SHAREHOLDER FRANCHISE—NO COMPROMISE:
WHY THE DELAWARE COURTS MUST PROSCRIBE ALL
MANAGERIAL INTERFERENCE WITH CORPORATE VOTING

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INTRODUCTION

After years of rationally apathetic slumber, the shareholder has reemerged, bulked up and ready to challenge management for control of America's corporations.¹ The managers, fresh off their victory in the "hostile takeover" wars, are ready for the challenge.² The shareholder's weapon?—the lowly proxy. While shareholder voting was once considered a mere formality, institutional investors with tremendous stock holdings have given the corporate election process a new vitality.³ These institutions, which own over half of the equity in U.S. corporations,⁴ have been using the proxy voting system to limit management excesses and to replace the leadership of underperforming companies. They have demanded that corpora-

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¹ See, e.g., PAUL R. BERGIN, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1988 PROXY SEASON 1 (1988) (stating that "institutional shareholders are continuing to become more active participants in the proxy voting process—taking their voting rights more seriously and using the proxy process to defend and promote their interests").

² See, e.g., Clare O'Brien & Alan S. Goudiss, *Hostile Takeovers in the '90s: What Are Boards' Options in Fashioning Responses?*, N.Y. L.J., Dec. 11, 1995, at 7 (stating that recent legal developments, particularly in the courts of Delaware, "reflect a trend toward permitting broader latitude in fashioning responses to hostile takeover threats and greater judicial deference in reviewing a corporate board's selection and implementation of defensive measures").

³ See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 570 (1990) (stating that "[i]nstitutional ownership is beginning to translate into significant voting power").

⁴ See, e.g., Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 447 (1991) (reporting that in 1989, institutions held over 45% of total equities in the United States). Many of the largest companies are the most heavily owned by institutions. For example, Capital Cities/ABC is 88% institutionally owned and Digital Equipment is 71% institutionally owned. *Id.* at 447-48 & n.5. By 1995, institutional holdings had increased to 54.2% of all equity ownership. See MARK A. SARGENT & DENNIS R. HONABACH, PROXY RULES HANDBOOK 1-1 (1995).

tions be governed for the benefit of the owners of the firm, the shareholders.⁵

Management has responded to this new shareholder activism by constructing barriers to the voting process.⁶ Managers have moved election dates, manipulated the size of the board, enforced ownership limits and placed stock into friendly hands—all to reduce or eliminate the possibility of shareholder success in a corporate election.⁷

The judicial response to this intrusion on the shareholder franchise has been mixed. While the courts have described the shareholder franchise as deserving of judicial protection,⁸ there is a marked unwillingness among judges to interfere with managerial decisionmaking.⁹ In many cases, the courts have acknowledged that even though a corporate maneuver will interfere with a proxy fight, they will not invalidate the measure because the impediment was not the primary purpose behind the action.¹⁰ In other cases, the courts blessed actions that seriously interfered with an election but did not totally preclude the shareholder's chances.¹¹ In still other cases, the courts argued that they needed to apply a balancing test to determine whether the degree of interference with an election was proportionate to a reasonably perceived threat to the company.¹²

⁵ See, e.g., *CalPERS Says Challenge to Boards Is Working*, L.A. TIMES, June 1, 1995, at D3, D8 [hereinafter *Challenge to Boards Is Working*] (describing how the California Public Employees' Retirement System ("CalPERS") has been petitioning corporate boards to create written guidelines for practices that "ensure the protection of shareholder rights").

⁶ See VIRGINIA K. ROSENBAUM, TAKEOVER DEFENSES: PROFILES OF THE FORTUNE 500, at 7-11 (1987) (describing the various methods by which managers try to prevent a change in corporate control).

⁷ See *infra* Part II.

⁸ See, e.g., *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1378 (Del. 1995) (declaring that "[t]his Court has been and remains assiduous in its concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising shareholders").

⁹ See *id.* at 1386 (arguing that "courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness" (quoting *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994))).

¹⁰ See *Stahl v. Apple Bancorp, Inc.*, No. CIV.A.11510, 1990 WL 114222, at *6 (Del. Ch. Aug. 9, 1990) (*Stahl II*) (stating that "board action taken in good faith . . . may be valid even though it affects in some respects the exercise of the franchise").

¹¹ See, e.g., *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 286 (Del. Ch. 1989) (finding that even though corporate defensive measures placed the insurgents in a position where they would have to "out poll management by a factor of 4 to 1," the actions were not preclusive of the shareholder franchise).

¹² See *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992) (declaring that "[i]n certain

This Comment proposes that the courts need to take a stronger stand against managerial interference with shareholder voting. The various tests the courts are applying—the primary purpose, total preclusion and balancing tests—are too deferential to management. The vote is the shareholder's only tool to oversee and discipline corporate management. With the elimination of the unsolicited tender offer, shareholders must vote management out of office if they are to recognize the gains from a change in control.¹³ The shareholder vote is at the heart of the economic principles that drive corporate efficiency,¹⁴ as well as the fiduciary principles that legitimate managerial exercise of power over the vast amount of assets that management does not own.¹⁵

Specifically, this Comment will argue that courts must not allow managers to *purposefully* interfere with the shareholder franchise. Additionally, the courts must carefully scrutinize defensive transactions that, although not primarily intended to interfere with the ability of shareholders to vote, have the *effect* of constraining the ability of shareholders to oust incumbent management. Presently, courts do not carefully examine the effect of defensive measures on the shareholder franchise.¹⁶ Because the shareholder franchise is so vital to the efficient operation of the modern corporation, the court must apply the strictest level of review to actions that impede

circumstances, a court must recognize the special import of protecting the shareholders' franchise within *Unocal's* requirement that any defensive measure be proportionate and 'reasonable in relation to the threat posed'" (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985))).

¹³ See Irwin H. Warren & Kevin G. Abrams, *Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests*, 47 BUS. LAW. 647, 648 (1992) (stating that "although the directors may be permitted to 'just say no' to a proposal to change control or corporate direction if they believe their current plan is superior, the stockholders ultimately retain the right to replace the incumbents with directors committed to the policy preferred by the holders of a majority of the company's voting stock").

¹⁴ See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 68 (1991) (arguing that voting is valuable because it pressures managers to "act in [the] shareholders' interest").

¹⁵ See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (stating that "the vote . . . is critical to the theory that legitimates the exercise of power by some . . . over vast aggregations of property that they do not own").

¹⁶ Compare *Moore Corp. Ltd. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1563 (D. Del. 1995) (stating that "retention of the [poison] pill will have no effect on the success of the proxy contest"), with Randall S. Thomas and Kenneth J. Martin, *The Impact of Rights Plans on Proxy Contests: Reevaluating Moran v. Household International*, 14 INT'L REV. L. & ECON. 327, 336 (1994) (stating that "limits on dissident stock ownership negatively affect the likelihood of dissident success in a proxy contest").

the electoral process. Additionally, courts must be willing to take positive steps to remedy impositions on the franchise by ordering the reimbursement of expenses, requiring the elimination of antiproxy measures or demanding the adjustment of corporate defenses.

After years of despairing over the inability of the shareholder to monitor management, there is finally an opportunity for efficient oversight.¹⁷ As shareholders have begun to utilize the vote to influence, pressure and ultimately oust management, companies have attempted to raise barriers to the voting process.¹⁸ Unless courts step in to limit managerial impositions, it is conceivable that the shareholder franchise will go the way of the unsolicited tender offer. This Comment will present a critique of the shareholder franchise case law and recommend a new direction for the courts to take.

Part I of this Comment discusses the reasons why the shareholder franchise is currently emerging as a potent weapon in the battle for corporate control. The rise of the institutional investors is discussed, as well as the changes in the legal environment that have facilitated the use of the shareholder proxy. Part II enumerates the various defensive measures that corporations are using to prevent proxy fights. Part III reviews the relevant case law, beginning with the unsolicited hostile offer cases that provide a background for understanding the courts' analysis in the franchise cases. Part IV presents the arguments for why the shareholder franchise must be protected. Part V discusses the problems with the current doctrine and presents alternative solutions.

¹⁷ See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 124 (1932) (arguing that "[t]he concentration of economic power separate from ownership has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating 'owners' to the position of those who supply the means whereby the new princes may exercise their power").

¹⁸ See INVESTOR RESPONSIBILITY RESEARCH CTR., *CORPORATE TAKEOVER DEFENSES* at ix (1995) [hereinafter *CORPORATE TAKEOVER DEFENSES*] (listing the different corporate proxy defenses and showing how they have become more popular over the past five years).

I. THE EMERGING POWER OF THE SHAREHOLDER FRANCHISE

A. *The Proxy Contest: A History of Irrelevance*

For many years, shareholder voting was considered a meaningless ritual.¹⁹ In a famous early work on the market for corporate control, a scholar referred to the proxy as “the most expensive, the most uncertain, and the least used of the various techniques” for acquiring control of a corporation.²⁰ Others were less kind, calling the proxy an “anti-democratic device,” totally dominated by management.²¹ In response to claims that shareholders were not participating in corporate government because they were not given enough information about the firm, the federal government enacted laws to regulate corporate disclosure and overhaul the proxy machinery.²²

¹⁹ See, e.g., *Blasius*, 564 A.2d at 659 n.1 (quoting Professor A.A. Berle as dismissing “the shareholders’ meeting as a ‘kind of ancient, meaningless ritual like some of the ceremonies that go with the mace in the House of Lords’” (citation omitted)). This Comment will use the terms proxy and vote interchangeably. The proxy is essentially a contract, granting the right to vote shares of stock. Because corporations typically have thousands of relatively small shareholders, it is impractical to expect all of them to appear personally at shareholders’ meetings to cast their votes. See MICHAEL D. WATERS, PROXY REGULATION 9 (1992). Shareholders can also place their own proposals on the proxy to be voted on as a means of communicating their concerns to management. See ROBERT CHARLES CLARK, CORPORATE LAW § 9.2-3, at 371-83 (1986).

The proxy system is authorized under state corporate law and extensively regulated by federal law. See generally SARGENT & HONABACH, *supra* note 4, at 2-1 (providing a thorough overview of SEC proxy regulation).

²⁰ Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 114 (1965).

²¹ Mortimer M. Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage*, 39 VA. L. REV. 141, 151 (1953) (stating that “as presently employed—with the proxy machinery completely dominated by the managers of industry . . . the proxy system of voting has become an anti-democratic device, destructive of any real system of checks and balances against possible managerial abuse, and operating in contravention of our fundamental notions of fair play,” quoted in *Dozier v. Automobile Club*, 244 N.W.2d 376, 384 (Mich. Ct. App. 1976)); see also BERLE & MEANS, *supra* note 17, at 139 (calling the proxy machinery “one of the principal instruments not by which a stockholder exercises power over the management of the enterprise, but by which his power is separated from him”).

²² See 15 U.S.C. § 78n (1994); see also CLARK, *supra* note 19, § 9.2, at 366 (stating that the focus of the federal regulation of proxies is to assure “that public investors have true and adequate information before they exercise their right to vote”); SARGENT & HONABACH, *supra* note 4, at 1-3 (stating that “[t]he drafters of Section 14 of the Securities Exchange Act of 1934 appeared to contemplate that public disclosure would . . . inhibit managerial misbehavior”).

Despite these rules, shareholders still did not take an active role in corporate management.²³ Only rarely did a proxy fight result in a change in corporate control.²⁴ For the most part, the proxy was a tool of activists and gadflies who were more interested in gaining publicity than actually electing candidates to the board.²⁵ There is a cogent explanation for the passivity of the owners of the firm: because each shareholder owns such a small share of the firm, the costs of participating in the corporate democracy—reading the proxy material, becoming informed, voting—exceeds any potential benefit the shareholder could receive.²⁶ Thus, shareholder apathy did not result from a lack of salient information, but was rather a rational response on the part of the numerous shareholders, each owning an insignificant amount of a firm.²⁷ This collective action problem also

²³ See A. Camille Nichols & James B. Swain, *Putting Proxies to Work*, CORP. BOARD, May/June 1995, at 11, 11 (stating that until recently, "[t]he possibility that the proxy vote could or should be used to effect change or send a message to management was not a major consideration").

²⁴ See, e.g., EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 266 (1981) (stating that "gaining directorships through the processes of corporate democracy . . . is close to impossible"); Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1084 (1992) (stating that between 1962 and 1978, there were only 71 proxy contests for control of firms traded on the New York and American Stock Exchanges, an insignificant figure given the number of firms that traded on those exchanges); Philip N. Hablutzel & David R. Selmer, *Hostile Corporate Takeovers: History and Overview*, 8 N. ILL. U. L. REV. 203, 204 (1988) ("It was said during the 1950s that insurgents were not likely to win such a [proxy] fight unless dividends had not been paid for several years.").

²⁵ See, e.g., HERMAN, *supra* note 24, at 270-77 (describing the proxy campaigns directed at U.S. corporations who did business in South Africa or sold infant formula in the Third World); HENRY C. EGERTON, THE CONFERENCE BD., HANDLING PROTEST AT ANNUAL MEETINGS 46-55 (1971) (describing social policy proposals included in the 1970 General Motors proxy statement). The vast majority of these proposals were voted down handily. See HERMAN, *supra* note 24, at 265 (stating that the Ralph Nader-led "campaign GM" failed to garner 5% of the vote for its proposals).

²⁶ See EASTERBROOK & FISCHER, *supra* note 14, at 83 (arguing that "[g]iven the combination of a collective action problem and easy exit through the stock market, the rational strategy for most dissatisfied shareholders is to sell rather than incur costs in attempting to bring about change through votes"). The collective action problem is inherent in all groups who must act together for a common good. See MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 35 (1965) (explaining that as a group gets larger and individual members get a decreasing percentage of the returns from any expenditure they make, the incentive for making expenditures for the collective good decreases).

²⁷ See, e.g., John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237, 242 (1988) (explaining that shareholder voting may not pay because shareholders "tend to hold a very small portion of all outstanding corporate votes" and that "[t]hey thus must rationally recognize that their own voting behavior is unlikely to affect the outcome of the voting process significantly").

explained the dearth of proxy contests. Shareholders who wished to challenge management had to expend their own resources to mount a proxy contest.²⁸ If they lost, they were not reimbursed.²⁹ If they won, they only received their proportionate share of the gain. Furthermore, management has a large advantage in a proxy contest because shareholders are more likely to vote for management than incur the expense of becoming informed about the opponent. Historically, the "Wall Street Rule" governed—if you did not like the way the firm was being managed, sell.³⁰

An additional reason existed for the relative unimportance of proxy contests—the availability of the tender offer.³¹ As directors mismanaged the firm and shareholders sold their stock, the price of a company's shares fell. A "takeover specialist," seeing an opportunity to make a large profit, purchased the depressed shares of the firm, replaced the inefficient management and brought the company back to health (or chopped it into pieces). The tender offer eliminated many of the drawbacks of the proxy fight. Because shareholders realized immediate gains through a tender offer, the problem of rational apathy diminished. A large reservoir of financing developed, so that hostile bidders could pursue even the

²⁸ Proxy contests for control can be very expensive. See, e.g., MARK A. SARGENT, PROXY CONTESTS HANDBOOK Intro.2 (1993) (stating that a "dissident shareholder can conduct a proxy contest for \$1 to \$15 million"); Bainbridge, *supra* note 24, at 1078 (stating that a serious proxy contest will entail expenses for "lawyers, accountants, financial advisers, printers, and proxy solicitors"); Mark A. Stach, *An Overview of Legal and Tactical Considerations in Proxy Contests: The Primary Means of Effecting Fundamental Corporate Change in the 1990s*, 13 GEO. MASON L. REV. 745, 776 (1991) (stating that during a proxy fight for Lockheed Corp., "the incumbents spent approximately \$8 million and the insurgents spent approximately \$6 million").

²⁹ See *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291, 293 (N.Y. 1955) (requiring the corporation to reimburse management for reasonable proxy expenses but declaring that the corporation had no duty to pay the expenses of the insurgent group); see also Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1106-17 (1990) (discussing the current rules regarding proxy reimbursement and suggesting that in some cases the reimbursement of the proxy expenses of challengers may be an efficient way to encourage proxy contests for control).

³⁰ See Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late*, 43 AM. U. L. REV. 379, 406 & n.163 (1994) (explaining that the "Wall Street Rule holds that shareholders who are dissatisfied with management can 'vote with their feet'").

³¹ See John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1017 (1993) (stating that "[b]y the late 1960s and 1970s, tender offers had come to dominate the landscape of corporate governance and control").

largest corporations.³² The hostile tender offer became the preferred method of effectuating a change in corporate control.³³ The threat of a hostile takeover also helped discipline corporate management. A firm whose stock price had become depressed through mismanagement was a more attractive takeover target.³⁴ Thus, management found it in its self-interest to ensure that the price of the firm's stock was high and that the shareholders were satisfied. By the 1980s, the tender offer had assumed the intended role of the proxy in monitoring management and effectuating corporate change.

B. *The End of the Hostile Takeover Era and the Emergence of the Proxy Contest*

1. Corporate Management, with Friends in High Places, Beats Back the Hostile Raiders

Management responded to the growing number of hostile offers by putting up defenses. Poison pills (also known as shareholder rights plans), shark repellants, white knights and other colorfully named techniques were developed in an attempt to protect corporations, and their management, from the possibility of being acquired (and fired).³⁵ The legitimacy of these defenses was contested in the Delaware Chancery Court and the Delaware Supreme Court. Although in a few cases the corporate defenses were found to be invalid, for the most part management was allowed to reject hostile bids, even if the shareholders were overwhelmingly in favor of the deal.³⁶ Today, most large firms have poison pills in place, making

³² See SARGENT, *supra* note 28, at 1.

³³ See Pound, *supra* note 27, at 237 (stating that "[i]n the period 1981-1984, there were over 250 tender offers for publicly held U.S. corporations, but only about 100 proxy contests, of which fewer than 60 were for control").

³⁴ See John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1163 (1984) (explaining that under the Disciplinary Hypothesis of hostile takeovers, "the role of the tender offer is to replace inefficient management"); 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, 1174-75 (1981) (arguing that efficiency demands that management be passive in the face of a tender offer). Corporate management spent the rest of the decade ignoring this sage advice. See generally ROSENBAUM, *supra* note 6, at 13-195 (reviewing the various antitakeover provisions in the charters and bylaws of the largest firms).

³⁵ For a discussion of the costs and benefits of defenses to hostile takeovers, see Coffee, *supra* note 34, at 1221-50.

³⁶ See *Moore Corp. Ltd. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1553, 1564 (D. Del. 1995) (arguing that even though 73.4% of all shareholders tendered

hostile takeovers prohibitively expensive, if not impossible.³⁷ Delaware courts have recognized the impact of their decisions.³⁸

In addition to the corporate takeover defenses, state legislatures have passed laws to help companies repulse unwanted bids. These antitakeover laws were passed in response to calls from local corporations and labor interests.³⁹ These statutes restrict takeovers through a number of mechanisms. The "control share" statutes provide that shareholders who purchase in excess of some threshold level of a firm's stock must receive approval from the majority of the shares of the disinterested shareholders before the purchaser is allowed to vote her shares.⁴⁰ Delaware has enacted a "business combination" statute, which places a three-year waiting period on mergers and takeovers by shareholders with more than 15% of a company's stock, unless the board or a supermajority of other shareholders approve.⁴¹ A Pennsylvania law requires "short-term

their shares, the company could still refuse to redeem the pill); see also Karen Donovan, *Poison Pills Redux: What Shareholders Don't Know*, NAT'L L.J., Dec. 25, 1995, at B1 (quoting a former member of the Delaware high court describing Moore as "the clearest decision on the right of a company to just say no" to a hostile bid).

³⁷ See CORPORATE TAKEOVER DEFENSES, *supra* note 18, at ix (reporting that 799 out of the 1500 largest firms had poison pills); see also Gabriella Stern, *Chrysler Corp. Is Expected to Be Asked to Loosen Its Antitakeover Defenses*, WALL ST. J., Oct. 17, 1995, at A4 (reporting that the trigger point for Chrysler's poison pill is 15%, thereby making takeovers "prohibitively expensive"); *Westinghouse Adopts a Plan Intended to Deter Takeovers*, N.Y. TIMES, Dec. 30, 1995, at 44 (quoting the company as saying that the shareholder rights plan was intended "to discourage takeovers that do not provide a fair value to all shareholders").

³⁸ See *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 489-90 (Del. Ch.) (stating that "over the past decade target company boards have successfully used antitakeover defenses, particularly the 'poison pill' rights plan, either to defeat unwanted bids or to force the bidders to raise their price"), *aff'd*, 670 A.2d 1338 (Del. 1995).

³⁹ See, e.g., Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 24-25 (1992) (stating that "politically diverse coalitions commonly supported antitakeover statutes"); Paul Richter, *States Act to Stem Tide of Takeovers*, L.A. TIMES, Sept. 15, 1987, at 1 (reporting how state legislatures have adopted antitakeover legislation at the behest of large local firms, often with little debate or opposition).

⁴⁰ See *Hablutzel & Selmer*, *supra* note 24, at 226. The Supreme Court has upheld the constitutionality of the Indiana Control Share Acquisition Act. See *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 94 (1987) (holding that the Indiana Act "does not conflict with the provisions or purposes of the Williams Act"). As states pass newer and more severe antitakeover rules, the court challenges continue. See, e.g., *WLR Foods, Inc. v. Tyson Foods, Inc.*, 65 F.3d 1172, 1180-82 (4th Cir. 1995) (holding that the Virginia Control Share Acquisitions Act, Affiliated Transactions Act, Poison Pill Statute and Business Judgment Statute were not preempted by the Williams Act and did not violate the Commerce Clause), *cert. denied*, 116 S. Ct. 921 (1996).

⁴¹ See DEL. CODE ANN. tit. 8, § 203(a) (Interim Supp. 1995) (stating that "a corporation shall not engage in any business combination with any interested

shareholders who dispose of their shares within eighteen months after attempting to acquire control of a firm to disgorge their sales profits to the firm."⁴² By mid-1995, forty-one states had adopted some type of statutory takeover control law.⁴³

To add insult to injury, financing for hostile takeovers is now hard to come by. These difficulties have resulted from "financial and regulatory pressures on United States banks and insurance companies, the virtual collapse of the market for new issues of high-yield securities, the unavailability of alternative sources of subordinated financing, . . . changes in the tax laws, [and] the heightening of margin requirements."⁴⁴ According to one scholar, "[t]he takeover wars are over. Management won."⁴⁵

2. A New Threat to Management: The Institutional Investor

At the same time that the market for corporate control through the tender offer was being eliminated, institutional investors emerged as a force in the world of corporate governance. In 1950, institutional investors owned approximately 8% of all equities.⁴⁶ By 1965,

stockholder for a period of three years following the time that such stockholder became an interested stockholder").

⁴² P.R. Chandy et al., *The Shareholder Wealth Effects of the Pennsylvania Fourth Generation Anti-Takeover Law*, 32 AM. BUS. L.J. 399, 412 (1995). A study of stock prices of Pennsylvania companies before and after the passage of the law found that "the passage of the Pennsylvania [antitakeover] statute had a substantial negative effect on the share prices of most Pennsylvania firms." *Id.* at 403.

⁴³ See *From the Hustings: The Roll of States with Takeover Control Laws*, MERGERS & ACQUISITIONS, Sept. 19, 1995, available in WL, 1995 WL 10030701 (listing the various types of statutory takeover defenses and the states that have adopted each). The most popular defense to hostile takeovers is the "business combination" rule, which freezes the shares of the acquiror. Thirty-two states, including Delaware, have this rule in place. Twenty-nine states have nonstockholder "constituency" statutes, which allow management to take into account the impact of the acquisition on nonshareholders. Twenty-seven states have control share acquisition rules, while 23 states mandate poison pills. Seven states have antigreenmail statutes, and five have labor/severance statutes, which require the acquiror to assume the firm's existing collective bargaining agreement. Pennsylvania and Ohio mandate the recapture of profits, while only Massachusetts requires companies to have classified boards. Most of these laws allow companies to opt out if they choose. For a thorough discussion of state antitakeover laws, see Andrew R. Brownstein & Mitchell S. Presser, *Developments in Takeover Defenses and Their Impact on Proxy Contests*, in PROXY CONTESTS, INSTITUTIONAL INVESTOR INITIATIVES, MANAGEMENT RESPONSES 1990, at 369, 407-27 (PLI Corp. Law & Practice Course Handbook Series No. 696, 1990).

⁴⁴ Warren & Abrams, *supra* note 13, at 647-48.

⁴⁵ Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 858 (1993).

⁴⁶ See Rock, *supra* note 4, at 447 (describing the increase in institutional ownership

almost 16% of all publicly traded shares were controlled by institutions.⁴⁷ By 1995, that number had risen to 54.2%.⁴⁸ The holdings of these institutions are concentrated into a few giant funds. In 1989, the fifty largest institutions collectively owned 27% of all public U.S. equities.⁴⁹ The holdings of these institutions are so large that they can no longer viably follow the "Wall Street Rule" of selling if they are dissatisfied with corporate performance.⁵⁰ In recent years institutional shareholders have begun to assert themselves, using the power of the vote to challenge boards and, in a number of prominent cases, to unseat them.⁵¹ Corporate defenses to hostile take-

of stock).

⁴⁷ See SARGENT & HONABACH, *supra* note 4, at 1-1.

⁴⁸ See *id.*

⁴⁹ See Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POLICY 671, 692 (1995). One of the benefits of concentrated ownership is that the cost of communication decreases. Thus, parties can be made aware of each other's positions. See, e.g., *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1383 n.33 (Del. 1995) (stating that the fact "[t]hat institutions held a high percentage of Unitrin's stock is not as significant as the fact that the relatively concentrated percentage of stockholdings would facilitate a bidder's ability to communicate the merits of its position"). See generally DIANA B. HENRIQUES, *FIDELITY'S WORLD: THE SECRET LIFE AND PUBLIC POWER OF THE MUTUAL FUND GIANT* 36 (1995) (describing the history behind the world's largest mutual fund).

⁵⁰ See, e.g., Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197, 227 (1991) (arguing that "large institutional investors . . . are just too big to sell out of a company every time they disagree with management"); James M. Tobin, *The Squeeze on Directors—Inside Is Out*, 49 BUS. LAW. 1707, 1731 (1994) (stating that selling a large stake in a firm would depress the price of the stock); Kimberly Blanton, *In the Fidelity Fold: An Investment by the Funds Giant Can Be a Mixed Blessing*, BOSTON GLOBE, May 16, 1995, at 57 (reporting that Fidelity Investments owns more than 5% of the shares of 792 publicly traded companies, including 104 Fortune 500 companies). Additionally, many large funds are now indexing. This means that the fund holds a share of each company in a given index (for example, the S&P 500). As a result, the fund does not have the ability to sell companies that are underperforming. The only option available is to try to improve the companies' performance.

⁵¹ See, e.g., Joann S. Lublin, *Archer-Daniels-Midland Is Drawing Fire from Some Institutional Holders*, WALL ST. J., Oct. 11, 1995, at B12 (describing how institutional investors planned to respond to corporate malfeasance by pressing for bylaw changes, opposing corporate compensation packages and withholding votes for board members). In 1992, shareholder pressure led to the ousting of chief executives at Westinghouse Electric, American Express and IBM Corp. See Angelo B. Henderson & Gabriella Stern, *Chrysler Board Seat Is Nonnegotiable to Avert a Fight*, WALL ST. J., Jan. 3, 1996, at B3 (describing how Chrysler's board is conducting a "90-day 'corporate governance' review," which includes consultation with the company's large institutional shareholders); Joann S. Lublin, *Despite Poor Returns, Champion's Chairman Hangs on for 21 Years*, WALL ST. J., Oct. 31, 1995, at A1, A8 [hereinafter Lublin, *Champion's Chairman*] (explaining how a manager of an underperforming company has managed narrowly to avoid attempts by institutional investors to replace him); Jennifer Steinhauer, *Pier 1's Loss Only Intensifies Investor Anger*, N.Y. TIMES, Dec. 29, 1995, at D1

overs have been under attack by institutional shareholders, who believe that they are nothing but tools to entrench inefficient managers.⁵²

The California Public Employees' Retirement System ("CalPERS") is the primary example of an institutional investor that has had an impact on the way corporations are managed.⁵³ The fund, which controls \$83 billion, monitors the performance of major corporations and works to make the companies more responsive to shareholder concerns.⁵⁴ The sheer size of institutions such as CalPERS eliminates the collective action problem that plagued the small shareholder.⁵⁵ It is now efficient for these giant investors actively to monitor companies and take action when a company is being managed poorly.⁵⁶

Institutional investors have changed the way the proxy machinery is used. For many years, shareholder initiatives were primarily related to social policy issues. Today the focus has shifted. Most proposals now involve corporate governance issues, and unlike the social policy proposals, receive a great deal of shareholder sup-

(discussing institutional investors' plans to take action against managers who have been ineffective in controlling the firm's assets); see also Vineeta Anand, '93 *Proxy Season Quiet but Effective*, PENSIONS & INVESTMENTS, May 31, 1993, at 3, 3.

⁵² See, e.g., Stephen Clark, *Why Dale Hanson Won't Go Away*, INSTITUTIONAL INVESTOR, Apr. 1990, at 79, 84 (reporting that the California Public Employees' Retirement System ("CalPERS") has filed "a dozen proposals asking for . . . shareholder votes on poison pills and board action to opt out of Delaware's antitakeover laws, something the state allows"); Rob Norton, *Who Owns this Company, Anyhow?*, FORTUNE, July 29, 1991, at 131, 138 (describing how large investors are demanding that takeover defenses be put to a shareholder vote).

⁵³ See Steve Hemmerick, *CalPERS Shifts Activism Focus*, PENSIONS & INVESTMENTS, Aug. 21, 1995, at 2, 2 (describing how CalPERS is increasing the number of companies it monitors from 200 to 1200).

⁵⁴ See *Challenge to Boards Is Working*, *supra* note 5, at D3 (describing CalPERS's request that companies create written guidelines of their board practices).

⁵⁵ See, e.g., *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1382 (Del. 1994) (stating that "[i]t is generally accepted that proxy contests have re-emerged with renewed significance as a method of acquiring corporate control because 'the growth in institutional investment has reduced the dispersion of share ownership'" (quoting Bebchuk & Kahan, *supra* note 29, at 1082)).

⁵⁶ See, e.g., Black, *supra* note 3, at 523-24 (explaining how large mutual funds now own sizable shares of the stock of large companies, eliminating the problem of rational apathy); Debbie Galant, *Putting New Muscle into Proxy Voting*, INSTITUTIONAL INVESTOR, Feb. 1990, at 161, 161 (reporting that a "new industry of consultants has sprung up to help [corporate] activists become more effective both in choosing and waging their battles"); Pound, *supra* note 31, at 1057 (describing how a number of leading institutional investors have begun to develop "smart" voting systems, in which economic and performance factors about the firm are used to determine how investors should vote on corporate issues).

port.⁵⁷ The proxy is now an effective tool for changing or influencing corporate management.⁵⁸

Ironically, the fact that shareholders are not able to tender their shares has enhanced the value of the shareholder proxy. The large premiums that shareholders received through tender offers are now a thing of the past. The only way for a shareholder to realize gains from changes in corporate management is to vote the management out of office.⁵⁹

⁵⁷ See Patrick McGeehan, *Social Issues Take Back Seat to Returns*, USA TODAY, June 23, 1995, at 3B (reporting that of the record 520 shareholder proposals in 1995, only 108 dealt with social issues, down from over 200 in 1991). The social policy proposals were supported by an average of 8.3% of voting shareholders. Meanwhile, the governance issues were supported by an average of more than 40% of voters. See *id.* A slightly older survey of institutional voters found a great deal of support for proposals to prohibit the payment of greenmail, redeem the poison pill, adopt confidential voting and repeal the classified board. See BERGIN, *supra* note 1, at 6 (listing different corporate governance proposals and their quantified levels of support).

⁵⁸ See, e.g., Glenn Collins, *Unlikely Allies Demand Spinoff at RJR Nabisco*, N.Y. TIMES, Dec. 26, 1995, at D1 (reporting that two large RJR shareholders, Carl Icahn and Bennett LeBow, had begun a proxy battle to replace the company's board of directors and then spin off the Nabisco food unit, with a "substantial dividend" inuring to the shareholders); *Dissident Holders Seek Control of Tesoro*, N.Y. TIMES, Dec. 27, 1995, at D2 (reporting that a group of shareholders who owned less than 6% of a company's shares were initiating a proxy fight to take control of the board of directors); *Hartmarx Holders Support Proposal on 'Poison Pill'*, WALL ST. J., Apr. 15, 1993, at A5 (reporting that a shareholder proposal calling for the Hartmarx company to dismantle its poison pill takeover defense received 78% of the shareholder vote). Often, the influence of institutional investors is such that the issue in dispute never has to reach the level of a proxy solicitation. See, e.g., Anand, *supra* note 51, at 3 (reporting that companies targeted for proxy solicitation agreed to make concessions and avoid the embarrassment of losing a contested fight); James A. White, *Shareholder-Rights Movement Sways a Number of Big Companies*, WALL ST. J., Apr. 4, 1991, at C1 (stating that in order "to avoid disruptive proxy contests during the annual meeting season, 25 companies have given ground by accepting corporate-governance measures in recent months"); Clark, *supra* note 52, at 84 (stating that CalPERS prefers to resolve issues by meeting with corporate management rather than through the adversarial process, and citing a number of behind-the-scenes successes).

⁵⁹ Hostile bidders are now beginning to couple proxy contests with their tender offers in an attempt to replace the board and redeem the poison pill. See, e.g., Grundfest, *supra* note 45, at 858 (predicting that "[h]ostile bidders . . . will likely have to couple proxy contests with tender offers"); Warren & Abrams, *supra* note 13, at 650 (noting that the "simultaneous or staged commencement of a tender offer with a proxy contest or a consent solicitation has emerged in several prominent control contests"). The courts recognize the phenomenon. See *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 490 (Del. Ch.) (explaining that "[r]eplacing the incumbent directors is . . . an efficient way to eliminate the target company's ability to utilize these antitakeover defenses"), *aff'd*, 670 A.2d 1338 (Del. 1995).

3. Rules Now Facilitate Communication and Coordination Among Investors

The growing influence of the institutional investors has resulted in changes to the federal proxy rules. Until 1992, SEC regulations required that anyone who wanted to communicate with more than ten shareholders in order to influence their votes would be considered a "soliciting party." Any statements made by a soliciting party would be subject to prior governmental review, a costly and burdensome process.⁶⁰ In 1992, the SEC created new "safe harbor" exemptions for shareholders who were not soliciting proxies, but were simply communicating about the management of the corporation.⁶¹ These exemptions allowed shareholders to communicate about managerial performance and potential activism without first having to go through expensive and time consuming disclosure requirements. This rule change has lowered the costs of a potential proxy contest. Since investors will now have an opportunity to communicate with large stockholders before commencing their solicitation, they should be able to gauge better their prospects for success.⁶²

Institutional investors are beginning to appreciate and apply the power of the franchise.⁶³ For the first time, voting has become a

⁶⁰ See Michael W. Goroff & Guy W. Winters, *Recent Developments in Proxy Contests, in* DOING DEALS: UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE 347, 349-50 (PLI Commercial Law & Practice Course Handbook Series No. A-711, 1995) (describing the SEC's pre-1992 regulations).

⁶¹ See 17 C.F.R. § 240.14a-1(l) (1995). For a discussion of the new shareholder communication rules see SARGENT & HONABACH, *supra* note 4, at 3-1 to 3-33. See also Robert S. Frenchman, Comment, *The Recent Revisions to Federal Proxy Regulations: Lifting the Ban on Shareholder Communications*, 68 TUL. L. REV. 161, 179 (1993) (stating that "[t]his reform provides a broad exemption from proxy delivery and disclosure requirements for unaffiliated shareholders that are not seeking proxy authority").

⁶² See Andrew E. Bogen, *Playing Hardball Under the New Proxy Rules*, INSIGHTS, Apr. 1993, at 13, 13; see also *Proxy Battles Take on Greater Importance*, MERGERS & ACQUISITIONS REP., Apr. 24, 1995, available in WL, 1995 WL 2401937 [hereinafter *Proxy Battles*] (stating that the new shareholder communication rules adopted in 1992 "allow suitors to enlist institutional shareholders in the effort to pressure target managements").

⁶³ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 830-45 (1992) (discussing the ability of institutional investors to monitor management, target poorly performing companies and strengthen the board of directors); Karl A. Groskaufmanis, *Proxy Reform and the Brave New World of Investor Relations: Ten Rules of Thumb for the 1990s*, INSIGHTS, Dec. 1993, at 18, 18 (stating that institutional investors helped unseat three of the most powerful CEOs in the country).

meaningful tool for monitoring and disciplining corporate management.⁶⁴

II. THE MANAGER STRIKES BACK: LIMITATIONS AND RESTRICTIONS ON THE SHAREHOLDER FRANCHISE

Management has responded to the threat from the emerging shareholder franchise just as it had when faced with threats from hostile tender offers—by attempting to protect itself through a variety of defensive tactics. The shareholder franchise is regarded as a weakness in management's otherwise impenetrable defenses.⁶⁵ Corporations have begun to take steps to prevent proxy battles.⁶⁶ A recent survey by the Investor Responsibility Research Center ("IRRC") found that "[l]arge U.S. corporations are continuing to bolster their defenses against proxy fights."⁶⁷ The IRRC surveyed 1500 public companies regarding takeover defenses and found that a large number of firms continue to employ traditional defenses and

⁶⁴ See, e.g., O'Brien & Goudiss, *supra* note 2, at 7 (declaring that "in an age of renewed shareholder activism, corporate boards are, from a practical point of view, increasingly accountable for their stewardship").

⁶⁵ See, e.g., *Proxy Battles*, *supra* note 62 (stating that "unsolicited suitors are turning to proxy contests as a means to fight a recalcitrant target" and that the proxy "often provides acquirors with substantial ammunition to bring down a target's defenses"); Judith R. Thoyer & Carl L. Reisner, *IBM's Recent Threat to Replace Lotus' Board Demonstrates the Vulnerability of Clients to Voting Contests When They Are Defending Against Pending Takeovers*, NAT'L L.J., July 10, 1995, at B6, B6 (stating that "counsel must be aware of the client's vulnerability to voting contests in a takeover context when designing takeover defenses").

⁶⁶ See, e.g., Peter J. Henning, *Corporate Law After the Eighties: Reflections on the Relationship Between Management, Shareholders and Stakeholders*, 36 ST. LOUIS U. L.J. 519, 613 (1992) (stating that "[i]n much the same way corporations adopted antitakeover measures to prevent transactions threatening to usurp management's power, so too can management undermine the power of institutional shareholders by diluting or restricting their voting power"); *Chase Amends Bylaws to Fortify Defenses Against Takeovers*, ASIAN WALL ST. J., May 22, 1995, available in WL, 1995 WL-WSJA 8773842 [hereinafter *Chase Amends Bylaws*] (reporting that Chase Manhattan Corp. amended its corporate bylaws by taking away the right of holders with more than 25% of the firm's stock to call special meetings and enacted an advance notice requirement in order to "strengthen its hand against a possible proxy contest"); *Independence Requires Diverse Measures Beyond the Poison Pill*, CFO ALERT, Oct. 30, 1995, available in WL, 1995 WL 2540952 (citing supermajority voting requirements, elimination of special meetings and shareholder consents, and staggered boards as some of the tactics management can use to prevent a change in control).

⁶⁷ Vineeta Anand, *New Proxy Defenses Gain Popularity*, PENSIONS & INVESTMENTS, Oct. 30, 1995, at 9, 9; see also *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 280 (Del. Ch. 1989) (enumerating Polaroid's defenses to stockholder actions, including prohibiting action by written consent, restricting the use of special meetings, and requiring advance written notice for nominating directors).

to develop new tactics to defeat proxy fights and other forms of shareholder activism.⁶⁸ The following is a survey of the main corporate defenses against proxy fights and other shareholder attempts to challenge the supremacy of a company's board.

Classified (Staggered) Boards—A classified board is one in which directors are divided into separate classes (normally three) with each class elected to different, overlapping terms.⁶⁹ In any given year, only one-third of the board seats are available. As a result, an opponent will need more than one election to take control of the board. This may act to deter proxy fights, and it gives management time to respond to threats to its control.⁷⁰ In a number of recent cases, insurgents have swept an election, only to find themselves an outvoted minority on the board of directors.⁷¹ State statutes generally permit the classification of directors.⁷² According to the IRRRC survey, 60% of firms had classified boards in 1995, up from 57% in 1990.⁷³

Event Risk Contracts—These are contractual devices that create special rights for bondholders or preferred shareholders if a change in control takes place. An event risk contract is similar to a flip-in shareholder rights plan, but rather than punishing an outsider

⁶⁸ See Anand, *supra* note 67, at 9. The study is called CORPORATE TAKEOVER DEFENSES, *supra* note 18. The IRRRC performed similar studies in 1990 and 1993.

⁶⁹ See REVISED MODEL BUS. CORP. ACT § 8.06 (1984) ("If there are nine or more directors, the articles of incorporation may provide for staggering their terms by dividing the total number of directors into two or three groups, with each group containing one-half or one-third of the total, as near as may be." (emphasis omitted)).

⁷⁰ See ROSENBAUM, *supra* note 6, at 7 (discussing the effects of classifying a board).

⁷¹ See, e.g., James P. Miller & Larry M. Greenberg, *Wallace Computer Holders Elect Directors Backed by Moore Corp.*, WALL ST. J., Dec. 11, 1995, at B3 (stating that even though nominees of Wallace Computer Service's hostile suitors won a proxy contest, their victory "won't yield a majority position on the eight-member board" because only three seats were up for election).

⁷² See DEL. CODE ANN. tit. 8, § 141(d) (1991) (stating that directors "may . . . be divided into one, two or three classes"). In fact, Massachusetts mandates staggered boards as a default rule as part of its antitakeover legislation. See MASS. ANN. LAWS ch. 156B, § 50A(a) (1996).

⁷³ See CORPORATE TAKEOVER DEFENSES, *supra* note 18, at ix. Institutional investors have acted to oppose classified boards. See BERGIN, *supra* note 1, at 22 ("Support for classified boards is almost non-existent among public pension funds . . ."). In 1994, a proposal to declassify the board of U.S. Shoe Corp. passed with 82% of the vote, and a proposal to declassify the board at Kmart Corp. won with 60.5% of the vote. See Thoyer & Reisner, *supra* note 65, at B6 (citing instances when shareholder proposals to declassify a board have been accepted).

attempting to take control, it punishes the common shareholders who voted the managers out. In the event of a change in control, new stock is issued to preferred shareholders, or bondholders are allowed to sell at a premium, supposedly in order to protect their rights under a new regime.⁷⁴ These restrictions act as disincentives to shareholder voting, since the value of common shares will decrease when the new rights are triggered.

Poison Pills—Although shareholder rights plans were initially developed to oppose unsolicited tender offers,⁷⁵ they can be an effective means of interfering with the shareholder franchise as well. A rights plan limits the number of shares that a single party “can accumulate before launching a proxy contest.”⁷⁶ The most common trigger is now 20%, but “some plans go as low as 10%.”⁷⁷ Rights plans can also stop a dissident from forming coalitions with other shareholders if collectively they would own a greater percentage of voting stock than the trigger level.⁷⁸ Some rights plans are written to prevent dissident groups from making informal agreements with one another.⁷⁹ Today 53% of surveyed firms have shareholder rights plans, up from 50% in 1990.⁸⁰

Advance Notice Requirements—Advance notice provisions serve to eliminate the element of surprise employed by challengers, giving management advance notice of challengers’ plans.⁸¹ These bylaws,

⁷⁴ See Robert J. Klein, Note, *The Case for Heightened Scrutiny in Defense of the Shareholders’ Franchise Right*, 44 STAN. L. REV. 129, 170-72 (1991) (describing Time Warner’s common stock dilution mechanism and other event risk arrangements that benefit bondholders).

⁷⁵ See Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 512 (1993) (describing the history of the use of shareholder rights plans).

⁷⁶ *Id.*

⁷⁷ *Id.*; see also Stern, *supra* note 37, at A4 (reporting that Chrysler’s poison pill is now set to trigger at 15% ownership, although earlier it had been as low as 10%).

⁷⁸ See Warren & Abrams, *supra* note 13, at 663 (1992) (“Most rights plans provide in broad terms that one stockholder will be deemed to be the ‘beneficial owner’ of another stockholder’s shares if the stockholders have any ‘agreement, arrangement or understanding’ regarding the voting of their stock.”).

⁷⁹ See *Stahl v. Apple Bancorp, Inc.*, No. CIV.A.11510, 1990 WL 114222, at *7 (Del. Ch. Aug. 9, 1990) (*Stahl II*) (holding that a rights plan which would be triggered if a shareholder made informal voting agreements with other shareholders was not a material interference with that shareholder’s ability to engage in a proxy contest).

⁸⁰ See CORPORATE TAKEOVER DEFENSES, *supra* note 18, at ix.

⁸¹ See, e.g., *American Gen. Corp. v. Torchmark*, No. CIV.A.H-90-1068, 1990 WL 595282, at *4 (S.D. Tex. Apr. 11, 1990) (refusing to enjoin the use of a 60-day

which "require notice of nominees or matters to be presented by stockholders at annual or special meetings,"⁸² impede potential opponents and give management more time to respond to a challenge. Advance notice requirements are a very recent phenomenon. As late as 1990, very few companies had them. In 1995, the IRRG found that 43.8% of survey companies had restrictions of this kind.⁸³

Elimination of Cumulative Voting—Cumulative voting permits shareholders to distribute the number of votes they are entitled to cast among several candidates.⁸⁴ This process allows a minority of shareholders to gain a board representative. Directors do not like cumulative voting since it allows for dissenting voices on the board. The percentage of surveyed firms that allow cumulative voting has decreased from 15.7% to 14.4% over the past five years.⁸⁵

Elimination of Shareholders' Ability to Call a Special Meeting—Many state corporation statutes allow shareholders to call a special meeting, unless that right is limited in the company's bylaws. Other states, such as Delaware, do not allow shareholders to call such a meeting unless the right is specified in the bylaws.⁸⁶ The ability to call a special meeting is advantageous to shareholders, since it allows them to change a company's control without having to wait for its annual meeting. Thirty-one percent of surveyed firms now specifically limit shareholders' rights to call special meetings, up from 24% in 1990.⁸⁷

Elimination of Shareholders' Ability to Take Action by Written Consent—Closely related to the right to call a special meeting is the right to act through consents. Shareholder consents are very powerful tools for an insurgent because action is taken against incumbent directors immediately upon delivery of the consents; there is no need for a

advance notice provision that was not adopted in response to a proxy contest).

⁸² Thoyer & Reisner, *supra* note 65, at B8.

⁸³ See CORPORATE TAKEOVER DEFENSES, *supra* note 18, at viii; see also *Chase Amends Bylaws*, *supra* note 66 (reporting that Chase Manhattan Corp. amended its corporate bylaws by enacting an advance notice requirement in order to "strengthen its hand against a possible proxy contest").

⁸⁴ See BERGIN, *supra* note 1, at 14 (explaining cumulative voting).

⁸⁵ See CORPORATE TAKEOVER DEFENSES, *supra* note 18, at viii.

⁸⁶ See DEL. CODE ANN. tit. 8, § 211(d) (1991) ("Special meetings of the stockholders may be called by the board of directors or by such person or persons as may be authorized by certificate of incorporation or by the bylaws.").

⁸⁷ See CORPORATE TAKEOVER DEFENSES, *supra* note 18, at viii.

meeting.⁸⁸ Since action can be taken at any time, management will not be able to respond to the threat until it is too late.⁸⁹ Most state corporation laws limit this right by requiring unanimity to take action through a consent.⁹⁰ Delaware and a number of other states allow non-unanimous consent solicitations.⁹¹ Many statutes, however, allow the corporation to opt out of the consent practice through an amendment or through a restriction in the certificate. In the last several years, companies have begun to change their charters to eliminate shareholder consent rights.⁹² Thirty-one percent of surveyed firms limit these rights, up from 24% in 1990.⁹³

Supermajority Voting Requirements—Supermajority voting was originally formulated as an antitakeover device. By requiring a greater percentage of stockholders to approve a proposed action, stockholders are given more power to defeat actions adverse to their interests. Supermajority provisions can be used in combination with other defenses such as the staggered board to entrench management.⁹⁴

⁸⁸ See Thoyer & Reisner, *supra* note 65, at B6 (stating that failing to opt out of a consent solicitation rule "can leave a target with severely limited flexibility once a takeover bid has begun"); see also *Allen v. Prime Computer, Inc.*, 540 A.2d 417, 419 (Del. 1988) ("When [title 8, § 228 of the Delaware Code], authorizing majority stockholder consent in lieu of a meeting, was added to the General Corporation Law in 1967, its broad use in takeover battles, which we now observe, was not contemplated." (footnote omitted)).

⁸⁹ See Thoyer & Reisner, *supra* note 65, at B8 ("Once a bidder's access to the voting machinery through the consent solicitation process and the process of calling a special meeting of stockholders has been thwarted, a corporation has gone a long way toward limiting the opportunity for a bidder to apply pressure through the ballot box.").

⁹⁰ See *id.* at B6, B8 n.8 (noting unanimity requirements).

⁹¹ See, e.g., CAL. CORP. CODE § 603 (1990) (stating that "any action which may be taken at any annual or special meeting of shareholders may be taken without a meeting and without prior notice, if a consent in writing, setting forth the action so taken, shall be signed by the holders of outstanding shares having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to votes thereon were present and voted"); DEL. CODE ANN. tit. 8, § 228(a) (1991) (stating that "any action which may be taken at any annual or special meeting of such stockholders, may be taken without a meeting, without prior notice and without a vote"). Delaware, however, does make a consent solicitation more difficult to win than a vote in a shareholder meeting. To succeed in a consent solicitation, a party needs an absolute majority of all the outstanding shares, not simply a majority of the voted shares. Thus, abstaining from a consent is "de facto voting against the proponent." Thoyer & Reisner, *supra* note 65, at B6.

⁹² See BERGIN, *supra* note 1, at 29 (stating that 130 of the Fortune 500 companies have changed their charters and bylaws to limit these rights).

⁹³ See CORPORATE TAKEOVER DEFENSES, *supra* note 18, at viii.

⁹⁴ See, e.g., Miller & Greenberg, *supra* note 71, at B3 (reporting that the Moore

Supermajority voting provisions give minority shareholders the power to veto the will of the majority, effectively disenfranchising the majority.⁹⁵

Dilution of Ownership Through an Employee Stock Ownership Plan ("ESOP")—An ESOP places shares of the company under the employees' control. This is an effective tactic to oppose a proxy fight since employees, concerned with job preservation, are usually fearful of control changes.⁹⁶ Additionally, "[m]anagement generally acts as a trustee of the firm's pension fund and of the firm's ownership plan, and hence it can significantly influence how the firm's shares held by the . . . stock ownership plan are voted."⁹⁷

Manipulation of the Size of the Board—Under the laws of almost every state, the directors have the power to fix the size of the board and to appoint new directors to fill vacancies, unless the bylaws or charter declares otherwise.⁹⁸ Directors can manipulate the size of the board to defend against a proxy fight. In a "musical chairs" defense, corporations can eliminate seats occupied by opponents or reduce the size of the board to foil a cumulative voting system.⁹⁹ Managers

Corp. failed in its attempt to overcome a supermajority requirement to remove the directors who were not up for election, and thus only came away from the election with three of the eight seats on the board).

⁹⁵ See *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923, 927-28 (Del. 1990) (holding that the shareholders "evidenced an intent" to "thwart attempts to seize control" of the corporation when they adopted an 80% supermajority requirement for changing the corporate bylaws).

⁹⁶ See, e.g., *NCR Corp. v. AT&T*, 761 F. Supp. 475, 482 (S.D. Ohio 1991) (holding that "[t]he size of the ESOP was not related to benefits objectives but, rather, was an attempt to place as large a number of shares into friendly hands as possible" (footnote omitted)); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 281 (Del. Ch. 1989) (stating that an ESOP gives the managers "a leg up in opposing a takeover bid").

⁹⁷ René M. Stulz, *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, 20 J. FIN. ECON. 25, 48 (1988).

⁹⁸ See DEL. CODE ANN. tit. 8, § 141(b) (1991) ("The number of directors shall be fixed by, or in the manner provided in, the bylaws."); *id.* § 142(e) ("Any vacancy occurring in any office of the corporation by death, resignation, removal or otherwise, shall be filled as the bylaws provide. In the absence of such provision, the vacancy shall be filled by the board of directors or other governing body."); *id.* § 223(a)(1) ("Vacancies and newly created directorships resulting from any increase in the authorized number of directors elected by all of the stockholders . . . may be filled by a majority of the directors then in office.").

⁹⁹ See, e.g., Klein, *supra* note 74, at 145-46 (stating that "Sears eliminated five inside director seats in a defensive move after Robert Monks, a shareholder rights activist, announced his intent to solicit proxies for election to the board" (footnote omitted)).

can also increase the size of the board and appoint allies to those seats in order to maintain a majority.

Moving the Date of the Election—When faced with a proxy fight, boards have frequently attempted to use their power to set the record date¹⁰⁰ and election date to harass, delay or otherwise impede their opponents.¹⁰¹ In one case, a board moved the date of an election forward in order to deny its opponents time to gather enough proxies to win the election.¹⁰² When faced with a potential election defeat, boards also may cancel or otherwise delay the election.¹⁰³

Continuing Director Provisions—These rules guarantee that only current directors of the firm or their handpicked successors can perform certain acts.¹⁰⁴ This is one of the strongest possible defenses because even if the proxy fight succeeds, the new managers will be left with a hollow victory as they will be limited in their available actions.¹⁰⁵ The IRRC Survey does not list companies with a continuing director defense, most likely because it is so rare at this time.

¹⁰⁰ The record date "functions in much the same way as voter registration requirements for elections in our political system." JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 579-80 (3d ed. 1989).

¹⁰¹ See DEL. CODE ANN. tit. 8, § 213(a) (1991) (stating that "the board of directors may fix a record date . . . [which] shall not be more than 60 nor less than 10 days before the date of such meeting").

¹⁰² See *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439-40 (Del. 1971) (holding that the directors had acted inequitably and that the original meeting date should be reinstated).

¹⁰³ See, e.g., *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1205 (Del. Ch. 1987) (finding that the directors delayed the board meeting scheduled for the next day because they were informed that they might lose the election).

¹⁰⁴ See, e.g., *Sutton Holding Corp. v. Desoto, Inc.*, No. CIV.A.12051, 1991 WL 80223, at *1 (Del. Ch. May 14, 1991). In *Sutton*, the board instituted a "change in control" provision in its employee pension plans. According to this provision, if any person became the beneficial owner of 35% of the company's stock without the approval of a majority of the "continuing directors" or without prior approval of two-thirds of the board, the funds in the pension plan would be frozen for five years. See *id.* Because the excess funding in the pension plan constituted a large part of the value of the firm, inability to reach the funds would effectively deter any potential acquiror. *Id.* at *2-3.

¹⁰⁵ See, e.g., Steven Lipin, *J&J Goes to Court to Disarm Cordis of an Unusual 'Pill'*, WALL ST. J., Oct. 27, 1995, at B2 (stating that the Cordis Corp.'s shareholder rights plan can only be disengaged by "existing directors or their handpicked successors"). This type of arrangement is known as the "dead-hand" defense since it allows people who are no longer directors "to rule from the grave." *Id.* (citation omitted).

The corporate law of most states allows almost any voting practice.¹⁰⁶ "The Delaware General Corporation Law affords considerable flexibility in the construction of mechanisms for corporate governance and control."¹⁰⁷ This flexibility is allowed so that corporations can tailor their laws to best respond to changing circumstances. Ironically, this same flexibility can also lead to abuse. The idea that the very rules that give shareholders the power to elect directors are being used by those directors to entrench themselves raises serious questions about who actually is in control of this country's corporations.

III. JUDICIAL RESPONSE TO CHALLENGES TO THE SHAREHOLDER FRANCHISE

A. *The Takeover Defense Line of Cases—A Blueprint for the Future of the Franchise?*

The Delaware courts are still formulating their response to management tactics that implicate the shareholder franchise.¹⁰⁸ These cases are particularly difficult for the courts because they involve a number of conflicting policies and philosophies.

The first and most fundamental idea is that management runs the corporation, not the shareholders,¹⁰⁹ and certainly not judges.¹¹⁰ When management has a conflict of interest or divided

¹⁰⁶ See EASTERBROOK & FISCHEL, *supra* note 14, at 63-65 (describing the variety of voting possibilities available under state statutes).

¹⁰⁷ Centaur Partners, IV v. National Intergroup, Inc., 582 A.2d 923, 927 (Del. 1990); see also Providence & Worcester Co. v. Baker, 378 A.2d 121, 124 (Del. 1977) (holding that a voting scheme that limited shareholder voting based on the number of shares owned was valid as it did not conflict with the Delaware corporation laws).

¹⁰⁸ See WNH Invs. v. Batzel, No. CIV.A.13931, 1995 WL 262248, at *7 (Del. Ch. Apr. 28, 1995) (stating that "[t]he courts are now in the process of harmonizing the cases and refining the rules" regarding franchise interference).

¹⁰⁹ See, e.g., Paramount Communications, Inc. v. Time Inc., Nos. CIV.A.10866, CIV.A.10670, CIV.A.10935, 1989 WL 79880, at *30 (Del. Ch. July 14) (stating that "[t]he corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of the shares. In fact, directors, not shareholders, are charged with the duty to manage the firm"), *aff'd*, 565 A.2d 280, 281 (Del. 1989); see also DEL. CODE ANN. tit. 8, § 141(a) (1991) (stating that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors").

¹¹⁰ See, e.g., Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989) (stating that "in our view, precepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders"); Sinclair Oil Corp. v. Levin, 280 A.2d 717, 720 (Del. 1971) (holding

loyalties, however, courts will frequently review the fairness of a board's actions.¹¹¹ There are a number of areas in corporate law where managerial action straddles this line, exhibiting attributes of both a "business judgment" transaction and a "self-interested" one. The most prominent examples of these cases are the takeover-defense cases. When a director rejects a hostile offer, she may honestly believe that the offer is an inferior one which is not in the corporation's best interest. On the other hand, it is also possible that the rejection is predicated on the manager's desire to retain her comfortable position and large paycheck. The Delaware courts have struggled greatly with these cases.

Initially the supreme court established a "reasonableness" standard for management actions aimed at preventing a takeover of the firm.¹¹² This was a very liberal standard, since any change in control could potentially present a "danger" to corporate policy. This standard stood for twenty years, until 1985, when the court attempted to strengthen it by adding a second prong to the test: not only did the defensive measure need to be in response to a reasonably perceived threat, but it also had to be "reasonable in relation to the threat posed."¹¹³

As time passed, the court realized that in deciding what was not a reasonable response to a threat, the court was "substituting its judgment . . . for that of a corporation's board of directors."¹¹⁴ Rather than usurp the power of the directors, the court began to defer to managerial assessments of danger.¹¹⁵ Not surprisingly,

that "[a] board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment").

¹¹¹ See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (stating that there is "no 'safe harbor' for such divided loyalties in Delaware"); *Loft, Inc. v. Guth*, 2 A.2d 225, 238 (Del. Ch. 1938) (stating that "the directors of a corporation stand in a fiduciary relation to the corporation and its stockholders").

¹¹² See *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. 1964) (stating that the directors only had to show "reasonable grounds to believe a danger to corporate policy and effectiveness existed . . . [D]irectors satisfy their burden by showing good faith and reasonable investigation").

¹¹³ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955-56 (Del. 1985) (finding that a selective exchange offer was a reasonable response to a "two-tier coercive tender offer coupled with the threat of greenmail"). For a narrative of the battle for Unocal, see ARTHUR FLEISCHER, JR. ET AL., *BOARD GAMES: THE CHANGING SHAPE OF CORPORATE POWER* 91-111 (1988).

¹¹⁴ *Time*, 571 A.2d at 1152-53.

¹¹⁵ See *id.* at 1153.

management saw danger in a wide variety of situations. One threat to a corporation was that its shareholders, "in ignorance or a mistaken belief," might tender their shares in response to an offer that, although much higher than the market price, was below what the directors believed the firm to be worth.¹¹⁶ The court agreed that this premium offer could be seen as a threat to the firm, stating that "[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit."¹¹⁷

The Delaware Supreme Court's most recent appraisal of a director's duty in the face of a hostile offer has, for all practical purposes, returned the court to the original 1964 reasonableness test. The court stated that as long as a defensive measure is not "preclusive or coercive,"¹¹⁸ it is allowable if it is "within the range of reasonable defensive measures available to the Board."¹¹⁹ A federal district court in Delaware recently applied this new standard and found that a tender offer "pose[d] a threat that shareholders might tender their shares without appreciating the fact that after substantial capital investment, [the corporation] is actually witnessing the beginning of the pay-off of its business strategy."¹²⁰

B. *The Question of Legitimacy in Corporate Law*

1. A Promising Beginning

It is now apparent that the courts will allow management to take almost any action to protect the corporation from a hostile tender offer.¹²¹ Courts have been more restrictive, however, regarding managerial interference with the shareholder franchise. As a

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 1154. The Delaware Supreme Court's decision in *Time* has been much criticized. See, e.g., Henning, *supra* note 66, at 574 (stating that the "weakness of *Time* is its failure to perform more than a cursory review of the reasonableness of the board's response to the threat from Paramount's bid").

¹¹⁸ See, e.g., *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 114 (Del. Ch. 1986) (finding that a management self-tender in response to a hostile offer was coercive because a "stockholder, acting with economic rationality, has no effective choice as between the contending offers as presently constituted").

¹¹⁹ *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1390 (Del. 1995) (noting that this decision was in accord with the holding in *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964), an indication that the court had come full circle).

¹²⁰ *Moore Corp. Ltd. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1560 (D. Del. 1995).

¹²¹ See, e.g., *Grundfest*, *supra* note 45, at 936 (stating that "[h]ostile contests for corporate control no longer threaten incumbent managers").

practical matter, it is difficult to see why. A proxy fight poses all the same threats as a tender offer. The management of the corporation is being faced with a challenge to its control: in a tender offer the insurgent is asking shareholders to sell her their share of the firm so that she can run it, while in a proxy fight, the insurgent is simply asking the shareholder to elect her to run the firm. In both cases management can reasonably believe that the change will be for the worse.

Sometimes the line is even blurrier—hostile bidders can join a tender offer with a proxy fight, so that the net result is truly identical. In other cases there is no tender offer, but an assurance by the challenger that, once elected, the challenger will remove defensive measures and the firm will be sold, either as a whole or in pieces. In such situations, management can reasonably fear that harm will come to the firm. Thus, it makes sense to allow managers to have the ability to repulse the threat from a proxy contest, as they can a threat from an unsolicited tender offer.

Proxy fights also implicate another set of principles. The idea that management should not interfere with or usurp the shareholder franchise has been well recognized in American law for over 150 years.¹²² Schemes in which directors voted the corporation's own stock according to their own self-interest were struck down as "entrusting to persons in power the means of keeping themselves in power."¹²³ The modern formulation of these laws was pronounced in *Schnell v. Chris-Craft Industries*, a case in which management tried to advance a scheduled election date to gain an advantage in a proxy contest.¹²⁴ The supreme court found that management had

¹²² See, e.g., *Lennane v. ASK Computer Sys., Inc.*, No. CIV.A.11744, 1990 WL 154150, at *5 (Del. Ch. Oct. 11, 1990) (stating that "[f]or more than 150 years courts have been careful to guard against attempts by directors to use their control over corporate property or corporate processes to assure their perpetuation in office").

¹²³ *Speiser v. Baker*, 525 A.2d 1001, 1009 (Del. Ch. 1987) (citing *Allen v. De Lagerberger*, 10 Ohio Dec. Reprint 341 (1888)). In *Speiser*, the court reviewed a number of 19th century cases in which courts struck down structures that "deprive[d] the true owners of the corporate enterprise of a portion of their voice in choosing who shall serve as directors." *Id.*; see also *Ex parte Holmes*, 5 Cow. 426, 435 (N.Y. Sup. Ct. 1826) (stating that "[i]t is not to be tolerated that a Company should procure stock . . . which its officers may wield to the purposes of an election; thus securing themselves against the possibility of removal").

¹²⁴ See *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971) (holding that management acted inequitably in moving the election date forward); see also *Coalition to Advocate Pub. Util. Responsibility, Inc. v. Engels*, 364 F. Supp. 1202, 1206-07 (D. Minn. 1973) (holding that when management classified the board of directors and eliminated cumulative voting rights before a contested election, there may have been

"attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office" and that although its action violated no law, "inequitable action does not become permissible simply because it is legally possible."¹²⁵ Delaware courts have also struck down attempts by directors to issue "shares to accomplish an improper purpose, such as to enable a particular person or group to maintain or obtain voting control."¹²⁶

The strongest argument in this area was made in the case of *Blasius Industries, Inc. v. Atlas Corp.*¹²⁷ An insurgent group, Blasius, organized a consent solicitation to increase the size of the board from seven to fifteen members, the maximum size allowed in the charter, and nominated eight individuals to fill the new seats.¹²⁸ Management responded by adding two new directors to the board, thus foreclosing the possibility of the insurgents gaining control of the board through the consent process.¹²⁹

The chancery court found that this step was taken "in order to impede or preclude a majority of the shareholders from effectively adopting the course proposed by [the challengers]."¹³⁰ Notably, the court found that the board had not acted in bad faith, but rather was responding to a "threat" from a takeover group that was proposing a radical, and potentially harmful, recapitalization of the company.¹³¹ Under a *Unocal* analysis, management likely would have prevailed—there was a reasonably perceived threat to the corporation and a proportionate response.¹³² The threat in *Blasius*, however,

a breach of fiduciary duty).

¹²⁵ *Schnell*, 285 A.2d at 439. The court focused on the fact that the management's purpose was inequitable, leaving open the question of whether such a move might be permissible if it were not meant to "obstruct[] the legitimate efforts of dissident stockholders." *Id.*

¹²⁶ *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 775 (Del. Ch. 1967) (quoting *Yasik v. Wachtel*, 17 A.2d 309, 313 (Del. Ch. 1941)).

¹²⁷ 564 A.2d 651 (Del. Ch. 1988). A number of articles have been written about the decision in *Blasius*. See generally Dennis J. Block et al., *Chancellor Allen, the Business Judgment Rule, and the Shareholders' Right to Decide*, 17 DEL. J. CORP. L. 785, 831-41 (1992); Andrew C. Houston, *Blasius and the Democratic Paradigm in Corporate Law*, 17 DEL. J. CORP. L. 843 (1992); Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 733-45 (1992); Gregory S. Schaer, Comment, *Blasius Industries, Inc. v. Atlas Corp.: Closer Scrutiny of Board Decisions Under the "Compelling Justification" Standard*, 16 DEL. J. CORP. L. 639 (1991).

¹²⁸ See *Blasius*, 564 A.2d at 654.

¹²⁹ See *id.* at 655.

¹³⁰ *Id.* at 656.

¹³¹ See *id.* at 658. Had the court found that the board members did not act in good faith, but rather to entrench themselves, the board would have violated its duty of loyalty. See *id.*

¹³² See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) ("If a

was not a hostile offer, but a shareholder vote that management believed might harm the firm. The court asked whether the same *Unocal* analysis should be applied in the face of a "threat" from a corporate election.¹³³ In the strongest possible language, the court said no:

The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. . . .

. . . [The vote] is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.

. . . .

. . . The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters.¹³⁴

The court declared that attempts to interfere with the shareholder franchise raise fundamental questions regarding the allocation of power between managers and shareholders which are not covered by the standard business judgment rule.¹³⁵ Therefore, this was not "a question that a court may leave to [an] agent finally to decide so long as he does so honestly and competently."¹³⁶

Rather than declare that actions taken for the primary purpose of interfering with the franchise were automatically void, the court left open the possibility that "some set of facts would justify such extreme action."¹³⁷ The court concluded that there would have to

defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

¹³³ See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (asking whether the *Unocal* rule applies to action designed to interfere with the effectiveness of a stockholder vote).

¹³⁴ *Id.* at 659, 663. This last statement has been criticized as lacking a factual basis. See, e.g., Houston, *supra* note 127, at 849 (stating that "*Blasius* cites neither legislative history nor case law to explain what the theory in question is or to confirm the assertion that it is the theory referred to that underlies the voting provisions of Delaware corporate law"). But see *Commonwealth Assocs. v. Providence Health Care, Inc.*, No. CIV.A.13135, 1993 WL 432779, at *8 (Del. Ch. Oct. 22, 1993) (explaining that protecting shareholder franchise is vital to the preservation of the corporate form in that it gives the "assurance of fair treatment" to shareholders who entrust their assets to managers without an enforceable right to a return).

¹³⁵ See *Blasius*, 564 A.2d at 660.

¹³⁶ *Id.*

¹³⁷ *Id.* at 662. In a hypothetical, the court described a scenario in which a corporation acted to dilute the holdings of a majority shareholder who intended to cash out the minority shareholder at a low price. While declining to "hazard an opinion on that abstraction," the court noted that such facts were "close enough" to demonstrate the "utility of a rule that permits, in some extreme circumstances, an

be a "compelling justification" for such a move.¹³⁸ The question of what constitutes a "compelling justification" for interference with the shareholder franchise has yet to be determined. In *Blasius*, there were valid reasons for the board to believe that a change in control would not be in the best interests of the firm. Even the Chancellor who decided the case believed that the proposal made by the insurgent group was flawed. Despite management's legitimate concern about the wisdom of the insurgent's plans, the Chancellor declared that shareholders "could view the matter differently than . . . the board," and that they should be entitled to express their views through the corporate franchise.¹³⁹

2. *Blasius* and *Interco*—A Common Starting Point, a Common Ending?

The language in *Blasius* was strong and precise in its defense of the shareholder franchise. But some of this language was repeated in a case decided by the chancery court three months later involving a tender offer rather than a proxy contest.¹⁴⁰ In *Interco*, the court held that a firm would have to repeal its poison pill in the face of an all-cash, all-shares offer at a fair price, since "reasonable minds not affected by an inherent, entrenched interest in the matter, could not reasonably differ with respect to the conclusion" that the tender offer did not constitute a threat to the corporation.¹⁴¹ The language is very similar to that in *Blasius*—the shareholder should have the right ultimately to decide the fate of the corporation. Much of the analysis is similar as well:

Our corporation law exists, not as an isolated body of rules and principles, but rather in a historical setting and as a part of a larger body of law premised upon shared values. To acknowledge that directors may employ the recent innovation of "poison pills" to deprive shareholders of the ability effectively to choose to accept a noncoercive offer . . . would, it seems to me, be so inconsistent with widely shared notions of appropriate corporate governance as to

incumbent board to act in good faith for the purpose of interfering with the outcome of a contemplated vote." *Id.* at 662 n.5.

¹³⁸ *Id.* at 661.

¹³⁹ *Id.* at 663.

¹⁴⁰ See *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988), *rejected by Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989).

¹⁴¹ *Id.* at 799.

threaten to diminish the legitimacy and authority of our corporation law.¹⁴²

The concern for the legitimacy of corporation law was the premise of both *Blasius* and *Interco*.¹⁴³ While not formally overturned, the holding in *Interco* has been repudiated. The Supreme Court of Delaware declared that a court has no business substituting its own judgment for that of a corporation's board of directors. The court stated that "[t]o the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis."¹⁴⁴ The court specifically cited *Interco* and its progeny as cases to be rejected.

The court declared that the demands of the shareholders must be subordinated to the strategic decisionmaking power of the board.¹⁴⁵ The court rejected the call for protecting the "legitimacy . . . of our corporation law" as defined in *Interco*,¹⁴⁶ dismissing it as judicial interference in the management of a corporation.¹⁴⁷ Would the similar dicta in *Blasius* be treated similarly? In a number of cases, the court has said no. The court has acknowledged that there is something different about the shareholder franchise, something that needs to be protected. But both the chancery court and supreme court have struggled to identify just how and when to defend the election process. The case law reflects a haphazard attempt to balance the competing goals of protecting the vote and respecting managerial power to exercise judgment when responding to threats to the firm.

¹⁴² *Id.* at 799-800.

¹⁴³ One commentator has suggested that the court's concern for legitimacy in the law was significant because the "legitimacy of Delaware corporate law has been vigorously questioned" by scholars who claim that Delaware, in order to attract corporations, "subordinate[s] concerns of legitimacy." Massey, *supra* note 127, at 689.

¹⁴⁴ *Time*, 571 A.2d at 1153.

¹⁴⁵ *See id.* at 1150 (stating that directors have a broad mandate to "set a corporate course of action, including time frame, designed to enhance corporate profitability").

¹⁴⁶ *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 800 (Del. Ch. 1988), *rejected by Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989).

¹⁴⁷ *Time*, 571 A.2d at 1153.

C. *The Confused Case Law*

1. Election Delay Cases—Purposeful Interference with the Franchise

Under most state corporation laws, the power to decide the time and place of the annual meeting is delegated by the corporate bylaws.¹⁴⁸ These bylaws usually give directors the right to set a record date, call a meeting, or cancel a meeting. In a number of cases, managers have used their power to control the time of a meeting to manipulate the election process for their own benefit. In *Aprahamian v. HBO & Co.*, a board of directors, upon hearing from a consultant that they might lose an election to be held at the shareholders' meeting scheduled for the next day, decided to postpone the meeting for five months.¹⁴⁹ According to Delaware law, there was no requirement that the meeting be held until the later date.¹⁵⁰ The directors argued that the postponement was necessary to inform the shareholders about the company's plans. The chancery court rejected this idea, reasoning that, since the company's stock was heavily owned by institutional investors and arbitrageurs, it could be assumed that the shareholders were already well informed.¹⁵¹ Additionally, because the shareholder proxies would expire before the new record date, the delay would be costly to the plaintiffs. Thus, the court declared that the meeting had to be held as soon as possible to protect the insurgent's record date.¹⁵²

¹⁴⁸ See DEL. CODE ANN. tit. 8, § 211(b) (1991) (designating time and place for meetings of stockholders); *id.* § 213(a) (fixing the record date for voting); *id.* § 222 (providing notice of meetings).

¹⁴⁹ See *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1205 (Del. Ch. 1987).

¹⁵⁰ See DEL. CODE ANN. tit. 8, § 211(b) (1991) (declaring that "[a]n annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws"). The last HBO annual meeting had been held the previous September. See *Aprahamian*, 531 A.2d at 1206.

¹⁵¹ See *Aprahamian*, 531 A.2d at 1207. The court also mentioned that the price of the stock was over \$23 per share when the current CEO sold 500,000 of his own shares. At the time of the trial, the share price was \$8.50. See *id.* at 1206. Perhaps the court believed that no amount of information would change the shareholders' minds about management.

¹⁵² See *id.* at 1208; see also *Gintel v. XTRA Corp.*, C.A. No. 11422 (Del. Ch. Feb. 27, 1990) (unpublished decision) (holding that the postponement of an election two days in advance of the meeting was invalid). But see *MAI Basic Four, Inc. v. Prime Computer, Inc.*, No. CIV.A.10868, 1989 WL 63900, at *1 (Del. Ch. June 13, 1989) (holding that a company could postpone its meeting for a month-and-a-half in the face of a proxy fight and a coercive two-tier front-loaded tender offer).

Three years later, the chancery court decided a similar case, *Stahl v. Apple Bancorp* ("Stahl I"). Stahl, a 30% shareholder in Apple Bancorp, declared his intent to replace the board at the next annual meeting.¹⁵³ The shareholder's goal was to install his own directors, redeem the poison pill, and then make a tender offer for all outstanding shares of common stock of the company.¹⁵⁴ On April 9, the company's proxy solicitor told the board that if it did not present the stockholders with an economic alternative to Stahl's offer, Stahl would easily prevail in the election. In response, the board withdrew the April 17 record date and did not set a new one.¹⁵⁵ The court decided the case on very narrow and formalistic grounds, stating that, because the meeting had not been formally called, the shareholder franchise was not impaired at all.¹⁵⁶ As a result, the defensive move was evaluated under the proportionality standard set forth in *Unocal* and found to be a justifiable response to the threat posed by Stahl's tender offer.¹⁵⁷ The court contrasted this situation with that in *Aprahamian*, where the meeting was called and then cancelled.¹⁵⁸ The *Stahl I* decision has been criticized for its abandonment of the *Blasius* ideal.¹⁵⁹ The court, however, was careful to explain that the mere "prospect that the shareholders might vote differently than the board recommends can[not] alone constitute any threat to the corporate interest."¹⁶⁰

The chancery court's most recent, and most confused, "election delay" decision is *Kidsco Inc. v. Dinsmore*.¹⁶¹ In *Kidsco*, a proxy fight was joined with a hostile tender offer.¹⁶² The target in this case was

¹⁵³ See *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1117 (Del. Ch. 1990) (*Stahl I*).

¹⁵⁴ See *id.* at 1119.

¹⁵⁵ The meeting must be held within 60 days of the record date. See DEL. CODE ANN. tit. 8, § 213(a) (1991) (stating that "the board of directors may fix a record date . . . [that is not] more than 60 nor less than 10 days before the date of such meeting").

¹⁵⁶ See *Stahl I*, 579 A.2d at 1123 (calling the formal setting of a meeting date "an act of some dignity and significance"); see also *Paramount Communications, Inc. v. Time Inc.*, Nos. CIV.A.10866, 10670, 10935, 1989 WL 79880, at *26 (Del. Ch. July 14) (stating that *Blasius* did not apply to a case where the defendant corporation did not allow shareholders to vote on a proposed merger because "Delaware law create[s] no right in these circumstances to vote"), *aff'd*, 565 A.2d 280, 281 (Del. 1989).

¹⁵⁷ See *Stahl I*, 579 A.2d at 1124.

¹⁵⁸ See *id.* at 1123.

¹⁵⁹ See Massey, *supra* note 127, at 739-43 (arguing that *Stahl I* was overly formalistic, and may have been influenced by the supreme court's rejection of the *Interco* logic in *Time*).

¹⁶⁰ *Stahl I*, 579 A.2d at 1124.

¹⁶¹ 674 A.2d 483 (Del. Ch.), *aff'd*, 670 A.2d 1338 (Del. 1995).

¹⁶² *Id.* at 496 (holding that a last minute bylaw change that delayed a special

The Learning Company ("TLC"), a software firm which was to be acquired by Broderbund, a larger firm in the same industry. The shareholder meeting in which the deal was to be voted on was scheduled for December 11, 1995.¹⁶³ Before that time, however, Kidsco,¹⁶⁴ a third firm, made a competing tender offer, and called for a special meeting. At this meeting, Kidsco was planning to replace the TLC board so that the firm's poison pill could be redeemed and the Kidsco tender offer could take place. According to the relevant corporate bylaw, this special meeting was to be held a minimum of thirty-five days after Kidsco came up with the requisite 10% of the shareholder proxies to order the meeting.¹⁶⁵ Under this formulation, the special meeting could have been held as early as December 13, 1995. Before Kidsco delivered the proxies, however, the TLC board met and revised the special meeting rules, changing the minimum notice from thirty-five to sixty days. Under this new formulation, the Kidsco special meeting could be held no earlier than January 7, 1996.¹⁶⁶ The TLC board argued that it did not move to entrench itself, but rather to allow the shareholders to consider the Broderbund acquisition free from the distraction of a competing offer, and additionally, if the Broderbund vote failed, to allow the firm time to find an alternate transaction to the Kidsco tender.¹⁶⁷ Kidsco argued that under *Schnell*, the board acted to entrench itself, and that under *Blasius*, the board acted for the primary purpose of impeding the stockholder franchise.¹⁶⁸ The chancery court agreed with TLC on both counts. On the *Schnell* claim, the court found that a twenty-five day delay was not tantamount to entrenchment.¹⁶⁹ On the *Blasius* claim, the court first distinguished board action taken in response to a joint tender/proxy from board action taken solely in response to a tender offer.¹⁷⁰ Only in the face of a pure proxy fight, the court argued, would it

election did not constitute inequitable conduct, since it was defensive in nature and would not lead to managerial entrenchment).

¹⁶³ See *id.* at 488.

¹⁶⁴ Although the court refers to the acquiring software company as SoftKey, the corporate parent, the case name is *Kidsco*. See *id.* at 485. This Comment will refer to the acquiring company as Kidsco to avoid confusion.

¹⁶⁵ See *id.*

¹⁶⁶ See *id.* at 489.

¹⁶⁷ See *id.* at 491-92.

¹⁶⁸ See *id.* at 490-91.

¹⁶⁹ See *id.* at 493.

¹⁷⁰ See *id.* at 495.

analyze the case under a *Blasius* standard.¹⁷¹ The court declared that when there is a joint tender/proxy both *Unocal* and *Blasius* would be invoked—an enhanced *Unocal* standard.¹⁷²

That said, the court decided that *Blasius* was not properly invoked in this case, since the board's action was not intended to impede the shareholder franchise. The court declared that the bylaw change giving the board an additional twenty-five days was not enacted for the "primary purpose" of impairing or impeding the effective exercise of the franchise.¹⁷³ Additionally, the court found that the board action would not have the effect of impeding or impairing the franchise. The court declared that the bylaw amendment was defensive in nature, taken in response to the hostile offer.¹⁷⁴ Analogizing to *Stahl I*, the court found that the delay was in "the stockholders' best interests" because the board would now have more time to evaluate the offer and look for alternatives.¹⁷⁵ As a result, the court reviewed the defensive delay under the *Unocal/Unitrin* reasonableness and proportionality tests and found that the delay was valid.¹⁷⁶

The *Kidsco* decision augurs poorly for the future of the shareholder franchise. The court applied the "primary purpose" analysis from *Blasius* in a way that eviscerates the test. The court essentially asked whether the primary purpose of the new bylaw, which extended the target corporation's special meeting deadline, was to postpone the election or to give the corporation more time to respond to the tender offer. The court chose the latter, deciding that the primary purpose was "to enable the TLC board to present the Broderbund transaction to its shareholders in an environment that would provide the board a reasonable time to explore and

¹⁷¹ See *id.*

¹⁷² See *id.* (declaring that when faced with a joint tender/proxy, "a board's unilateral decision to adopt a defensive measure 'touching upon issues of control' that 'purposefully disenfranchises its shareholders' will be evaluated under *Unocal*." Even within that framework, however, the board decision will be viewed as "strongly suspect . . . and cannot be sustained without a 'compelling justification'" (quoting *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992)) (alteration in original)).

¹⁷³ *Id.* at 496.

¹⁷⁴ See *id.*

¹⁷⁵ See *id.* But see *ER Holdings, Inc. v. Norton Co.*, 735 F. Supp. 1094, 1102 (D. Mass. 1990) (holding that when a firm's bylaws authorized a specific meeting date, allowing a board to postpone the date for two months would cause the plaintiffs "irreparable harm").

¹⁷⁶ See *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 497 (Del. Ch.) (stating that the "board's response to the threat was 'extremely mild'" (quoting *Stahl v. Apple Bancorp. Inc.*, 579 A.2d 1115, 1125 (Del. Ch. 1990) (*Stahl I*))), *aff'd*, 670 A.2d 1338 (Del. 1995).

develop other options if the Broderbund deal were rejected."¹⁷⁷ This analysis appears to be sensible since the board was not trying to impede the shareholder franchise but was trying to protect the shareholders and the corporation from what it viewed as a threat. This reasoning, however, is in direct opposition to the holding in *Blasius* and is the first step toward *Time*, *Unitrin* and untrammelled managerial discretion. Had *Blasius* been decided by the *Kidsco* court, the directors could have easily argued that the "primary purpose" of the board packing scheme was not to interfere with the shareholder franchise, but rather to protect the corporation from the misconceived plans of the insurgents. The *Blasius* holding was so powerful because even though the board may have been completely correct in fearing that the corporation would be irreparably harmed if the challengers won, management still had no right to interfere with the shareholder franchise. Managers are agents of the shareholders, not "Platonic masters."¹⁷⁸

The court in *Kidsco* should have asked the more basic question: Despite the ultimate goal of the election delay, did the board purposefully interfere with the shareholder franchise? The answer to this question is yes, since the board denied the shareholders the ability to vote on the *Kidsco* offer as planned on December 13.¹⁷⁹ Any other analysis would limit *Blasius* to only those cases where boards cannot create a rational business reason for delaying an election. This would mean the end of the *Blasius* "compelling justification" standard.

¹⁷⁷ *Id.* at 496.

¹⁷⁸ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988).

¹⁷⁹ Even if the court finds that management has impeded or precluded the shareholder franchise, management may still have a "compelling justification" for its actions. Although not decided under *Blasius*, *MAI Basic Four, Inc., v. Prime Computer*, No. CIV.A.10868, 1989 WL 63900 (Del. Ch. June 13, 1989), is a good example of a case where the "compelling justification" language could have been applied. In this case, a party making a joint tender/proxy offer changed the nature of his tender offer two weeks before the election. The offer changed from all cash for all shares to a two-tiered front-loaded offer, with "junk" paper on the back end. *See id.* at *1. In response, management delayed the election for six weeks. The court allowed the election delay as a legitimate defensive measure, explaining that

[t]he proxy battle . . . is merely part of Basic's effort to acquire the shares of Prime and it is obviously in the best interests of the Prime shareholders that they ultimately receive the best possible price for their shares. If the election goes forward tomorrow any chance for a higher price for Prime shares may vanish.

See id. at *2.

Perhaps sensing the weakness in its "primary purpose" analysis, the *Kidsco* court added a second level of analysis. The court claimed that the twenty-five day delay did not interfere with the shareholder franchise, since at the time of the bylaw change the shareholders had not yet presented the necessary proxies to call the special meeting. As a result, the shareholders had no legal right to the meeting. This analysis, however, is also inconsistent with the *Blasius* holding. There is no question that the board had the legal authority to delay the meeting date.¹⁸⁰ The question was whether the board used its legal powers for the primary purpose of impeding the exercise of the shareholder franchise.

The court's references to *Stahl I* were also unwarranted. In *Stahl I*, the court held that there was "some dignity and significance" to the fixing of an election date.¹⁸¹ Since the date had not been set and the board was under no obligation to set a date for some time, a deferral of the date was not an impediment to the franchise.¹⁸² In *Kidsco*, however, there is no such parallel argument. The board changed the bylaws at the last possible moment to keep the shareholders from voting on both transactions at almost the same time. Perhaps the board felt that its chosen deal would have fared poorly.

The court could have also argued that the election delay was de minimis since a twenty-five day delay may not have cost *Kidsco* anything. The court implied this line of reasoning in referring to the "brief deferral" of the election.¹⁸³ It is possible to read the Delaware case law as being consistent with this analysis. In *Aprahamian*, delaying the meeting would have been very costly to the plaintiffs since their proxies would expire and become void by the next

¹⁸⁰ If the board had not had the legal authority to adopt the bylaw, the case could have been decided in a formal and technical manner, predicated on a literal reading of the requisite statute. See, e.g., *Allen v. Prime Computer Inc.*, 540 A.2d 417, 421 (Del. 1988) (holding that a bylaw that mandated a 20-day delay in the effectiveness of shareholder consents was void as it violated shareholder rights under the consent authorization section of the corporation law); *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031, 1035 (Del. 1985) (holding that a bylaw adopted by management to postpone a consent solicitation for 60 days was unenforceable because it was "clearly in conflict with the letter and intent of" the shareholder consent authorization section of the corporation law).

¹⁸¹ *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1123 (Del. Ch. 1990) (*Stahl I*).

¹⁸² See, e.g., *Savin Bus. Mach. Corp. v. Rapifax Corp.*, 375 A.2d 469, 472 (Del. Ch. 1977) (holding that a shareholder has no right to insist that an annual meeting be held at a certain time).

¹⁸³ *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 496 (Del. Ch.), *aff'd*, 670 A.2d 1338 (Del. 1995).

election date.¹⁸⁴ In barring the delay, the court spoke of the shareholders having "expended considerable sums of money on this proxy contest."¹⁸⁵ In *Stahl I*, on the other hand, the insurgent was a 30% shareholder who had not yet expended any resources on the election or solicited any proxies.¹⁸⁶ The size of his holdings, however, indicated that he would have little trouble winning an election when one was held.¹⁸⁷ Thus, even if the court had not decided *Stahl I* on the narrow ground of the setting of an initial election date, it still could have argued that the franchise was not impeded since no real harm was done to the plaintiff.

Although this "de minimis" argument would have been more consistent with the Delaware case law than the arguments the court made, it still would not have been correctly applied to *Kidsco*. The "brief deferral" in *Kidsco* could have caused major harm to the plaintiff. The small change in the meeting date altered the entire nature of the election. Because the original election dates were only two days apart, a reasonable shareholder could see this as an opportunity to weigh the competing choices and pick the better deal: management's recommended deal with Broderbund or the Kidsco offer. By delaying the vote on the Kidsco deal, a reasonable shareholder might be concerned that if she did not accept the Broderbund deal, management might impose a third, less palatable option before the January Kidsco vote. Thus, a risk-averse shareholder who might prefer the Kidsco offer to the Broderbund offer might reluctantly vote for the Broderbund offer to avoid the risk of some unspecified management offer.¹⁸⁸

¹⁸⁴ See *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1208 (Del. Ch. 1987).

¹⁸⁵ *Id.*

¹⁸⁶ See *Stahl I*, 579 A.2d at 1118-19.

¹⁸⁷ See *Stahl v. Apple Bancorp, Inc.*, No. CIV.A.11510, 1990 WL 114222, at *8 (Del. Ch. Aug. 9, 1990) (*Stahl II*) (stating that "[s]hould the board fail to develop an attractive alternative, experience suggests that it is quite likely, particularly considering his 30% personal ownership, that Mr. Stahl's position will be accepted by a substantial majority of shareholders in the proxy contest").

¹⁸⁸ See *San Francisco Real Estate Investors v. Real Estate Inv. Trust of Am.*, 701 F.2d 1000, 1003 (1st Cir. 1983) (noting that "loss of [a] best opportunity to seize control of a major corporation . . . could be crucial" (quoting *Dan River, Inc. v. Icahn*, 701 F.2d 278, 284 (4th Cir. 1983)) (alterations in original)).

2. Limitations on Shareholder Ownership I—Poison Pill Cases

Unlike the “election delay” cases, the poison pill cases present an actual “primary purpose” question. The purpose of enacting the shareholder rights plans in most cases was not to impede the proxy contest, but rather to defend against a hostile tender offer.

In *Moran v. Household International Inc.*,¹⁸⁹ the plaintiff claimed that the target firm’s shareholder rights plan, which had a 20% trigger, effectively precluded him from engaging in a successful proxy contest.¹⁹⁰ The argument was very sensible since the fewer shares the proxy solicitor owned, the more he had to rely on other shareholders in a proxy contest. Likewise, the fewer shares owned, the greater the collective action problem, since the solicitor would have to “share the capital-gain potential with all other shareholders” while expending the entire amount for the contest himself.¹⁹¹ The Delaware Supreme Court, on the basis of anecdotal evidence, decided that the effect of the restriction on the proxy contest would be “minimal” and that “the key variable in proxy contest success is the merit of an insurgent’s issues, not the size of his holdings.”¹⁹² The court relied on evidence provided by Household’s witnesses, who described cases in which insurgents with “less than 10% stock ownership” mounted successful proxy contests.¹⁹³

In the ten years since *Moran* was decided, accumulated data on the level of success of insurgents in proxy contests have been evaluated. The studies have found that “limits on dissident stock ownership negatively affect the likelihood of dissident success in a proxy contest.”¹⁹⁴ This new data, however, have not been used in any court decision. In *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*, the district court went so far as to cite the holding in *Moran*,

¹⁸⁹ 500 A.2d 1346 (Del. 1985).

¹⁹⁰ See *id.* at 1355 (holding that a poison pill with a 20% trigger did not preclude a proxy fight).

¹⁹¹ Manne, *supra* note 20, at 114. Manne added that “to the outsider seeking control, every voter represents another person with whom he must share the potential gain resulting from his more efficient management.” *Id.* at 115.

¹⁹² *Moran*, 500 A.2d at 1355.

¹⁹³ *Id.*

¹⁹⁴ Thomas & Martin, *supra* note 16, at 336. The authors were surprised to find that the existence of rights plans was positively correlated with dissident victories. One possible explanation for this phenomenon is that the rights plan discouraged shareholders who did not believe that they had a significant chance of success. See *id.* at 335-36; see also Thomas, *supra* note 75, at 552-58 (analyzing the impact of rights plans on dissident election campaigns).

reiterating that the existence of a poison pill with a 20% trigger did not "[a]ffect . . . the success of the proxy contest."¹⁹⁵

The chancery court dealt with the poison-pill-ownership-limitation issue in *Stahl v. Apple Bancorp, Inc.* ("*Stahl II*").¹⁹⁶ Stahl, a 30% shareholder, was joining a tender offer and a proxy contest. Because the firm's poison pill kept Stahl from accumulating more shares for himself, he wanted to enter into agreements with other shareholders to form committees, run on the same slate or help share the cost of the proxy contest. The firm's rights plan, however, declared that a shareholder would be considered the "beneficial owner" of any stock "with which such person . . . has any agreement, arrangement or understanding . . . for the purpose of acquiring, holding, voting or disposing of any securities."¹⁹⁷ As a result of this language, if Stahl and another shareholder agreed to work together to oppose management, then Stahl would be considered the beneficial owner of that person's stock and the poison pill would be triggered, diluting Stahl's holdings. The company argued that it needed this provision to prevent Stahl from reaching agreements with other shareholders regarding the election contest. If Stahl were to reach an agreement with other shareholders, potential bidders would realize that Stahl had the election locked up and would be deterred from making bids.¹⁹⁸

The court reviewed the *Moran* holding without challenging the finding that the effect of the poison pill on the proxy contest would be "immaterial." In fact, the court extended the *Moran* reasoning to the prohibition on voting agreements. The court declared: "[V]oting agreements or understandings of the type here . . . could be (and in this instance probably are) immaterial in the sense that a shareholder may put forth a slate of candidates and communicate her position to others, and others may vote for that slate without restriction."¹⁹⁹

The court dismissed Stahl's *Blasius* claim because the rights plan did not have the "primary purpose of interfering with the exercise of

¹⁹⁵ *Moore Corp. Ltd. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1563 (D. Del. 1995).

¹⁹⁶ No. CIV.A.11510, 1990 WL 114222 (Del. Ch. Aug. 9, 1990) (*Stahl II*). The firm had its annual meeting earlier to allow it more time to respond to Stahl's attack. The court allowed the delay. See *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1123 (Del. Ch. 1990) (*Stahl I*) (holding that deferral of the meeting date was valid).

¹⁹⁷ *Stahl II*, 1990 WL 114222, at *3.

¹⁹⁸ See *id.* at *3-4.

¹⁹⁹ *Id.* at *6.

the shareholders' right to elect directors," even though it may have that effect.²⁰⁰ The court believed that there was little harm done by the prohibition. Because of Stahl's large personal ownership, and because he was making an all shares cash offer, the court reasoned that if the "board fail[ed] to develop an attractive alternative," Stahl's offer would probably "be accepted by a substantial majority of shareholders in the proxy contest."²⁰¹ Thus, the court argued that the impact of the prohibitions on Stahl's proxy efforts would be minimal.

3. Limitations on Shareholder Ownership II— Dilution and Entrenchment Cases

Diluting the opponent's shares or placing the shares out of the opponent's reach represents another tactic that can be used to defend against a tender offer or a proxy contest. The board can accomplish this goal by issuing new shares to a friendly party, or by buying back shares from dissatisfied shareholders who would have otherwise voted against management. These transactions limit the number of shares that the opponent can hope to recruit to her cause, and conversely, decrease the number of independently held shares that management must win. The courts have generally found these tactics to be valid, so long as they are not done for the "primary purpose" of interfering with the proxy contest.

In *Shamrock Holdings, Inc. v. Polaroid Corp.*,²⁰² Shamrock had been attempting to acquire Polaroid. Along with a tender offer, Shamrock made plans to conduct a proxy contest and replace the Polaroid board at the next annual meeting.²⁰³ As a defensive measure, Polaroid adopted an Employee Stock Ownership Plan ("ESOP") and a stock repurchase plan to increase the percentage of the firm's shares in friendly hands.²⁰⁴ Shamrock claimed that because the plans reduced its ability to win a proxy fight, the court should find them invalid as they were undertaken for the purpose of interfering with the electoral process.²⁰⁵

The chancery court disagreed, finding that the ESOP and buy-back plans had been reviewed and negotiated "several weeks, if not

²⁰⁰ *Id.* at *7.

²⁰¹ *Id.* at *8.

²⁰² 559 A.2d 278 (Del. Ch. 1989).

²⁰³ *See id.* at 285.

²⁰⁴ *See id.* at 281.

²⁰⁵ *See id.* at 285-86.

months" before the announcement of the proxy contest.²⁰⁶ Even though "the directors were aware of the possibility of a proxy fight" and considered it in their deliberations, the record indicates that "the directors were focusing more on ways to defeat Shamrock in the market place than upon a means to defeat it at the polls."²⁰⁷ Thus, unlike in *Blasius*, these defensive measures were not undertaken with the "primary purpose" of interfering with the electoral process.²⁰⁸

In a second analysis, the court looked at the outcome of the defensive moves in order to test whether the management plans were "preclusive." According to the court, the management steps were not preclusive to the shareholder franchise because the plaintiff could still accumulate enough votes to win an election. Because the management and the ESOP owned a combined 33.4% of the shares, while Shamrock itself owned 9.6% of the voting shares, 57% of the shares were "uncommitted."²⁰⁹ By winning 70% of those shares, Shamrock could get the 50% of the vote it needed to win.²¹⁰ As support for its argument that Shamrock had not been precluded, the court argued that because "at least 22% of Polaroid's outstanding stock [wa]s held by arbitrageurs and other 'short term' investors," Shamrock would be going into the election "with about the same percentage of likely votes as will Polaroid."²¹¹

The problem with this analysis, and the analysis in the "poison pill" voting cases, lies in the court's conclusory argument that Shamrock has not been precluded from winning the election. Certainly, so long as management has less than 50% of the vote, the insurgent could still theoretically win. But this "preclusion" analysis ignores the fact that the shareholder's chances have been significantly diminished. Winning a proxy contest where management

²⁰⁶ *Id.* at 286.

²⁰⁷ *Id.* at 286 (claiming that "[t]he timing . . . is much less suspicious here than it was in *Blasius*"). *But see* NCR Corp. v. AT&T, 761 F. Supp. 475, 496 (S.D. Ohio 1991) (holding that an ESOP was an invalid form of entrenchment, as "[t]he timing of the ESOP is . . . enough to raise an inference that it was motivated by a desire to perpetuate management control").

²⁰⁸ *Cf.* Glazer v. Zapata Corp., 658 A.2d 176, 186 (Del. Ch. 1993) (holding that a stock issuance that diluted the shares of a challenger for control was valid since it was "the outgrowth of a long-term plan pursued by management for more than a year"). For a discussion of this case, see Barry J. Benzing, Glazer v. Zapata Corp.: *Under What Circumstances May a Board of Directors Interfere with a Shareholder Vote?*, 19 DEL. J. CORP. L. 464 (1994).

²⁰⁹ *Shamrock*, 559 A.2d at 286.

²¹⁰ *See id.*

²¹¹ *Id.*

owns a small percentage of the firm is difficult enough because of rational apathy and the shareholders' propensity to vote with management.²¹² Winning a contest where management is already two-thirds of the way to victory is very likely impossible.²¹³ Although the court argued that the presence of arbitrageurs and other short-term investors would give the shareholder support, the court made no effort to provide quantitative proof that the ESOP and buyback would not preclude the shareholder's chances.

The relationship between the outcome and the purpose of the transaction presents a second problem with the *Shamrock* court's analysis. According to the court, "[t]he effect of the Management Transactions . . . does not provide strong evidence of a primary purpose to interfere with the election."²¹⁴ This statement implies that the "primary purpose" analysis only applies to cases where the purpose is total preclusion. It is not out of the question, however, that management would take steps for the primary purpose of impeding, but not precluding, the vote. For example, management would likely have wanted to place 50% of the shares in friendly hands, but may have been unable to do so because of the high cost. Thus, management settled for placing 33% of the shares out of Shamrock's reach. The board should not be rewarded for its inability totally to preclude the shareholder's election chances. A serious impediment to victory, just as a total preclusion, must be considered a violation of the shareholder's franchise rights.

The supreme court's most recent decision in this area is *Unitrin, Inc. v. American General Corp.*²¹⁵ American General had made a bid for all the shares of Unitrin at a 30% premium above the market price.²¹⁶ The Unitrin board refused the offer as inadequate and instituted three defensive measures: a poison pill, an advance notice

²¹² See, e.g., Bebachuk & Kahan, *supra* note 29, at 1084-85 (explaining the advantages of incumbency in a proxy contest, including full reimbursement of expenses, informational advantages and goodwill).

²¹³ See *Packer v. Yampol*, No. CIV.A.8432, 1986 WL 4748, at *9 (Del. Ch. Apr. 18, 1986) (holding that when a company puts 44% of the voting stock in the hands of one group, election victory will be almost certainly assured because "the concentration of such voting power . . . will . . . cause stockholders to perceive that the result is a foregone conclusion, thereby fatally chilling any proxy solicitation by the dissident shareholders' group").

²¹⁴ *Shamrock*, 559 A.2d at 286.

²¹⁵ 651 A.2d 1361, 1389 (Del. 1995) (holding that so long as a defensive move was not preclusive and was within the "range of reasonableness" it would be upheld).

²¹⁶ See *id.* at 1368.

bylaw and a stock repurchase program.²¹⁷ The chancery court found that the poison pill and the advance notice bylaw constituted appropriate responses to the "low ball" bid.²¹⁸ The stock repurchase program, though, was found to be "an overreaction to the threat posed by American General's offer."²¹⁹ One of the reasons behind the court's finding was that the directors of Unitrin already owned 23% of the firm's outstanding shares. After the planned repurchase, their combined holdings would rise to over 28%.²²⁰ The court declared that even though American General could theoretically wage a proxy fight for control of the Unitrin board, "each share repurchased under this plan makes a successful proxy contest more unlikely."²²¹ Additionally, the Unitrin charter required a 75% supermajority vote of the shareholders to approve a merger not approved by the board.²²² The repurchase plan would have given the directors, as shareholders, veto power over any potential merger plan.

The Delaware Supreme Court rejected this logic. First, the court declared that the increased holdings on the part of the directors would not "have a preclusive effect upon American General's ability successfully to marshal [sic] enough shareholder votes to win a proxy contest."²²³ The court noted that 42% of Unitrin's shareholders were institutions, with twenty institutions holding 33% of the stock. These institutions would be more likely than other shareholders to vote against management.²²⁴ As for the director's "veto power," the court reasoned that the directors would most likely vote with their wallets and quoted the testimony of Fayez Sarofim, one of Unitrin's directors, who stated that "everything has a price parameter."²²⁵

²¹⁷ See *id.* at 1370.

²¹⁸ See *American Gen. Corp. v. Unitrin, Inc. (In re Unitrin, Inc. Shareholders Litigation)*, Nos. CIV.A.13656, 13699, 1994 WL 698483, at *8 (Del. Ch. Oct. 14, 1994), *rev'd*, 651 A.2d 1361 (Del. 1995).

²¹⁹ *Id.* at *9 (holding that a preliminary injunction against the repurchase plan was necessary because the plan went "beyond what was needed to protect the stockholders").

²²⁰ See *id.* at *3.

²²¹ *Id.* at *9. The chancery court, citing *Packer v. Yampol*, No. CIV.A.8432, 1986 WL 4748 (Del. Ch. Apr. 18, 1986), stated that "[t]his Court does not have to ignore the long odds of winning a proxy contest against a board that has acted to assure itself a large block of friendly votes." *Id.*

²²² See *id.* at *3.

²²³ *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1383 (Del. 1995).

²²⁴ See *id.* at 1382 (citing, *inter alia*, Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 925 (1992)).

²²⁵ *Id.* at 1383. The court also quoted Harold Hook, the American General

The Delaware courts appear reluctant to invalidate measures that interfere with the shareholder's ability to wage a proxy fight if the company can show that the defenses were put in place to defend against a tender offer.²²⁶ While not formally rejecting *Blasius*, the courts are taking a step away from the ideal of an election process free from managerial meddling. There are cases, however, where the courts do not find a dual motive for the interference. In these cases, where the primary purpose of the transaction was unquestionably to preclude a proxy contest, the courts have demanded that the barriers be removed.²²⁷

In a recent case, *Commonwealth Associates v. Providence Health Care, Inc.*,²²⁸ a company facing a consent solicitation made a friendly deal to exchange 20% of its own stock for 40% of another firm's stock.²²⁹ The second firm immediately granted a consent to the directors to vote the 20% of the shares for the incumbent board. Because the manager of the target firm already owned 30% of the stock, this effectively ended the proxy fight.²³⁰ In its decision, though, the chancery court did not focus on the issue of whether the effect of the deal would be to impede or preclude the shareholder franchise. Rather, the court asked whether the interference with the

Chairman, who stated that directors who own stock "will act in their own best interest if the price is high enough." *Id.*

²²⁶ See *Lennane v. ASK Computer Sys., Inc.*, No. CIV.A.11744, 1990 WL 154150, at *5 (Del. Ch. Oct. 11, 1990) (validating an agreement which secured the right of incumbent directors to control the voting of 30% of the firm's stock, but finding it "deeply troubling").

²²⁷ See, e.g., *Gregory v. Correction Connection Inc.*, No. CIV.A.88-7990, 1991 WL 42992, at *28 (E.D. Pa. Mar. 27, 1991) (finding that a corporate stock issuance that had the effect of diluting the majority shareholder to a minority position did not meet the *Blasius* "altered *Unocal*" inquiry because, even though the corporation needed to raise money, it did not prove that the issuance was "the least restrictive means" of doing so); *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 408 (Del. 1985) (finding that a board attempt to dilute the shares of a new majority shareholder by funding an ESOP with treasury shares was an inequitable action); *Mendel v. Carroll*, 651 A.2d 297, 304 (Del. Ch. 1994) (arguing in dictum that when "a board of directors acts in good faith and on the reasonable belief that a controlling shareholder is abusing its power . . . the board might permissibly [dilute the shares of the majority shareholder]" (citation omitted)); *Canada S. Oils Ltd. v. Manabi Exploration Co.*, 96 A.2d 810, 813 (Del. Ch. 1953) (holding that a transaction involving the issuance of shares was invalid because "the primary purpose behind the sale of these shares was to deprive plaintiff of the majority voting control").

²²⁸ No. CIV.A.13135, 1993 WL 432779, at *9 (Del. Ch. Oct. 22, 1993) (holding that management violated its duty of loyalty by taking action to thwart the effective exercise of a shareholder's consent solicitation).

²²⁹ See *id.* at *6.

²³⁰ See *id.* at *1.

franchise was "collateral," which does not constitute an equitable wrong, or whether it was done for the *primary purpose* of winning the proxy contest.²³¹ The court found that the stock placement was an intentional interference with voting rights, since it was apparent from the facts that the "principal, indeed probably the sole reason" for the deal was to prevent a change in control.²³²

4. Advance Notice Requirements and Misuse of Election Machinery Cases

Management can also impede an election by putting up structural barriers to the nomination of directors and the presentation of proxies. The Delaware jurisprudence in this area is unclear. In *Lerman v. Diagnostic Data Inc.*, a corporation adopted a bylaw amendment that required anyone (other than management) who wished to nominate candidates for the board to do so "not less than seventy days prior to any meeting of stockholders called for the election of directors."²³³ Management took advantage of this bylaw when it announced that the annual meeting would be held in sixty-three days, thereby foreclosing the possibility of a challenge.²³⁴ The chancery court, applying *Schnell*, found that the application of the bylaw amendment was invalid because it had "a terminal effect on the aspirations" of the challenger.²³⁵

In *Hubbard v. Hollywood Park Realty*, the chancery court also found that an advance notice bylaw had been inequitably applied.²³⁶ The

²³¹ See *id.* at *8.

²³² *Id.*; see also *WNH Invs. v. Batzel*, No. CIV.A.13931, 1995 WL 262248, at *6 (Del. Ch. Apr. 28, 1995) (holding that "the purpose of the dilutive issuance was to defeat the challenge to the board's control"); *Packer v. Yampol*, No. CIV.A.8432, 1986 WL 4748, at *16 (Del. Ch. Apr. 18, 1986) ("An inequitable purpose can be inferred where the directors' conduct has the effect of being unnecessary under the circumstances, of thwarting shareholder opposition, and of perpetuating management in office.").

²³³ 421 A.2d 906, 909 (Del. Ch. 1980).

²³⁴ See *id.* at 911.

²³⁵ *Id.* at 912. In *International Banknote Co. v. Muller*, the district court found that a 45-day advance notice requirement, adopted one day after the announcement of a proxy fight and 58 days before the annual meeting, was a breach of the directors' duty of care. See 713 F. Supp. 612, 626 (S.D.N.Y. 1989). The court also declared that the defendants could meet their burden at trial by showing, under *Unocal*, that they had reasonable grounds for believing that there was a danger to corporate policy and effectiveness, and that their response was reasonable. See *id.*

²³⁶ No. CIV.A.11779, 1991 WL 3151, at *11 (Del. Ch. Jan. 14, 1991) (holding that a neutral advance notice bylaw was inequitably applied when an unforeseen change in circumstances demanded that the notice requirement be waived); see also Warren & Abrams, *supra* note 13, at 666-68 (calling *Hubbard* an important development

court declared that even though "an advance notice by-law will be validated where it operates as a reasonable limitation," it cannot be used for inequitable purposes.²³⁷ The court held that the advance notice bylaw operated to prevent the potential challengers from reacting to a change in board policy that occurred after the nomination deadline had expired. The court found that since there was a "material change of circumstances," the bylaw should not be enforced to prevent the challengers from nominating directors to the board.²³⁸

One of the more confusing cases in recent Delaware law, *Stroud v. Grace*, dealt with the validity of a corporate bylaw that required advance notice for the nomination of directors and allowed current board members to disqualify the shareholders' nominees at any time before the election.²³⁹ Shareholders challenged this bylaw, claiming that under *Blasius* it impeded their exercise of the shareholder franchise.²⁴⁰ The chancery court agreed, finding that "the By-law as written clearly infringes upon the rights of Milliken stockholders to nominate persons to the Board, and is therefore unfair and unreasonable."²⁴¹

The supreme court reversed, stating that it was wrong for the chancery court to apply the *Blasius* standard. While the court said that it "accept[s] the basic legal tenets of . . . *Blasius*,"²⁴² it read the standard as applicable only when the "'primary purpose' of the board's actions was to interfere with or impede exercise of the shareholder franchise."²⁴³ The court argued that because the board members owned an absolute majority of the firm's stock they did not face any threat to their control. Therefore the primary purpose of the bylaw could not have been to impede the shareholder franchise.

because it signalled that the court may be willing to correct procedural unfairness even in the absence of manipulative conduct).

²³⁷ *Hubbard*, 1991 WL 3151, at *11.

²³⁸ *Id.* at *12. *But see* *Nomad Acquisition Corp. v. Damon Corp.*, Nos. CIV.A.10173, 10189, 1988 WL 383667, at *8 (Del. Ch. Sept. 20, 1988) (finding that a 60-day advance notice bylaw was not unreasonable because the plaintiffs failed to show that they had suffered any harm).

²³⁹ *See* 606 A.2d 75, 80 (Del. 1992).

²⁴⁰ *See* *Stroud v. Grace*, No. CIV.A.10719, 1990 WL 176803, at *5 (Del. Ch. Dec. 11, 1990) (stating that the defendants' acts must be reviewed for intrinsic fairness "because the amendments directly affect the exercise of the stockholder franchise"), *aff'd in part, rev'd in part*, 606 A.2d 75 (Del. 1992).

²⁴¹ *Id.* at *13.

²⁴² *Stroud*, 606 A.2d at 91.

²⁴³ *Id.* at 92.

Moreover, the bylaw was approved by a majority of the corporation's shareholders.²⁴⁴

This argument raised the question of the roles of "purpose" and "outcome" in shareholder franchise analysis. Even assuming that the court was correct that the "purpose" of the bylaw was not to impede the franchise, the "outcome" of the bylaw was that directors could reject any and all challengers as unqualified—certainly an inequitable result. The court, however, argued that the outcome—the transfer of power from shareholders to directors—was fair since it was ratified by the shareholders.²⁴⁵ The court also addressed the role of *Blasius* and declared that it fit within the framework of *Unocal Corp. v. Mesa Petroleum Corp.*²⁴⁶ When the board "adopts any defensive measure taken in response to some threat to corporate policy and effectiveness which touches upon issues of control," the *Unocal* standard must be applied.²⁴⁷ The court added that because of the importance of the shareholders' franchise, a board's action "that purposefully disenfranchises its shareholders is strongly suspect" and "cannot be sustained without 'a compelling justification.'"²⁴⁸

5. Continuing Director Provisions

The only case to address this issue is *Bank of New York v. Irving Bank*.²⁴⁹ One of the defensive measures taken by Irving Bank in its efforts to fend off a hostile bid was the addition of a bylaw amendment denying any board elected by insurgents the ability to redeem the poison pill, unless that board was elected with a vote of at least two-thirds of the shares. The court struck down the amendment as

²⁴⁴ See *id.* The firm, Milliken Enterprises, was controlled by the descendants of the founder. Shareholders controlling 17% of these shares comprised the dissident group. The core family group, including those on the board, controlled the majority of the stock. The bylaw was approved by 78% of the eligible voting shares. See *id.* at 79-81.

²⁴⁵ The shareholders who ratified the rules included the board, who owned or controlled more than 50% of the corporation's stock. See *id.* at 79. The court did not discuss this potential conflict of interest.

²⁴⁶ 493 A.2d 946 (Del. 1986).

²⁴⁷ *Stroud*, 606 A.2d at 92 n.3 (quoting *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1144 (Del. 1990)).

²⁴⁸ *Id.* The Delaware courts have been inconsistent in their interpretation of *Blasius*. Compare *Hubbard v. Hollywood Park Realty*, No. CIV.A.11779, 1991 WL 3151, at *8 (Del. Ch. Jan. 14, 1991) (calling *Blasius* "a particularized application of the *Schnell* doctrine"), with *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 286 (Del. Ch. 1989) (finding that the *Blasius* standard was a "specific expression of the proportionality test" from *Unocal*).

²⁴⁹ 528 N.Y.S.2d 482 (Sup. Ct. 1988).

“contrary to the statute” delegating power to the board of directors.²⁵⁰ According to the court, the reason the amendment was invalid was “not that it deprives a Board of certain powers,” but rather because “it is selective in the deprivation.”²⁵¹

6. Supermajority Voting Cases

Just as in the limitation cases, when a board adopts a supermajority voting provision, the courts examine the measure for purpose rather than outcome. In *Williams v. Geier*, a company that was 36% family-owned created a system in which a holder of a share of stock was entitled to ten votes per share if that stock was held continuously for three years.²⁵² This plan was designed in part to deter arbitrageurs and other raiders looking for a short-run gain. The plan was challenged as a scheme to allow the family to retain control. The *Williams* court acknowledged that the plan would have some entrenchment effect but argued that “the fact that a plan has an entrenchment effect does not mean that it was so motivated.”²⁵³ The court examined the motives behind the plan and found them acceptable.²⁵⁴

D. A Jurisprudence of Contradictions

To summarize the seemingly confused and contradictory case law, the Delaware courts have held:

- A shareholder rights plan which restricts the number of shares that one shareholder can own, and punishes an individual for entering into voting agreement with other shareholders, was not considered interference with the shareholder franchise because the interference was “minimal.”²⁵⁵

²⁵⁰ *Id.* at 486. The statute the court referred to is N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986), which lists the conditions under which the powers of the board may be modified.

²⁵¹ *Id.* at 485.

²⁵² See No. CIV.A.8456, 1994 WL 514871, at *1 (Del. Ch. Sept. 9, 1994), *aff'd*, 671 A.2d 1368 (Del. 1996).

²⁵³ *Id.* at *3.

²⁵⁴ See *id.* (stating that “the directors were motivated by the good faith belief that long term corporate planning would be enhanced by the recapitalization plan”).

²⁵⁵ *Stahl v. Apple Bancorp, Inc.*, No. CIV.A.11510, 1990 WL 114222, at *8 (Del. Ch. Aug. 9, 1990) (*Stahl II*).

- A defensive measure where a board funds an employee stock option plan with corporate stock to fend off a tender offer is not interference with the franchise, even though management will be assured of 33% of the vote, two-thirds of what it needs for victory.²⁵⁶
- A last-minute bylaw change postponing an election that would offer the shareholders an alternative to the board's plans was not considered interference with the vote because the primary purpose of the plan was defensive.²⁵⁷
- A bylaw that allows current directors to reject board candidates nominated by opponents is valid where the move has been approved by the shareholders.²⁵⁸
- A decision by a board of directors not to call a regularly scheduled election when it appears that they will lose is considered a valid measure because there is no requirement that the election be called in the first place.²⁵⁹

While the courts have upheld decisions that allow significant interference with the franchise, they have also made statements such as "[w]here the franchise is involved, a special obligation falls upon courts to review with care action that impinges upon legitimate election activities."²⁶⁰ Part V of this Comment suggests a means of interpreting the case law and suggests a clear standard for analysis.

IV. WHY UNIMPEDED SHAREHOLDER VOTING IS VITAL TO THE CORPORATE LAW

²⁵⁶ See *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 286 (Del. Ch. 1989).

²⁵⁷ See *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 496 (Del. Ch.), *aff'd* 670 A.2d 1338 (Del. 1995).

²⁵⁸ See *Stroud v. Grace*, 606 A.2d 75 (Del. Ch. 1992).

²⁵⁹ See *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1123-24 (Del. Ch. 1990) (*Stahl I*) (limiting its holding to the "narrow ground" where no meeting has been set and no proxies have yet been solicited and noting that a breach of fiduciary duty would occur if the board rescinded an election for fear of losing).

²⁶⁰ *Stahl II*, 1990 WL 114222, at *5.

A. *The Economic Justification for the Shareholder Franchise*

To understand why it is imperative that the courts strike down managerial attempts to limit shareholder voting, it is important to understand the role voting plays in corporate law and theory. Economics helps explain how corporations are organized and why the shareholder vote is so vital to corporate efficiency. Professors Berle and Means noted that the separation of ownership and control found in most large corporations raises the fear that managers will run the firm in their own interest, rather than in the interest of the shareholders.²⁶¹ To control and limit this divergence of interests, the shareholders must oversee the managers' behavior. The costs associated with this oversight are known as agency costs. They include the costs of monitoring management, bonding costs to align managerial and shareholder interests,²⁶² and the residual expenses that can not be efficiently eliminated.²⁶³

The market for capital helps to monitor management.²⁶⁴ Corporations must compete for capital. Managers who run firms for their own benefit rather than for the benefit of the shareholder may find themselves unable to raise funds.²⁶⁵ Shareholders, who are the residual claimants²⁶⁶ to the firm's income, will provide capital only

²⁶¹ See BERLE & MEANS, *supra* note 17, at 119-25 (suggesting that managers may aim to maximize their own profits, prestige or power). This idea is not new. See ADAM SMITH, *THE WEALTH OF NATIONS* 700 (Edwin Cannan ed., Random House 1937) (1776) ("The directors of such companies, however, being the managers rather of other peoples money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.").

²⁶² These include performance related bonuses and options. *But see* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 886-87 (arguing that performance-based compensation is a poor method for controlling managerial behavior since management helps create the compensation schedules).

²⁶³ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (arguing that the existence of agency costs explains the organization of firms and related corporate behavior).

²⁶⁴ See Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 544 (1984) ("Managers may do their best to take advantage of investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart.").

²⁶⁵ See *id.* (arguing that the competitive market for capital is a "limitation on managers' efforts to enrich themselves at investors' expense").

²⁶⁶ Under the "nexus of contract" view of the firm, shareholders do not "own" the company in the traditional private property sense. Rather, they are one of many parties who have contracted to provide various inputs in exchange for certain

if the firm is managed efficiently. It would seem logical that shareholders and managers would simply contract as to how the corporation will be managed, but this would be inefficient. In order to account for market shifts and new technologies, shareholders must allow managers the flexibility to direct the firm as the managers see fit.²⁶⁷ In order to ensure that management is not abusing its power, however, the shareholders demand the right to vote so that they can remove inefficient managers. Managers, knowing that shareholders can vote them out of office if the firm's fortunes lag, will manage the firm in the shareholders' best interest.²⁶⁸

As mentioned earlier, the collective action problem and the availability of the tender offer made shareholder voting a non-issue for many years. Today, however, with institutional investors having overcome the collective action and rational apathy problems, and with the tender offer precluded by the poison pill and state antitakeover statutes, the proxy has become not only the preferred but also the only available instrument for the monitoring and control of management.²⁶⁹

It is often asked why the corporation is run for the interest of the shareholders rather than for the employees, the creditors, the community or society as a whole. Shareholders have the least to do

outcomes. For example, the employees are providing labor in exchange for a salary. Creditors provide capital in exchange for a fixed rate of return. Shareholders provide capital as well, but rather than demanding a specific return, shareholders have contracted for a residual interest—what is left when all other parties have been paid. See Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1426-27 (1993).

²⁶⁷ See *Commonwealth Assoc. v. Providence Health Care, Inc.*, No. CIV.A.13135, 1993 WL 432779, at *8 (Del. Ch. Oct. 22, 1993) ("In a technological, market economy these corporate enterprises require broad power and discretion in the hands of boards and managers in order to enable the enterprise to adapt to changing markets in a timely way."). The court noted that shareholders give managers this power so that "action taken for the sole or primary purpose of impeding the effectiveness of the shareholder vote is deeply suspect . . ." *Id.*

²⁶⁸ See EASTERBROOK & FISCHER, *supra* note 14, at 68 ("[M]anagers' knowledge . . . that the [shareholders'] claims could be aggregated and votes exercised, lead managers to act in shareholders' interest in order to advance their own careers and to avoid being ousted.").

²⁶⁹ Commentators caution that the promise of institutional monitoring may not be realized. See Black, *supra* note 63, at 817 (claiming that political and managerial influence may chill the ability of institutions to effectively monitor management); Rock, *supra* note 4, at 464 (arguing that institutional investors are another level of agents, creating agency costs of their own). Institutions have agendas of their own. See, e.g., Nick Gilbert, *Glass Houses*, FIN. WORLD, July 4, 1995, at 26 (claiming that the managers of TIAA-CREF, one of the largest pension funds, have "been on a politically correct crusade" to increase race and gender diversity on corporate boards).

with the firm of all the corporate constituencies. Shareholders can and will sell their shares for a small premium.²⁷⁰ Unlike other constituencies, shareholders have the potential to be well diversified. If a company goes bankrupt, the shareholder has lost only a small portion of her investment portfolio, while the employee has lost her livelihood.²⁷¹ Economists have answered this question through the "nexus of contract" analysis, claiming that efficiency demands that the party who is the residual risk bearer be in a position to oversee the performance of the firm. Of all the constituencies involved in the corporation, only the shareholders have the correct incentives: to reduce costs and increase revenues as much as possible. Because shareholders are paid after the parties who have formally contracted with the firm, such as employees, creditors and suppliers, a rational shareholder will demand that the firm be run profitably so that there will be money left for her. To defend this assertion, economists point to the evidence, arguing that since shareholders do have the right to vote, this is the efficient solution.²⁷²

Many academics, however, have argued that management needs to look beyond the narrow, short term, profit-maximizing interests of the shareholders.²⁷³ State constituency statutes demand as

²⁷⁰ See, e.g., Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 194 (1991) (stating that "the stockholder/investors of the modern publicly held corporation view the corporation like a holder of a betting slip views a horse," caring only about her payoff and ignoring the fate of the company).

²⁷¹ See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 291 (1980) (stating that "portfolio theory tells us that the optimal portfolio for any investor is likely to be diversified across the securities of many firms," so that "an individual security holder generally has no special interest in personally overseeing the detailed activities of any firm"); see also Henning, *supra* note 66, at 578 (stating that "[s]takeholders in a corporation depend on a firm's stability and its continuation as an enterprise to protect their investments; in short, stakeholders are risk averse").

²⁷² See EASTERBROOK & FISCHEL, *supra* note 14, at 67 (arguing that this arrangement maximizes a firm's value because "[t]he gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line").

²⁷³ A recent chancery court case could give these "entity theorists" an economic basis for their arguments. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. CIV.A.12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991). In the case of a "corporation operating in the vicinity of insolvency," the court found that the directors owed their duty not to the shareholders, but to the corporate enterprise. *Id.* The reason for this switch is that the shareholders, who were about to wind up with nothing, had the incentive to take an unreasonable gamble with the money that would have otherwise gone to the creditors upon the dissolution of the firm. Thus, managers in this situation must act in the interest of the "corporate enterprise," rather than the interests of the shareholders. See *id.* at n.55. Many people would argue that shareholders are always willing to take unreasonable and

much.²⁷⁴ This has been a lively issue in corporate law for most of this century and remains so today.²⁷⁵

During the 1980s, Delaware courts had to face this question when dealing with takeover defense cases. In these cases, shareholders were voluntarily tendering their stock, but management was refusing to redeem the poison pill so that a takeover could occur. The courts decided that "corporate directors, if they act in pursuit of some vision of the corporation's long-term welfare, may take action that precludes shareholders from accepting an immediate high-premium offer for their shares."²⁷⁶

inefficient gambles with other people's jobs, health and futures. See, e.g., Ronald M. Green, *Shareholders As Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1420 (blaming the Bhopal disaster on the "chain of business reasoning predicated on the shareholder model," where investments in safety were not made because of concerns about "quarterly results").

²⁷⁴ See generally Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 975 (1992) (arguing that "the statutes should not provide a cloak behind which the behavior of self-interested directors may escape scrutiny"); Orts, *supra* note 39, at 14 (reviewing the history and policy behind the constituency statutes).

²⁷⁵ See, e.g., John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 13 (1986) (claiming that a "rational manager has good reason to be risk averse, while the fully diversified shareholder has every reason to be risk neutral"); Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513, 531-80 (1993) (arguing that corporations and their employees have been harmed by the shareholder focus on short-term profit maximization); A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Sixty Years Later*, 16 DEL. J. CORP. L. 33, 55 (1991) (arguing that courts and legislatures have yet to resolve the question of whether directors owe a duty to parties other than shareholders).

²⁷⁶ William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 276 (1992) (stating that courts and legislators have endorsed the "entity" view of a corporation). The Delaware courts believe that shareholders have difficulty appreciating the long-term benefits of corporate action, while management is better situated to understand these future benefits. See, e.g., *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1376 (Del. 1995) (noting the chancery court's opinion to have acknowledged that "the directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long term value of the corporation under its present management plan"); *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989) (claiming that shareholders may be "ignorant" or "mistaken" about the long-term benefits of a proposed merger); *TW Servs., Inc. v. SWT Acquisition Corp.*, Nos. CIV.A.10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) (arguing that "directors, in managing the business and affairs of the corporation, may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected" (footnote omitted)).

These arguments are strongly disputed by many economic theorists who claim that the market price of a stock reflects its actual value. See, e.g., RONALD J. GILSON,

The language used in these cases suggests that the interests of the shareholder are just one of a number of factors the management of a firm needs to examine in making decisions about what is best for the corporation. The supreme court stated that "the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source."²⁷⁷ The court found that a manager may take into account "the impact on 'constituencies' other than shareholders," mentioning creditors, customers, employees and the community generally.²⁷⁸

As more shareholders turn to the proxy as the means of effecting corporate changes, the courts will have to face the question of whether management should be allowed to defend itself against the shareholder vote. Managers will argue that the importance of the long-term viability of the corporation and the protection of its various constituencies demands that short-term profit maximizing shareholders not be allowed to impose their will on the corporate entity. Although the supreme court has claimed that a heightened standard is applied when management interferes with the ability of shareholders to vote,²⁷⁹ the court also claims to be applying a

THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 156-204 (1986) (describing the efficient capital market hypothesis and the market for information). *But see* Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CAL. L. REV. 1053, 1055-59 (1991) (explaining why shareholders and management tend to value stock differently). There are other arguments against allowing management to take the "long term" view. *See* Minow, *supra* note 50, at 224 (stating that "[n]o one is in favor of an overly short-term outlook, but long-term may be a euphemism for something that never happens").

²⁷⁷ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (citations omitted). The court's decision in *Unocal* was fiercely attacked:

Boards of directors did not seek to take into account other constituencies out of a new-found enthusiasm to do something nice for their employees or surrounding communities. Their motivation, pure and simple, was to adopt a new takeover defense that is applicable even when a tender offer would be in the best interests of their shareholders.

Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 20 (1993).

²⁷⁸ *Unocal*, 493 A.2d at 955.

²⁷⁹ *See, e.g.,* *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1378 (Del. 1995) (stating that "[t]his court has been and remains assiduous in its concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising shareholders" (citations omitted)); *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992) (stating that "[a] board's unilateral decision to adopt a defensive measure touching 'upon issues of control' that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a 'compelling justification'").

heightened standard when management rejects a tender offer. If franchise interference cases are decided under the *Unocal/Unitrin* line of cases, the court will likely be very deferential to management.

The Delaware courts are now at a crossroads. They can choose to apply the "compelling justification" standard to corporate franchise cases, a mixed version of *Blasius* and *Unocal*,²⁸⁰ or the deferential *Unocal/Unitrin* standard. This Comment argues that the courts need to assure that shareholders can exercise their franchise unimpeded by management. There are a number of strong arguments for the courts to protect the viability of the shareholder vote.

1. The Need For Shareholder Monitoring of Management

In any agency relationship, there is a need for monitoring.²⁸¹ Anecdotal evidence of managerial misconduct would fill many books.²⁸² In our current corporate structure, the shareholder vote is just one of the means by which managerial behavior is constrained. Legal constraints include shareholder derivative suits, mandatory disclosure, state and stock exchange governance requirements, and antifraud laws.²⁸³ Courts, however, will not interfere in the day-to-day operation of the business, deferring to management decision.²⁸⁴ The shareholder derivative suit is an expensive, post hoc tool, designed "only for remedying violations of legal norms, not for policing underperformance, slack, or incompetence."²⁸⁵

²⁸⁰ See *Unitrin*, 651 A.2d at 1379 (stating that interference with the shareholder franchise in response to a joint tender offer/proxy fight would "necessarily invoke[]" both *Unocal* and *Blasius*" (quoting *Stroud*, 606 A.2d at 92 n.3)).

²⁸¹ See Jensen & Meckling, *supra* note 263, at 308 (stating that the "principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent").

²⁸² See, e.g., Diana B. Henriques, *Preaching but Not Practicing?: Austerity at Dial Does Not Always Reach the Top*, N.Y. TIMES, Dec. 23, 1995, at D1, D3 (discussing managerial extravagance at a corporation which is firing employees). But see, e.g., Lipton & Rosenblum, *supra* note 270, at 195 (claiming that the assumption that managers are self-interested is unfounded and that it is only the rare manager who acts to the detriment of the corporation).

²⁸³ See Bainbridge, *supra* note 49, at 716 (arguing that even though managers are not accountable to anyone, they operate in a "pervasive web of indirect accountability mechanisms").

²⁸⁴ See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (stating that "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose'" (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971))).

²⁸⁵ CLARK, *supra* note 19, § 9.5, at 397 (noting that this is a "great problem" with

Economic constraints also limit managerial behavior. Product markets discipline managers, though only by threatening firms with bankruptcy.²⁸⁶ The market for corporate control still pressures managers to run their firms efficiently, but the era of the hostile takeover has come to an end.²⁸⁷ Compensation schemes that offer pay for performance are tools to align managers' interests with those of the shareholders, but these plans are very hard to craft and are created by management-dominated directors.²⁸⁸ Creditor contracts discipline management, but only to the extent that the corporation is able to pay principal and interest when due. Lenders, however, not only do not care whether the firm maximizes profits, they also share some of the risk aversion of the managers.²⁸⁹ Outside directors are supposed to impart an independent viewpoint to corporate decisionmaking, but for the most part have been deferential to management.²⁹⁰ Currently, the only way for shareholders to monitor management effectively is through the vote.

Even those who reject the shareholder-dominated view of the corporation acknowledge the need to monitor management.²⁹¹ Al-

the derivative suit).

²⁸⁶ See Dent, *supra* note 262, at 886 (arguing that "[e]ven when bankruptcy does discipline managers, it does so only at great costs to investors, employees and others").

²⁸⁷ See Easterbrook & Fischel, *supra* note 34, at 1169 (stating that "[t]he most probable explanation for unfriendly takeovers emphasizes their role in monitoring the performance of corporate managers"); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 875 (1981) (arguing that the tender offer is "the key displacement mechanism through which the market for corporate control constrains management behavior").

²⁸⁸ See Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 656 (1995) (stating that compensation becomes problematic when "a board beholden to a particular executive agrees to a salary package upon demand"); Ronald J. Gilson, *Executive Compensation and Corporate Governance: An Academic Perspective*, 24TH ANNUAL INSTITUTE ON SECURITIES REGULATION 1992, 647, 671 (PLI Corporate Law & Practice Course Handbook Series No. B4-7017, 1992) (arguing that "[i]ncentives impose risk on executives, and executives are poor risk bearers").

²⁸⁹ See Dent, *supra* note 262, at 887.

²⁹⁰ See, e.g., *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986) ("The so-called outsiders . . . are often friends of the insiders."), *rev'd on other grounds*, 481 U.S. 69 (1987); William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2059 (citing cases in which special committees of independent directors were unable or unwilling to provide meaningful review of corporate actions); Dent, *supra* note 262, at 899-900 (arguing that outside directors have limited knowledge about the firm, lack incentives to challenge the CEO, and have had little effect on executive compensation); Lublin, *Champion's Chairman*, *supra* note 51, at A1 (describing how an embattled corporate chairman handpicked friends and suppliers for the company's board).

²⁹¹ See Black, *supra* note 224, at 927-31 (discussing the Japanese and European

though alternative systems for monitoring may be possible,²⁹² the only one that currently exists is the shareholder franchise.²⁹³ In fact, with the new proxy rules and increased power of institutions, the ability of shareholders to monitor is greater now than ever before.²⁹⁴ Institutions overcome the collective action problem because their large holdings justify an investment in monitoring. Large institutions also benefit from economies of scale. An institution owning a large percentage of a company's stock has reason to invest more time and attention in casting an informed vote.²⁹⁵ Institutions, because of their huge size and long-term perspective, are in the best position to ensure that corporations are managed for long-term success.²⁹⁶ The number of proxy fights and shareholder proposals is increasing every year.²⁹⁷ This explains why manage-

experiences with corporate managerial monitoring by banks and insurance companies); Estreicher, *supra* note 275, at 593-614 (suggesting professional outside directors, shareholder advisory committees, relationship banking and enhanced employee voice as alternatives to monitoring by "myopic" shareholders); Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1302-05 (1992) (arguing that shareholder voting should be abolished and replaced with judicial oversight through derivative suits which could be brought by any corporate constituent group).

²⁹² See Black, *supra* note 224, at 927-31 (discussing the role of institutional monitoring in several European and Asian economies); Mitchell, *supra* note 291, at 1301-17 (contemplating a theory that replaces the shareholder franchise with an independent and controlling board of directors).

²⁹³ Former Secretary of Labor Robert B. Reich offered a very logical solution to this shareholder/constituency dichotomy. See Robert B. Reich, *How to Avoid These Layoffs*, N.Y. TIMES, Jan. 4, 1996, at A21. The Secretary argued that the way to ensure that corporations take employees and nonshareholders into account in their decisionmaking would be for the government to alter the corporate incentive structure. By reserving the benefits of incorporation for corporations that demonstrate community responsibility, or by raising the tax rate for those that do not, shareholders' profit maximization will necessarily demand the protection of employees and communities. See *id.*

²⁹⁴ See Marlene Givant Star, *Investors Plan to Get Tough, Abandon Nice Guy Approach*, PENSIONS & INVESTMENTS, Oct. 26, 1992, at 3, 3, 33 (reporting that CalPERS, the United Shareholders Association, the Council of Institutional Investors, and other state and local retirement and pension funds have begun actively to target underperforming companies through shareholder proposals).

²⁹⁵ See Black, *supra* note 63, at 822 (suggesting that institutional investors, as large shareholders, will actively participate in monitoring because the private gain from monitoring exceeds the private cost).

²⁹⁶ See John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1356 (1992) (stating that institutions have the time and incentive to monitor management and quoting an institutional fund manager as stating "we're the quintessential long-term investors" (citation omitted)).

²⁹⁷ See *Shareholders Gear Up for Annual Rite*, L.A. TIMES, Mar. 26, 1996, at D2 ("[T]he

ment is working now to oppose the shareholder proxy and why the courts need to protect it.

2. Other Constituencies Are Now Shareholders

Many argue that the shareholder focus is misguided and that corporations need to concern themselves with the interests of "other constituencies," such as employees, creditors and customers.²⁹⁸ State legislatures have passed statutes allowing managers of target companies to consider the impact of a proposed takeover on other constituencies.²⁹⁹ Although many scholars have argued that these rules are harmful to the very constituencies they are intended to protect,³⁰⁰ courts have accepted the notion that managers may consider constituencies other than the shareholders in deciding whether to accept a tender offer.³⁰¹

Recent trends in stock ownership have indicated that these "constituency statutes" may be counterproductive as employees and community activists are becoming as well-represented as shareholders.³⁰² The Teamsters union alone controls pension plans with

number of shareholders proposals related to board governance issues has surged 74% from 1995 levels.").

²⁹³ See, e.g., Lipton & Rosenblum, *supra* note 270, at 192 (arguing that the modern public corporation is not private property, but is rather the central productive element in the economy, affecting "the destinies of employees, communities, suppliers, and customers").

²⁹⁹ See Brownstein & Presser, *supra* note 43, at 397 (listing the states that have passed constituency statutes and describing what they entail). The Missouri statute, for example, allows a company's management to consider the impact on "employees, suppliers, customers . . . and the communities in which the corporation conducts its businesses" when considering a hostile bid. MO. REV. STAT. § 351.347(4) (1995).

³⁰⁰ See, e.g., Bainbridge, *supra* note 274, at 1013 (arguing that "[t]here is a very real possibility that unscrupulous directors will use nonshareholder interests to cloak their own self-interested behavior"); Matheson & Olson, *supra* note 296, at 1351-54 (arguing that corporations already rationally protect valuable inputs, so nonshareholder constituency statutes protect primarily "suboptimal employees, suppliers, or creditors"); Orts, *supra* note 39, at 24 (arguing that state legislatures passed corporate constituency statutes in order to deter the hostile takeover of local firms).

³⁰¹ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (stating that managers may concern themselves with "the impact on 'constituencies' other than shareholders"); *TW Servs., Inc. v. SWT Acquisition Corp.*, Nos. CIV.A.10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) ("[D]irectors in pursuit of long run corporate (and shareholder) value may be sensitive to the claims of other 'corporate constituencies.'").

³⁰² See Aaron Bernstein, *Labor Flexes its Muscles—As a Stockholder*, BUS. WK., July 18, 1994, at 79, 79 (stating that since 1992, union-mounted proxy battles have quadrupled and that 70 occurred during the first half of 1994).

more than forty-six billion dollars in stock.³⁰³ In 1994, unions sponsored sixty corporate governance resolutions, making unions the leading institutional sponsors of such proposals.³⁰⁴ Employee stock ownership has also expanded. There are now over 10,000 firms with at least 5% employee ownership.³⁰⁵ Pension funds, which rank among the largest of the institutional investors, have acted to protect the rights of employees in the workplace.³⁰⁶ Some institutions have even taken up social causes, such as protecting the environment.³⁰⁷ In short, those who argue for an entity view of the corporation, where managers are beholden to employees and other constituencies, would be well advised to defend the shareholder franchise.

3. The Delaware Courts' Previous Decisions Were Predicated on the Ability of Shareholders to Exercise Their Franchise Rights

Consistency demands that the Delaware courts give the highest level of protection to the shareholder franchise. Many of the decisions in the takeover defense area were predicated on the idea that if shareholders did not like the way the managers were running the corporation, they had the ability to unseat and replace the managers.³⁰⁸

³⁰³ See *id.*

³⁰⁴ See Jeff Cossette, *A Consolidated Effort*, INVESTOR REL., June 1, 1995, available in WL, 1995 WL 10825511 ("One factor underlying the surge in labour activism is the growth over the last decade in the value of union pension plans."). Unions are also becoming more active in defending themselves through the vote. See Groskaufmanis, *supra* note 63, at 21 (stating that in place of work stoppages, strikes and pickets, unions are using proxy contests to fight the company "like a shareholder").

³⁰⁵ See Goroff & Winters, *supra* note 60, at 373.

³⁰⁶ See *Beware Politically Correct Investing*, INVESTOR'S BUS. DAILY, Sept. 28, 1995, at A2 (stating that CalPERS considers how companies treat their employees as an investment criterion).

³⁰⁷ See Marlene Givant Star, *Companies Act to Avoid Proxy Showdowns*, PENSIONS & INVESTMENTS, Feb. 22, 1993, at 3, 39 (reporting that the Sun Company, Inc., has become the first Fortune 500 firm to agree to sign a set of environmental guidelines which were backed by large pension funds).

³⁰⁸ See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1383 (Del. 1995) (claiming that despite the existence of the poison pill, "a proxy contest apparently remained a viable alternative" for the potential acquiror to pursue); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985) (stating that if a challenger for control wanted to eliminate the company's poison pill, she could "solicit proxies for consents to remove the Board and redeem the Rights"); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (stating that "[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out").

The supreme court made its clearest statement about the value of shareholder voting in *Paramount Communications, Inc. v. QVC Network, Inc.*³⁰⁹ The directors of Paramount, a large, publicly owned company, were planning to sell their firm to Viacom, a firm with a controlling shareholder.³¹⁰ Paramount was also being pursued by QVC, but the affection was not mutual.³¹¹ In order to assure that the Viacom transaction would be consummated, the Paramount board guaranteed Viacom a \$100 million termination fee in case the deal fell through, a "no shop" provision declaring that Paramount would not solicit any other offers, and a stock option agreement, ensuring that Viacom would profit handsomely if another company bought Paramount.³¹² The court found that because the transaction would render the Paramount shareholders a minority in the new enterprise, this was one of the rare situations where directors were obligated to get "the best value reasonably available for the stockholders."³¹³ Because the Paramount directors had agreed to the "no shop" provision, the stock option agreement and the large termination fee, they had "squandered" their chance to seek the best value available for their shareholders and thereby were in violation of their fiduciary duties.³¹⁴

The court's reasoning reflected a great concern for the value of the shareholder franchise. In a firm without a controlling shareholder, each individual shareholder would have a say in the running of the firm. They would be able to vote on "elections of directors, amendments to the certificate of incorporation, mergers, consolidations, sales of all or substantially all of the assets of the corporation,

³⁰⁹ 637 A.2d 34, 51 (Del. 1994) (holding that the directors violated their fiduciary duties when they did not endeavor to get the "best value reasonably available to the stockholders" in a sale of control situation). See generally Steven J. Fink, *The Rebirth of the Tender Offer?* Paramount Communications, Inc. v. QVC Network, Inc., 20 DEL. J. CORP. L. 133 (1995); 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).

³¹⁰ See *Paramount*, 637 A.2d at 37, 38 (stating that while Paramount's stock was held by numerous unaffiliated investors, 85% of the shares of Viacom were owned by a single individual).

³¹¹ See *id.* at 41 (declaring that "the Paramount Board determined that the new QVC offer was not in the best interests of the stockholders").

³¹² See *id.* at 39.

³¹³ *Id.* at 44. The court stated that "when a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a break-up of the corporate entity, the directors' obligation is to seek the best value reasonably available to the stockholders." *Id.* at 48.

³¹⁴ *Id.* at 50.

and dissolution."³¹⁵ After the "sale of control," the Paramount shareholders would be minority shareholders of the Viacom corporation. Thus, these protective devices would become mere formalities as the controlling shareholder would be able to run the company as he saw fit.³¹⁶

It is important to appreciate that the supreme court cited many of the cases in which voting rights were held inviolate.³¹⁷ The court did not speak of agency costs, collective action problems or rational apathy. It spoke of the vote as something of value, an important protection which cannot be taken from the shareholder without adequate reimbursement.³¹⁸

In other cases, the courts have clearly expressed the importance of the franchise. In *Stahl I*, the chancery court declared "the prospect of losing a validly conducted shareholder vote cannot . . .

³¹⁵ *Id.* at 42 (citing the relevant sections of the Delaware corporate code).

³¹⁶ *See id.* at 42-43 (arguing that "[i]n the absence of devices protecting the minority shareholders, stockholder votes are likely to become mere formalities where there is a majority stockholder"). The court's analysis is reminiscent of that of Professor Manne, who suggested in 1965 that the value of a share is composed of two interests—the vote and the underlying investment interest. The vote has value in that it can be used to improve corporate performance through a change in management. If for any reason the shareholders could not implement a change in control, the vote becomes worthless. *See* Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1430-31 (1965).

³¹⁷ The court declared that "[b]ecause of the overriding importance of voting rights, this Court and the Court of Chancery have consistently acted to protect stockholders from unwarranted interference with such rights." *Paramount*, 637 A.2d at 42. The court cited *Schnell* and *Blasius* to support this proposition. *See id.* at 42 n.11.

³¹⁸ The court claimed that this value was a "control premium," which is reflected in the above-market-price paid for a controlling block of shares. The source of this control premium is a subject of no small dispute. *See, e.g.,* Mendel v. Carroll, 651 A.2d 297, 305 (Del. Ch. 1994) (stating that "[o]ptimists see the control premium as a reflection of the efficiency enhancing changes that the buyer of control is planning," while others see it as "the price that a prospective wrongdoer is willing to pay in order to put himself in the position to exploit [the shareholder]"); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 715-20 (1982) (arguing that requiring the control premium to be shared by all shareholders would stifle efficient sales of control); Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248, 252-61 (1985) (discussing the longstanding academic dispute regarding the source of the premium); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1247 (1990) (arguing that control premiums reflect nothing more than the "downward-sloping demand" for the shares of a firm (citation omitted)). *See generally* DAVID COWAN BAYNE, S.J., *THE PHILOSOPHY OF CORPORATE CONTROL* (1986). Father Bayne attacks the policy of allowing controlling shareholders to retain the control premium as a moral wrong, a perversion and as the legalization of bribery. *See id.* at 197-236.

constitute a legitimate threat to a corporate interest, at least if one accepts the traditional model of the nature of the corporation that sees shareholders as 'owners.'³¹⁹ It is apparent from cases such as *Paramount* that the courts have not abandoned the "shareholder as owner" conception of the firm. While the courts will allow directors to be sensitive to the concerns of "other 'corporate constituencies,'" the underlying duty of directors is to run the firm with "due care and in a way intended to maximize the long run interests of shareholders."³²⁰

4. The Vote Protects the Legitimacy of the Corporate Form

In *Blasius*, the chancery court asserted: "[W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own."³²¹

There is no need to repeat the history of organizations where small groups have been vested with great power over many, free from oversight. Much of the world has been controlled on the idea that the citizen did not have the foresight, intelligence or ability to have a say in the manner in which she was governed. Rather, leadership would spring from an elite, who could be trusted to manage with wisdom, compassion and insight. This model has proven to be an utter failure. The idea of democratic control is a sacred one to our society. The courts must appreciate that, like the leaders of government, the elected leaders of a corporation must be held accountable for their actions. For the first time since economies of scale created the need for numerous small owners and a professional class of managers, shareholders are in a position actively to oversee the management of the firm. These shareholders include retirees, employees, community activists, environmental groups—all of the constituencies that the courts aim to protect. The only way to give them true protection is for the courts to ensure that management cannot interfere with the shareholder franchise.

³¹⁹ *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1124 (Del. Ch. 1990) (*Stahl I*).

³²⁰ *TW Servs., Inc. v. SWT Acquisition Corp.*, Nos. CIV.A.10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989).

³²¹ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

5. The Vote Is the Shareholder's Defense of Last Resort

Finally, we must recognize that the shareholder franchise is the monitoring tool of last resort.³²² The courts, the state legislatures and the financial markets have eliminated the unsolicited tender offer as a means of transferring corporate control. When the *Time* court rejected *Interco*, it did so because of the fear that courts would substitute their judgment "for that of a corporation's board of directors."³²³ If the board's business judgment is faulty, a court will not be able to correct it. The only monitoring mechanism left is the shareholder vote. This vote now has become valuable, as institutions can use it effectively. To allow management to interfere with the shareholder franchise would effectively end any hope for real oversight and would leave the main engine for economic growth in our society in the hands of a small, isolated group, rather than in the control of the tens of millions of shareholders who have provided their hard-earned capital.

There are two ways that management can protect itself from being ousted by the shareholders. The first is to enhance the value of the company to ensure that shareholders are satisfied with managerial performance. The second is to put up roadblocks to proxy contests.³²⁴ The courts must ensure that directors choose the former. Corporate management realizes that its control is being threatened and is using every weapon in its arsenal to limit the burgeoning shareholder power. The courts must not let this effort succeed.

V. THE COURTS MUST RESTRICT ALL INTERFERENCE WITH THE SHAREHOLDER FRANCHISE, PURPOSEFUL AND OTHERWISE

³²² See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1379 (Del. 1995) (stating that the proxy contest is "the only alternative to hostile takeovers to gain control against the will of the incumbent directors" (quoting *Bebchuk & Kahan, supra* note 29, at 1134)).

³²³ *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989).

³²⁴ See *Bebchuk & Kahan, supra* note 29, at 1101 (describing managerial "[o]uster-preventive activities").

A. *Shareholder Franchise—No Compromise*

Delaware case law concerning shareholder franchise had a promising beginning, but is now moving rapidly in the wrong direction. Rather than applying the clear, sound *Blasius* compelling-justification test, the courts are now trying to apply a balancing test to managerial interference with the election process. There are two major problems with the courts' decisions. First, the courts are beginning to analyze cases in which the corporation purposefully interferes with the shareholder franchise under the liberal *Unocal* enhanced-business-judgment standard. Second, the courts are refusing to restrict companies whose otherwise valid defensive measures, such as poison pills and employee stock option plans, have the effect of impeding the shareholder franchise. This Comment argues that the courts are not doing enough to defend the shareholder franchise from the growing threat of corporate defensive measures. The shareholder vote is not something which can be balanced against other interests. No threat justifies curtailing the shareholders' ability to remove managers with whom they disagree.

To analyze the situation properly, it is important to realize that shareholder franchise cases come in two flavors—purposeful interference and nonpurposeful interference. Although this Comment discusses the purposeful interference cases first, it is the nonpurposeful interference cases which pose the greatest menace to shareholders. This is because a manager can construct permanent structural barriers to shareholder voting through legal defensive measures such as limitations on ownership and the placement of shares in friendly hands. While the purposeful interference cases may cause the temporary delay of an election, a poison pill with a low trigger could permanently entrench management.

1. Purposeful Interference Cases—No Balancing Allowed

According to the Delaware Supreme Court's most recent holding on the subject, when an acquiror launches both a proxy fight and a tender offer, the court must decide the case under the *Unocal* test, but also must recognize "the special import of protecting the shareholder's franchise within *Unocal*'s requirement that a defensive response be reasonable and proportionate."³²⁵ This raises the question of what kind of threat can justify delaying or otherwise

³²⁵ *Unitrin*, 651 A.2d at 1379.

interfering with a shareholder election. The court implied that a hostile tender offer joined with a proxy contest could be considered a threat to the firm. Ultimately, though, it is not the hostile offer from which management is defending itself. The poison pill and other defensive measures can easily repulse a hostile offer. Rather, it is the shareholders that the board is concerned about, because it is they who would change management. The defensive measure is not aimed against the tender offer, but against the proxy contest.

Why would a proxy contest be a threat to management? The court has spoken of shareholder ignorance in the tender offer cases, but if ignorance is a major concern, why hold elections at all?³²⁶ The real answer is that no threat can possibly justify interfering with the shareholder franchise. Managers may claim, and the courts may agree, that the company is delaying an election for the benefit of the shareholders out of concern that shareholders will make a poor, uninformed decision.³²⁷ But this has the process backwards. The vote exists so that shareholders can remove managers who make poor, uninformed decisions.

The vote is the only effective tool shareholders have to discipline management. The supreme court should reject this invalid balancing test and return to the original *Blasius* "compelling justification" test. The difficulty with the balancing test, as was seen in the *Unocal/Time/Unitrin* decisions, is that the courts are seldom prepared to tell management that its decisions are unreasonable.³²⁸ In an area as vital to corporate law as the shareholder franchise, the courts need to apply a test that puts a heavy burden on management to prove that it has a compelling justification for its actions.

³²⁶ See, e.g., *Time*, 571 A.2d at 1153 (stating that "[o]ne concern was that Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce").

³²⁷ See, e.g., *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 494-95 (Del. Ch.) (stating that a bylaw amendment delaying an election was justified in the face of a joint proxy contest/tender offer), *aff'd*, 670 A.2d 1338 (Del. 1995). But see *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988) (declaring that the fact that "the board knows better than do the shareholders what is in the corporation's best interest [is] irrelevant . . . when the question is who should comprise the board of directors").

³²⁸ See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994) (stating that "courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness").

*Paramount Communications, Inc. v. QVC Network, Inc.*³²⁹ presented one such justification for delaying a shareholder vote. In that case, the supreme court held that when there is to be a sale of control, the directors have a duty to get the "best value reasonably available to the stockholders."³³⁰ In a situation where the opponent in a proxy contest is currently a significant shareholder of the firm, the directors should be allowed temporarily to delay an election if they believe that they can find the shareholders a better deal right away. The reason for this exception to the general rule is that once the significant shareholder takes control of the board, she will become a controlling shareholder and will be allowed to retain any control premium on the sale of the firm.³³¹ In a number of cases decided before *Paramount*, the courts seem to be applying this "controlling shareholder" logic. In *Stahl I*, the chancery court declared that management could delay an election that had been scheduled but not called.³³² Although the court technically based its holding on the formality of setting an election date, the decision may be seen as allowing management time to find an "attractive alternate" transaction when there was a strong possibility that a majority shareholder would be assuming control of the firm.³³³ In *Blasius*, the court was faced with a similar situation, but the acquirors were not large enough to be controlling shareholders. In rejecting the attempt to impede the election, the court stated that "[t]he board was not faced with a coercive action taken by a powerful shareholder It was presented with a consent solicitation by a 9% shareholder."³³⁴ The advantage of this analysis is that it gives very clear rules about when management should be allowed to delay or otherwise purposely interfere with an election. Without these clear rules, the law in this

³²⁹ *Id.*

³³⁰ *Id.* at 43.

³³¹ See *Mendel v. Carroll*, 651 A.2d 297, 305 (Del. Ch. 1994) (stating that "[t]he law has acknowledged, albeit in a guarded and complex way, the legitimacy of the acceptance by controlling shareholders of a control premium"); see also F. H. O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS ch. 4 (2d ed. 1995) (discussing the sale of control case law).

³³² See *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1123 (Del. Ch. 1990) (*Stahl I*) (asserting that fixing the date of an annual meeting is "an act of some dignity and significance").

³³³ See *Stahl v. Apple Bancorp, Inc.*, No. CIV.A.11510, 1990 WL 114222 (Del. Ch. Aug. 9, 1990) (*Stahl II*) (finding that Stahl, as a 30% shareholder, would likely win a proxy contest). Even though *Stahl II* was a separate decision, the underlying fact pattern was the same in both cases.

³³⁴ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 662-63 (Del. Ch. 1988).

area becomes muddled, as was seen in the *Kidsco*³³⁵ case. The *Unocal/Unitrin* analysis is a business judgment test, where the court will determine if management's response to a threat was a "proportionate" one and "on balance, within a range of reasonableness."³³⁶ Because the shareholder vote, whether joined with a tender offer or not, cannot be a threat, there can be no managerial response which can be proportionate or reasonable. Only when it is apparent that control of the firm will shift from the shareholders to the proxy opponent will management have the right to interfere temporarily with the vote if it reasonably believes that it can find the shareholders a better immediate price through a different transaction.

2. Nonpurposeful Interference—An Outcome Orientation

To a shareholder who cannot conduct an effective proxy contest because of a firm's poison pill ownership limitation, it does not matter whether the impediment to the vote is the "primary purpose" of the defensive measure. The shareholder is concerned with the effect of the measure, not its purpose. The Delaware courts believe otherwise. In cases such as *Moran*,³³⁷ *Moore*,³³⁸ *Shamrock*,³³⁹ *Stahl II*³⁴⁰ and *Unitrin*,³⁴¹ the courts refused to find that defensive measures were an invalid limitation on the shareholder franchise because the impediment to the vote was not the "primary purpose" of the transaction. In other cases, the courts found the impediments invalid, but only because they determined that obstruction of the proxy constituted the "primary purpose" of the measure.³⁴² The

³³⁵ *Kidsco Inc. v. Dinsmore*, 674 A.2d 483 (Del. Ch.), *aff'd*, 670 A.2d 1338 (Del. 1995).

³³⁶ *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).

³³⁷ See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1355 (Del. 1985) (finding that the effect of a 20% ownership ceiling on proxy contests is "minimal").

³³⁸ See *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1563 (D. Del. 1995) ("[R]etention of the pill will have no effect on the success of the proxy contest.").

³³⁹ See *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 286 (Del. Ch. 1989) ("The effect of the Management Transactions . . . does not provide strong evidence of a primary purpose to interfere with the election.").

³⁴⁰ See *Stahl v. Apple Bancorp, Inc.*, No. CIV.A.11510, 1990 WL 114222, at *6 (Del. Ch. Aug. 9, 1990) (*Stahl II*) (stating that "the restrictions imposed by the stock rights plan on a proxy contest were immaterial").

³⁴¹ See *Unitrin*, 651 A.2d at 1383 ("The key variable in a proxy contest would be the merit of American General's issues, not the size of its stockholdings." (citing *Moran*, 500 A.2d at 1355)).

³⁴² See, e.g., *WNH Invs. v. Batzel*, No. CIV.A.13931, 1995 WL 262248, at *6 (Del. Ch. Apr. 28, 1995) ("The circumstances compel the conclusion that the purpose of the

Stahl II court went so far as to state that “board action taken in good faith and advisedly may be valid even though it affects in some respects the exercise of the franchise.”³⁴³

The shareholder franchise is so vital to the proper functioning of the corporate structure that even unintended interference with the vote should be prohibited. The courts need to scrutinize carefully all board actions that create impediments to shareholder voting and determine the extent of the interference. They should use all available data to identify potential harm. For example, even though the Delaware courts claim that the effect of a poison pill on a proxy contest “will be minimal,”³⁴⁴ recent studies have found otherwise.³⁴⁵ Under an effects test analysis, courts will have to take the studies into account in their decisions.

This Comment suggests that courts should not only examine the *purpose* of a defensive measure, but also its *effect*. As proxy contests become more frequent, boards increasingly will implement structural impediments to the proxy, while arguing that the effect on the vote is “secondary.” An effects test will save a court from having to inquire into the specific motivation of each corporate defensive decision, which makes the test very practical. Because of the growing threat to incumbency posed by proxy contests, a court can safely assume that when a defensive measure impedes the shareholder franchise, the results were not entirely unintended.

dilutive issuance was to defeat the challenge to the board’s control.”); *Williams v. Geier*, No. CIV.A.8456, 1994 WL 514871, at *3 (Del. Ch. Sept. 9, 1994) (“[T]he fact that a plan has an entrenchment effect does not mean that it was so motivated.”), *aff’d*, 671 A.2d 1368 (Del. 1996); *Commonwealth Assoc. v. Providence Health Care, Inc.*, No. CIV.A.13135, 1993 WL 432779, at *8 (Del. Ch. Oct. 22, 1993) (finding that “the effect that stock placement had on the consent solicitation was not collateral or secondary but was the main, principal, indeed probably the sole reason” for the deal in question); *Glazer v. Zapata Corp.*, 658 A.2d 176, 186 (Del. Ch. 1993) (“These cases stand for the proposition that directors may not act to frustrate the efforts of stockholders to elect new directors by engaging in transactions that are designed and pursued for the primary purpose of diluting the votes held by the insurgent stockholders.”); *Packer v. Yampol*, No. CIV.A.8432, 1986 WL 4748, at *16 (Del. Ch. Apr. 18, 1986) (“An inequitable purpose can be inferred where the directors’ conduct has the effect of being unnecessary under the circumstances, of thwarting shareholder opposition, and of perpetuating management in office.” (citing *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906, 912 (Del. Ch. 1980))).

³⁴³ *Stahl II*, 1990 WL 114222, at *6.

³⁴⁴ *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1355 (Del. 1985).

³⁴⁵ See, e.g., *Thomas & Martin*, *supra* note 16, at 336 (finding that “limits on dissident stock ownership negatively affect the likelihood of dissident success in a proxy contest”).

There are a number of precedents for this type of analysis. In *Hubbard v. Hollywood Park Realty Enterprises, Inc.*, an otherwise legitimate advance notice bylaw was found to have been inequitably applied because "the policy underlying the shareholders' fundamental right to exercise their franchise significantly outweighs the policies favoring the continued enforcement of the by-law."³⁴⁶ Likewise, the legitimate policy behind allowing companies to enact poison pills and other defenses must be subordinated to the overriding importance of protecting the shareholder franchise.³⁴⁷

Interference with the vote is not a Boolean function. There are many degrees of obstruction and levels of impediments. The courts' decisions need to reflect this reality. In order to identify when an otherwise legitimate defensive measure presents an impediment to the shareholder franchise that requires a judicial remedy, a court should analyze and weigh several factors.

First, a court should identify the relative strengths of the protagonists. A weak insurgent battling for control of a company whose board controls 35% of the stock is especially susceptible to harm from an ownership limit or a further transfer of stock into friendly

³⁴⁶ No. CIV.A.11779, 1991 WL 3151, at *13 (Del. Ch. Jan. 14, 1991). The extenuating circumstance in this case was that the board had made a last-minute decision to change their policy. Had the plaintiffs known about this change in advance, they would have run a competing slate at the annual meeting. They did not find out about the change, though, until after the advance notice deadline had expired. See *id.* at *4.

³⁴⁷ It is important to recognize that this analysis should not apply to transactions that are not defensive, but have a valid business justification:

[A]cts taken in the ordinary course of the company's business, or indeed extraordinary transactions, may have collateral effects upon a forthcoming vote. Any such effect, however, does not constitute an equitable wrong; directors [sic] duty of loyalty to shareholders does not require them to stop managing the enterprise in good faith while a proxy contest or consent solicitation goes forward.

Commonwealth Assoc. v. Providence Health Care, Inc., No. CIV.A.13931, 1993 WL 432779, at *8 (Del. Ch. Oct. 22, 1993); see also *Glazer v. Zapata Corp.*, 658 A.2d 176, 184 (Del. Ch. 1993) (stating that an incumbent-perpetuating effect "does not itself provide a ground to invalidate board action; rather it is the purpose that motivates the board to take action having that effect that is critical"). In *Glazer*, the court also stated that the principle in *Blasius* and *Schnell* does not

require that management refrain from issuing voting securities, and thereby diluting [sic] the voting strength of insurgent stockholders, during the pendency of a proxy contest, when the issuance legitimately has a primary purpose directed to the management of the corporation and its business. Thus, like most equity cases, resolution of issues of this sort are typically highly particularized; factual.

Id. at 186.

hands. On the other hand, when the board and other insiders own a small percentage of the stock, and the challenger is a 30% shareholder, defensive measures that limit ownership probably will not have a harmful effect on the shareholder's chances.³⁴⁸ The court should apply the same analysis to the effects of other types of structural impediments, such as supermajority voting provisions, advance notice requirements and defensive recapitalizations.

Another factor a court should consider in weighing the effect of a defensive measure on a proxy fight is the nature of a firm's stock ownership. When a company has a large institutional ownership, it is less likely that a defensive employee-stock-option plan or a poison pill with a low trigger will substantially harm the insurgent's chances.³⁴⁹ Likewise, when a firm's stock is held by speculators and arbitrageurs, the proxy contestant need not concern herself with shareholder apathy.³⁵⁰ In a firm with rationally apathetic shareholders with relatively small holdings, however, a lower level of interference may be enough to damage seriously a shareholder's chances for victory.

Another factor a court should consider is whether the firm has put up other roadblocks to a successful proxy contest. A company that does not allow consents, special elections or cumulative voting, but has a classified board, should not be given the ability to enact further defensive measures that interfere with an election.

The final factor is whether there has been any statistical analysis of whether the defensive measure in question affects proxy fights. A number of studies have been done involving poison pill limitations on shareholder ownership.³⁵¹ One study found that, while a 20%

³⁴⁸ See *Stahl v. Apple Bancorp, Inc.*, No. CIV.A.11510, 1990 WL 114222, at *8 (Del. Ch. Aug. 9, 1990) (*Stahl II*) (arguing that when the opponent is a 30% shareholder, an ownership limitation and association restriction would have no effect on the outcome of the contest).

³⁴⁹ See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1382 (Del. 1995) ("[Institutions] are more likely than other shareholders to vote at all, more likely to vote against manager proposals, and more likely to vote for proposals by other shareholders." (quoting Black, *supra* note 224, at 925)); see also *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1207 (Del. Ch. 1987) (declaring that corporate management cannot further delay the annual meeting with the excuse that stockholders needed to review information because it is "obvious that the stock is now heavily owned by sophisticated institutional investors and arbitrageurs who are likely to be well-informed about what is happening in this on-going proxy contest").

³⁵⁰ Cf. *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 286 (Del. Ch. 1989) (noting that "at least 22% of Polaroid's outstanding stock is held by arbitrageurs and other 'short term' investors").

³⁵¹ See generally Paul H. Malatesta & Ralph A. Walkling, *Poison Pill Securities:*

ownership ceiling will not have a strong negative impact on the shareholder's chances, a 10% trigger will be harmful.³⁵²

If, after the court has performed this "level of interference" test, it determines that the franchise is impeded, it must find a remedy. When the interference is significant enough, the court should require the company to drop its defenses. In other cases the court may be reluctant to force a firm to open itself up to potential hostile tender offers. A better solution would be to tailor the remedy specifically to improve a challenger's ability to win a proxy contest. For example, when a company's defenses have the effect of impeding a proxy contest, the court could order the company to reimburse its opponent's proxy expenses.³⁵³ This would encourage proxy contests against the firm that would otherwise be too expensive to undertake and would also discourage firms from interfering with the vote since to do so would be costly.

In the case of a poison pill defense, the court should require the company to adjust its trigger level if that level is set so low that it begins to interfere with the electoral process. Likewise, defensive funding of an employee stock option plan could be limited to prevent the firm from significantly hindering a proxy fight.

This type of analysis requires a more active judicial response than the courts are currently willing to perform. The courts claim that they will not "substitute their business judgment for that of the directors."³⁵⁴ It is important to understand, however, that defensive measures that interfere with the shareholder franchise do not constitute transactions where a court should respect the managers' business judgment. Rather, the importance of the shareholder franchise demands that courts consider these transactions as being self-interested, because restrictions on shareholder voting eliminate the oversight which restrains managerial behavior.

Stockholder Wealth, Profitability, and Ownership Structure, 20 J. FIN. ECON. 347 (1988) (showing a reduction in stockholder wealth); Pound, *supra* note 27, at 237 (concluding that the proxy system is burdened with an inefficient incentive structure which benefits management); Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988) (finding a detrimental effect on shareholder wealth); Thomas & Martin, *supra* note 16 (concluding that rights plans can benefit dissidents or management).

³⁵² See Thomas & Martin, *supra* note 16, at 336-37.

³⁵³ Cf. Bebchuk & Kahan, *supra* note 29, at 1113-22 (discussing the merits of partial reimbursement of challengers in a proxy contest).

³⁵⁴ *Unitrin*, 651 A.2d at 1386 (citing *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994)).

CONCLUSION

The shareholder franchise is becoming an increasingly important tool for monitoring management and enhancing corporate efficiency. Institutional investors are beginning to confront underperforming companies and to demand that management be more responsive to shareholder concerns. Corporate government, not surprisingly, is resisting this trend by erecting barriers to the election process. The courts understand the importance of shareholder voting but are reluctant to declare that these management tactics are inequitable. Part of this reluctance stems from the fact that the courts recently confronted a similar issue when management defended itself against the hostile tender offer. There, the courts spent years trying to set a limit on managerial behavior, but ultimately gave up, deferring to the board's judgment in the vast majority of cases. The courts appear to be moving in this direction with the shareholder franchise cases, declaring that impediments to the franchise must be balanced, reasonable and proportionate. This judicial deference to managerial interference with the shareholder franchise is unwarranted and unwise.

Eliminating the tender offer was harmful to shareholders, but allowing management to interfere with the proxy would be devastating. Shareholder voting is the basis of the corporate form, and it represents the crux of corporate efficiency. A manager who can interfere with an election becomes her own boss, free from oversight and external control. It is not surprising that management is attempting to combat the growing shareholder power. It is surprising, however, that the courts have not responded to the threat these measures pose to the corporation. Although management argues that it needs to consider the interests of "other constituencies," its true goal is more likely to entrench itself. Thus, we see cases where management delays elections, packs boards, places shares in friendly hands, and enacts advance notice provisions, all to preserve its power over the corporation.

This Comment has argued that the courts must prevent these intrusions, whether purposeful or not. Courts must carefully examine any corporate defensive measure which impedes the shareholder franchise, and they should remedy even a limited interference with the vote. The courts must ensure that managers remain accountable to the shareholders.

As the use of the proxy increases and shareholders begin to exercise their power, management will undoubtedly expand its

current defenses and enact new and more powerful ones. The same arguments from the hostile takeover era will be heard again—shareholders are uninformed, management needs to run the corporation for the long run, and other constituencies must be protected. This time the courts have to draw the line and demand that the vote be absolutely protected. Unlike the tender offer, the shareholder franchise goes to the fundamental question of corporation law—the allocation of power between principal and agent. A determination that managers may set up defenses which “unintentionally” impede shareholder voting will lead only to more advanced and sophisticated “unintentional” impediments. The time to draw the line is now, before the promise of shareholder monitoring is thwarted, and the corporation becomes the private fiefdom of an entrenched elite.