OVERTURN *TIME-WARNER* THREE DIFFERENT WAYS

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ABSTRACT

The Paramount Communications, Inc. v. Time Inc. (Time-Warner) *decision and its reasoning exemplify a modern trend in corporate governance affording boards of directors unilateral power to transform a corporation. This article proposes three statutory limits on the current permissive model of corporate governance. The first proposal is a statutory standard of fiduciary duty specifying that a director's duty in deciding whether or not to oppose a purchase of corporate control is to act reasonably and in good faith to maximize the company's value and its investors' returns. The second proposal would allow stockholders to set the terms by which they can sell their shares, by allowing bylaws to restrict a poison pill's use or duration. The third proposal would require majority stockholder consent to any corporation transforming action initiated by a board of directors, such as Time's acquisition of Warner. These three proposals would each check the unilateral power boards currently enjoy in transforming a corporation or blocking a purchase of corporate control.*

I. INTRODUCTION

Shortly after the 1967 revision of the Delaware General Corporation Law (DGCL), Ernest L. Folk, III published the following observation, which suggests a cultural link between corporate law revisers and hippies: "Almost without exception, the key movement in corporation law revisions is towards ever greater permissiveness. . . . [S]tatutory revisers in the most recent period have usually sought to enlarge the ambit of freedom of corporate management to take whatever action it may wish."[1] This "key movement . . . towards ever greater permissiveness," Folk observed, was not limited to statutory revisions.[2] Then-recent cases, such as *Cheff v. Mathes*,[3] "seemingly throw[] the protective mantle of the 'business judgment' doctrine around a transaction savoring of

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[1]Ernest L. Folk, III, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. B.J. 409, 410 (1968).

[2]*Id.*

[3]199 A.2d 548 (Del. 1964).

Electronic copy available at: http://ssrn.com/abstract=1310405

conflict of interest."[4] Folk wondered whether state corporation statutes would become "insignificant, even contemptible, things"[5] and what new legal structures would arise to preserve "the principle of management responsibility."[6]

A generation later, Delaware jurists kept moving "towards ever greater permissiveness."[7] Boards of directors were authorized to take unprecedented steps to prevent the purchase of corporate control, such as adopting a poison pill that made the purchase economically impractical or entering into transactions that discriminated against the potential acquirer. The leading case of *Paramount Communications, Inc. v. Time Inc.* (*Time-Warner*)[8] punctuated the trend by tacitly endorsing the professed desire of the directors and senior managers of Time Incorporated (Time) to preserve the "Time Culture,"[9] and by permitting Time to recast the proposed merger of a Time subsidiary with Warner Communications Inc. (Warner) as an acquisition. This foreclosed Time's stockholders from voting down the Time-Warner transaction and selling their shares to Paramount Communications Inc. (Paramount). *Time-Warner* remains good law, but it is mocked by the continuing economic stagnation and cultural impoverishment of the corporation that bears its name.[10] In this article, three statutory revisions are advocated which would overturn *Time-Warner* and reverse the "key movement . . . towards ever greater permissiveness."[11]

First, the scope of director discretion should be narrowed to focus on shareholder interests. This article proposes a statutory standard of fiduciary duty specifying that a director's duty in deciding whether or not to oppose a purchase of corporate control is to act reasonably and in good faith to maximize the company's value and the return to its investors. *Time-Warner* rejected judicial inquiry into the relative value of Time's proposed combination with Warner and the price offered by Paramount. Time's board was allowed to consider other threats, as well as "Time's objectives," "Time's needs," "the preservation of "Time's 'culture,'" and the "impact on constituencies other than

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[4]Folk, *supra* note 1, at 431.

[5]*Id.* at 432.

[6]*Id.* at 434.

[7]*Id.* at 410.

[8]571 A.2d 1140 (Del. 1990).

[9]*Id.* at 1143 n.4.

[10]*See generally* Joel Edan Friedlander, *Corporation and* Kulturkampf*: Time Culture as Illegal Fiction*, 29 CONN. L. REV. 31 (1996).

[11]Folk, *supra* note 1, at 410.

Electronic copy available at: http://ssrn.com/abstract=1310405

shareholders."[12] These open-ended concepts allow a board to disregard or slight the best interests of shareholders.

A board of directors' opposition to a purchase of corporate control presents a circumstance where the potential loss of shareholder value is greatest and a conflict of interest may contribute to a loss of value. The judicial standard of review should allow a court to discern whether a board is acting unreasonably or if impermissible motivations are at work, such as a hubristic desire for empire building or corporate continuity, or a venal interest in increased compensation. Yet, as a consequence of *Time-Warner*, a sharp distinction exists in Delaware law between the heightened scrutiny applied when directors decide to sell the corporation and the deferential review applied to a decision to acquire another corporation or remain independent. Requiring directors to justify the latter decisions with reference to a statutory standard of maximizing firm value would better assure that this goal is realized.

Second, stockholders should be empowered to set the terms by which they may sell their shares. This can be done by amending section 109(b) to clarify that stockholders may adopt bylaws that restrict the duration or use of a board-adopted poison pill.[13] *Time-Warner* pointedly criticized prior Delaware Court of Chancery decisions that forbade boards of directors from foreclosing shareholder choice by maintaining a poison pill in the face of a structurally noncoercive tender offer. Clarifying language to section 109(b) would overturn the recent decision of *CA, Inc. v. AFSCME Employees Pension Plan*,[14] which narrowly interprets the permissible scope of a stockholder-adopted bylaw under the current statutory framework.

Third, majority stockholder consent should be required before a board undertakes a corporation-transforming acquisition such as Time's acquisition of Warner. American corporation law prior to the statutory revisions of the late nineteenth century required unanimous stockholder consent to fundamentally change the corporation. Prior to the 1967 revision of the DGCL, various restrictions made it difficult for an acquisition to proceed by way of a merger without overwhelming stockholder support.[15] Today's permissive statutes still require majority stockholder consent in various transactions, allowing Chancellor Chandler to declare: "The Delaware General Corporation

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[12] *Time-Warner*, 571 A.2d at 1152-54 (internal quotations omitted).

[13] Section 109(b) states: "The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." DEL. CODE ANN. tit. 8, § 109(b) (2001).

[14] 953 A.2d 227 (Del. 2008).

[15] ERNEST L. FOLK, III, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 318 (1972).

Law gives shareholders an immutable right to vote on fundamental corporate changes."[16] Yet the DGCL does not give shareholders an immutable right to vote on *all* fundamental corporate changes, such as major acquisitions.

Chancellor Allen's opinion in *Time-Warner* turned, in part, on the fact that the original Time-Warner merger did not require a vote by Time stockholders under Delaware law.[17] The ability to avoid a stockholder vote for a transaction as transformative as Time's acquisition of Warner suggests that the statutory stockholder vote requirements are incoherent and do not serve the salutary purpose of checking unilateral director power. Therefore, this article proposes the creation of a statutory analogue in the acquisition context to the requirement of majority stockholder consent to the sale of "all or substantially all" of a corporation's assets. Stockholders should have the power to vote down a major acquisition, just as they now may veto a major divestiture. Instead of allowing boards of directors to reenact the permissiveness of the Summer of Love, our statutory revisers should rediscover the maxim of the medieval canonists who founded corporation law: "What concerns everyone ought to be considered and approved by everyone."[18]

II. HOLD DIRECTORS IN A CONTEST FOR CONTROL TO A FIDUCIARY STANDARD DIRECTED TOWARD WEALTH MAXIMIZATION

Time-Warner should be overruled by statute because its rhetoric and reasoning subverts, rather than subserves, loyalty to shareholders in the high-stakes context of a board of directors confronted with an unsolicited offer to purchase control of a corporation.

In a recent essay devoted to the "non-legal social forces that affect director behavior," former Chancellor Allen writes of the importance of "judicial exhortation" to try to influence the "group based norms" of corporate directors about what constitutes conduct consistent with the fiduciary duty of

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[16]UniSuper Ltd. v. News Corp., No. 1699-N, 2005 Del. Ch. LEXIS 205, at *25 n.48 (Del. Ch. Dec. 20, 2005), *reprinted in* 31 DEL. J. CORP. L. 1186, 1196 n.48 (2006) (citing DEL. CODE ANN. tit. 8, § 242 (2001) (charter amendment); *id.* § 251 (merger); *id.* § 271 (sale of assets); *id.* § 275 (dissolution)).

[17]Paramount Commc'ns, Inc. v. Time Inc., Nos. 10,866, 10,670, 10,935, 1989 Del. Ch. LEXIS 77, at *76-77 (Del. Ch. July 14, 1989) (revised July 17, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 743 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990).

[18]Friedlander, *supra* note 10, at 110 (citing HAROLD J. BERMAN, LAW & REVOLUTION: THE FORMATION OF THE WESTERN LEGAL TRADITION 221, 608 n.54 (1983), and the Roman legal maxim *Quod omnes tangit omnibus tractari et approbari debet* [What concerns everyone ought to be considered and approved by everyone]).

loyalty.[19] A decade ago, Professor Rock similarly contended that Delaware judicial decisions "can be understood as providing a set of parables—instructive tales—of good managers and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players."[20] Professor Rock interpreted *Time-Warner* "as yet another example of a case in which the courts approve directorial conduct because they are convinced that the directors behaved in *good faith* and with *due care*."[21]

This interpretation of *Time-Warner* may be correct, but neither the opinion of the Delaware Court of Chancery nor the Delaware Supreme Court persuades the reader that Time's directors acted in good faith and with due care in a reasonable effort to maximize the economic interests of shareholders. To the contrary, each opinion tacitly endorses what Chancellor Allen described as the Time board's "transcendant aim . . . to maintain an independent Time Incorporated that reflected a continuation of what management and the board regarded as [a] distinctive and important 'Time Culture.'"[22] Neither opinion applies a legal rule that measures that professed aim using an economic yardstick. Nor does either opinion scrutinize the factual contention that Time would preserve its corporate culture by combining with a corporation in a different industry on terms that would result in an equally divided board and co-CEOs.

Chancellor Allen acknowledged the possibility that "the law might recognize as valid a perceived threat to a 'corporate culture' that is shown to be palpable (for lack of a better word), distinctive and advantageous."[23] He then proceeded to decide the case by relying on the presumption, legal fiction, and/or investment banker opinion that rejecting a premium offer by Paramount in favor of an acquisition of Warner by Time was a good faith effort "to manage the corporation for long-term profit."[24] In a later speech, Chancellor Allen suggested that deference to protecting the "Time Culture" was the unspoken rationale for the outcome. He acknowledged "that the short-term/long-term distinction was really of little analytical or rhetorical use in

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[19] William T. Allen, *Modern Corporate Governance and the Erosion of the Business Judgment Rule in Delaware Corporate Law* 3, 13-14 (4 Comp. Res. in Law & Pol. Econ. Research Paper No. 6, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1105591.

[20] Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997).

[21] *Id.* at 1086. More specifically, according to Rock, "[F]ully informed directors acted deliberately pursuant to a well-thought-out long-term plan." *Id.* at 1081.

[22] *Paramount*, 1989 Del. Ch. LEXIS 77, at *13, *reprinted in* 15 DEL. J. CORP. L. at 711.

[23] *Id.* at *14, *reprinted in* 15 DEL. J. CORP. L. at 711-12.

[24] *Id.* at *86, *reprinted in* 15 DEL. J. CORP. L. at 748.

resolving the takeover issues,"[25] given the immense size of the foregone premiums, and suggested "that anyone trying to understand how our law deals with corporations must have in mind that they are the locus of many conflicting claims, and not all of those claims are wholly economic."[26]

The opinion by the Delaware Supreme Court also fits that description. The opinion makes clear that Time rejected Paramount's offers in part because they "pose[d] a threat to Time's survival and its 'culture.'"[27] The court did not hold Time's board to a standard requiring service to shareholder interests. Directors have no duty to maximize shareholder value in the short term "absent a limited set of circumstances as defined under *Revlon*[*, Inc. v. MacAndrews & Forbes Holdings, Inc.*]."[28] Otherwise, they need only "set a corporate course of action, including [a] time frame, designed to enhance corporate profitability,"[29] and they "are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."[30]

Upon determining that *Revlon* was inapplicable, the court turned to the legal rubric of *Unocal Corp. v. Mesa Petroleum Co.*,[31] which the *Time-Warner* court described as mandating an "open-ended analysis" and not "a simple mathematical exercise: that is, of comparing the discounted value of Time-Warner's expected trading price at some future date with Paramount's offer and determining which is the higher."[32] *Unocal* itself allowed a board to consider a multiplicity of factors, including "the impact on 'constituencies' other than shareholders."[33] The *Time-Warner* court added that "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."[34]

The court found that Time's board reasonably determined that the Paramount offer posed "other threats" besides inadequate value.[35] Those

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[25]William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 274-75 (1992).

[26]*Id.* at 280.

[27]Paramount Commc'ns, Inc. v. Time Inc. (*Time-Warner*), 571 A.2d 1140, 1149 (Del. 1990).

[28]*Id.* at 1150 (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985)).

[29]*Id.*

[30]*Id.* at 1154.

[31]493 A.2d 946 (Del. 1985).

[32]*Time-Warner*, 571 A.2d at 1153.

[33]*Id.* (quoting *Unocal*, 493 A.2d at 955).

[34]*Id.*

[35]*Id.*

"other threats" were not clarified or enumerated. The court mentioned the possibility of stockholder ignorance or confusion, as well as the board's determination that the Paramount offer "did not serve Time's objectives or meet Time's needs."[36] Two pages earlier, the court had referred "to the zealousness of Time's executives, fully supported by their directors, in seeing to the preservation to Time's 'culture,' i.e., its perceived editorial integrity in journalism."[37]

The court ruled that the reformulation of the Time-Warner combination as a cash acquisition "was reasonably related to the threat."[38] The operative threat was not directed to stockholder interests and the means of redress were not targeted to stockholder concerns. The board had not cured potential shareholder confusion by allowing for a more fully informed vote. Nor had the board remedied the threat of inadequate value by obtaining a higher-value transaction. Instead, the board canceled the vote and deterred a premium offer. The operative threat was to the corporate combination preferred by the board, and the court endorsed the "goal . . . [of] carrying forward . . . a pre-existing transaction in an altered form."[39]

This summary of *Time-Warner* is meant to show that the law affords directors tremendous latitude to oppose a premium offer for control, without purporting to test whether boards use that discretion in a manner designed to maximize shareholder wealth. As the Delaware Supreme Court stated in the subsequent leading decision of *Unitrin, Inc. v. American General Corp.*,[40] "When a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion . . . [and] the law affords boards of directors substantial latitude in defending the perimeter of the corporate bastion against perceived threats."[41]

This article proposes the adoption of a statutory standard that focuses judicial review of defensive actions on whether they serve shareholder interests, as opposed to the corporation's purported needs, objectives, identity, culture, independence, survival, or the interests of other constituencies of the corporate entity. Such a statutory amendment would be fitting considering an intervening shift in public rhetoric concerning corporation governance. As former Chancellor Allen observed in a recent essay, the rise of shareholder

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[36] *Time-Warner*, 571 A.2d at 1154.
[37] *Id.* at 1152.
[38] *Id.* at 1155.
[39] *Id.*
[40] 651 A.2d 1361 (Del. 1995).
[41] *Id.* at 1388 & n.38.

advocacy has caused the public rhetoric of CEOs to make shareholder welfare the metric of success:

> No longer does one find directors or CEOs publicly defending the view—as they once thought right to do—that shareholders are just one of several corporate constituencies—all of which are to be treated fairly by senior management. Now directors and senior officers as well, appear to believe that shareholder welfare is the metric of success, even if the board has discretion about how and over what period to do that.[42]

New public rhetoric by CEOs does not necessarily translate into a commitment to negotiate merger proposals that deliver the highest reasonably attainable value to stockholders. That is why legal rules to that effect are desirable, and why it is problematic that the rhetoric of contemporary CEOs and their public relations staffs are more focused on loyalty to the economic interests of shareholders than are the exhortations in our leading judicial opinions establishing the legal rules in a control contest.

III. ENABLE THE ADOPTION OF AN ANTI-POISON PILL BYLAW

One reason why the *Time-Warner* decision is historically significant is because of a critical line of dicta respecting poison pills. The Delaware Supreme Court expressed disapproval of prior Delaware Court of Chancery decisions requiring the redemption of poison pills in the face of all-cash, all-shares tender offers "as not in keeping with a proper *Unocal* analysis."[43] That dicta has been sufficient to vitiate any claim over the past nineteen years that a board of directors must redeem a poison pill.

Several years after *Time-Warner*, the question arose whether stockholders could adopt bylaws restricting the duration or use of a poison pill. Commentators addressed the question but the Delaware courts never had the occasion to entertain this restriction. A comprehensive law review article written in 1998 by Professor Hamermesh observed, "[N]either the courts, the

[42] Allen, *supra* note 19, at 15.

[43] *Time-Warner*, 571 A.2d at 1153. Chancellor Allen had sought to preserve the vitality of those precedents. His *Time-Warner* decision dropped a footnote stating, "[A] decision not to redeem a poison pill, which by definition is a control mechanism and not a device with independent business purposes, may present distinctive considerations than those presented in this case." Paramount Commc'ns, Inc. v. Time Inc., Nos. 10,866, 10,670, 10,935, 1989 Del. Ch. LEXIS 77, at *88 n.22 (Del. Ch. July 14, 1989) (revised July 17, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 749 n.22 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990).

legislators, the SEC, nor legal scholars have clearly articulated the means of resolving this conflict and determining whether a stockholder-adopted by-law provision that constrains director managerial authority is legally effective."[44]

For a decade that question remained unanswered. When confronted with a proposed bylaw that sought to prevent a board, by less than unanimous vote, from maintaining a poison pill of indefinite duration, the Delaware Court of Chancery decided that the question of its validity was unripe, and commented that the proposed bylaw was not "obviously invalid."[45] In the absence of adjudication, shareholder advocates relied on political pressure to limit poison pills by pressing for precatory shareholder resolutions urging boards of directors to eliminate poison pills,[46] or by negotiation with companies to urge the adoption of a proposed bylaw amendment.[47]

That legal landscape changed in August 2008, when the Delaware Supreme Court handed down *CA, Inc. v. AFSCME Employees Pension Plan*,[48] which answered two certified questions propounded by the United States Securities and Exchange Commission respecting a proposed stockholder bylaw. The court ruled that a bylaw mandating the reimbursement of proxy expenses in a partially successful proxy contest would, if adopted, violate section 141(a) of the DGCL.[49] The court reasoned that the bylaw "contains no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all."[50] Any bylaw that purported to restrict the use or duration of a poison pill would fail under that same test, since the purpose of such a bylaw is to prevent a board of directors from availing itself of a poison pill in certain circumstances when the board might otherwise contend that its fiduciary duties required that a poison pill be kept in place.

This legal landscape points to the need for a legislative solution clarifying the permissible scope of a stockholder-adopted bylaw. Such an enabling statute would allow a majority of stockholders, on a company-by-

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[44]Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 416 (1998) (footnote omitted), *quoted in* Gen. Datacomm Indus., Inc. v. Wis. Inv. Bd., 731 A.2d 818, 821 n.2 (Del. Ch. 1999).

[45]Bebchuk v. CA, Inc., 902 A.2d 737, 742 (Del. Ch. 2006).

[46]*See* Guhan Subramanian, *The Emerging Problem of Embedded Defenses: Lessons from* Air Line Pilots Ass'n, International v. UAL Corp., 120 HARV. L. REV. 1239, 1243 (2007).

[47]Posting of Lucian Bebchuk to The Harvard Law School Corporate Governance Blog, http://blogs.law.harvard.edu/corpgov/2008/04/ (Apr. 3, 2008, 12:50 EST).

[48]953 A.2d 227 (Del. 2008).

[49]*Id.* at 239-40.

[50]*Id.* at 240.

company basis, to opt into a legal regime resembling that which existed prior to *Time-Warner*. Depending on the words of such a statute and the words of such a bylaw, boards of directors would no longer have the unilateral legal power to place a poison pill in effect indefinitely. A corporate governance marketplace could emerge in which stockholder majorities are empowered to consider and determine the appropriate parameters for board discretion to block stockholder acceptance of noncoercive, nonfraudulent tender offers. Stockholder majorities should be reserved with the power to set parameters on board discretion to interfere with the purchase and sale of their stock.

IV. REQUIRE STOCKHOLDER CONSENT FOR ALL TRANSFORMATIVE TRANSACTIONS

One of Time's outside directors initially opposed the merger of Time and Warner on the ground that Time's move into the entertainment business "was absolutely counter to everything that . . . [Time founder Henry Luce] had conceived"[51] and that shareholder consent should have been sought for a transaction that so altered Time's direction.[52] That sentiment is hardly alien to corporation law and the DGCL should be revised to better reflect this sentiment.

The notion that fundamental corporate transactions require the consent of the corporation's members dates back to the medieval canonists who developed a systematic body of corporate law to resolve disputes concerning the Church of Rome, its component bishoprics and abbeys, and their members. Certain major transactions pertaining to the common utility of the corporate body required the consent of the clergy, either by unanimous or majority vote, or by vote of the sounder part.[53] As noted above, the canonists elaborated the following constitutional principle: "What concerns everyone ought to be considered and approved by everyone."[54]

At common law, unanimous stockholder consent was needed to change the business of the corporation, to merge, or to alienate all of a corporation's

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[51]Friedlander, *supra* note 10, at 65 (citations omitted).

[52]*Id.* at 107.

[53]BERMAN, *supra* note 18, at 221, 608 n.54. The voting concept of the "sounder and greater part" [*sanior et maior pars*] was an intellectual device "to create apparent unanimity where it did not exist," by more heavily weighting the vote of select voters while also requiring majority support. Iain McLean & Haidee Lorrey, Voting in the Medieval Papacy and Religious Orders 13-15 (2006) (unpublished manuscript), *available at* http://www.nuffield.ox.ac.uk/politics/papers/ 2006/mclean 02.pdf. This approach created conflicts in papal elections that ultimately led to the adoption in 1179 of a two-thirds supermajority rule. *Id.*

[54]BERMAN, *supra* note 18, at 221.

property. In discussing the innovations worked by general incorporation statutes in the late nineteenth century, Berle and Means observed that:

> the most drastic step, (though it does not so appear at first sight), is the grant of power to a majority to authorize the sale or lease of the entire property of the corporation without unanimous vote, thereby handing over the enterprise to a different management altogether beyond the control of the former participants in it.[55]

Today, a sale of control by merger or sale of substantially all assets still requires majority stockholder consent. A major acquisition, however, even if effected through a merger, can be implemented by a board of directors unilaterally, without unanimous, supermajority, or even majority stockholder consent.

Current statutes concerning the voting powers of stockholders respecting mergers date back to the 1967 DGCL. Immediately prior to 1967, the stockholders of each participating corporation in a merger had to approve the transaction, and they had to do so by a two-thirds vote.[56] A package of statutory revisions in 1967 and shortly thereafter eviscerated the concept that the stockholders of an acquiring corporation can veto a merger. Formal requirements remain in the DGCL respecting the need for stockholder consent of the acquirer in a merger, but they easily can be evaded.

Professor Folk noted that Delaware's statutory revisers received letters and comments recommending "a statutory provision which would excuse a stockholder vote in the case of a corporation making 'small' acquisitions by the merger route."[57] In what Folk described as a "major innovation in American corporate law,"[58] section 251(f) of the DGCL was amended to eliminate voting rights and appraisal rights of stockholders of the acquiring corporation in a merger in certain circumstances.[59]

One of these essential circumstances is that the acquiring corporation in the merger must not issue common stock (or securities convertible into common stock) exceeding twenty percent of the shares of common stock outstanding immediately prior to the effective date of the merger.[60] The theory

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[55] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 130-31 (rev. ed. 1968).

[56] FOLK, *supra* note 15, at 318.

[57] *Id.* at 330 n.34.

[58] *Id.* at 318.

[59] *Id.* at 318-19.

[60] FOLK, *supra* note 15, at 319. The threshold was originally set at fifteen percent in 1967 and then increased to twenty percent in 1970. *Id.* at 320.

behind this condition was that "a merger which involves less than [twenty] percent of the survivor's shares is not such a major change as to require a stockholder vote or appraisal rights."[61] Such a small acquisition by way of a merger was viewed as "an enlargement of the business which could be achieved by other means without triggering stockholder rights," i.e., an asset acquisition using cash or stock.[62] This twenty percent threshold is still found in section 251(f)(3) of the DGCL.[63]

As a practical matter, the DGCL does not require the affirmative vote of an acquiring corporation's stockholders to approve an acquisition of virtually any size. An acquiror can avoid a stockholder vote for a large acquisition by forming a wholly owned subsidiary that merges into the target. In that situation, the parent corporation (and not the parent corporation's stockholders) authorizes the merger. Such three-party or triangular mergers were facilitated by amendments to section 251(b)(4) of the DGCL in 1967, 1968, and 1969 that progressively expanded the permissible forms of merger consideration.[64]

Prior to 1967, section 251(b) required that the currency for a merger be the stock or other securities of the surviving corporation.[65] The amendments in 1967 and shortly thereafter allowed for payment in "cash" or the "securities of corporations other than the surviving or resulting entity," such as the shares of the parent corporation of a wholly owned acquisition subsidiary.[66] Parent corporation's stockholders have no say under Delaware law in this use of the parent corporation's stock.

Another critical statutory amendment limiting the voting power of stockholders in a merger came in 1969, when section 251 of the DGCL was revised to lower the stockholder vote requirement for mergers from "two-thirds of the total number of the outstanding shares of the capital stock of each such corporation . . . to 'a majority of the outstanding stock of the corporation entitled to vote thereon.'"[67] The purposes behind the 1969 amendments were twofold: "to ease the burden of effecting a merger . . . [and] to achieve further parity between the necessary vote on merger, sale of assets, dissolution and certain other actions requiring stockholder approval."[68]

[61] *Id.* at 319.
[62] *Id.*
[63] DEL. CODE ANN. tit. 8, § 251(f)(3) (2001).
[64] FOLK, *supra* note 15, at 324.
[65] *Id.*
[66] *Id.* at 324, 326-27.
[67] *Id.* at 323.
[68] FOLK, *supra* note 15, at 323.

The cumulative effect of these amendments is stark. Prior to 1967, mergers were disfavored because they required the affirmative vote of two-thirds of the shares of the acquiring corporation, and stockholders of the acquiring corporation had "unlimited appraisal rights."[69] Effectively, the stockholders of the acquiring corporation had to overwhelmingly support the merger. In the aftermath of the 1967 amendments, and the technical amendments that followed, stockholders of acquiring corporations did not have any power to disapprove an acquisition consummated by a triangular merger under Delaware law. A separate 1967 amendment also reduced the import of an affirmative vote for a merger by the target company's stockholders by allowing a board to subsequently terminate the merger.[70] Thus, the lack of a stockholder vote requirement for an acquiring corporation under the DGCL can be summarized as follows: no acquiring company stockholder vote is required (and no appraisal rights exist for the acquirer's stockholders) for an acquisition in which (1) the number of shares outstanding of the acquiring corporation in a merger does not increase by more than twenty percent; (2) the acquisition is effected through a wholly owned acquisition subsidiary; or (3) the acquisition is effected by means other than a merger, such as an acquisition of assets or an acquisition of stock, such as by tender offer.

The DGCL, however, is not the only source of stockholder voting rights. When the DGCL was revised in 1967, New York Stock Exchange (NYSE) rules required, and still require, that stockholders vote on any transaction that entails the issuance of twenty percent or more of the corporation's common stock.[71] That twenty percent threshold is not subject to any exception for mergers effected by a wholly owned subsidiary.[72] Therefore, majority stockholder consent of the acquiring corporation is still required for major mergers in which the acquiring corporation's stock is a significant portion of the merger consideration.

The twenty percent exclusion in section 251(f)(3) matches the twenty percent threshold under section 312.03(c) of the NYSE Listed Company Manual.[73] Those matching provisions can be interpreted as reflecting a policy judgment that acquisitions entailing the issuance of more than twenty percent of a corporation's stock are of sufficient significance that a stockholder vote is required. Alternatively, the revisions to the DGCL can be seen as an effort to

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[69] *Id.* at 318.

[70] Section 251 was amended in 1967 to add subsection 251(d), which permits a board of directors to abandon a merger that had already been approved by stockholders. *Id.* at 324.

[71] *Id.* at 320; MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 176 (1995); NYSE, Inc., Listed Company Manual § 312.03(c) (2007).

[72] NYSE, Inc., Listed Company Manual § 312.03(c) (2007).

[73] *Id.* *See also* DEL. CODE ANN. tit. 8, § 251(f)(3) (2001).

facilitate those mergers for which the NYSE does not require a stockholder vote.

The current statutory regime lends itself to divergent interpretations of the import of the stockholders' power to approve or disapprove major transactions. Chancellor Chandler describes the voting power of stockholders in vigorous terms: "The Delaware General Corporation Law gives shareholders an immutable right to vote on fundamental corporate changes."[74] Professor Bainbridge, who advocates the director primacy model of corporate law, disparages these same stockholder voting rights, advising that "shareholder control rights in fact are so weak that they scarcely qualify as part of corporate governance."[75] Professors Black and Kraakman observe that "[e]very corporation statute in the United States (and every company law statute in the world that we know of) reserves a small number of basic corporate decisions for shareholder ratification . . . [and those statutes] belie the assumption that the law should always presume that the board knows best."[76]

The relative weakness of shareholder control rights is evident in the acquisition context. The fact that the DGCL does not require a stockholder vote for any transactions requiring the issuance of less than twenty percent of a corporation's stock, or require a stockholder vote for all means of effecting a major acquisition, means that boards of directors have tremendous latitude to structure transactions to evade a stockholder vote.

Time's board took notable advantage of this legal regime. The original transaction approved by Time's board was a merger between a Time wholly owned subsidiary and Warner, in which Warner common stock was to be converted into Time common stock.[77] Section 251 of the DGCL required a vote by Warner stockholders, since Warner shares were being converted in the transaction.[78] The DGCL did not require a vote by the Time stockholders since Time itself authorized a merger of its wholly owned subsidiary.[79] The NYSE did, however, require a vote by the stockholders of Time, due to the

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[74]UniSuper Ltd. v. News Corp., No. 1699-N, 2005 Del. Ch. LEXIS 205, at *25 n.48 (Del. Ch. Dec. 20, 2005), *reprinted in* 31 DEL. J. CORP. L. 1186, 1196 n.48 (2006).

[75]Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 616 (2006); Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 779 n.48 (2006); Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 801 n.60 (2002).

[76]Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 559 (2002).

[77]Paramount Commc'ns, Inc. v. Time Inc., Nos. 10,866, 10,670, 10,935, 1989 Del. Ch. LEXIS 77, at *27 (Del. Ch. July 14, 1989) (revised July 17, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 718 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990).

[78]*Id.*

[79]*Id.* at *26-27, *reprinted in* 15 DEL. J. CORP. L. at 718.

magnitude of the contemplated issuance of Time shares.[80] In the face of a cash tender offer by Paramount, Time's board recast the proposed transaction as an acquisition of Warner by means of a tender offer followed by a merger.[81] Several billion dollars of new debt were required to finance the all cash acquisition of Warner at a much higher premium than was originally envisioned.[82] Chancellor Allen determined, preliminarily, that Time's board "sought to avoid the risk that the [Time-Warner] merger would not get an affirmative vote."[83]

The Time shareholder-plaintiffs sought to enjoin the Time-Warner acquisition and contended that one basis for an injunction was that the recasting of the transaction to avoid a shareholder vote that Time management seemed destined to lose, constituted an inequitable manipulation of the corporate machinery.[84] Chancellor Allen rejected this claim, reasoning that unlike the stockholders' right to elect directors at issue in *Blasius Indus., Inc. v. Atlas Corp.*,[85] "Delaware law created no right in these circumstances to vote upon the original Warner merger."[86] The Chancellor added in a footnote: "Recall that it was only NYSE rules that prompted the proposed submission of that transaction to the Time annual meeting."[87] Chancellor Allen concluded that the decision to recast the merger as a leveraged cash acquisition "entailed [no] intrusion upon the effective exercise of a right possessed by the shareholders, either under our statutes or under the corporation's charter . . . [and] can therefore not be seen as implicating the policy of protection of the corporate franchise, which our law has studiously sought to protect."[88]

Both the Delaware Court of Chancery and the Delaware Supreme Court held that the decision by the Time board to enter into the original merger agreement was protected by the business judgment rule, and that the board's decision to recast the acquisition as a leveraged tender offer satisfied the enhanced scrutiny of *Unocal Corp. v. Mesa Petroleum Co.*,[89] as a reasonable step to effectuate the goals of the original merger agreement.[90] The Delaware

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[80] *Id.* at *27, *reprinted in* 15 DEL. J. CORP. L. at 718.

[81] *Paramount*, 1989 Del. Ch. LEXIS 77, at *34, *reprinted in* 15 DEL. J. CORP. L. at 722.

[82] *Id.* at *42-46, *reprinted in* 15 DEL. J. CORP. L. at 726-28.

[83] *Id.* at *43, *reprinted in* 15 DEL. J. CORP. L. at 726.

[84] *Id.* at *73-74, *reprinted in* 15 DEL. J. CORP. L. at 742.

[85] 564 A.2d 651 (Del. Ch. 1988).

[86] *Paramount*, 1989 Del. Ch. LEXIS 77, at *76, *reprinted in* 15 DEL. J. CORP. L. at 743.

[87] *Id.* at *77 n.18, *reprinted in* 15 DEL. J. CORP. L. at 743 n.18.

[88] *Id.* at *78, *reprinted in* 15 DEL. J. CORP. L. at 744.

[89] 493 A.2d 946 (Del. 1985).

[90] Paramount Commc'ns, Inc. v. Time Inc. (*Time-Warner*), 571 A.2d 1140, 1152-55 (Del. 1990); *Paramount*, 1989 Del. Ch. LEXIS 77, at *85-90, *reprinted in* 15 DEL. J. CORP. L. at 748-49.

judiciary cannot be expected to craft fiduciary duty principles that would afford stockholders the right to enjoin major acquisitions that they have no power to veto.

There has been little academic debate in recent decades about the appropriate scope of stockholder power to veto or ratify major transactions. In a 1984 law review article, Professor Coffee proposed the adoption of a rule (either a state or federal statute, or a stock exchange rule) requiring a tender offer bidder to obtain approval of its tender offer from the bidder's own shareholders.[91] Professor Dent raised certain practical objections to the proposal, but noted that it "might ameliorate the current state of affairs."[92]

In 1989, Professor Black wrote:

> Approval of transactions over a certain size by the bidder's shareholders, suggested by Coffee, is worth exploring, at least for transactions that would not be delayed by such a rule because they already require the target's shareholders to vote. Shareholder approval may have a prophylactic effect, and the British use such a system now for mergers.[93]

More recently, Professors Black and Kraakman advocated a corporate governance regime requiring stockholder approval for major transactions, stating, "For other similarly fundamental transactions that are now outside the voting requirements under Delaware law, we would encourage the courts or the legislature to extend shareholder voting rights."[94]

Professor Coffee's proposal was animated by economics literature contending that "managements seek to maximize growth even when it is contrary to the shareholders' best interests," a phenomenon commonly known

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[91]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, 1269-72 (1984).

[92]George W. Dent, Jr., *Unprofitable Mergers: Toward a Market-Based Legal Response*, 80 NW. U. L. REV. 777, 794 (1986).

[93]Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 652 (1989) (footnote omitted). Professor Black was presumably referring to Listing Rule 10 of the United Kingdom Financial Services Authority, which requires approval of bidder shareholders where the target represents more than twenty-five percent of the assets, profits, revenue, market capitalization, or gross capitalization of the bidder. Financial Services Authority Handbook, Listing Rule 10.2.2 (2008) (U.K.), *available at* http://fsahandbook.info/FSA/html/handbook/LR/10/2; Financial Services Authority Handbook, Listing Rule 10.5.1(2) (2008) (U.K.), *available at* http://fsahand book.info/ FSA/ html/handbook/LR/10/5; Paul Davies, Shareholder Value, Company Law and Securities Markets Law: A British View 29 n.78 (Oct. 2000) (unpublished manuscript), *available at* http:// papers.ssrn.com/sol3/papers.cfm?abstract_id=250324.

[94]Black & Kraakman, *supra* note 76, at 561.

as empire building.[95] The various suggested reasons for managers' pursuit of empire building include: (1) to obtain additional executive compensation and perquisites by an increase in firm size; (2) to obtain increased immunity from a hostile takeover; and (3) to provide more opportunities for internal employee advancement and continued employment for acquisition specialists.[96]

Professor Coffee's bidder-ratification proposal was meant to "discourage empire building," while preserving the disciplinary function of hostile takeovers.[97] He thought that requiring stockholder approval by the bidder would discourage inefficient empire building and prevent overpayment by bidders.[98] Writing before the advent of the poison pill, he also thought that any delay associated with the operating of a bidder-ratification rule "should help foster an improved auction market" by affording a target time to structure a counterproposal.[99]

Professor Black's 1989 article focused on what he called his "Overpayment Hypothesis," explaining why buyers repeatedly pay significant premiums for targets in the absence of clear evidence that takeovers improve target performance.[100] Professor Black hypothesized that gains to target shareholders derive in part from systemic overpayment by buyers.[101] Repeated overpayment can occur because managers who make takeover bids tend to be (1) habitually optimistic and overestimate a target's value and overestimate their own ability to run another business; (2) ignorant of bidding theory and the problem of the "winner's curse" (i.e., the winning bidder on an asset of unknown value that is common to all bidders is the bidder that overestimates the asset's value); or (3) overly incentivized to achieve growth, diversification, and success in a takeover contest.[102] Professsor Black concludes that "the Overpayment Hypothesis is consistent with most of the evidence on takeovers in the late 1970s and 1980s,"[103] including the stock price reactions of publicly held bidders.[104]

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[95]Coffee, *supra* note 91, at 1157 & n.24, 1167-69 (analyzing the empire building hypothesis of corporate takeovers).

[96]*Id.* at 1224.

[97]*Id.* at 1269.

[98]*Id.* at 1269-72.

[99]Coffee, *supra* note 91, at 1271-72.

[100]Black, *supra* note 93, at 598-99.

[101]*Id.* at 599.

[102]*Id.* at 623-28.

[103]*Id.* at 634.

[104]Black, *supra* note 93, at 602. The theoretical arguments and economic studies supporting increased protections for bidder shareholders were assembled more recently in Miriam P. Hechler, *Towards a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319, 346-72. Hechler argues that "some sort of voting mechanism might

Time's acquisition of Warner presents a case study of bidder tendencies and incentives potentially inconsistent with value maximization. By combining with Warner, Time expanded radically into industries known for glamour and high compensation. Time was acquiring a movie studio and entering into the music business, as part of a strategic process in which Time's directors thought it critical that Time management dominate the CEO succession and that Time be perceived as the acquiror.[105] Time's most senior managers stood to "receive new contracts at substantial increases" in this deal.[106] The enhanced prestige associated with the proposed merger was such that Time and Warner inaugurated the ceremony by announcing their merger agreement via a letter addressed to the President of the United States.[107] Once Paramount made its unsolicited cash tender offer, a new set of managerial incentives arose, including defeating the "threat to Time's survival and its 'culture.'"[108]

The mechanism of a vote by Time stockholders would not have posed a difficult logistical hurdle. It did not occur, however, because the DGCL did not require it and because the common concern of Time stockholders that they be afforded the opportunity to sell their shares to Paramount was trumped by deference to the more complex considerations deliberated by Time's board about the merits of an acquisition of Warner. Chancellor Allen concluded his opinion in *Time-Warner* stating "[t]hat many, presumably most, shareholders would prefer the board to do otherwise than it has done does not, in the circumstances of a challenge to this type of transaction, in my opinion, afford a basis to interfere with the effectuation of the board's business judgment."[109]

Requiring shareholder approval for these types of transformative transactions would overturn the judicial deference engendered by the 1967 amendments. In their 2002 article, Professors Black and Kraakman "propose a return to the bilateral decision-making that has long been traditional in the

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serve as a useful tool for preventing particularly destructive acquisitions . . . [and] might allow shareholders of target firms to prevent managers from derailing a potentially lucrative takeover by defensively acquiring other companies." *Id.* at 382. *But see* Ryan Houseal, Note, *Beyond the Business Judgment Rule: Protecting Bidder Firm Shareholders from Value-Reducing Acquisitions*, 37 U. MICH. J.L. REFORM 193, 246 (2003) (arguing that "a bidder firm forced to seek the approval of its shareholders in this manner may actually deter acquisitions that create efficiency and maximize shareholder wealth").

[105]Paramount Commc'ns, Inc. v. Time Inc. (*Time-Warner*), 571 A.2d 1140, 1144-45 (Del. 1990).

[106]Paramount Commc'ns, Inc. v. Time Inc., Nos. 10,866, 10,670, 10,935, 1989 Del. Ch. LEXIS 77, at *51 (Del. Ch. July 14, 1989) (revised July 17, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 730 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990).

[107]*See* Friedlander, *supra* note 10, at 70.

[108]*Time-Warner*, 571 A.2d at 1149.

[109]*Paramount*, 1989 Del. Ch. LEXIS 77, at *89-90, *reprinted in* 15 DEL. J. CORP. L. at 750.

corporate law of Delaware and other jurisdictions."[110] A stockholder vote requirement for significant acquisitions is an elegant solution to the problem of conflicting incentives and potentially imprudent tendencies that are bound up with board approval of transformative transactions, but not amenable to a judicial finding of disloyalty or gross negligence. The millennium of law that preceded 1967, and a generation of experience thereafter, provides a sound basis for revitalizing stockholder voting powers.

V. CONCLUSION

Delaware statutory and decisional law grants boards of directors unilateral power to transform a corporation and block an attempted purchase of corporate control without having to demonstrate that such an exercise of power is in the best interest of shareholders. The statutory proposals outlined in this article impose three checks on the outer bounds of that permissive model of corporate governance.

[110] Black & Kraakman, *supra* note 76, at 560.