The Rise and Fall of Delaware's Takeover Standards

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Abstract

The takeover standards that we learn and teach in law school, Revlon, Unocal, Weinberger, and Blasius, appear to be in decline. In this chapter for the book The Corporate Contract In Changing Times: Is the Law Keeping Up? (eds. William Savitt, Steven Davidoff Solomon, Randall Thomas), we attempt to explain the rise and fall of jurisprudential takeover standards in Delaware. We theorize that these standards were created by Delaware courts in the mid-1980s to rectify a perceived failure in the corporate governance system, principally the apparent failure of directors to act responsibly in the corporate governance eco-system. These new standards successfully channeled takeovers into certain preferred forms, but also helped ameliorate the problematic practices of that period. These new standards collectively had another effect: encouraging the rise of private enforcement activities, initially by the raiders themselves, but once hostile transactions became a less significant force, through expanded shareholder litigation.

In this new environment, private litigation became increasingly unnecessary, a fact which became quite apparent with the rise in litigation rates to 96% of all takeovers. At the same time, the rise of institutional investors, coordinating bodies such as proxy solicitors, hedge fund activism and corporate governance movements, as well as the expansion of federal securities law into areas like executive compensation and board independence/monitoring, occurred. The consequence was a largely justifiable relaxation of these standards.

Keywords: Delaware, Takeovers, Revlon, Unocal, Blasius, Weinberger, Fiduciary Duties

JEL Classifications: G30, K20 and K22

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I. Introduction

The takeover standards that we learn and teach in law school, *Revlon*, *Unocal*, *Weinberger*, and *Blasius*, appear to be in decline. Promulgated in the 1980s these standards, named after the cases which created them, have been subject to judicial pruning or wholesale replacement in the last two decades. In some instances, they have been replaced with more structured standards providing for business judgment review. Alternatively, they have been transmogrified into tests that call for lower judicial scrutiny, such as reasonableness. At least one, the *Blasius* standard appears to be on the chopping block. Another, the *Unocal* standard, has been described by some commentators as "dead" (Smith & Thompson 2001).

This is a remarkable turn of events.

In this chapter, we attempt to explain the rise and fall of jurisprudential takeover standards in Delaware. We theorize that these standards were created by Delaware courts in the mid-1980s to rectify a perceived failure in the corporate governance system, principally the apparent failure of directors to act responsibly in the corporate governance eco-system. At that moment in time, the Delaware courts issued new "rules of the road" designed to regulate the conduct of takeovers. These new standards successfully channeled takeovers into certain preferred forms, but also helped ameliorate the problematic practices of that period. These new standards collectively had another effect: encouraging the rise of private enforcement activities, initially by the raiders themselves, but once hostile transactions became a less significant force, through expanded shareholder litigation.

The costs of private litigation activities were justifiable when there was a governance gap which needed to be filled. Over time, as standards evolved, practitioners adapted to the new reality and clear rules were set forth about how to conduct both friendly and hostile takeovers. The perceived need for Delaware court intervention became less and it occurred only when players acted to substantially deviate from the now established norms of takeover contests.

In this new environment, private litigation became increasingly unnecessary, a fact which became quite apparent with the rise in litigation rates to 96% of all takeovers (Cain and Davidoff Solomon 2015). At the same time, the rise of institutional investors, coordinating bodies such as proxy solicitors, hedge fund activism and corporate governance movements, as well as the expansion of federal securities law into areas like executive compensation and board independence/monitoring, occurred. These new developments created alternative monitors to a culture of litigation which were perceived as substitutes for litigation and corrections to the market failures which necessitated the 1980s court-ordered standards. The recent move to limit shareholder litigation further reflects the Delaware courts' renewed focus on reducing the burdens and costs of private enforcement in favor of other governance mechanisms.

While these new developments spurred Delaware to back away from active judicial intervention, largely leaving private actors to engage in monitoring, this does not mean that everything is now perfectly frozen in time. We conclude this chapter by drawing lessons from the rise and fall of Delaware takeover standards. The historical arc of takeover standards has largely been a positive development, though there may still be areas where court intervention may be more appropriate such as in the realm of hostile takeover defenses and the staggered board. The lessons of this rise and fall also provide a theoretical construct for looking at Delaware's jurisprudence as well as parameters for when Delaware courts should consider future imposition of higher-level standards in takeovers and corporate governance. We develop this point by examining whether Delaware or private enforcement mechanisms should apply to regulate hedge fund shareholder activism, concluding that the current judicial hesitancy to wade into this debate appears appropriate.

II. The Rise of 1980s Standards

The 1980s began with little existing state regulation of takeovers. Indeed, the 1970s had produced the first substantive state regulation, but only in a narrow subset of going private transactions. The controversy over going-privates in the wake of the 1973 recession and the Securities and Exchange Commission (SEC) crusade against these takeovers led by SEC Chairman Manuel F. Cohen spurred state action. In 1977, the Delaware Supreme Court adopted the business purpose test for evaluating going-privates, representing a step away from business judgment review in takeovers.[1] Delaware's move to regulate going private transactions was also a sign of its willingness to protect shareholders against corporations, something of import in the wake of Cary's (1974) savage criticism of Delaware as engaged in a "race to the bottom".

But this was just the start. In the beginning of the 1980s, there occurred a sharp rise in the number and frequency of hostile takeovers, and takeovers generally. The reasons for this rise are still debated but were spurred in part by relaxed antitrust enforcement under the Reagan administration, easy credit as a result of earlier Federal Reserve actions and the invention of the high yield debt market by Michael Milliken (Jarrell, 1992).

In this cauldron, the Delaware courts transformed its jurisprudence through a series of decisions which adopted heightened judicial review standards to takeover-related actions.[2] The first hostile takeover decision came in 1985 in *Unocal v. Mesa Petroleum*,[3] a decision which arose out of the raider T. Boone Pickens's two-tiered hostile offer for Unocal. The Delaware Supreme Court ultimately upheld the defensive self-tender conducted by Unocal. In doing so, the Court held that such defensive actions would be subject to a heightened standard of review. The *Revlon* case in the following year was a decision in which the court weighed the actions of the Revlon board in fighting off another hostile raider, Ronald Perelman.[4] The

[1] Singer v. Magnavox Co., 380 A. 2d 969, (Del. 1977).

[2] There were two principal conflicts during this time period that the Delaware courts confronted. The first was the clear conflict between a majority/controlling shareholder on one side and the minority shareholders in a going-private transaction. The second was less clear and involved possible conflicts among directors, managers and shareholders in an arms-length takeover. In the latter instance, the issue was a possible misalignment of interests due to management entrenchment, but such misalignment was not necessarily present and could be counteracted by mechanisms such as the golden parachute which would incentivize management to sell. The clear conflict of the going-private gave rise to Delaware's initial foray into takeover jurisprudence, though by the middle of the 1980s the approach and remedy (higher rather than lower standards) was arguably uniform. We thank Professor Robert Thompson for drawing our attention to this point.

[3] 493 A.2d 946 (Del. 1985).

[4] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

Delaware Supreme Court this time sided with the hostile bidder, holding that in a break-up or change of control of the company, a target was required to obtain the highest price reasonably available. Consequently, Revlon could not unduly favor another competing bid by a friendly private equity group.

The standards proliferated in a variety of settings. In *Weinberger*, decided two years before *Unocal*, the Delaware Supreme Court repudiated the business purpose standard and instead held that the entire fairness standard would apply for review of take privates.[5] In the 1985 case *Smith v. Van Gorkom,*[6] the Delaware Supreme Court considered the takeover of the TransUnion Corporation, and issued a decision specifying standards for duty of care violations in the takeover context. The blizzard of standard setting was capped off in 1988 when Chancellor Allen in *Blasius Indus. v. Atlas Corp.*[7] imposed strict scrutiny on actions taken by the board with a primary purpose of impeding or impairing the shareholder vote. The *Blasius* case was notable for being about the efficacy of board defensive actions to fight off an early version of shareholder activist.

The consequence of the proliferation of standards was to insert the Delaware judiciary directly as arbiters of takeover contests. As Prentice and Langmore (1990) wrote summing up the decade of court action:

> Whereas ten years ago, target boards could defeat hostile tender offers with virtually no scrutiny from the courts, today they must justify their actions under stringent standards of review and a presumption that creating an alternative transaction (at a higher premium) is the best form of defense. Litigation is expensive, but it is possible to conclude that using the courts to resolve such disputes is more cost-effective than alternatives which have been proposed, such as written contracts between shareholders and managers.

Messrs. Prentice and Langmore highlighted the rise of judicial enforcement mechanisms through shareholder litigation. Their analysis is notable in observing this shift but also for its narrow cabining of the available alternative enforcement mechanisms at the time. This would change, as would Delaware law.

III. The Shift Away

[5] Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
[6] 488 A.2d 858 (Del. 1985).
[7] 564 A.2d 651 (Del.Ch. 1988).

Late in the 1980s, Delaware began to back away from these standards. This was not an immediate process with clear rejection decisions. Rather, in response to subtle changes in market forces, the courts gradually backed away from the interventionist approach and new standards of the 1980s. The result over a 25-year period spanning from the 1990s until today are clear, a wholesale change in the application and use of these standards.

The first signs of Delaware's less interventionist approach came with the *Unocal* doctrine. In the 1980s *Unocal* appeared to have substantive content which would provide space for court intervention to provide an end to corporate control contests. In *City Capital Associates vs. Interco Inc.*[8] and *Grand Metropolitan PLC vs. The Pillsbury Company*,[9] Chancellor Allen had interpreted *Unocal* to permit the Chancery Court to play an active part in deciding takeover contests. But after the Delaware Supreme Court's decision in *Paramount Communications Co. v. Time, Inc.*,[10] *Interco* and *Pillsbury were* left for dead, directly repudiated by the higher court as contrary to Delaware law beginning with the *Time* decision in 1989.

In the wake of the *Time* decision, *Unocal* became a standard with limited substantive effect[11] as the courts continued to narrow *Unocal's* effect in *Unitrin, Inc. v. American General Corp.*[12] and other cases. The gradual hollowing of *Unocal* was noted in a law review article by Smith and Thompson (2001). They surveyed the existing case-law and came to the conclusion that *Unocal* was, in their words, "dead". *Unocal* was still invoked, but in the handful of times it was used to strike down board action, the court acted only to maintain pre-established rules of the road. Thus, in 1998 the *Unocal* standard was utilized by the Chancery Court to strike down a dead-hand poison pill before a separate ruling by the Delaware Supreme Court invalidating no-hand poison pills on statutory grounds.[13] By acting to prevent these more powerful forms of poison pill, the courts maintained an equilibrium which had been established between bidders

[8] 551 A.2d 787 (Del. Ch. 1988).
[9] 558 A.2d 1049 (Del. Ch. 1988).
[10] 571 A.2d 1140 (Del. 1989).
[11] Randall S. Thomas, Judicial Review of Defensive Tactics in Proxy Contests: When is Using a Rights Plan Right?, 46 Vanderbilt Law Review 503, 517 (1993) (Paramount "mark[s] the collapse of heightened judicial scrutiny for takeover defenses against hostile tender offers and a retreat to their deferential review under the business judgment rule.")
[12] 651 A.2d 1361 (Del. 1995).
[13] *See* Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del.Ch.1998); Mentor Graphics v. Quickturn Design Systems, 721 A.2d 1281 (Del. 1998). The lower court opinion in Mentor Graphics had relied on *Unocal* to strike down the no-hand pill. Mentor Graphics v. Quickturn Design Systems, 728 A.2d 25 (Del. Ch. 1998).

and targets in hostile takeovers. The culmination of the court's backing away from intervention arguably came in the *Airgas* case.[14] There Chancellor Chandler refused to redeem a poison pill, despite his apparent distaste for the *Time* holding and the offer being deemed to be fair. The decision validated the "just say no" defense and left targets wide latitude to resist takeover offers in accordance with the practices set up over the prior decades.[15]

The *Revlon* doctrine, the core doctrine governing friendly takeovers, was also reworked. While the language of the standard remained the same, in *Lyondell Chemical Co. v. Ryan*,[16] the Delaware Supreme Court effectively viewed *Revlon* through the lens of "good faith" analysis, holding that so long as the actions of the board were "reasonable" and in "good faith" they would not be challenged. The decision provided boards with wide latitude to choose how to sell themselves and the appropriate sale process. Once again, the court had removed itself from a more searching scrutiny, instead preferring in this instance to subsume *Revlon* within the general fiduciary duty of loyalty and its standard of good faith.[17] As Johnson and Ricca (2014) wrote:

> Both the actual words and the clear "music" of the Lyondell opinion imposed a demanding liability standard for challenging director conduct in the Revlon setting. Thus, in the nearly quarter century from Revlon to Lyondell, the court-with a little help from the General Assembly-substantially redrew the director liability landscape on both the duty of care and duty of loyalty fronts, and then fitted the pre-existing Revlon doctrine into the larger arc of those fiduciary developments.
>
> In light of Lyondell, continuing assertions about the Revlon duty imposing a higher "reasonableness" standard of scrutiny than ordinary business judgment rule review, and requiring that directors carry an initial burden of proof, are, in the personal liability context, outworn and faulty doctrinal vestiges.

[14] Air Products and Chemicals, Inc. v. Airgas, Inc., 16 a.3d 48C.A. No. 5249 (Del. Ch. Ct. Feb. 15. 2011).

[15] The only deviation from this analogy was arguably the *Omnicare* decision in 2003, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A. 2d 914 (Del. 2003), but it was met with fury by the corporate law bar --for reasons that have little to do with this discussion-- and subsequently was also whittled away. *See* Davidoff, Steven M., Aug. 28, 2008, "The Long, Slow Death of Omnicare", *N.Y. Times DealBook*, available at http://dealbook.nytimes.com/2008/08/28/the-long-slow-death-of-omnicare/.

[16] 970 A.2d 235 (2009).

[17] *See also* In re Synthes S'holder Litig., C.A. 6452 (Del. Ch. Aug. 17, 2012) (holding that a controlling stockholder could legitimately refuse to sell and finding that even if *Revlon* applied the board took "reasonable steps to maximize the sale price of the Company").

As for *Blasius*, it became a doctrine rarely applied. This was true despite the fact that the standard appeared tailor made for the analysis of many shareholder activism situations. In one of the few cases in the last decade to apply a *Blasius* analysis, *Merceir v. Intertel*,[18] then Vice Chancellor Strine argued that the strict scrutiny standard should be abandoned and incorporated into the *Unocal* reasonableness standard. The then Vice Chancellor found for the first time that board action impeding or impairing the shareholder vote met Blasius' compelling justification requirement, an implicit argument for adopting his revised standard.

In the turn of the millennium, there also occurred a sustained effort to turn back the *Weinberger* entire fairness standard which addressed issues associated with minority/majority shareholder relationships. In a series of decisions which spanned over 15 years, the Delaware courts validated separate arrangements for business judgment review first for tender offers and later in the merger context. This line of cases culminated in a 2014 decision by the Delaware Supreme Court, *Kahn v. M&F Worldwide Corp.*[19] The transaction involved a controlling shareholders' squeezeout of the minority shareholders in a public company, a case that under the *Weinberger* standard would have required fairness analysis. There the Court determined that the approval of an empowered, independent special committee of directors coupled with a fully informed, non-coerced, majority of the minority shareholder vote approving of the merger, was sufficient to shift the standard of review to the business judgment rule. The result was that a principled standard – the Weinberger entire fairness test – was replaced with a more structured rule-like test for going private transactions.

The rationale for this shift was explained earlier in the *Cox* decision of the Chancery Court.[20] Private litigation mechanisms through plaintiffs' law firms no longer functioned effectively. Meanwhile, the rise of independent directors and institutional investors had provided Delaware courts with alternative monitoring mechanisms. As then Vice Chancellor Strine wrote, the value of shareholder litigation in this context had been diminished even though it appeared that deals pursuant to the old *Weinberger/Kahn* standard produced higher premiums than tender offers

[18] 929 A.2d 786 (2007).
[19] 88 A.3d 635 (2014).
[20] In re Cox Communications, Inc. S'holders Litig., 879 A.2d 604 (Del. Ch. 2005).

under the *Pure Resources* standard (Subramanian, 2007). In other words, the view changed that judges were necessary to police this market as the courts recognized other private mechanisms.

The collective result of these cases was a significant reduction in judicial oversight of takeovers. This idea was cemented in a recent law review piece written by now Chief Justice Strine. Strine (2015) surveyed the landscape acknowledging that so long as there were independent and conflict free directors and advisers, Delaware's role was to stand aside and let these private monitors function. He stated:

> You and your clients get to write the play. Not only is there nothing wrong with that, but done properly and with integrity, there is everything right with that. If the play is one where your clients appear to have made sensible, good faith judgments for legitimate, well-documented reasons, those judgments are likely to withstand judicial scrutiny. By focusing on the quality of the deliberative process, you maximize the directors' ability to bring their best collective judgment to bear on the difficult decisions they must make in the M & A context. And if avoiding legal embarrassment is a motivating factor for directors, use that factor for all it is worth to help them live up to what should be their overriding objective: doing the right thing for the company and its stockholders.

In this world, Delaware's focus is on ensuring that directors serve their own role as independent monitors and ensuring that the "road" stays open. The importance of the independent director monitoring process explains Delaware's current exploration of financial adviser liability as well. Beginning with the *Del Monte* case,[21] and culminating in the *RBC Capital Markets v. Jervis*[22] decision, Delaware made it clear that independent directors have a duty to run the sale process independently. Directors that close their eyes and let financial advisors drive the deal without supervision create potential liability for themselves. However, if these private monitors do their job and follow the rules set forth in Delaware opinions, then a high scienter requirement will protect their financial advisors (and third party acquirers) from liability.

The intersection of the financial advisor liability cases and the move away from close judicial scrutiny was reached in a recent Delaware Supreme Court decision, *Singh v. Attenborough*,[23] where the Court dismissed an aiding and abetting claim against a board's financial advisor after

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[21] In re Del Monte Foods Co. S'holders Litig., 25 A.3d 813 (Del. Ch. 2011).
[22] No. 140 (Del. Sup. Ct. Nov. 30, 2015).
[23] No. 645 (Del. Sup. Ct. May 16, 2016).

a fully informed, uncoerced vote of disinterested shareholders. The Court held that the business judgment rule should be applied in these circumstances. The end-result of this movement is clear, the 1980s standards are gone, replaced by newer standards which rely upon private monitoring.

IV. Theoretical Foundations

A. Explaining the 1980s

The most commonly offered theoretical explanation for Delaware's actions in the 1980s is a political economy one. Delaware's constituency can be defined as the corporations which charter there and pay incorporation fees and taxes. The controversy over takeovers and corporate demands for protection pushed Delaware courts to adopt a jurisprudence meeting the needs of its corporate constituency. By acceding to corporate wishes, Delaware maintained its attraction for public incorporations and prevented an outward migration of charters to other states.

This explanation ignores the fact that in many cases Delaware did not go so far as to provide complete protection from hostile takeovers. The principal state legislative response was rather weak, and consisted of the adoption of a business combination statute. Pennsylvania in comparison adopted six different types of anti-takeover statutes. The Delaware courts also adopted the *Unocal* and *Revlon* doctrines, both of which limited a public corporation's ability to resist a hostile takeover, though *Unocal* itself turned out to be weak medicine.

This more particularized response has been explained by Roe (2003) and Solomon (2007) as a possible consequence of fears of federal intervention. Delaware's response in the 1980s can be seen as one crafted to counter SEC pressure. At that time, the SEC was seeking to regulate takeovers and was opposed to hostile takeover defenses instead openly advocating for a level playing field. Delaware's response can be seen as a preemptive one seeking to forestall SEC action while at the same time attempting to still cater to its corporate constituency.

We offer a complementary theory; Delaware's response was also driven by a perceived need to address existing corporate governance failures. Prior to the invention and validation of the poison pill, corporations were struggling to defend themselves against the hostile takeover. *Unocal* itself concerned Unocal's attempts to defend itself against what the court concluded was a coercive, two-tiered hostile tender offer. Against this struggle, there was real concern about the board conflicts created by these offers and the perception that a targeted board would not appropriately and in good faith consider a takeover offer. Instead, the concern was that the board would seek to entrench themselves through takeover defenses.

Market mechanisms did not then exist to stem either of these problems. The role of institutional shareholders during this time period was passive. Institutional and other shareholders did not actively engage with management or otherwise seek to affect the course of takeover offers or corporate governance generally. Other monitoring mechanisms were still developing. Proxy advisory services were in their infancy, as was the corporate governance movement. Boards at this time were mostly inside directors. The board as a majority of independent directors as a norm did not begin to take hold until the 2000s. Shareholder activism by hedge funds was also limited: there were some activist blockholders that targeted poorly performing companies, seeking asset divestitures or stock buybacks, but the market reaction to them was minimal. (Bethel, Liebeskind, and Opler, 1988).

The Delaware courts' actions during this time period through their rapid promulgation of different standards can be seen as an attempt to remedy this private market failure. The Delaware courts as regulator were providing a market good by establishing order and stability to the market when it otherwise could not provide this order itself. But the Delaware court's action was predicated on this lack of other alternatives. When the market structure changed, so did Delaware's role.

B. The effect of the 1980s

These standards had a significant number of short- and long-term effects. In the short term, these standards were regulatory in nature, setting rules of the road for takeovers generally and hostile takeovers in particular. These rules ultimately encouraged private ordering solutions around the poison pill. Later decisions would establish the proxy contest as the clear mechanism to circumvent the pill and allow for a hostile takeover to proceed. These decisions also set limits for what defensive actions could be taken and how boards should respond to hostile deals.

The insertion of standards of conduct made Delaware a regulator, but it was a regulator only when litigation was brought. These decisions thus created a culture of litigation ultimately leading to litigation in almost every single takeover. In the longer term this obviated the need for market enforcement. Instead, the courts (and plaintiffs' law firms) served as monitors.

In the 1980s, the Delaware court also established itself as the final arbiter of takeovers and for the institutionalization of litigation as an enforcement mechanism. The steady stream of litigation ensured that the Delaware court became both the rule-maker and umpire in these takeover contests. As Rock (1997) has detailed these decisions often took the form of morality opinions which detailed extensive rules of conduct. These lessons and rules initially established a neutral playing field which allowed hostile takeovers to proceed. Raiders now knew the limits of their bids and the structures which would pass muster. Companies knew that they could adopt certain takeover defenses but not others.

But the structure of the market changed over time. More powerful, and more pervasive institutional shareholders appeared providing an active monitoring force for corporate governance. This force was complemented by hedge fund activism. Hedge funds, empowered and backed by institutional shareholders, could police misconduct and oppose, support or event instigate, takeovers. Similarly, the rise of proxy advisory services and corporate governance agents allowed for additional monitoring and collective action by shareholders. Finally, the expansion of federal securities law into areas like executive compensation and board independence/monitoring allowed for a semi-private form of monitoring.

The market of the 2000s thus looked very different than the market of the 1980s. In addition to empowered shareholders were more empowered and active, boards were now comprised of a majority of independent directors who presumably were more willing to serve as a check against conflicted management responses. The federal government regulated broad areas of corporate governance. These market developments largely served to fix the market failures of the 1980s. In this brave new world, the need for a court regulator was diminished. Indeed, by 2010 the costs of such regulation were proving to be excessive due to widespread and admittedly frivolous litigation (Fisch, Griffith, Davidoff Solomon 2015; Thomas and Thompson (2011); Thomas and Thompson (2004)).

To be sure, this does not mean that the Delaware courts became irrelevant. The rules for takeovers were still set by the court in the 1980s and created the space for Delaware courts to later retreat. And the courts still serve to police outside conduct which does not fall within the allowed conduct. The difference today is that that the scope of permissible conduct is well-defined and its range is broad so that most takeovers create little need for court intervention. The lack of widespread intervention these days is illustrated by the small number of cases which result in a significant monetary payment to shareholders or an injunction enjoining the deal from completion. In 95% of cases, the transaction completes as contemplated with little judicial intervention beyond the occurrence and quick settlement of litigation (Cain & Davidoff 2015).

We do not think that the current state of play is a paradise where all corporate law problems are resolved. To the contrary, there still exists market failures and areas where judicial intervention to correct market failures may be appropriate. And Delaware courts may still act for political economy or strategic reasons to the detriment of market solutions (Davidoff 2012). In particular, we note the issues raised by the staggered board and poison pill in the face of a hostile bid may be a case for judicial intervention due to the heightened chance of market failure. But we put forth this theory as a general explanation and guide for Delaware's conduct and actions.

We also do not put our theory as this forth as the sole explanation for the rise and fall of these standards. However, we believe that our theory offers a structure for when and where Delaware courts should step in to actively supervise corporate conduct, a topic we take up in the next section. Our theory also jibes with a theory of the Delaware courts. Generally, Delaware law and its courts should generally be oriented towards free market solutions and private contracting. While this is not always the case and political economy considerations sometimes predominate, in many instances left to themselves, the Delaware courts will let markets decide the issue except there is a clear market failure. Where none is identified, then the courts will abstain from action. The evolution of the marketplace over the years permitted the Delaware courts to step back and allow the market to do its work.

V. The Future

It may be that the takeover standards of the 1980s are still evolving. Our theory – that these standards filled a corporate governance failure – provides a touchstone for future Delaware action. This would be in line with the view of Delaware courts as market-oriented, favoring private solutions. If a similar governance failure arose today or in the future, a ratcheting back up of these standards, or the development of new ones, may be appropriate.

In today's market, the best candidates for such renewed interventions appear to be hedge fund activism and shareholder power generally. Critics have argued that activism and the increased power of shareholders has encouraged short-termist behavior. They have led to the adoption of corporate governance initiatives which some claim lack sound theoretical or empirical support, such as the separation of the chairman and CEO position and the abandonment of the staggered board. In extreme cases, shareholder activism has led to significant harm to companies such as J.C. Penney which experienced a substantial decline in revenue due to the implementation of a controversial plan promoted initially by Pershing Square, which was later put in place after Pershing Square seized control of the company.

To date, there has been little judicial appetite for intervention in these matters. Instead, the courts have maintained the status quo, largely applying the *Unocal* standard to review a number of prominent disputes about takeover contests. The most prominent example of this occurred in the Sotheby's case.[24] In that decision the Delaware Chancery Court reviewed the adoption of a two-tiered poison pill which set a 10% trigger for all shareholders except passive institutional ones which could acquire 20% of Sotheby's shares without triggering the poison pill. Sotheby's asserted that it had acted to influence and forestall the activist fund Third Point from building a bigger stake and to prevent it from cooperating with other hedge funds.

The initial question before the Chancery Court was the standard of review to apply, since this would in large part determine the outcome of the case. In this case the court found that the adoption of the poison pill was not done for the "primary purpose" of interfering with the shareholder franchise, the touchstone of *Blasius* analysis, and so that standard did not apply to the poison pill adoption. Third Point had also requested that the Sotheby's board waive of the 10% threshold in order to permit Third Point to accumulate a larger position to

[24] Third Point LLC v. Ruprecht, C.A. No. 9469-VCP (May 2, 2014).

influence an upcoming proxy contest. This would seem to naturally implicate *Blasius* but again Vice Chancellor Parsons refused to apply the standard. The Vice Chancellor called the question "uncomfortably close" but ultimately ruled that *Moran* had implied that the poison pill would have some deleterious effect on shareholder voting, and that while there was incidental voting power reduction here, the Sotheby board's actions did not preclude a proxy contest.

Since *Blasius* did not apply to the Sotheby's board action, it was reduced to a *Unocal* case. Not surprisingly, given the weakness of the *Unocal* standard, the court ultimately upheld the poison pill and the refusal to waive the threshold as valid acts under *Unocal*. The court reasoned that the 10% threshold was appropriate because it was substantially higher than the board's cumulative offsetting ownership of 1% of Sotheby's. The 10% thus seemed reasonable given the larger stake a hedge fund could accumulate and its effect of forestalling a "wolf pack" of hedge funds from collectively accumulating a more significant, controlling stake.

The Sotheby's case is the latest in a string of cases, including the *Yucaipa* case involving an activist attack on Barnes and Noble, where the Delaware court utilized *Unocal* to analyze defensive measures against an activist. The fit could be questioned. *Unocal* was designed to address excessive measures taken by boards defending hostile takeovers, not activists, and each is a different situation. Given the markedly different contexts, the Delaware court could have easily created a different standard or perhaps utilized the *Blasius* standard which seems more focused on the type of voting issues which occur in an activist situation. But the courts did neither, instead preferring an effectively abstentionist approach.

In the case of Sotheby's, we think the lack of a more substantive intervention made sense. The Sotheby's board may have acted aggressively, but there were still existing and plausible market mechanisms to check their behavior. Indeed, the day after the Vice Chancellor's decision, the Sotheby's board settled its proxy fight with Third Point, appointing a number of Third Point representatives to the Sotheby's board. It did so due to its imminent defeat in the proxy contest.

More generally, we also believe that the current market dynamics do not justify more searching standards on defensive actions against hedge fund activism. The market appears to be functioning with motivated large shareholders serving as a monitor, willing to take steps to remove and replace directors when their conduct oversteps bounds. For example, in the case of Darden Restaurants, the board acted to sell its Red Lobster restaurants despite protests of institutional shareholders and activist shareholders. The result was a replacement of the entire board at a proxy contest.[25] Some may criticize institutional shareholders as unduly favoring activists, but in fairness they have been seen to be willing to act contrary to activists demands in appropriate cases, such as Cracker Barrel and Du Pont.

Another way to put this is that we believe that there currently exist market mechanisms which can serve as an effective check on company defensive action. We believe this force is animating Delaware's hesitancy to wade into this debate. This hesitancy is mirrored in the SEC's stated refusal to "take sides" in the shareholder activist battle despite the SEC's earlier willingness to intervene in the 1980s. And it is a force buttressed by the number of studies which have found that in general activism increases the value of firms.

More broadly, there is the issue of short termism and board's ability to respond effectively to this pressure. We note at the outset that there is a widespread debate about the existence of short-termism. Theoretically speaking short-termism should not exist if markets are functioning efficiently. Markets will simply price in this conduct and so shareholders and boards will avoid detrimental actions. Of course, there may be market malfunctions or imperfections which make the market unable to price these actions, and that may be occurring here but there is no definitive evidence either way.

In this cauldron it is hard to see a role for the Delaware courts in regulating short-termist behavior, which is conduct which can be alleged to be short-termist in nature. Delaware already emphasizes the role of directors in corporate decision making as well as the clear right for shareholders to freely elect directors. These sometime counter-vailing considerations mitigate forbearance to allow both boards and shareholders to establish their own private equilibrium. Even putting aside the issue of judicial capability and the actions Delaware could even take, given the multiple private forces present, action at this time would seem to be precipitous.

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[25] See Alexandra Stevenson, "Activist Hedge Fund Starboard Succeeds in Replacing Darden Board", *The N.Y. Times*, Oct 11, 2014, B6.

This does not mean that Delaware should be quiescent. Markets evolve rapidly, and there will no doubt be future market malfunctions in corporate governance. Delaware should be prepared to fill clear gaps with judicial enforcement mechanisms and a willingness to set rules of the road for new conduct in order to allow the development of private solutions. This may happen at a later date, but right now there appears to be limited need for Delaware to once again fulfill the role as regulator and rule maker in chief.

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