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Publication Date

2003-02-10

**University of California, Los Angeles
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Law and Economics Research Paper No. 02-02

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**DEAD HAND AND NO HAND PILLS:
PRECOMMITMENT STRATEGIES IN CORPORATE LAW**

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Abstract: Corporations frequently make use of precommitment strategies. Examples include such widely used devices as negative pledge covenants and change of control clauses in bond indentures, fair price shark repellents, no shop and other exclusivity provisions in merger agreements, mandatory indemnification bylaws, and so on. This paper argues that poison pills also can be understood as a form of precommitment, by which the board of directors commits to a policy intended either to negotiate a high acquisition price or to maintain the corporation's independence.

In *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*, the Delaware supreme court invalidated a no hand poison pill on grounds that a board of directors lacks authority to adopt such devices. In doing so, the court misinterpreted relevant Delaware law. Its unjustifiably called into question the validity of a host of corporate precommitment strategies. Finally, and perhaps most troublingly, it called into question the central tenet of Delaware corporate law; namely, the plenary authority of the board of directors.

This article argues that the Delaware supreme court's decision was wrong both as a doctrinal and a policy matter. There simply is no firebreak between the sorts of board self-disablement deemed invalid by *Quickturn* and the host of other precommitment strategies routinely used by corporate boards of directors. The Delaware supreme court's conclusion that the former are invalid for lack of statutory authority thus threatens to invalidate all of the latter. The article concludes by arguing that the Delaware supreme court should have analyzed the no hand pill under standard fiduciary duty principles rather than creating a new prophylactic ban on precommitment strategies.

Keywords: poison pill, precommitment, board of directors, corporate law

JEL Classification: G34, K22

***Dead Hand and No Hand Pills:
Precommitment Strategies in Corporate Law***

Stephen M. Bainbridge^{*}

I. INTRODUCTION

In *The Odyssey*, Homer tells a story illustrating the use of a precommitment strategy to achieve a desired goal. Circe warned Odysseus that his course would lead him past the Sirens, whose song famously enchanted all who passed near them.¹ Once they trapped passing sailors, the Sirens warbled the sailors to death. Following Circe's advice, Odysseus adopted a plan by which he would be able to hear the Sirens' song but still escape their trap.² Odysseus charged his men to lash him to the mast of their boat and not to release him until they were far beyond the Sirens. Odysseus then stopped up his sailor's ears with beeswax, so they could hear nothing. As his ship passed the Sirens, their song overwhelmed Odysseus' will power and he tried desperately to get his men to approach the Sirens.³ Unable to hear the song, and thus being free of its enchantment, however, his men merely tied him even more tightly to the mast and sailed on. Only once they were safely past the Sirens did they release Odysseus.⁴

As Homer's tale illustrates, self-disablement is a critical aspect of any precommitment strategy.⁵ Odysseus knew he would not be able to trust himself once he heard the Siren's song. Hence, he had to create a situation in which he would be unable to effect a change in the course to which he was committed. As Homer's tale also illustrates, however, precommitment strategies sometimes require one to disable others. Odysseus also knew, after all, that he would not be able to trust his crew if they could hear the Siren's song.

Precommitment strategies of both types abound in everyday life. We frequently face situations in which "our rational planner [self] foresees an episode in which the preferences then governing his decisions—the actual choices he will

^{*} Professor, UCLA School of Law. I am grateful for the able research assistance of Steven Chasin, UCLA School of Law Class of 2003. I am also grateful for constructive criticism by Iman Anabtawi, Jack Jacobs, William Klein, Lynn Stout, and the participants in a faculty workshop at the Ohio State University College of Law.

¹ HOMER, ODYSSEY 182 (Stanley Lombardo trans., Hackett Publishing Co., Inc., 2000).

² *Id.*

³ *Id.* at 183-84.

⁴ *Id.* at 184.

⁵ See Thomas C. Schelling, *Enforcing Rules on Oneself*, 1 J. L. ECON. & ORG. 357, 370 (1985) (describing some precommitment strategies as "disabling rules").

make on that future occasion—are contrary to his current preferences with respect to that *future* occasion.”⁶ Put another way, we wish to protect ourselves “against a future lack of willpower.”⁷ The dieter who cleans all the junk food out of his pantry before starting a new diet precommits to the diet by disabling himself from enjoying a late night snack.⁸ The Congress that passed First Amendment to the U.S. Constitution precommitted to a policy of free speech, by disabling itself from regulating speech and assembly.⁹ Indeed, that Congress went even further by disabling future Congresses from doing so as well, a point that becomes quite significant for our analysis.¹⁰ And so on.

Precommitment strategies also abound in business life. When a corporation’s board of directors authorizes the inclusion of a negative pledge clause in a bond indenture, the board disables the corporation from issuing certain types of secured debt.¹¹ When the board and/or shareholders adopt a mandatory indemnification amendment to the bylaws, they precommit the corporation to a policy of indemnifying officers and directors under circumstances in which the statute does not mandate such indemnification.¹² And so on.¹³

⁶ *Id.* at 361.

⁷ GEORGE J. STIGLER, *THE THEORY OF PRICE* 57 (3d ed. 1966).

⁸ See Schelling, *supra* note 5, at 370 (noting that “keeping nothing to eat in the kitchen precludes a midnight snack”).

⁹ See, e.g., Cass R. Sunstein, *Constitutionalism and Secession*, 58 U. CHI. L. REV. 633, 641 (1991) (suggesting that “constitutional precommitment strategies might serve to overcome myopia or weakness of will on the part of the collectivity, or to ensure that representatives follow the considered judgments of the people. Protection of freedom of speech . . . might represent an effort by the people themselves to provide safeguards against the impulsive behavior of majorities.”). But see JON ELSTER, *ULYSSES UNBOUND* 92 (2000) (calling into question the extent to which constitutions can be considered as precommitment devices).

¹⁰ See generally ELSTER, *supra* note 9, at 170 (questioning whether constitutions should attempt to bind future generations).

¹¹ Cf. WILLIAM A. KLEIN AND JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 244 (8th ed. 2002) (describing negative pledge clauses).

¹² Section 145(f) of the Delaware General Corporation Law provides that statutory indemnification rights “shall not be deemed exclusive of any other rights” to indemnification created by “bylaw, agreement, vote of the stockholders or disinterested directors or otherwise.” DEL. CODE ANN. tit. 8, § 145(f) (2002). Most public corporations have availed themselves of this provision to extend “indemnification guarantees via bylaw to cases where indemnification is typically only permissive” by statute. *VonFeldt v. Stifel Fin. Corp.*, 714 A.2d 79, 81 n.5 (Del.1998).

¹³ Other examples of corporate precommitment strategies are discussed *infra* Part IV.A.

In *Carmody v. Toll Brothers*,¹⁴ however, the Delaware chancery court cast considerable doubt on the validity of an emergent corporate precommitment strategy—the dead hand poison pill—suggesting, *inter alia*, that the board of directors likely lacked authority to adopt such devices. In *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*,¹⁵ the Delaware supreme court invalidated a related device—the no hand poison pill—solely on grounds that a board of directors lacks authority to adopt such devices.

By relying on the scope of the board's authority, the Delaware supreme court made a serious error. The court misinterpreted relevant Delaware law.¹⁶ Its unjustifiably called into question the validity of a host of corporate precommitment strategies.¹⁷ Most important, however, it called into question a basic tenet of Delaware corporate law; namely, the plenary authority of the board of directors.¹⁸ Delaware law wisely vests formal decisionmaking authority in the hands of the board of directors. Indeed, it is fair to say that if Delaware did not do so, the modern corporation could not exist.¹⁹ Yet, if read broadly, *Quickturn* denies the board's authority to make many ordinary corporate governance devices requiring board self-disablement.²⁰

Part II of this Article provides the necessary background by describing precommitment strategies and explaining their roles in both individual and groups settings. Part III reviews the development of poison pills, culminating in the no hand and dead hand variants and the Delaware cases invalidating them. Part IV explains why *Quickturn* potentially invalidates most, if not all, board of directors-adopted precommitment strategies. Finally, Part IV also argues that the basic principle of Delaware corporate law is—and should remain—the plenary authority of boards of directors.²¹

¹⁴ 723 A.2d 1180 (Del. Ch. 1998).

¹⁵ 721 A.2d 1281 (Del. 1998).

¹⁶ See *infra* notes 174-179 and accompanying text.

¹⁷ See *infra* notes 182-208 and accompanying text.

¹⁸ See *infra* Part IV.B.

¹⁹ See *infra* notes 217-256 and accompanying text.

²⁰ See *infra* notes 180-181 and accompanying text.

²¹ In the academic literature, the prevailing view tends to be that directors and managers of target corporations should be granted little, if any, discretion to resist unsolicited takeover bids. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing for a rule requiring target directors and managers to be passive in the face of an unsolicited bid); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982) (arguing that target directors and managers should have a carefully circumscribed ability to

II. PRECOMMITMENT STRATEGIES

A precommitment strategy may be effected in any of four basic ways in which: (1) The actor may create a situation in which certain options are removed from the feasible set.²² For example, a bylaw provision mandating director and officer indemnification in situations where the statute merely permits it, is such a precommitment strategy because it denies the corporation the option of not paying.²³ (2) The actor may increase the cost of choosing specific options.²⁴ A negative pledge clause in a bond indenture thus increases the cost of raising new secured debt by making the issuance of such debt an event of default on the existing bond.²⁵ (3) The actor may make certain options available only after a delay or cooling off period.²⁶ So as to elicit employee commitment, for example, various forms of compensation are subject to vesting periods that delay their enjoyment.²⁷ (4) The actor may insulate himself from knowledge about the existence of certain options.²⁸ Hence, the old adage “ignorance is bliss” turns out to be true, at least in some cases.²⁹ In each of these ways, the actor self-disables—albeit to varying degrees—by limiting the array of feasible choices.

induce an auction of corporate control in response to an unsolicited bid). The Delaware supreme court has rejected this view, however, making clear that the board of directors has substantial discretion to resist unsolicited takeover bids. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 n.10 (Del. 1985) (observing that the academic argument for passivity “clearly is not the law of Delaware”). Deciding whether the academics of the courts are correct on this score is a task for another day. In this article, I assume *arguendo* that target board and management resistance is proper.

²² ELSTER, *supra* note 9, at 1.

²³ *See, e.g., Citadel Holding Corp. v. Roven*, 603 A.2d 818 (Del. 1992) (holding that an indemnification provision properly may mandate advancement of expenses even where the statute does not require it).

²⁴ ELSTER, *supra* note 9, at 1.

²⁵ *See KLEIN & COFFEE, supra* note 11, at 244 (discussing negative pledge covenants); *see also id.* at 248 (discussing events of default).

²⁶ *See ELSTER, supra* note 9, at 12-13 (discussing examples).

²⁷ Katherine V.W. Stone, *The New Psychological Contract: Implications of the Changing Workplace for Labor and Employment Law*, 48 UCLA L. REV. 519, 557 (2001) (noting “human resource policies such as longevity-based benefits, long vesting periods for pensions, and seniority systems . . . that make it worthwhile for an employee to stay and costly for her to leave”).

²⁸ ELSTER, *supra* note 9, at 15 (noting the use of self-imposed ignorance as a way of preventing passionate actions).

²⁹ *Id.* at 2.

But why do people voluntarily impose limit their choices, given that we usually assume more choices are better than fewer?³⁰ Precommitment strategies are adopted to solve the problems known to behavioral economists as time inconsistent discount rates and multiple selves.³¹ As to the former, the discount rate an individual applies when making net present value calculations often declines as the date of the reward recedes. Korobkin and Ulen offer the following example of this phenomenon, which is known as hyperbolic discounting:

Suppose that an individual is to choose between Project A, which will mature in nine years, and Project B, which will mature in ten years. Suppose, further, that an individual who compares the two projects across all their different dimensions prefers Project B to A. Now suppose that we bring the dates of maturity of the two projects forward while maintaining the one-year difference in their maturity dates. Because discount rates increase as maturity dates get closer, it is possible that the individual's preference will switch from Project B to Project A as the dates of maturity decline (but preserving the one-year difference).³²

Richard Thaler offers a more homely explanation of the same phenomenon: "In the morning, when temptation [Project B] is remote, we vow to go to bed early, to stick to our diet, and not have too much to drink [collectively, Project A]. That night we stay out to 3:00 A.M., have two helpings of chocolate decadence, and sample every variety of Aquavit at a Norwegian restaurant."³³ Put yet another way, one consequence of hyperbolic discounting is that people "always consume more in the present than called for by their previous plans."³⁴ In response, the actor may develop a precommitment strategy designed to restrict over time the rate at which the good in question is consumed.

The somewhat related phenomenon of multiple selves posits that individuals do not have a single utility function, but rather multiple competing utility functions. Because each self orders preferences differently, there is an ever-present risk that the self predominating at a given moment may make decisions not in the complete individual's best interest. Again, Korobkin and Ulen explain:

³⁰ See *id.* at 1-2 (acknowledging that self-imposed limits on choice seem counterintuitive).

³¹ See generally Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1119-24 (2000) (explaining how these problems can lead actors to make choices inconsistent with the predictions of the standard neoclassical model of rational choice). Elster likewise identified four basic reasons actors might choose to limit choice: "passion, preference change, and (two varieties of) time-inconsistency." ELSTER, *supra* note 9, at 1.

³² Korobkin & Ulen, *supra* note 31, at ____.

³³ RICHARD H. THALER, *THE WINNER'S CURSE* 98 (1992).

³⁴ *Id.*

“A stiff tax on cigarettes, to take an obvious example, can be viewed as aiding the future-oriented self in its battle with a more present-oriented self that values immediate gratification over long-term health. . . . Today’s self can attempt to make commitments that either will completely bind tomorrow’s self or, at least, raise the cost of taking action that today’s self wishes to avoid.”³⁵ In Homer’s tale, Odysseus lashed himself to the mast precisely so that his future self would be unable to satisfy its expected desire to prolong exposure to the Sirens’ song. Being lashed to the mast was a precommitment strategy by which he avoided making an unwise decision in the future. Hence, Odysseus privileged the desires of his farsighted “planner” self, who was concerned with lifetime utility, over those of his myopic and selfish “doer” self.³⁶ In general, where precommitment strategies are desirable to disempower the myopic “doer” self, “people rationally chose to impose constraints on their own behavior.”³⁷

Thus far we have been focusing on ways in which individuals precommit themselves (or, as Odysseus’ story illustrates, those around them) so as to achieve some desired personal goal. We might refer to these as self-regarding precommitments. Once we introduce collaborative effort, however, the potential emerges for what might be termed other-regarding precommitments.³⁸ Specifically, other-regarding precommitments are a response to the problem of opportunism (a.k.a. strategic behavior) inherent in all collaborative effort.³⁹ Other-regarding precommitments address strategic behavior by making both threats and promises more credible.⁴⁰

Consider, for example, the classic economic problem known as agency costs. Agency costs arise because agents have incentives to shirk, which we might define as any action by a member of a production team that diverges from the interests of the team as a whole.⁴¹ As such, shirking includes not only culpable cheating, but

³⁵ Korobkin & Ulen, *supra* note 31, at ____.

³⁶ See generally Richard H. Thaler & H.M. Shefrin, *An Economic Theory of Self-Control*, 89 J. POL. ECON. 392, 394-95 (1981) (distinguishing between planner and doer selves).

³⁷ *Id.* at 398.

³⁸ *Cf. id.* at 396 (noting the parallel between “self-control” and “the principal-agent conflict between the owner and manager of a firm”).

³⁹ Opportunism arises because parties to a contract are inevitably tempted to pursue their own self-interest at the expense of the collective good, which in market transactions leads to contract breaches requiring resort to costly enforcement mechanisms. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47-49 (1985) (discussing opportunism).

⁴⁰ See ELSTER, *supra* note 9, at 34 (noting the relationship between precommitments and “the problem of making credible threats and promises”; emphasis deleted).

⁴¹ See MICHAEL C. JENSEN, *A THEORY OF THE FIRM* 86 (2000) (noting that the agency cost problem arises because “there is good reason to believe that the agent will not always act in the

also negligence, oversight, incapacity, and even honest mistakes.⁴² A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor's optimal trade-off between labor and shirking is, by definition, the same as the firm's optimal trade-off.⁴³ Agents of a firm will not internalize all of the costs of shirking, however, because the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking.⁴⁴

To limit shirking, principals may monitor their agents. For example, a corporate compensation committee's "primary function is to monitor and evaluate the inside board member's performance and determine inside board members' compensation."⁴⁵ In order for monitoring to be effective, however, principals must be able to make both credible threats to discipline agents who shirk and credible commitments to reward agents who do not shirk.⁴⁶

Often, however, monitoring is prohibitively costly.⁴⁷ In such cases, the principal simply may assume that all agents shirk and discount the compensation of all agents so as to off-set the expected level of shirking. As such, it may be worthwhile for faithful agents to bond their performance. In theory, for example, corporations bond their promises to investors by having certified accountants audit their financial statements.⁴⁸ In order for a bond to be effective, however, the

best interests of the principal"); cf. Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 465 (1992) (defining the closely related concept of "opportunism" as "the constant human temptation to pursue self-interest at the expense of others").

⁴² Dooley, *supra* note 41, at 465.

⁴³ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. ECON. 305, __ (1976).

⁴⁴ *Id.*

⁴⁵ JENSEN, *supra* note 41, at 144.

⁴⁶ Cf. WILLIAMSON, *supra* note 39, at 167 (distinguishing between credible threats and commitments).

⁴⁷ Economists Armen Alchian and Harold Demsetz offered the useful example of two workers who jointly lift heavy boxes into a truck. Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, __ (1972). The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components. *Id.* at __. In such situations, obtaining information about a team member's productivity and appropriately rewarding each team member is costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness. See generally Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LIT. 1382, 1405-07 (1992) (providing a detailed treatment of the incentive effects pursuant to which rational agents will shirk).

⁴⁸ JENSEN, *supra* note 41, at 103.

agent's promise must be a credible one. Consequently, when several high-profile accounting scandals called into question the credibility of audits, investor confidence significantly eroded.⁴⁹

Taken together with any residual loss, these monitoring and bonding costs constitute the agency costs associated with a given relationship.⁵⁰ To the extent precommitment strategies lend credibility to threats and promises, agency costs thus are reduced. Suppose a prospective lender is concerned that a would-be corporate borrower might undermine the security of its loan by subsequently mortgaging existing assets. The prospective debtor might promise to refrain from incurring new debt having a security interest superior to that of the current lender. Yet, the lender has doubts. Just as a dieter might raid the refrigerator for a midnight snack unless all junk food has been thrown out, the debtor might later renege on its promise. By incorporating that promise into a negative pledge clause and making a violation of that clause an event of default, the corporate debtor enters into a precommitment strategy making its promise more credible.

Many provisions of a corporation's articles of incorporation and bylaws in fact are best understood as other-regarding precommitments, just as are many of the terms of the contracts by which the corporation's securities are sold. Among the examples already noted are negative pledge covenants, other provisions of bond indentures, and mandatory indemnification clauses.⁵¹ Similarly, many internal firm policies are best understood as precommitment strategies. One common precommitment strategy is the adoption of rules that limit discretion over a class of action presenting particularly risky conflicts between the planner and doer self.⁵² A compulsive gambler, for example, may adopt a rule of personal conduct forbidding him from entering Las Vegas.⁵³ Similarly, a corporation might adopt a rule forbidding plant managers from making capital decisions involving more than a specified sum or for longer than a specified term. Other examples of organizational precommitment strategies are discussed below.⁵⁴

No one seriously contends that individuals should be prohibited from making other-regarding precommitments. The question before us is whether a corporation should be prohibited from doing so in some or all cases.

⁴⁹ *Badly in Need of Repair—Company Accounts*, *ECONOMIST*, May 4, 2002, at S2.

⁵⁰ Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 *J. L. & ECON.* 301, 304 (1983).

⁵¹ See *supra* notes 11-13 and accompanying text.

⁵² Thaler & Shefrin, *supra* note 36, at 398.

⁵³ *Id.*

⁵⁴ See *infra* Part IV.A.

III. POISON PILLS: FROM THE FIRST GENERATION TO THE DEAD AND NO HAND PILLS

Recent years have seen a resurgence of the corporate governance issues that dominated the 1980s, including: hostile takeover bids, white knights, and takeover defenses. In 1998, for example, almost 350 public corporations adopted poison pills for the first time.⁵⁵ At the same time, the arsenal of takeover defenses developed during the 1980s has been reinforced with new variants, notably the so-called dead hand and no hand poison pills.⁵⁶

Takeover defenses frequently involve some form of precommitment strategy. Consider, for example, the controversial “just say no” strategy: The target’s board of directors simply refuses either to allow the firm to be acquired or to pursue an alternative transaction, such as a negotiated acquisition with a white knight.⁵⁷ Takeover defenses, especially the poison pill, lend credibility to the target board’s asserted commitment to independence.

Alternatively, the target’s board might wish to make a credible commitment to sell the company only at the highest possible price. Again, takeover defenses are necessary to give that commitment credibility. Unless the directors can plausibly threaten to preclude the bid from going forward, they have no negotiating leverage. The prospective acquirer easily could bypass the board by making a lowball bid directly to the shareholders in a tender offer or proxy contest.

Finally, the board may wish to bind either subsequently elected boards and/or the shareholders to the board’s chosen course of action. (Just as Odysseus limited his sailors’ choices by stuffing their ears with wax.) As we shall see, it is this aspect of poison pills as a precommitment device that is most problematic.⁵⁸

Poison pills take a wide variety of forms, but today most are based on the class of security known as a right. Hence, the pill’s official name, the “shareholder rights plan.” A traditional right, such as a warrant, grants the holder the option to purchase new shares of stock of the issuing corporation. The modern

⁵⁵ Patrick S. McGurn, *Corporate Governance in a Changing Market*, INSIGHTS, Dec. 1998, at 3.

⁵⁶ WILLIAM A. KLEIN ET AL., *BUSINESS ASSOCIATIONS* 814-16 (4th ed. 2000) (discussing recent developments in Delaware takeover jurisprudence driven by newly developed takeover defenses).

⁵⁷ See, e.g., *Delaware Court Explains Action on Time Merger*, WALL ST. J., Feb. 28, 1990, at A3; *The “Buzz-Off” Defense: A Play on the Time Ruling*, 24 MERGERS & ACQUISITIONS, Mar./Apr. 1990, at 7-8.

⁵⁸ See *infra* Part IV.C.

poison pill adds three additional elements not found in traditional rights: a “flip-in” element; a “flip-over” element; and a redemption provision.⁵⁹

A. First Generation Pills

The first poison pill was adopted in 1983 by Lenox.⁶⁰ Like most of the first generation pills, the Lenox plan was based on so-called blank check preferred stock.⁶¹ Many corporate charters authorize a class of preferred stock whose rights are not detailed in the articles.⁶² Instead, the preferred stock’s rights are defined by the board of directors at the time the stock is issued.⁶³ Typically, the issuance of such shares does not require any shareholder action—hence, the name “blank check.”⁶⁴ The Lenox pill was issued as a special dividend consisting of nonvoting convertible preferred stock, the dividend issuing at the ratio of one preferred share for every forty shares of common stock.⁶⁵

The anti-takeover effect of the preferred stock lay in the conversion rights conferred on its holders. If Lenox was merged into another corporation, the preferred stock became convertible into common stock of the acquiring corporation at a price well below market.⁶⁶ Any such conversion would result in undesirable balance sheet effects for the bidder and dilute the holdings of pre-existing bidder shareholders, which would make an acquisition of Lenox less attractive.⁶⁷

The Lenox plan was an early variant of what are now known as flip-over plans. Modern flip-over plans start not with preferred stock as did the Lenox pill,

⁵⁹ Warrants can trade as separate securities, although they are often sold initially as part of a package with other securities. Warrants have value because they confer on the holder the right to buy issuer common stock at a discount from the prevailing market price. MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 168 (1995). In contrast, the poison pill right typically is “stapled” to the common stock and does not trade separately until some triggering event occurs. *See id.* at 545-46 (describing pills).

⁶⁰ Martin M. Cohen, “Poison Pills” as a Negotiating Tool: Seeking a Cease-Fire in the Corporate Takeover Wars, 1987 COLUM. BUS. L. REV. 459, 468-469.

⁶¹ *See id.* at 464 (discussing use of preferred stock in first generation pills).

⁶² KLEIN & COFFEE, *supra* note 11, at 135 n.23.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ Cohen, *supra* note 60, at 468.

⁶⁶ *Id.*

⁶⁷ *See generally* Thomas R. Wilcox, Note, *Delaware’s Attempt to Swallow a New Takeover Defense: The Poison Pill Preferred Stock*, 10 DEL. J. CORP. L. 569, 574 (1985) (discussing deterrent effect of early pills).

but with the issuance of rights as a pro rata dividend on the common stock to the shareholders of the target corporation.⁶⁸ Rights are corporate securities that give the holder of the right the option of purchasing shares of the issuer.⁶⁹ Because issuance of rights does not require shareholder approval, a rights-based pill may be adopted by the board of directors without any shareholder action.⁷⁰ When adopted, the rights initially attach to the corporation's outstanding common stock, cannot be traded separately from the common stock, and are priced so that exercise of the option would be economically irrational.⁷¹ The rights become exercisable, and separate from the common stock, upon a so-called distribution event, which is typically defined as the acquisition of, or announcement of an intent to acquire, some specified percentage of the issuer's stock by a prospective acquirer.⁷² Although the rights are then exercisable, and remain so for the duration of their specified life (typically ten years), they remain out of the money.⁷³ Because the rights trade separately from the issuer's common stock, however, an acquirer remains subject to the pill's poisonous effects even if an over-whelming majority of the target's shareholders accept the bidder's tender offer. It is this feature that enables the pill to be used as a precommitment device.

⁶⁸ KLEIN & COFFEE, *supra* note 11, at 188.

⁶⁹ DOOLEY, *supra* note 59, at 168.

⁷⁰ See *Account v. Hilton Hotels Corp.*, 2001 WL 1047417 (Del. 2001) (noting the power of "directors of a Delaware corporation" to "adopt a rights plan unilaterally").

⁷¹ Harvey L. Pitt, *On the Precipice: A Reexamination of Directors' Fiduciary Duties in the Context of Hostile Acquisitions*, 15 DEL. J. CORP. L. 811, 813 n.8 (1990). The rights are initially stapled to the common stock so as to ensure that the rights cannot trade separately from the common. If the rights traded separately, the potential target corporation would have to issue a separate security. More important, if the rights did not trade with the common, holders might sell common without selling the rights—or vice-versa if a separate secondary trading market developed for the rights.

⁷² Pitt, *supra* note 71, at 813 n.8.

⁷³ Why are the rights detached from the shares in a way that initially makes them unattractive to exercise? By detaching the rights once a bidder is on the scene, the target ensures that the bidder has to buy up the rights separately. Some stockholders will tender their common or sell their common shares on the market, but retain the rights. Consequently, the bidder has to deal with two distinct groups. As for the provision under which the rights are initially convertible into preferred (out of the money) and only convertible into common (in the money) in the event of a second-step transaction, it is intended to preclude an argument that the right was a sham security. Delaware law allows the corporation to issue rights, but does not facially authorize the issuance of rights for takeover defenses purposes. See *infra* notes 102-105 and accompanying text. Presumably, the transaction planner who devised the pill intended that this provision would make it appear as though the rights had economic value.

The pill's flip-over feature typically is triggered if, following the acquisition of a specified percentage of the target's common stock, the target is subsequently merged into the acquirer or one of its affiliates.⁷⁴ In such an event, the holder of each right becomes entitled to purchase common stock of the acquiring company, typically at half-price, thereby impairing the acquirer's capital structure and drastically diluting the interest of the acquirer's other stockholders.⁷⁵ In other words, once triggered, the flip-over pill gives target shareholders the option to purchase acquiring company shares at a steep discount to market. As with the older style preferred stock pills, this causes dilution for the bidder's pre-existing shareholders and may have undesirable balance sheet effects.⁷⁶

In order for the pill to be an effective negotiating device, of course, the target's board must be able to eliminate its poisonous effect so as to allow a negotiated acquisition to go forward. Flexible redemption provisions are imperative for this purpose. Such provisions give the board the option to redeem the rights at a nominal cost. The so-called window redemption provision allows the board to redeem the rights for a specified time period following the issuance of the rights.⁷⁷ The white knight redemption provision allows the board to redeem the rights in connection with a transaction approved by a majority of the continuing directors.⁷⁸

As a precommitment strategy, the first generation flip-over pills lacked credibility. To be sure, target boards frequently deployed them as a negotiating device or in an attempt to remain independent.⁷⁹ Yet, so long as the pill was redeemable, the board had not tied itself to the mast very tightly. Indeed, the board was bound so loosely that the first generation pill arguably should not even

⁷⁴ See KLEIN & COFFEE, *supra* note 11, at 188 (discussing flip-over pills)

⁷⁵ See *id.* (noting the "substantial discount" characteristic of flip-over pills).

⁷⁶ See Guhan Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 Del. J. Corp. L. 375, 397 (1998) (noting that the "dilution resulting from triggering [a pill] makes a tender offer a prohibitively expensive method of acquisition").

⁷⁷ STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 684 (2002).

⁷⁸ *Id.*

⁷⁹ See KLEIN & COFFEE, *supra* note 11, at 188 (observing that "[t]he nominal purpose of the pill is to require bidders to negotiate with the board, to enable the board to seek competing bids, and to give the board the ability to resist offers that are, in its judgment, inadequate or coercive"); Subramanian, *supra* note 76, at 398 (arguing, however, that a pill tips "the negotiating balance too far toward management").

be characterized as a precommitment device.⁸⁰ It was all too easy, moreover, for a hostile bidder to defeat a flip-over pill. The classic example of a bidder turning such a pill to its own advantage was Sir James Goldsmith's takeover of Crown Zellerbach.⁸¹ Like most first generation pills, the Crown Zellerbach pill only had teeth if the bidder sought to effect a freezeout merger. Goldsmith acquired a substantial interest in Crown Zellerbach, but decided not to squeeze out the remaining Crown Zellerbach shareholders.⁸² This decision had a rather nifty payoff. Because Goldsmith was willing to forgo a freeze-out merger, the pill had no effect on him, but because the rights were now exercisable in the event of a merger, Goldsmith had precluded anyone from merging with Crown Zellerbach—any merger partner would suffer the poisonous effects.⁸³ As a result, he had effectively precluded the board from attracting a white knight.⁸⁴

As the defects in the first generation of pills became increasingly obvious, takeover lawyers developed new features to close the various loopholes that had been identified. Among the most important of these was the so-called flip-in element, which prevents a bidder from implementing the Goldsmith strategy. The critical difference between the two types of pills is that the flip-in plan enables shareholders of the target to purchase target stock at a discount.⁸⁵ The flip-in pill is triggered typically by the actual acquisition of some specified percentage of the issuer's common stock.⁸⁶ If triggered, the flip-in pill entitles the holder of each right—except, and this is key, the hostile bidder and its affiliates or associates—to buy shares of the target issuer's common stock or other securities at half price.⁸⁷ In other words, the value of the stock received when the right is exercised is equal to two times the exercise price of the right. The flip-in plan's deterrent effect thus comes from the dilution caused in the target shares held by the acquirer.⁸⁸ For

⁸⁰ On the other hand, many other recognized precommitment strategies in both personal and economic life provide only weak constraints. See *infra* notes 261-263 and accompanying text (arguing that weak constraints still qualify as precommitments).

⁸¹ Peter V. Letsou, *Are Dead Hand (and No Hand) Poison Pills Really Dead?*, 68 U. CIN. L. REV. 1101, 1109 (2000).

⁸² *Id.*

⁸³ *Id.*

⁸⁴ For a catalog of other means by which first generation pills could be defeated, see *Moran v. Household Intern., Inc.*, 500 A.2d 1346, 1354 (Del. 1985).

⁸⁵ See KLEIN & COFFEE, *supra* note 11, at 188 (describing flip-in pills).

⁸⁶ DOOLEY, *supra* note 59, at 546.

⁸⁷ *Id.*

⁸⁸ See KLEIN & COFFEE, *supra* note 11, at 188 (noting that the flip-in pill dilutes “the value of the target shares held by the bidder”).

example, in Grand Metropolitan's bid for Pillsbury, Pillsbury's flip-in plan would have reduced Grand Met's interest in Pillsbury from 85% to 56 percent.⁸⁹ The value of Grand Met's holdings would have declined by more than \$700 million dollars.⁹⁰

B. Moran and the Board's Authority to Adopt Pills

In *Moran v. Household International*, the Delaware supreme court upheld a poison pill against challenges based on both the board's authority and the board's fiduciary duties.⁹¹ Household's poison pill was a fairly standard flip-over pill. The pill could be triggered by either of two events: (1) the making of a tender offer for 30% or more of Household's shares or (2) the purchase of 20% or more of Household's outstanding shares by any person or group.⁹² In either case, if the rights issued they were immediately exercisable and would entitle the holders to purchase 1/100th of a share of Household preferred stock at a price of \$100.⁹³ Only in the event of a second-step transaction, such as a freeze-out merger, did the rights become exercisable for stock of the acquiring company.⁹⁴

If triggered by announcement of a tender offer, the rights were redeemable at a nominal price.⁹⁵ If the pill was triggered by a stock purchase, however, the rights were nonredeemable.⁹⁶ The transaction planner presumably intended this distinction to deter hostile beachhead acquisitions exceeding 20% of the shares,⁹⁷ while still allowing a friendly deal to be accomplished by means of a tender offer launched from below the 20% threshold. Note that the effect of this provision, however, was to substantially limit the board of directors' authority. Once the pill was triggered via the requisite stock acquisition, the board was disabled from redeeming the pill.

Two shareholders sued to have the pill invalidated. Among other charges, plaintiffs argued that the relevant provision of the Delaware General Corporation Law, § 157, did not authorize the issuance of the rights as structured by

⁸⁹ *Grand Metropolitan, PLC v. Pillsbury Co.*, 558 A.2d 1049, 1051 n.2 (Del. Ch. 1988).

⁹⁰ *Id.*

⁹¹ *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

⁹² *Id.* at 1348.

⁹³ *Id.* at 1349.

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ A beachhead acquisition considerably enhances a hostile bidder's chances for success. See BAINBRIDGE, *supra* note 77, at 655.

Household.⁹⁸ Delaware § 157 provides, in pertinent part: “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 purchase from the corporation any shares of its capital stock of any class or classes.”⁹⁹ This statutory language presented two significant issues.¹⁰⁰ First, were the rights and/or the preferred stock into which they were initially convertible sham securities? Although the rights are initially convertible into preferred (at a conversion rate far out of the money) and only convertible into common (in the money) in the event of a second-step transaction, they did separate from the common stock in the event of a triggering event. At that point, they presumably would develop a secondary market in which they could be bought and sold. If a second-step merger occurred, moreover, sensible shareholders would exercise the rights. Presumably, the transaction planner who devised the pill intended that these provisions would make it appear as though the rights had economic value. If so, the planner succeeded, because the court rejected the argument that Household’s poison pill consisted of sham securities.¹⁰¹

A second issue, however, was presented by § 157’s authorization of rights “entitling the holders thereof to purchase from the corporation any shares of *its* capital stock.”¹⁰² Plaintiff argued that § 157 thus only authorized Household to issue rights convertible into Household stock.¹⁰³ Household therefore could not issue rights purporting to give Household shareholders the right to buy shares of another corporation. The court rejected this argument, analogizing the Household pill to anti-destruction provisions commonly found in convertible securities.¹⁰⁴ Anti-destruction clauses give holders of target company convertible securities the right to convert their securities into whatever securities the acquiring company is

⁹⁸ *Id.* at 1351-53.

⁹⁹ DEL. CODE ANN. tit. 8, § 157(a) (2002).

¹⁰⁰ In addition, plaintiff made two other minor arguments. First, that § 157 “has never served the purpose of authorizing a takeover defense.” *Moran*, 500 A.2d at 1351. The court found no basis in the statute or its legislative history, however, to suggest that the legislature intended to limit § 157 to rights issued “for the purposes of corporate financing.” *Id.* Second, plaintiff argued that Delaware had adopted a very limited anti-takeover statute. Hence, plaintiff argued, the legislature must have intended to allow tender offers to go forward essentially unimpeded. *Id.* at 1352-53. The court rejected this argument on grounds that legislative intent to “have little state regulation of tender offers cannot be said to also indicate a desire to also have little private regulation.” *Id.* at 1353.

¹⁰¹ *Id.* at 1351-52.

¹⁰² DEL. CODE ANN. tit. 8, § 157(a) (2002) (emphasis supplied).

¹⁰³ *Moran*, 500 A.2d at 1352.

¹⁰⁴ *Id.*

offering in exchange for target company common stock. Because anti-destruction provisions are valid, the court upheld the pill.¹⁰⁵

Plaintiffs' final set of authority arguments asserted that the board had no power to block shareholders from receiving proxy contests or tender offers. As to the former, Delaware law provides that a board may not erect takeover defenses that disenfranchise its shareholders without a "compelling justification."¹⁰⁶ But while the board thus cannot preclude proxy contests, the *Moran* court concluded that Household's pill did not do so. Soliciting proxies did not trigger the pill, even if the challenger held proxies for more than 20% of the shares.¹⁰⁷ Moreover, although the court acknowledged that the pill would effectively prohibit one from buying more than 20% of the shares before conducting a proxy contest, the court opined that that restriction was unlikely to have a significant impact on the success rate of such contests.¹⁰⁸

Finally, while *Moran* implied that the board must leave some mechanism by which the bidder can present an offer to the shareholders, it strongly emphasized that the board of directors has authority to erect defenses with teeth.¹⁰⁹ As to the Household pill, the court identified several methods by which a hostile bidder could structure its offer so as to avoid the pill's poisonous effects, including conditioning the offer on redemption of the pill by board, soliciting written consents to remove the board at same time that the offer is made, and conducting a proxy contest to oust the incumbent board.¹¹⁰ Nowhere in this analysis did the Delaware supreme court object to the self-disablement inherent in the *Moran* pill's redemption provision.

Having determined that the board of directors has authority to adopt poison pills and re-emphasized the more general principle that a board of directors has authority to resist unsolicited offers, the Delaware supreme court then turned to whether the Household board had violated its fiduciary duties by adopting the pill.¹¹¹ In this portion of the opinion, the court relied heavily on its then-still novel

¹⁰⁵ *Id.*

¹⁰⁶ See, e.g., *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1379 (Del. 1995); *Stroud v. Grace*, 606 A.2d 75, 92 n. 3 (Del. 1992); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

¹⁰⁷ *Moran*, 500 A.2d at 1355.

¹⁰⁸ *Id.*

¹⁰⁹ See generally *id.* at 1354-55 (discussing tender offer issues).

¹¹⁰ *Id.*

¹¹¹ See generally *id.* at 1355-57 (discussing whether the board of Household had violated its duties of care and loyalty).

Unocal decision. In *Unocal v. Mesa Petroleum Co.*,¹¹² the court had set out what has been called an “intermediate” or “enhanced business judgment” standard of judicial review, but is perhaps best described as a “conditional business judgment rule.”¹¹³ Famed corporate raider T. Boone Pickens, whom the court referred to as having “a national reputation as a ‘greenmailer,’”¹¹⁴ controlled Mesa, which in turn owned 13% of Unocal’s voting stock. Mesa launched a hostile two-tiered tender offer, pursuant to which it initially offered to buy slightly over 37% of the remaining shares for \$54 per share.¹¹⁵ According to Mesa, if the initial bid succeeded, Mesa would then eliminate the remaining shares by means of a freeze-out merger, in which the consideration would be junk bonds ostensibly worth \$54 per Unocal share.¹¹⁶

In hopes of fending off Mesa’s bid, Unocal’s board of directors authorized a discriminatory self-tender offer for Unocal’s own stock.¹¹⁷ Under Unocal’s counter offer, if Mesa’s front-end tender offer succeeded in giving Mesa a majority of Unocal’s stock, Unocal would then offer to repurchase the remaining minority shares with debt securities purportedly worth \$72 per share.¹¹⁸ Unocal’s self-tender offer was intentionally discriminatory in that any shares tendered by Pickens would not be accepted.¹¹⁹ If effected, the self-tender offer would drain Unocal of most of its significant assets and leave it burdened by substantial debt.¹²⁰ Mesa sued to enjoin the self-tender offer, alleging that Unocal’s board of directors had violated its fiduciary duties to both Mesa and Unocal’s other

¹¹² 493 A.2d 946 (Del. 1985).

¹¹³ DOOLEY, *supra* note 59, at 547.

¹¹⁴ *Unocal*, 493 A.2d at 956.

¹¹⁵ *Id.* at 949.

¹¹⁶ *Id.* Two tier offers like Mesa’s are regarded as structurally coercive. See generally Ronald J. Gilson & Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is there Substance to Proportionality Review*, 44 BUS. LAW. 247, 267 (1989) (defining structural coercion as bidder tactics creating a “risk that disparate treatment of non tendering shareholders might distort shareholders’ tender decisions”). As illustrated by the result in *Unocal*, courts have given target board of directors largely unfettered discretion to defeat structurally coercive offers. BAINBRIDGE, *supra* note 77, at 720.

¹¹⁷ After the Delaware supreme court validated discriminatory self-tender offers in *Unocal*, the SEC adopted Securities Exchange Act Rules 13e-4(f)(8) and 14d-10(a), 17 C.F.R. §§ 240.13e-4 & 240.14d-10, to prohibit discriminatory tender offers by either the issuer or an outside bidder. BAINBRIDGE, *supra* note 77, at 702 n.18.

¹¹⁸ *Unocal*, 493 A.2d at 951.

¹¹⁹ *Id.*

¹²⁰ See *id.* at 950 (describing probable effect of self-tender offer).

shareholders. In particular, Mesa objected to the discriminatory nature of the proposed self-tender offer.¹²¹

The Delaware supreme court recognized that a target board's decision to resist an unsolicited takeover bid is tainted by a potential conflict of interest.¹²² Inherent in all corporate takeovers is a well-documented conflict between the interests of target managers and target shareholders. The tension between shareholders and managers is perhaps most obvious in hostile takeovers. According to conventional wisdom, shareholders unquestionably benefit from a successful takeover. Successful bids produce substantial positive abnormal returns for targets; moreover, target shareholders appear to capture the most of the gains, because abnormal positive returns to bidding firms are low.¹²³ If a hostile takeover bid fails because of management resistance, the consequences to target company shareholders thus are thought to be quite severe.¹²⁴ In contrast, incumbent target managers are the one group unarguably harmed by hostile takeovers. Target directors and officers know that a successful bidder is likely to fire many of them.¹²⁵ Any defensive actions by management are thus tainted by the specter of self-interest.

In light of this well-established conflict of interest, the Delaware supreme court in *Unocal* adopted a more intrusive form of judicial review than the traditional business judgment rule.¹²⁶ The initial burden of proof is on the directors, who must show that they had reasonable grounds for believing that a

¹²¹ See *id.* at 951 (describing Mesa's amended complaint).

¹²² See *id.* at 954 (noting the "omnipresent specter that a board may be acting primarily in its own interests"). There is an important distinction to be drawn between the role and incentives of target board members and directors (especially independent directors), which *Unocal* largely ignored. See BAINBRIDGE, *supra* note 77, at 712-15 (discussing this point at greater length).

¹²³ BAINBRIDGE, *supra* note 77, at 613-14 (summarizing data).

¹²⁴ Note, however, that some commentators contend that the demand curves for stocks slope downwards and may even approximate unitary elasticity (i.e., buying 50% of a company's stock requires a price increase of 50%). See, e.g., Laurie Simon Bagwell, *Dutch Auction Repurchases: An Analysis of Shareholder Heterogeneity*, 47 J. FIN. 71 (1992); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579 (1986). If so, little or no new wealth is created by takeovers. Instead, takeover premia are purely an artifact of supply and demand.

¹²⁵ See Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671 (1991) (discussing management discharge following a takeover).

¹²⁶ *Unocal*, 493 A.2d at 954 (stating: "Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.").

danger to corporate policy or effectiveness existed.¹²⁷ The directors satisfy this burden by showing good faith and reasonable investigation.¹²⁸ The good faith element requires a showing that the directors acted in response to a perceived threat to the corporation and not for the purpose of entrenching themselves in office.¹²⁹ The reasonable investigation element requires a demonstration that the board was adequately informed, with the relevant standard being one of gross negligence.¹³⁰ Assuming the directors carry their initial burden, they next must prove that the defense was reasonable in relationship to the threat posed by the hostile bid.¹³¹ If the board succeeds carrying its burden of proof on all points, the business judgment rule comes into play and insulates the board's decision from further judicial scrutiny.¹³² It is for this reason that the *Unocal* standard appropriately is referred to as a "conditional business judgment rule."¹³³

In *Unocal*, the Delaware supreme court deemed the discriminatory self-tender offer to be reasonable in relation to the threat posed.¹³⁴ Given the coercive nature of Mesa's bid, the probable price inadequacy of Mesa's bid, and Pickens' reputation as a greenmailer, *Unocal* was entitled to take strong measures to defeat the Mesa offer.¹³⁵ Because excluding Mesa from the self tender offer was essential to making the defense work, the directors could discriminate against Mesa without violating their fiduciary duties.¹³⁶

In *Moran*, the Delaware supreme court concluded that Household's pill also was a reasonable response to the generalized threat of coercive takeover tactics

¹²⁷ *Id.* at 955.

¹²⁸ *Id.*

¹²⁹ *See id.* (noting that "directors may not have acted solely or primarily out of a desire to perpetuate themselves in office").

¹³⁰ *See Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (finding that the Household board was "not grossly negligent" in informing itself); *see also Pitt, supra* note 71, at 878 n.264 (noting a decision in which court found that directors were not grossly negligent in adopting defenses).

¹³¹ *Unocal*, 493 A.2d at 955.

¹³² *See Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 269-70 (Del.Ch.1989) (holding that "before the business judgment rule will be applied in this context, the directors must establish reasonable grounds for believing that a danger to corporate policy and effectiveness existed and the defensive measure chosen by the board must be reasonable in relation to the threat posed"; internal quotations and citations omitted)

¹³³ *See supra* text accompanying note 113.

¹³⁴ *Unocal*, 493 A.2d at 957.

¹³⁵ *Id.* at 956.

¹³⁶ *Id.*

then being employed by bidders.¹³⁷ In doing so, however, the court was careful to emphasize that Household was not then faced with an actual takeover bid. The court stressed that: “When the Household Board of Directors is faced with a tender offer and a request to redeem the [pill], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the [pill].”¹³⁸ Having said that, however, the key point is that the court deemed the pill to be a “reasonable defensive mechanism.”¹³⁹

Despite repeated criticism from academics,¹⁴⁰ the Delaware supreme court has consistently reaffirmed the *Unocal* analysis.¹⁴¹ Of particular present relevance, the Delaware supreme court recently invoked the principle of *stare decisis* to reject a post-*Moran* challenge to poison pills: “It is indisputable that *Moran* established a board’s authority to adopt a rights plan” without shareholder approval or consent.¹⁴² “To recognize viability of the [plaintiff’s] claim would emasculate the basic holding of *Moran*, both as to this case and *in futuro*, that directors of a Delaware corporation may adopt a rights plan unilaterally. The Chancellor determined that the doctrine of *stare decisis* precluded that result and we agree.”¹⁴³

¹³⁷ *Moran*, 500 A.2d at 1357.

¹³⁸ *Id.* at 1355. *See also* Hills Stores Co. v. Bozic, 769 A.2d 88, 106-07 (Del.Ch.2000) (opining that: “Delaware case law has assured stockholders that the fact that the court has approved a board’s decision to put defenses in place on a clear day does not mean that the board will escape its burden to justify its use of those defenses in the heat of battle under the *Unocal* standard.”).

¹³⁹ *Moran*, 500 A.2d at 1357.

¹⁴⁰ *See, e.g.*, Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 512 (2001) (concluding that he was “quite negative in my assessment of the fifteen-year *Unocal* experiment”); Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PENN. L. REV. 315, 330 (1987) (arguing that *Unocal* is a “toothless standard” that is “fairly inconsequential”); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 Tex. L. Rev. 261, 284 (2001) (arguing that *Unocal* is “incapable of policing management entrenchment”).

¹⁴¹ *See, e.g.*, *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 n.18 (Del. 1989) (rejecting purported views of Professors Johnson and Siegel). Once again, deciding whether the courts or commentators have it right is a task for another day.

¹⁴² *Account v. Hilton Hotels Corp.*, 780 A.2d 245, 249 (Del. 2001).

¹⁴³ *Id.*

C. The Development of Dead Hand and No Hand Pills

Most pills today have both flip-in and flip-over elements.¹⁴⁴ As a precommitment device, however, even a pill with both features is not a wholly credible threat. The traditional pill's key vulnerability is its redemption feature. A board that can redeem the pill, after all, is not securely lashed to the mast. A determined hostile bidder could trigger the pill, moreover, launch a proxy contest for control of the target's board of directors, and, if successful, cause the newly-elected board to redeem the pill.¹⁴⁵ To make the poison pill an even more credible threat, transaction planners developed the so-called no hand and dead hand pills.¹⁴⁶

In *Carmody v. Toll Brothers*, the Delaware chancery court first considered dead hand poison pills.¹⁴⁷ In addition to fairly standard flip-in and flip-over features, the Toll Brothers pill provided that it could be redeemed only by those directors who had been in office when the shareholder rights constituting the pill had become exercisable (or their approved successors). This provision was intended to close the proxy contest/redemption loophole in standard poison pills by precluding newly elected directors from redeeming the pill. Vice Chancellor Jacobs therefore characterized the dead hand pill as a "show stopper":¹⁴⁸

[I]f only the incumbent directors or their designated successors could redeem the pill, it would make little sense for shareholders or the hostile bidder to wage a proxy contest to replace the incumbent board. Doing that would eliminate from the scene the only group of persons having the power to give the hostile bidder and target company shareholders what they desired: control of the target

¹⁴⁴ See Janet E. Kerr, *Delaware Goes Shopping For a "New" Interpretation of the Revlon Standard: The Effect of the QVC Decision on Strategic Mergers*, 58 Alb. L. Rev. 609, (1995) (explaining that a "poison pill may contain a flip-over and/or flip-in provision"; emphasis supplied). For discussion of additional variations on the poison pill theme, see BAINBRIDGE, *supra* note 77, at 684-85.

¹⁴⁵ See Thompson & Smith, *supra* note 140, at 319 (describing that strategy); cf. Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1086 (noting how the development of more effective takeover defenses encouraged bidders to conduct a proxy contest in conjunction with a tender offer).

¹⁴⁶ See generally Letsou, *supra* note 81, at 1112-15 (describing dead hand and no hand pills); Brian J. McTear, Comment, *has the Evolution of the Poison Pill Come to an End?*, 24 DEL. J. CORP. L. 881, 893-97 (1999) (same).

¹⁴⁷ *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del.Ch.1998). Cases from other jurisdictions are divided on the validity of such pills. *Compare* Bank of N.Y. Co., Inc. v. Irving Bank Corp., 139 Misc.2d 665, 528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988) (dead hand pill violated New York law) *with* Invacare Corp. v. Healthdyne Technologies, Inc., 968 F. Supp. 1578 (N.D. Ga. 1997) (applying Georgia law; dead hand pill permissible).

¹⁴⁸ *Carmody*, 723 A.2d at 1187.

company (in the case of the hostile bidder) and the opportunity to obtain an attractive price for their shares (in the case of the target company stockholders).¹⁴⁹

A shareholder sued, alleging both lack of authority and breach of fiduciary duty claims.

Note that as a precommitment device, the dead hand pill still shared some of the flaws of traditional pills. In particular, because the continuing directors could redeem the pill under some circumstances, those directors were not tied to the mast very tightly, if at all. Instead, the dead hand pill mainly tied the hands of other players; most notably, subsequently elected members of the board of directors and the shareholders. These facts, however, do not preclude analysis of the dead hand pill as a precommitment strategy. Many precommitment strategies entail tying the hands of other actors. Recall, for example, that Odysseus not only had himself tied to the mast but also stuffed beeswax into the ears of his sailors.¹⁵⁰

In denying Toll Brothers' motion to dismiss, Vice Chancellor Jacobs opined that dead hand pills likely ran afoul of several aspects of Delaware law. First, such pills implicated the Delaware statutes governing the powers of directors: "Absent express language in the charter, nothing in Delaware law suggests that some directors of a public corporation may be created less equal than other directors, and certainly not by unilateral board action."¹⁵¹ Second, by deterring proxy contests by prospective acquirers, the dead hand pill effectively disenfranchised shareholders who wished to elect a board committed to redeeming the pill.¹⁵² Accordingly, the plaintiff stated a claim under *Stroud v. Grace*,¹⁵³ in which the Delaware supreme court had held that defensive measures that disenfranchise shareholders are strongly suspect and cannot be sustained absent a compelling

¹⁴⁹ *Id.*

¹⁵⁰ See *supra* text accompanying notes 2-3. In terms of Elster's typology, Odysseus's overall strategy entailed two distinct precommitment strategies. As to himself, he created a situation in which the option of approaching the Sirens had been removed from his feasible set of options. See *supra* text accompanying note 22. As to his sailors, Odysseus insulated them from the Siren's song, and thus insulated them from awareness about the existence of the option of approaching the Sirens. See *supra* text accompanying note 28. A dead hand pill imposes the former type of precommitment strategy on the non-continuing members of the board of directors by forbidding them from redeeming the pill and on the shareholders by disabling them from electing new directors who intend to redeem the pill.

¹⁵¹ *Id.* at 1191. For an argument that dead hand pills are statutorily authorized by the delegation provisions of Delaware General Corporation Law § 141(c), see Letsou, *supra* note 81, at 1133-45 (discussing delegation under DEL. CODE ANN. tit. 8, § 141(c) (2002)).

¹⁵² See *Carmody*, 723 A.2d at 1193-94 (discussing shareholder disenfranchisement claim).

¹⁵³ *Stroud v. Grace*, 606 A.2d 75 (Del. 1992).

justification.¹⁵⁴ Finally, Vice Chancellor Jacobs concluded that the plaintiff-shareholder had stated a “far from conclusory” breach of fiduciary duty claim under *Unocal* and its progeny.¹⁵⁵ Although standard pills had been upheld against such claims, the dead hand pill was both preclusive and coercive. It was coercive because the pill effectively forced shareholders to re-elect the incumbent directors if they wished to be represented by a board entitled to exercise its full statutory powers.¹⁵⁶ The pill was preclusive because the added deterrent effect of the dead hand provision made a takeover prohibitively expensive and effectively impossible.¹⁵⁷

In *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*,¹⁵⁸ Vice Chancellor Jacobs invalidated a so-called no hand pill on similar grounds. In contrast to the Toll Brother’s pill, Quickturn’s pill contained no provision for redemption by continuing directors.¹⁵⁹ Instead, it made the pill nonredeemable for six months after a change in control of the board.¹⁶⁰ Unlike *Carmody*, where he had implied that the dead hand pill exceeded the board’s statutory authority,¹⁶¹ Jacob’s opinion in *Quickturn* relied solely on fiduciary duty principles.¹⁶² Although the no hand pill was neither preclusive nor coercive,¹⁶³ Jacobs

¹⁵⁴ *Id.* at 92 n. 3.

¹⁵⁵ *Carmody*, 723 A.2d at 1195.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* *Unocal* emphasized that the target board’s discretion to resist unsolicited tender offers did not extend to the use of “any Draconian means available.” *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). The court has further held that coercive or preclusive defensive tactics are excessively Draconian and, consequently, invalid. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1387 (Del. 1995).

¹⁵⁸ 728 A.2d 25 (Del. Ch.), *aff’d on other grounds*, 721 A.2d 1281 (Del. 1998).

¹⁵⁹ *Id.* at 28.

¹⁶⁰ *Id.*

¹⁶¹ See *supra* text accompanying note 151. In contrast to the Delaware supreme court’s analysis in *Quickturn*, in *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del.Ch.1998), Vice Chancellor Jacob’s statutory analysis focused not on § 141 but on the distinct notion that devices creating de facto classes of directors having different powers may be created only by a shareholder-approved amendment to the articles of incorporation. That approach is quite different from the prophylactic frontal attack on director authority mounted by the supreme court’s interpretation of § 141 in *Quickturn*.

¹⁶² See *Quickturn*, 728 A.2d at 28 (holding “that the DRP [i.e., the no hand pill] is invalid on fiduciary duty grounds”). Plaintiffs did argue that the no hand pill violated the Delaware corporation statute, but Jacobs declined to reach that issue. *Id.* at 44.

¹⁶³ *Id.* at 49.

concluded that the pill's deterrent effect was disproportionate to the threat posed.¹⁶⁴

The Delaware supreme court affirmed, but on different grounds.¹⁶⁵ Unlike Vice Chancellor Jacobs, the supreme court focused exclusively on the board's authority.¹⁶⁶ According to the supreme court's opinion, Delaware law "requires that any limitation on the board's authority be set out in the" articles of incorporation.¹⁶⁷ The no hand pill limited a newly elected board's authority by precluding redemption of the pill—and thereby precluding an acquisition of the corporation—for six months. Consequently, the no hand pill tended "to limit in a substantial way the freedom of [newly elected] directors' decisions on matters of management policy."¹⁶⁸ Accordingly, it violated "the duty of each [newly elected] director to exercise his own best judgment on matters coming before the board."¹⁶⁹ Absent express authorization of such a limitation in the articles, the no hand pill therefore was invalid as beyond the board's authority.¹⁷⁰

Just as with other poison pills, dead hand and no hand pills are a form of precommitment strategy. As we saw in Part II, precommitment strategies are useful for both individuals and groups because they protect ourselves against passion and time inconsistency. In using a device such as the poison pill to make a precommitment, the incumbent board binds itself—and future boards (possibly with new members holding differing views)—to a particular strategy, just as Odysseus bound himself to the mast.¹⁷¹ In striking down the no hand poison pills on authority grounds, however, the Delaware supreme court seemingly has limited the use of such precommitment strategies by adopting a broad principle

¹⁶⁴ See *id.* at 49-52 (discussing proportionality requirement).

¹⁶⁵ *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*, 721 A.2d 1281 (Del. 1998).

¹⁶⁶ See *id.* at 1283 (noting that the supreme court affirmed on the "alternative basis" that the board lacked statutory authority to adopt a no hand pill).

¹⁶⁷ *Id.* at 1291.

¹⁶⁸ *Id.* at 1292 (quoting *Abercrombie v. Davies*, 123 A.2d 893, 899 (Del. Ch. 1956), *rev'd on other grounds*, 130 A.2d 338 (Del. 1957)).

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 1293. Most observers "assume that the theory applies equally to dead-hand pills." Letsou, *supra* note 81, at 1103. Professor Letsou, however, argues that *Quickturn* should be interpreted narrowly only to invalidate no hand pills. *Id.* at 1124-31.

¹⁷¹ Despite Jacob's determination that the no hand pill was neither preclusive nor coercive, the no hand pill does tie the board's hands far more effectively than does the dead hand variant. Once the no hand pill was triggered, the board no longer had the option of redeeming the pill. Consequently, the board could effectively say to the bidder: "We will not be sold at less than \$X per share. (Or: "We are not prepared to sell at any price.") To prove our determination, we are prepared to lash ourselves to this mast for six months."

that boards have an ongoing duty to constantly re-evaluate their decisions.¹⁷² But analyzing the wisdom extending *Quickturn* to other precommitment strategies is the task of the next Part. Suffice it for the moment to note that the Delaware supreme court's decision was scarcely compelled by the relevant statutory language.¹⁷³

In striking down the no hand pill as lacking statutory authority, the Delaware supreme court relied solely on § 141(a) of the Delaware General Corporation law.¹⁷⁴ Section 141(a) states:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.¹⁷⁵

¹⁷² See *Quickturn*, 721 A.2d at 1292 (noting the “unremitting” fiduciary duties of directors).

¹⁷³ The Delaware supreme court's analysis of its prior precedents relating to the authority issue, especially *Moran*, was disingenuous.

Our analysis of the Delayed Redemption Provision in the *Quickturn* Rights Plan is guided by the prior precedents of this Court with regard to a board of directors authority to adopt a Rights Plan or “poison pill.” In *Moran*, this Court held that the “inherent powers of the Board conferred by 8 Del. C. § 141(a) concerning the management of the corporation's ‘business and affairs’ provides the Board additional authority upon which to enact the Rights Plan.” Consequently, this Court upheld the adoption of the Rights Plan in *Moran* as a legitimate exercise of business judgment by the board of directors. In doing so, however, this Court also held “the rights plan is not absolute.”

When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights [Plan], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standards as they were held to in originally approving the Rights Plan.

In *Moran*, this Court held that the “ultimate response to an actual takeover bid must be judged by the Directors’ actions at the time and nothing we say relieves them of their fundamental duties to the corporation and its shareholders.” Consequently, we concluded that the use of the Rights Plan would be evaluated when and if the issue arises.

Id. at 1291 (footnotes omitted). As the court's own selections from *Moran* make clear, however, *Moran* contemplated that subsequent judicial review would focus on whether the board's use of a poison pill violated the board's fiduciary duties, not on issues of statutory authority.

¹⁷⁴ *Id.* at 1291-92.

¹⁷⁵ DEL. CODE ANN. tit. 8, § 141(a) (2002) (emphasis supplied).

On its face, § 141(a) is directed to an entirely different problem than the one raised by the no hand pill. In particular, note the reference in the second sentence of § 141(a) to the “powers and duties” of the board being “exercised or performed” by such other persons as provided in the certificate of incorporation. This language clearly reflects a concern with the special problems of close corporations, whose shareholders often seek to modify the default rules of corporate governance so as to run the firm as though it were a partnership.¹⁷⁶ Delaware has a special set of statutory provisions for close corporations whose articles of incorporation contain an election to be governed by those provisions.¹⁷⁷ Among the special rules applicable only to such so-called statutory close corporations is a provision authorizing shareholders to limit the powers of the board of directors by mere contract.¹⁷⁸ Outside of that limited context, however, § 141(a) makes clear that any such shareholder-initiated limitation on the board’s authority must be included in the articles of incorporation.¹⁷⁹ Taken as a whole, therefore, § 141(a)’s language regarding exceptions to the board’s authority is not concerned with self-imposed limitations on the board’s authority. Instead, § 141(a) is concerned with ensuring the validity of such close corporation governance provisions, while requiring that they be included in the articles of incorporation rather than by mere contract. On its face, nothing in the statute compels a conclusion that the board cannot create self-imposed limitations on its authority.

IV. DOES *QUICKTURN* INVALIDATE ALL PRECOMMITMENT STRATEGIES?

As the Delaware supreme court elsewhere recognized, boards commonly enter into contracts limiting their future authority to varying degrees:

A board which has decided to manufacture bricks has less freedom to decide to make bottles. In a world of scarcity, a decision to do one thing will commit a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course and do another.¹⁸⁰

¹⁷⁶ See BAINBRIDGE, *supra* note 77, at 806 (noting that close corporation shareholders “frequently adopt agreements restricting director discretion”).

¹⁷⁷ See DEL. CODE ANN. tit. 8, §§ 341-56 (2002).

¹⁷⁸ *Id.* at § 350.

¹⁷⁹ *Cf.* II RODMAN WARD, JR., ET AL., FOLK ON THE DELAWARE CORPORATION LAW § 350.1 at GCL-XIV-38 (4th ed. 2002) (noting that “in the absence of section 350, an agreement limiting director discretion could be void under the ‘corporate norm’ concept embodied in section 141(a)”).

¹⁸⁰ Grimes v. Donald, 673 A.2d 1207, 1214-15 (Del. 1996).

Just how literally then are we to take the Delaware supreme court's reference to "any limitation on the board's authority"?¹⁸¹ And, if the word "any" is not to be taken literally, where is the firebreak between permissible and impermissible limitations? As we saw in Part II, boards of directors commonly bind themselves to particular strategies through the use of various devices. Many such devices limit the discretionary authority not only of the adopting board, but also of future boards that might wish to pursue a different strategy. Indeed, it is the very ability to bind future decisionmakers that is the hallmark of any precommitment strategy. We begin this Part by examining four examples of routine corporate governance devices endangered by *Quickturn*.

A. Common Corporate Precommitment Strategies

1. Bond Indentures

As already noted, bond indentures commit the board to long-term obligations that will continue to bind future boards for many years.¹⁸² A particularly pertinent example is the change of control clause contained in poison debt securities. So-called poison debt emerged as a response to the rise in highly leveraged takeover bids financed by junk bonds.¹⁸³ The indentures for many poison debt securities include change of control provisions, with continuing director provisions similar to those of a dead hand pill, pursuant to which a change of control not approved by the continuing directors triggers a put option allowing the bondholders to sell their bonds back to the company at face value.¹⁸⁴ In effect, the bondholders may accelerate the loan and force the bidder to immediately redeem the bonds, which has a significant adverse effect on the company's cash flow. The indentures frequently also contain provisions by which the board is disabled from pursuing certain courses, such as limiting sales of assets or loans that are not approved by the continuing directors.¹⁸⁵ Yet, no Delaware court has ever invalidated a bond indenture on grounds that such self-disablement clauses violate § 141(a). To the

¹⁸¹ *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*, 721 A.2d 1281, 1291 (Del. 1998) (emphasis supplied).

¹⁸² See *supra* note 11 and accompanying text (discussing negative pledge clauses).

¹⁸³ See generally Richard G. Clemens, *Poison Debt: The New Takeover Defense*, 42 BUS. LAW. 747 (1987).

¹⁸⁴ PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 180 (3d ed. 2002).

¹⁸⁵ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 177 (Del. 1986) (describing poison notes limiting the issuer's ability to "incur additional debt, sell assets, or pay dividends").

contrary, the Delaware Supreme Court in *Revlon* upheld poison debt containing these provisions as “proper and fully accord[ing] with the powers, duties, and responsibilities conferred upon directors under our law.”¹⁸⁶

2. Fair Price Shark Repellents

The class of takeover defenses known as fair price shark repellents also commonly include continuing director provisions.¹⁸⁷ Like the dead hand pill, the continuing director provision of a fair price shark repellent allows a bid to go forward only if approved by those members of the board of directors who were on the board when the acquirer first triggered the defensive provision.¹⁸⁸ As such, it seems to run afoul not only of *Quickturn*’s injunction against limitations on the board’s authority, but also Vice Chancellor Jacobs’ observation in *Carmody* that Delaware law does not permit some directors to be “created less equal than other directors.”¹⁸⁹ If the fair price shark repellent was included in the articles of incorporation, rather than the bylaws, of course, it might satisfy the supreme court’s view that “any limitation on the board’s authority be set out in the” articles of incorporation.¹⁹⁰ Query, however, whether a typical fair price provision would contain language explicitly authorizing a limitation of the board’s authority and whether the Delaware courts would require an explicit statement to that effect.

3. Nonredeemable Poison Pills

We have noted that a poison pill constitutes a strategy for the board to precommit to a particular takeover strategy, whether it be remaining independent or getting the best possible deal. *Quickturn* acknowledged that *Moran* validated traditional poison pills lacking dead hand features.¹⁹¹ Yet, the *Quickturn* court overlooked the fact that any nonredeemable poison pill—whether of the dead hand, no hand, or traditional variety—*de facto* precludes the board of directors from selling the company so long as the pill remains in effect.¹⁹² The pill upheld in *Moran*, for example, was nonredeemable if triggered by the acquisition of 20%

¹⁸⁶ *Id.* at 180. See generally Letsou, *supra* note 81, at 1145-48 (arguing that *Revlon* validates dead hand pills).

¹⁸⁷ BAINBRIDGE, *supra* note 77, at 689.

¹⁸⁸ *Id.*

¹⁸⁹ *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1991 (Del.Ch.1998).

¹⁹⁰ *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*, 721 A.2d 1281, 1291 (Del. 1998).

¹⁹¹ *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*, 721 A.2d 1281, 1291 (Del. 1998). Recall, also, that the Delaware supreme court has recently reaffirmed *Moran*, emphasizing the *stare decisis* power of that decision. See *supra* text accompanying notes 142-143.

¹⁹² Letsou, *supra* note 81, at 1125.

or more of the shares and had a ten year life.¹⁹³ Why then does such a pill not also constitute an impermissible “limitation on the board’s authority” barred by *Quickturn*? The court did not provide an answer (or even acknowledge the conflict with *Moran*).

4. No Shops and Other Exclusivity Clauses in Merger Agreements

Merger agreements likewise commonly contain provisions by which the board of directors binds itself to particular courses of conduct.¹⁹⁴ A best efforts clause, for example, obliges the target’s board to use its “best efforts” to consummate the transaction.¹⁹⁵ No shop clauses prohibit the target corporation from soliciting a competing offer from any other prospective bidders.¹⁹⁶ The no negotiation covenant, a variant on the no shop theme, goes further to prohibits negotiations with unsolicited bidders.¹⁹⁷

As precommitment devices, exclusivity provisions in merger agreements are useful because they enable the target’s board of directors to make credible promises that frequently are necessary to induce a bid. There is a significant risk in any negotiated acquisition that the deal will not be consummated.¹⁹⁸ From the perspective of a prospective bidder, the risk of nonconsummation is troubling because it incurs substantial up-front costs in making a bid.¹⁹⁹ Exclusivity provisions thus give the target’s board of directors a useful negotiating tool. In return for reducing the risk of nonconsummation, they can be used to extract a higher price from the bidder.²⁰⁰

Just as with a no hand or dead hand pill, however, no shop and best efforts clauses limit the board of directors’ authority—as well as the authority of any future

¹⁹³ *Id.* at 1125 n.114.

¹⁹⁴ See generally Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 242-46 (1990) (describing exclusivity provisions of merger agreements).

¹⁹⁵ See *id.* at 243-44 (describing best efforts clauses).

¹⁹⁶ *Id.* at 244.

¹⁹⁷ *Id.* at 245.

¹⁹⁸ *Id.* at 240-41.

¹⁹⁹ See *id.* at 242 (detailing such costs). Fraidin and Hanson criticized my analysis on grounds that such expenses are sunk costs, which a rational bidder will ignore. Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1814 (1994). But Fraidin and Hanson overlooked the key point that these costs are sunk only when viewed *ex post*. From an *ex ante* perspective, a rational bidder will consider whether it will be able to recoup and earn a return on its upfront costs. The no shop clause thus may help induce bids from prospective acquirers.

²⁰⁰ Bainbridge, *supra* note 194, at 285.

board elected while the merger agreement remains in place. A no-shop clause restricts the board's ability to seek out and/or offer alternative transactions to the shareholders. Likewise, best efforts clauses restrict the board's discretion, particularly when the board is obligated to recommend the favored bidder's offer even in the face of a higher competing bid or changed business conditions. To be sure, a competing bidder could bypass the no shop or best efforts clause by making a tender offer directly to the shareholders.²⁰¹ Yet, a determined bidder faced with a no hand pill could conduct a proxy contest to elect a new board of directors that, if elected, would then wait the requisite six months before redeeming the poison pill. Indeed, it was for this very reason that Vice Chancellor Jacobs found that the no hand pill did not preclude takeover bids.²⁰² Despite Vice Chancellor Jacobs' characterization of the dead hand pill as a "show stopper,"²⁰³ even a dead hand pill can be overcome if the bidder can persuade the continuing directors to redeem it. Indeed, many dead hand pills have more liberal redemption provisions, providing that the redemption is authorized by the continuing directors, than do traditional poison pills.²⁰⁴

In a number of cases, the Delaware courts have expressed doubts as to whether merger exclusivity provisions are consistent with the board of directors' fiduciary duties.²⁰⁵ Their hostility is puzzling in light of the competing bidder's ability to bypass the clause by making a tender offer. In any event, however, no case prior to *Quickturn* had struck down a no shop clause as being an invalid self-imposed limitation on the board's authority. Many courts in fact had upheld no shop clauses, albeit without much in the way of analysis.²⁰⁶ Dicta in *Ace Ltd. v. Capital Re Corp.*,²⁰⁷ however, suggests the viability of a *Quickturn*-based challenge to no shop clauses:

[O]ne would think that there would be limited circumstances in which a board could prudently place itself in the position of not being able to entertain and consider a superior proposal to a transaction dependent on a stockholder vote. . . .

²⁰¹ *Id.* at 283-84.

²⁰² *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25, 49 (Del. Ch.), *aff'd on other grounds*, 721 A.2d 1281 (Del. 1998).

²⁰³ *See supra* text accompanying note 148.

²⁰⁴ Letsou, *supra* note 81, at 1131-32.

²⁰⁵ *See, e.g.*, *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 48-49 (1994); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

²⁰⁶ *See, e.g.*, *McMillan v. Intercargo Corp.*, 768 A.2d 492 (Del. Ch. 2000); *Matador Capital Mgmt. Corp. v. BRC Holdings*, 729 A.2d 280 (Del. Ch. 1998); *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994).

²⁰⁷ 747 A.2d 95 (Del. Ch. 1999).

A ban on considering such a proposal, even one with an exception where legal counsel opines in writing that such consideration is “required,” comes close to self-disablement by the board. Our case law takes a rather dim view of restrictions that tend to produce such a result.²⁰⁸

Capital Re thus illustrates how *Quickturn* threatens to invalidate well-established corporate precommitment strategies.

B. Analysis

1. Why Might Delaware Object?

In *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,²⁰⁹ Chancellor Chandler opined that no shop clauses “are troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party.”²¹⁰ But this begs the question of why the board cannot make an informed decision to tie itself to the lash. Suppose the board of directors makes an informed decision that the merger proposal on the table is the best deal they are likely to get for their shareholders and that granting a no shop clause is necessary and appropriate to induce the prospective acquirer to make a formal bid. The board recognizes that a no shop clause will impede its ability to negotiate with any competing bidders who subsequently emerge, but the board decides to accept that risk and go forward. In doing so, the board relies on the old adage that a bird in the hand is worth two in the bush. So long as the decision to enter into the no shop clause was an informed one, why should a board of directors have an on-going fiduciary duty to constantly reevaluate its decision?²¹¹

In *Grimes v. Donald*,²¹² by way of contrast, the board of directors approved an employment agreement with a newly-hired CEO giving the CEO largely unfettered control of the corporation. Among other things, the agreement empowered the CEO to declare unilaterally that he had been constructively terminated if, in his good faith judgment, the board substantially interfered in his management of the company. In that event, the CEO would receive a very

²⁰⁸ *Id.* at 107.

²⁰⁹ 1999 WL 1054255 (Del. Ch. 1999).

²¹⁰ *Id.* at *1.

²¹¹ For an argument that a board of directors’ “compliance with its fiduciary duties” should be judged solely “at the time it approves a merger agreement,” see R. Franklin Balotti & A. Gilchrist Sparks, III, *Deal-Protection Measures and the Merger Recommendation*, 96 Nw. U. L. Rev. 467 (2002).

²¹² 673 A.2d 1207 (Del. 1996).

substantial severance package. A shareholder complained that “the potentially severe financial penalties which the Company would incur in the event that the Board attempts to interfere in [the CEO’s] management of the Company will inhibit and deter the Board from exercising its duties under Section 141(a).”²¹³ The court aptly observed that “business decisions are not an abdication of directorial authority merely because they limit a board’s freedom of future action,”²¹⁴ a turn of phrase that nicely captures the basic thesis of this Article. Unfortunately, *Grimes* cannot be read as a sweeping validation of precommitment strategies. In the case below, the chancery court had upheld the employment agreement by distinguishing it from agreements that “formally preclude the . . . board from exercising its statutory powers and fulfilling its fiduciary duty.”²¹⁵ The Delaware supreme court quoted that distinction with apparent approval.²¹⁶ Yet, neither court explained why a *de facto* precommitment strategy is permissible but a *de jure* precommitment is not.

In sum, no Delaware case has yet cogently explained why its case law takes a “rather dim view” of board self-disablement. No Delaware case has yet cogently distinguished the self-disablement effected by bond indentures, no shop clauses, employment agreements, fair price shark repellents, nonredeemable standard pills, and their ilk from the self-disablement effected by no shops or no hand pills. Nor has any Delaware case has yet explained why it is that individuals may freely disable themselves from pursuing certain courses of conduct but that boards may not.

2. Board Precommitments and Director Primacy²¹⁷

A corporation is not a New England Town meeting.²¹⁸ Rather, it is one of the most hierarchical of our social institutions. Under all state corporation codes, the

²¹³ *Id.* at 1214.

²¹⁴ *Id.*

²¹⁵ *Grimes v. Donald*, 20 DEL. J. CORP. L. 757, 774-75 (Del. Ch. 1995).

²¹⁶ *Grimes*, 673 A.2d at 1214 n.3.

²¹⁷ The argument advanced in this section against the “rather dim view” Delaware takes of precommitment strategies is based on my recent work on director primacy, which this section summarizes and applies to the problem at hand. Readers familiar with my earlier director primacy work probably can skip this section. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, __ NW. U. L. REV. __ (forthcoming); see also Stephen M. Bainbridge, *The Board as Nexus of Contracts*, __ IOWA L. REV. __ (forthcoming).

²¹⁸ See *In re TW Services, Inc. Shareholders Litigation*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. 1989), in which the court opined:

Questions of this type call upon one to ask, what is our model of corporate governance? “Shareholder democracy” is an appealing phrase, and the notion of shareholders as the

key players in the statutory decisionmaking structure are the corporation's directors.²¹⁹ As the Delaware code puts it, the corporation's business and affairs "shall be managed by or under the direction of a board of directors."²²⁰ The vast majority of corporate decisions accordingly are made by the board of directors alone (or by managers acting under delegated authority).²²¹

Put another way, director primacy is the central organizing principle of corporate governance. Indeed, it must be so or public corporations as we know them could not exist. As Ronald Coase explained long ago, firms emerge when it is efficient to substitute entrepreneurial fiat for the price mechanisms of the market.²²² In markets, resources are allocated by the price system, while in firms

ultimate voting constituency of the board has obvious pertinence, but that phrase would not constitute the only element in a well articulated model. While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation. . . .

Id. at 92,180 n.14. The analysis in this section assumes the reader's familiarity with the arguments I have made elsewhere against shareholder democracy. *See, e.g., Shareholder Activism in the United States and Slovenia: A Comparative Analysis*, 43 VA. J. INT'L L. ____ (forthcoming); *The Politics of Corporate Governance*, 18 HARV. J. L. & PUB. POL'Y 671 (1995). The argument is summarized *infra* notes 236-238 and accompanying text. For a discussion of why directors nevertheless should be held accountable for self-dealing at the expense of shareholder wealth, see Bainbridge, *Director Primacy*, *supra* note 217, at ____.

²¹⁹ All state corporate codes provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to further delegate power to subordinate firm agents. *See* MODEL BUS. CORP. ACT ANN. § 8.01 at 8-10—8-11 (1995) (reviewing statutes).

²²⁰ DEL. CODE ANN. tit. 8, § 141(a) (2002). Of course, operational decisions normally are delegated by the board to subordinate employees. The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board's exclusive determination. *See, e.g., Lee v. Jenkins Bros.*, 268 F.2d 377 (2d Cir. 1959); *Lucy v. Hero Int'l Corp.*, 281 N.E.2d 266 (Mass. 1972).

²²¹ Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution. *See* DOOLEY, *supra* note 59, at 174-77 (summarizing state corporate law on shareholder voting entitlements). As a formal matter, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible. DEL. CODE ANN., tit. 8, §§ 109, 211 (2002). In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board. *See generally* Bayless Manning, *Book Review*, 67 YALE L.J. 1477, 1485-89 (1958) (describing incumbent control of the proxy voting machinery).

²²² *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386, 389 (1937) (arguing that "the distinguishing mark of the firm is the suppression of the price mechanism").

resources are allocated by authoritative direction.²²³ This was Coase's fundamental insight: "If a workman moves from department *Y* to department *X*, he does not go because of change in relative prices, but because he is ordered to do so."²²⁴ Accordingly, economic activity will be conducted within a firm when the costs of bargaining exceed those of command-and-control. The relevant costs can be divided into three basic categories: (1) search and other transaction costs associated with bargaining; (2) asset specificity; and (3) uncertainty and complexity.²²⁵

In Coasean theory, firms arise when it is possible to mitigate these costs by delegating to a team member the power to direct how the firm utilizes factors of production.²²⁶ One team member is empowered to unilaterally rewrite certain terms of the contract between the firm and its various constituents.²²⁷ By creating a central decisionmaker with this power of fiat, the firm substitutes *ex post* governance for *ex ante* contract.²²⁸ Uncertainty and complexity are no longer as problematic, because the central decisionmaker can exercise its power of fiat to mandate a chosen adaptive response to new circumstances. Opportunism is deterred by the prospect of *ex post* sanctions, obviating the necessity of drafting a complete contract *ex ante*.

Coordination need not imply fiat, as illustrated by the democratic decisionmaking processes of many partnerships and other small firms.²²⁹ In the public corporation, however, fiat is essential. All organizations must have some mechanism for aggregating the preferences of the organization's constituencies and converting them into collective decisions. Kenneth Arrow identified two basic mechanisms for carrying out this task: "consensus" and "authority."²³⁰ Consensus is used where each member of the organization has identical information and interests,

²²³ *Id.* Drawing a distinction between across-market transactions and intra-firm transactions serves a useful pedagogic purpose, but is not a wholly accurate description of the real world, in which there is a wide array of choices falling between purely contractual relationships and the classical economic firm. See KLEIN & COFFEE, *supra* note 11, at 19-21 (critiquing the economists' sharp dichotomy between firms and markets).

²²⁴ Coase, *supra* note 222, at 387.

²²⁵ For a more detailed treatment of these costs, see Bainbridge, *The Board as Nexus of Contracts*, *supra* note 217, at ____.

²²⁶ See Coase, *supra* note 222, at ____ (discussing the role of the "entrepreneur-co-ordinator, who directs production" within the firm).

²²⁷ Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 663 (1996).

²²⁸ See *id.* at 671 (discussing the need for *ex post* governance within a firm).

²²⁹ Cf. Dooley, *supra* note 41, at 467 (noting that partnerships tend to make decisions informally and by consensus).

²³⁰ KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 69-70 (1974).

which results in preferences that are easily aggregated.²³¹ In contrast, authority-based decisionmaking structures arise where group members have different interests and access to information.²³² Because collective decisionmaking is impracticable in such settings, authority-based structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.²³³

The necessity of a center of power within the corporation that is capable of exercising fiat thus follows from the asymmetries of information and interests among the corporation's various constituencies. Shareholders care about the value of the residual claim on the corporation. Customers care about the quality and quantity of the goods produced by the corporation. Workers care about salary and conditions of employment. And so on. Under such conditions, efficient decisionmaking demands an authority-based governance structure in which information is channeled to a central decisionmaker empowered to make choices binding on the firm as a whole.²³⁴

To take but a single constituency as our example, consider the difficulties shareholders would face in acting as the public corporation's central decisionmakers.²³⁵ At the most basic level, the mechanical difficulties of achieving consensus amongst thousands of decisionmakers impede shareholders from taking an active role. Yet, even if those collective action problems could be overcome, active shareholder participation in corporate decisionmaking would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information.

As for Arrow's similarity of interest condition, although neoclassical economics assumes that shareholders come to the corporation with wealth maximization as their goal, and most presumably do so, once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course will maximize share value. More prosaically, shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, which in turn

²³¹ See Dooley, *supra* note 41, at 467 (noting that "where an organization's decision makers have *identical* information and interests, decisions will be reached by 'Consensus'"; emphasis in original).

²³² Arrow, *supra* note 230, at 68-69.

²³³ *Id.* at 68.

²³⁴ See Dooley, *supra* note 41, at 467-69 (discussing authority-based governance).

²³⁵ I choose shareholders because they are the constituency conventionally assumed to possess the strongest claim on control of the corporate decisionmaking apparatus. For a director primacy-based defense of that convention, see Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1060-75 (1998).

is likely to result in disagreements about corporate strategy. Even more prosaically, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as are shareholders with differing views on the merits of allowing management to invest the firm's free cash flow in new projects.

As to Arrow's equality of access to information condition, shareholders lack incentives to gather the information necessary to actively participate in decisionmaking. A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs.²³⁶ Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have significant effect on the vote's outcome. Corporate shareholders thus are rationally apathetic.²³⁷ Instead of exercising their voting rights, disgruntled shareholders typically adopt the so-called Wall Street Rule—it's easier to switch than fight—and sell out.²³⁸

In large corporations, the resulting desirability of authority-based decisionmaking structures is further enhanced by the potential for division and

²³⁶ See ROBERT C. CLARK, *CORPORATE LAW* 391 (1986).

²³⁷ See *id.* at 390-92. Some scholars have argued that institutional investor activism can give real teeth to shareholder control. See, e.g., MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For more skeptical analyses, see Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).

²³⁸ The efficient capital markets hypothesis provides yet another reason for shareholders to eschew active participation in the governance process. If the market is a reliable indicator of performance, as the efficient capital markets hypothesis claims, investors can easily check the performance of companies in which they hold shares and compare their current holdings with alternative investment positions. An occasional glance at the stock market listings in the newspaper is all that is required. Because it is so much easier to switch to a new investment than to fight incumbent managers, a rational shareholder will not even care why a firm's performance is faltering. With the expenditure of much less energy than is needed to read corporate disclosure statements, he will simply sell his holdings in the struggling firm and move on to other investments. According to the orthodox view, "there is no other proposition in any of the social sciences" more firmly established than the efficient capital market hypothesis. Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, MIDLAND CORP. FIN. J., Summer 1986, at 6, 11. For heterodox critiques of the hypothesis, see Donald A. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992); Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475 (1997).

specialization of labor. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize.²³⁹ Directors specialize in the efficient coordination of other specialists.²⁴⁰ In order to reap the benefits of director specialization, shareholders (and all other corporate constituents) should prefer to specialize in functions unrelated to decisionmaking, such as risk-bearing (shareholders) or labor (employees), delegating decisionmaking to the board.²⁴¹ This natural division of labor, however, requires that the chosen board members be vested with discretion to make binding decisions. Separating ownership and control by vesting decisionmaking authority in a centralized nexus distinct from the shareholders and all other constituents—i.e., the board—therefore is what makes the large public corporation feasible.²⁴²

Consequently, it is hardly surprising that the modern public corporation's decisionmaking structure precisely fits Arrow's model of an authority-based decisionmaking system. The chief economic virtue of the public corporation thus is not that it permits the aggregation of large capital pools, as some have suggested,²⁴³ but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm,

²³⁹ CLARK, *supra* note 236, at 802.

²⁴⁰ More precisely, monitoring and oversight of other specialists is one of the board of directors' three primary functions—and arguably the most significant. *See* Jonathan L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 J. MGMT. 409, 411 (1996) (mapping the board of directors' "responsibilities into three broadly defined roles ... labeled control, service, and resource dependence."

²⁴¹ Put another way, economies of scale in the information transmission process can be achieved by elite control of organizations. Kenneth J. Arrow, *Scale Returns in Communication and Elite Control of Organizations*, 7 J. L. ECON. & ORG. (s.i.) 1 (1991).

²⁴² The phrase "separation of ownership and control" as a description of modern corporations was popularized by Adolf Berle in the 1930s. *See* ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 84-89 (1932). Although I follow convention in using the term "separation of ownership and control," ownership is not a particularly useful concept in the corporate context. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1427-28 (1993) (arguing against applying ownership concepts to the corporation). Indeed, a central claim of the director primacy model is that the board is a better candidate for identification as the corporation's owner than are the shareholders. An early New York opinion seemingly anticipated this claim, positing that "the directors in the performance of their duty possess [the corporation's property], and act in every way as if they owned it." *Manson v. Curtis*, 119 N.E. 559, 562 (N.Y. 1918).

²⁴³ *See* ROE, *supra* note 237, at 3-4 (summarizing this argument).

someone must be in charge: “Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success.”²⁴⁴ It is “cheaper and more efficient to transmit all the pieces of information to a central place” and to have the central office “make the collective choice and transmit it rather than retransmit all the information on which the decision is based.”²⁴⁵

If the efficiency gains attributable to the use of a central office are to be realized, however, the decisions of that central office must be given deference. The power to review, in a very real sense, is the power to decide.²⁴⁶ If shareholders or courts are empowered to overturn board decisions, they have been given the power of ultimate decision. As a result, the board can no longer function as the requisite central office and the efficient decisionmaking and governance system corporations require has been destroyed. To be sure, some attention must be paid to ensuring that the board’s power is used responsibly. Given the significant virtues of discretion, however, one ought not lightly interfere with the board’s decisionmaking authority in the name of accountability. To the contrary, preservation of the board of directors’ authority should always be the null hypothesis.

This principle is reflected in many corporate law doctrines,²⁴⁷ but nowhere more explicitly than in corporate law’s central doctrine—the business judgment rule.²⁴⁸ In a passage that has received less attention than it deserves, the Delaware supreme court opined:

Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors. . . . The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.²⁴⁹

²⁴⁴ ARROW, *supra* note 230, at 69.

²⁴⁵ *Id.* at 68-69.

²⁴⁶ *See infra* text accompanying note 255.

²⁴⁷ *See, e.g.,* Dooley, *supra* note 41, at 487-91, 500-04 (explaining how the doctrines governing conflicted interest transactions and shareholder derivative litigation, respectively, protect the board’s decisionmaking authority).

²⁴⁸ *See* BAINBRIDGE, *supra* note 77, at 241-42 (noting the pervasive role of the business judgment rule in corporate law); *see generally id.* at 267-69 (noting how the business judgment rule protects the board’s authority).

²⁴⁹ *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del.1985). *See also Nahikian v. Mattingly*, 251 N.W. 421, 423 (Mich. 1933) (stating: “It is a well settled rule of law that the authority of the directors is absolute when they act within the law, and that questions of policy and internal

In other words, the rule ensures that the null hypothesis is deference to the board's authority as the corporation's central and final decisionmaker.

It is this foundational principle that the Delaware supreme court so cavalierly cast aside in *Quickturn*. To be sure, the board's authority is not unbounded. In some cases, the statute clearly and unquestionably reflects a legislative intent to deprive the board of directors of authority to pursue some proscribed action or course of conduct. To take but a single and admittedly minor example, the Delaware General Corporation Law forbids a board to conduct a meeting by telecommunications unless all members of the board may hear one another.²⁵⁰ Consequently, for example, the board lacks authority to conduct a meeting using real time text-based messaging systems.²⁵¹ Absent such an express legislative restriction on the board's authority, however, the overarching principle of deference to the board's authority should control. As we have seen, however, § 141(a) scarcely provides such guidance and, indeed, can be read on its face to deal with other issues.²⁵² In such cases, the courts should presume that the board has authority to pursue its chosen course of conduct.

This presumption should hold even if the board's chosen course entails self-imposed limitations on the authority of either the current or future boards. As we saw in Part II and again in the preceding section of this Part, it is just as rational for a corporation to pursue a precommitment strategy as it is for an individual to do so. The economic justification for the board's authority, moreover, demonstrates that no one within the corporation is better positioned to make the precommitment decision than is the board of directors. Consequently, deference to the board's authority still should be the null hypothesis even when the exercise of that authority entails either self-disablement by the board or board actions that disable other corporate constituencies.

A complete theory of the firm requires one to balance the virtues of authority against the need to require that authority be used responsibly, of course.²⁵³ In the corporate context, the separation of ownership from the power of fiat results in

management are, in the absence of nonfeasance, misfeasance or malfeasance, left wholly to their decision. . . .").

²⁵⁰ DEL. CODE ANN. tit. 8, § 141(i) (2002).

²⁵¹ See Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 45-46 (2002) (explaining why this seemingly arcane procedural rule has a sound economic basis).

²⁵² See *supra* notes 41-44 and accompanying text.

²⁵³ See Dooley, *supra* note 41, at 464 (noting that both authority and accountability are "essential values").

agency costs that must be constrained by appropriate accountability mechanisms.²⁵⁴ Given the considerable virtues of authority-based decisionmaking, however, such mechanisms should proceed on a case-by-case basis rather than by adopting prophylactic restrictions on the board's authority. Once again, economist Kenneth Arrow is instructive:

[Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.

To maintain the value of authority, it would appear that [accountability] must be intermittent. This could be periodic; it could take the form of what is termed "management by exception," in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations. . . .²⁵⁵

In contrast, the Delaware supreme court in *Quickturn* opted against case-by-case review of self-imposed limits on the board's authority in favor of a prophylactic bar. As Arrow explains, however, the problem with such rules is that drafting them "to take care of all possible relevant contingencies is itself highly costly in terms of effort and in particular of information"²⁵⁶ In this case, the Delaware supreme court failed to "take care of all possible relevant contingencies." As we have seen, its sweeping pronouncement threatens to invalidate the panoply of ways in which board self-disablement is a commonly accepted feature of corporate governance.

C. A Better Standard

In the preceding section, I argued that *Quickturn* was wrongly decided because prophylactic limitations on the board of directors' authority are unacceptable. Recognizing that many readers will not accept such an expansive understanding of the directors' primacy, in this section I assume *arguendo* that at least some prophylactic restrictions on board authority are appropriate. Even with that concession, however, *Quickturn* still was wrongly decided. We have seen that *Quickturn*—plausibly interpreted—threatens to invalidate any precommitment strategy not authorized in the articles of incorporation.²⁵⁷ Surely the Delaware

²⁵⁴ See *supra* notes 175-179 and accompanying text.

²⁵⁵ ARROW, *supra* note 230, at 78.

²⁵⁶ *Id.* at 74.

²⁵⁷ See *supra* Part IV.A.

supreme court did not intend such a result. At the very least, one would have expected such a sweeping change in the law to be more explicitly signaled. Yet, as we have also seen, *Quickturn* has already been extended—fortunately only in *dicta*—to no shop clauses.²⁵⁸ In sum then, the weakness in the supreme court's *Quickturn* opinion is twofold: (1) the court cannot possibly intend for their holding to be read broadly, but (2) their opinion provides no firebreak between valid and invalid precommitment devices.

In my opinion, no such firebreak exists. The effectiveness of the precommitment device is one candidate for the requisite firebreak.²⁵⁹ Bond indentures are a relatively weak precommitment, for example, because future boards could always choose to breach the contractual obligations imposed by the indenture and pay damages. Many bond indenture provisions, moreover, can be evaded by creative deal structures.²⁶⁰ Nevertheless, it remains the case that bond indentures do constrain the board's authority to some extent. Many precommitment strategies are far less effective as the one employed by Odysseus, but they remain precommitments nonetheless.²⁶¹ In any case, is the level of precommitment effected by a bond indenture really all that much weaker than that effected by a no shop merger clause or a no hand poison pill? As already noted, no shop clauses and related exclusivity provisions only weakly deter competing bids for the target corporation. The shareholders remain free to accept or reject the merger proposal presented by the board, to respond to a merger proposal or a tender offer made by another firm subsequent to the board's execution of an exclusive merger agreement, or to hold out for a better offer.²⁶² Likewise, as also

²⁵⁸ See *supra* notes 207-208 and accompanying text.

²⁵⁹ In other words, as my UCLA colleague Iman Anabtawi asked, is there a way to parse precommitment strategies along a continuum between those that are problematic and those that are not? A fair question, but one that I concluded ran counter to the thesis I am advancing. To be clear, I am arguing against any sorting rule that attempts to validate or invalidate precommitments *ex ante*. Instead, I am arguing for a fiduciary duty-based standard of review by which courts determine the validity of precommitments *ex post* on a case by case basis. Of course, in some substantial number of cases the business judgment rule will preclude courts from even asking that question.

²⁶⁰ See, e.g., *Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co.*, 570 F. Supp. 1529 (S.D.N.Y. 1983) (holding that ADM did not breach the source of funds clause in a sinking fund indenture provision, which prohibited refinancing the debt obligation represented by the bonds by using the proceeds from incurring lower interest rate debt, because ADM had raised equity capital simultaneously with raising additional lower interest rate debt).

²⁶¹ See ELSTER, *supra* note 9, at 78-79 (noting potential obstacles to effective precommitments).

²⁶² *Jewel Cos., Inc. v. Pay Less Drug Stores Northwest, Inc.*, 741 F.2d 1555, 1564 (9th Cir. 1984); *Belden Corp. v. InterNorth, Inc.*, 413 N.E.2d 98, 102-03 (Ill. App. 1980).

noted above, the no hand pill has only somewhat greater bid-preclusive effect than did traditional pills.²⁶³ Indeed, as these examples suggest, the no hand pill arguably is no more effective a precommitment device than other corporate precommitment strategies of heretofore unquestioned validity. In any event, *Quickturn* gave no indication that the effectiveness of a limitation was relevant to its validity. Nor did the supreme court provide any metric by which to separate validly ineffective precommitment strategies from invalidly effective ones.

Alternatively, the validity of a precommitment strategy might depend on whether it is adopted by an individual to bind himself or to bind others. In *Ulysses Unbound*, Jon Elster developed several “disanalogies” between individual and societal precommitments, of which the most pertinent for our purposes is the fact that societal precommitments (such as constitutions) bind others without their consent.²⁶⁴ Thomas Jefferson famously opined that “the earth belongs to each generation, during it’s [sic] course, fully, and in their own right.”²⁶⁵ Consequently, Jefferson further opined, “no generation can contract debts greater than may be paid during the course of it’s [sic] own existence.”²⁶⁶ In the political arena, Elster likewise suggests, societal precommitments are potentially troubling because of their anti-democratic tendency to bind minorities and future generations.²⁶⁷ Drawing on these analogies, the no hand pill perhaps could be distinguished from other precommitment devices on grounds that it binds the hands of shareholders and/or future boards, rather than merely of the adopting board.²⁶⁸ Again, however, nothing in *Quickturn* turns on this distinction. Some other corporate precommitment strategies, such as no shop clauses, moreover, also effectively

²⁶³ See *supra* text accompanying note 202. I argue below that the effectiveness of a precommitment device should be incorporated into a fiduciary duty-based analysis rather than affecting the question of the board’s authority to adopt such a device. See *infra* note 278.

²⁶⁴ ELSTER, *supra* note 9, at 92.

²⁶⁵ Letter of Thomas Jefferson to James Madison (Sept. 6, 1789), reprinted in 15 PAPERS OF THOMAS JEFFERSON, 392, 393 (Julian P. Boyd ed. 1958).

²⁶⁶ *Id.*

²⁶⁷ ELSTER, *supra* note 9, at 169-70.

²⁶⁸ See *supra* notes 264-267 and accompanying text.

disable shareholders.²⁶⁹ Finally, it is precisely because the corporation is not a democracy that this objection has little traction in the corporate context.²⁷⁰

The only remaining potentially plausible firebreak might be cut along the distinction Delaware supreme court Chief Justice Veasey drew between “enterprise” and “ownership” decisions.²⁷¹ As to enterprise decisions implicating the internal operation of the business, such as whether the firm should launch a new product line, the board would have unfettered authority to tie both its hands and the hands of future boards. Consequently, for example, bond indentures that limit the board’s power to incur future indebtedness would be unproblematic. As to ownership decisions, involving the rights of shareholders to dispose of their stock, however, *Quickturn*’s restrictions on the board’s ability to bind its hands would operate. Consequently, for example, the dead hand and no hand pills would necessarily fall.

In my view, however, this firebreak is unacceptable and unworkable. First, the enterprise/ownership distinction seemingly also would invalidate no shop clauses and other merger exclusivity provisions. Such a result would make no business sense and would run counter to the rulings in *Revlon* and *QVC* recognizing the board’s power to use such devices, subject only to fiduciary duty constraints.²⁷² Second, the enterprise/ownership distinction often can be difficult to draw in practice. What do we do, for example, with change of control provisions in bond indentures? Finally, Chief Justice Veasey developed the enterprise/ownership distinction to help explain Delaware decisions involving the directors’ duty of care, which anticipates my argument that fiduciary duty principles are the best mode of analyzing board precommitment devices.²⁷³

If there is no firebreak, what should the Delaware supreme court have done? Instead of creating a novel doctrine based on statutory authority, the court should

²⁶⁹ Because shareholders are not entitled to vote on a merger until it has been approved by the board of directors, acquisition agreement provisions that bind the board to a particular course of conduct necessarily also limit the range of shareholder options. *See generally supra* notes 194-197 and accompanying text.

²⁷⁰ *See supra* notes 217-256 and accompanying text (developing the director primacy model, which suggests that shareholder democracy-based arguments should be given little weight in this context).

²⁷¹ *See* E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997) (elaborating on the distinction between “enterprise” and “ownership” decisions).

²⁷² *See supra* Part IV.A.4 (discussing Delaware case law on no shops).

²⁷³ I am indebted to Jack Jacobs for raising the firebreak issue with me.

have relied on the well-established principles outlined in *Unocal* and its progeny.²⁷⁴ Dead hand and no hand pills unquestionably raise very serious issues of target director fiduciary duty.²⁷⁵ The market for corporate control and, in particular, the unsolicited tender offer are critical accountability mechanisms by which agency costs are constrained in the corporate setting.²⁷⁶ Director action that impedes unsolicited bids therefore is tainted by a conflict of interest, as *Unocal* recognized.²⁷⁷ Indeed, it is difficult to imagine a legally cognizable threat sufficiently severe for a dead hand pill to pass muster under the proportionality prong of *Unocal*.²⁷⁸ Binding someone else's hands, as the dead hand pill does, does seem more problematic than binding one's own. Such concerns become even more pronounced, when the decision to disable another is tainted by a conflict of interest situation.

Yet, never before had the Delaware supreme court adopted a prophylactic prohibition in response to that taint. To the contrary, the court rejected just such an approach when it rejected academic calls for a rule mandating director passivity in the face of an unsolicited bid. Moreover, Delaware courts have employed even

²⁷⁴ To be clear, I believe that *Unocal* is the appropriate standard regardless of whether one believes in shareholder or director primacy. In a shareholder primacy-based regime, which accepts the legitimacy of limitations on the board's authority, the various flaws associated with *Quickturn*'s analysis suggest that a fiduciary duty-based inquiry is preferable to the prophylactic bar raised by the court. In a director primacy-based regime, which acknowledges the legitimacy of accountability concerns, a fiduciary duty-based analysis strikes an appropriate balance between respect for the board's authority and the need to ensure that the board uses its authority responsibly.

²⁷⁵ See Letsou, *supra* note 81, at 1148 (noting that dead hand pills must pass muster under fiduciary duty principles).

²⁷⁶ As is so often the case in the law and economics of corporations, the intellectual roots of this line of argument are to be found in the work of Henry Manne. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Henry G. Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen*, 1967 DUKE L.J. 231. For appreciations of Manne's influence on the subsequent literature, see William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215 (1999); Fred S. McChesney, *Manne, Mergers, and the Market for Corporate Control*, 50 CASE W. RES. L. REV. 245 (1999).

²⁷⁷ See *supra* note 126 and accompanying text.

²⁷⁸ Unlike the authority-based analysis in *Quickturn*, which was unable to account for the ways in which precommitment strategies vary in their effectiveness, the *Unocal* regime is well-suited to incorporate that factor into its analysis. Recall that under *Unocal* a takeover defense must be proportional to the threat posed by the unsolicited offer. See *supra* text accompanying note 131. A precommitment strategy that bonds the board only weakly, such as a redeemable poison pill, therefore should more easily pass muster under *Unocal* than a stronger precommitment strategy, such as a no hand pill.

Unocal cautiously. They recognize the danger “that courts—in exercising some element of substantive judgment—will too readily seek to assert the primacy of their own view on a question upon which reasonable, completely disinterested minds might differ.”²⁷⁹ Consequently, just as is called for by Arrow’s analysis, *Unocal* and its progeny establish an “intermittent” accountability mechanism “capable of correcting errors” but which does not “destroy the genuine values of authority.”²⁸⁰

The Delaware supreme court should acknowledge that both self-disablement by the board of directors and disablement by the board of other constituencies are legitimate and accepted corporate governance practices. It then should emphasize that such self-disablement raises issues of fiduciary duty, especially when tainted by the sort of potential conflict of interest inherent in takeover defense decisions.

V. CONCLUSION

By basing its *Quickturn* decision on the purported lack of statutory authority for board of directors to adopt self-imposed limitations on their own powers, the Delaware supreme court made a serious doctrinal error. A host of well-established corporate governance devices of heretofore unquestioned validity entail board self-disablement to one degree or another. As the *Capital Re* dicta on no shop clauses indicates, however, *Quickturn* has called into question all such devices.²⁸¹ In my view, there simply is no firebreak between the sorts of board self-disablement deemed invalid by the dead hand and no hand poison pill cases and the host of other precommitment strategies routinely used by corporate boards of directors. The Delaware supreme court’s conclusion that the former are invalid for lack of statutory authority thus threatens to invalidate all of the latter. Worse yet, it also threatens to undermine the basic corporate law norm of director primacy. The Delaware supreme court therefore should disavow *Quickturn*.

²⁷⁹ City Capital Assoc. Ltd. Partnership v. Interco, Inc., 551 A.2d 787, 796 (Del. Ch. 1988).

²⁸⁰ See *supra* note 255 and accompanying text.

²⁸¹ See *supra* note 208 and accompanying text.