bears the heavy burden of demonstrating a compelling justification for [franchise-impairing] action”<sup>26</sup> – as a bulwark against managerial electoral manipulation, but it is unclear whether this standard has survived. It seems difficult to rationalize *Blasius's* requirement that the board demonstrate a compelling justification for manipulating the election process with the Delaware Supreme Court's tepid direction on remand in *Unitrin* that the Chancery Court determine only whether the target board's machinations have made a proxy contest “mathematically impossible or realistically unattainable.” Similarly, Vice Chancellor Jacobs' inability to impose limits on board delay of a shareholder called meeting in *Mentor Graphics* provides further evidence of the difficulty of policing the evenhandedness of the electoral process against the weight of determined defensive tactics. Despite the Vice Chancellor's obvious recognition of the potential for abuse, the opinion provides no constraints beyond urging counsel to exercise caution and restraint.<sup>27</sup> As I said in *Unocal Fifteen Years Later*, “[i]t is rather hard to imagine an electoral process that can both confer legitimacy on the victor and still leave the incumbent very

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<sup>25</sup> A Reply to Professor Gilson, at 32.

<sup>26</sup> A Reply to Professor Gilson, at 38, quoting *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 666 (Del.Ch. 1988).

<sup>27</sup> *Mentor Graphics Corporation v. Quickturn Design Systems*, C.A. Nos. 16854 & 16855 (Del.Ch. 1998).

substantial discretion to manipulate the process.”<sup>28</sup> There I referred to the first Peruvian presidential election seeking to displace Alberto Fujimoro as providing an example of the corrosive power of scheduling on the legitimacy of elections.

This debate matters because the genius of the American corporate system over the last twenty years has been precisely its ability to quickly adapt to changed economic conditions, assisted in major respects by the ability of those outside the corporation to impose change through the mechanism of the market for corporate control.<sup>29</sup> In the early 1990s, a number of critics, including importantly Harvard Business School Professor Michael Porter and Mr. Lipton, compared the U.S. capital market unfavorably to those of Germany and Japan, precisely because of the operation of the market for corporate control.<sup>30</sup> Fifteen years later, the U.S. economy has changed rapidly, reallocating resources by downsizing in some industries and increasing resources devoted to others, accomplished in important respects through the operation of the market for corporate control and through restructurings voluntarily initiated in anticipation of that market. Reflecting this success, international corporate governance reform has followed an explicitly non-managerialist version of the U.S. corporate governance system rather than the much more managerialist systems of Germany and Japan. For example, U.S. style governance reform was an important part of the World Bank and IMF’s response to the 1997-1998 East Asian financial crisis. In the meantime, Japan remains frozen with a corporate governance system that is impervious to external change despite a decade long

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<sup>28</sup> Unocal Fifteen Years Later, at \_\_\_.

<sup>29</sup> See, e.g., Ronald J. Gilson, Corporate Governance and Economic Efficiency: When Do Institution Matter, 74 Washington University Law Quarterly 327 (1996); The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment, 61 Fordham Law Review 161 (1992).

recession, and the European Union seeks persistently (although with mixed success) to more fully open European corporate governance to external influence.<sup>31</sup>

Lipton and Rowe's response to this concern, I take it, would be that the poison pill and the increasingly managerial bent of Delaware law, exemplified by *Unitrin*, did not interfere with the remarkable restructuring process the U.S. experienced. But here Lipton and Rowe cannot have it both ways. Lipton and Rowe may be right that the pill did not present a serious barrier because, in the end, the issue of what management could do with the pill turned out to be resolved in the market. The views of the institutional investment community made it unlikely that a company ultimately could block shareholders from deciding whether to accept an offer even if the courts might have allowed it. In effect, Lipton and Rowe's point is that the marketplace turned Mr. Lipton's pill into an *Interco* pill. But if that is right, then all that saved the pill from having a negative economic impact is that it did not function as Lipton and Rowe would have liked. And in that event, it would be helpful if the courts (and Lipton and Rowe) acknowledged that there is no just say no defense. It now has been more than fifteen years since *Unocal*; clarity is long overdue.

That leaves us with the problem of repositioning Delaware law on the assumption that the Delaware Supreme Court will prove characteristically reluctant to reconsider its doctrinal construct.<sup>32</sup> Allowing shareholders, by initiating bylaws, a hand in assuring that

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<sup>30</sup> Michael Porter, Capital Disadvantages: America's Failing Capital Investment System, Harv. Bus. Rev. Sept. – Oct. 1992, 43-66.

<sup>31</sup> The Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids (Sept. 4, 2001), which was commissioned by the European Commission following the European Parliament's surprising rejection by a tie vote of the Proposed Thirteenth Directive on takeovers, recommends a new takeover regime that largely embraces the principle of shareholder choice.

<sup>32</sup> In a remarkable recent article, the former Chancellor and two sitting Vice Chancellors set out an extra judicial road map for how the Delaware Supreme Court might usefully uncomplicate its takeover doctrine. William T. Allen, Jack B. Jacobs, & Leo T. Strine, Function Over Form: A Reassessment of Standards of

the design of a poison pill actually benefits them, is a workable, if partial, solution that finds its support in the language of the DGCL and in the Delaware Supreme Court's penchant for according each statutory provision equal dignity. It would also take the pressure off of the electoral process and eliminate the embarrassing spectacle of directors manipulating their own election in a fashion that we would be quick to condemn in a developing country election.

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Review in Delaware Law, 56 Bus. Law. 1287 (2001). While their proposals are quite moderate, the Supreme Court has evidenced no inclination to follow their advice. See A. Gilbert Sparks & Patricia R. Uhlenbrock, Progress Update: Delaware's Common Law Simplification Initiative, unpublished paper (Jan. 2002).

**Figure One: TIME WARNER ADJUSTED STOCK PRICE, Jan. 4, 1988 – Jan. 11, 2001**

Source: CRSP

