Delaware and the Transformation of Corporate Governance

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Brian R. Cheffins
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The corporate governance arrangements of publicly traded companies have been transformed over the past four decades. Various observers have suggested that Delaware, where more than half of U.S. public companies are incorporated, has done much to influence corporate governance changes. This Article considers the nature and extent of Delaware's contribution to the development of corporate governance, indicating in so doing that this contribution was substantial but not decisive. Delaware had only a marginal impact on changes affecting key corporate governance topics such as executive pay and shareholder activism. On the other hand, with boards a series of well-known Delaware court decisions in the mid-1980s fortified the status of independent directors and provided incentives for boards to be attentive. Also, Delaware court rulings helped to bring to an end the hectic takeover activity of the 1980s, which in turn likely prompted a shift in emphasis away from the market for corporate control in favor of "internal" corporate governance mechanisms.

Keywords: Delaware, corporate governance, boards of directors, takeovers, executive pay, shareholder activism

JEL Classifications: G34, G38, K22, N22

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Abstract

The corporate governance arrangements of publicly traded companies have been transformed over the past four decades. Various observers have suggested that Delaware, where more than half of U.S. public companies are incorporated, has done much to influence corporate governance changes. This Article considers the nature and extent of Delaware's contribution to the development of corporate governance, indicating in so doing that this contribution was substantial but not decisive. Delaware had only a marginal impact on changes affecting key corporate governance topics such as executive pay and shareholder activism. On the other hand, with boards a series of well-known Delaware court decisions in the mid-1980s fortified the status of independent directors and provided incentives for boards to be attentive. Also, Delaware court rulings helped to bring to an end the hectic takeover activity of the 1980s, which in turn likely prompted a shift in emphasis away from the market for corporate control in favor of "internal" corporate governance mechanisms.

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I. INTRODUCTION

With the Francis G. Pileggi Lecture there is something of a tradition of marking anniversaries of significant Delaware cases. Ronald Gilson began the trend in 1999 with "Unocal Fifteen Years Later (And What We Can Do About It)".[1] Stephen Bainbridge's 2005 Pileggi lecture was "Unocal at 20: Director Primacy in Corporate Takeovers".[2] Hillary Sale, who focused on *In re Caremark International Inc. Derivative Litigation*[3] in her 2006 lecture, noted that it had been a decade since Chancellor Allen had authored the decision.[4]

At the time I gave the Pileggi lecture upon which this article is based (October 2014) it had been 15 years since Professor Gilson's Unocal lecture. It has now have been 30 years since *Unocal Corp. v. Mesa Petroleum Co.*[5] and a series of other landmark judgments handed down the same year that were the focal point of the most remarkable period of judicial activity that has ever occurred with U.S. corporate law.[6] It has also been 40 years since the launch of the *Delaware Journal of Corporate Law*.[7] Correspondingly, it would seem to be a propitious moment to use the Pileggi lecture to mark the anniversary of a significant Delaware case.

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1 Ronald Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001).

2 Stephen Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769 (2006).

3 In re Caremark International Inc. Derivative Litigation 698 A. 2d 959 (Del. Ch.).

4 Hillary Sale, *Monitoring* Caremark's *Good Faith*, *In re Caremark International Inc. Derivative Litigation* 32 DEL. J. CORP. L. 719, 720 (2007).

5 493 A.2d 946 (Del. 1985).

6 Charles M. Elson and Robert B. Thompson, Van Gorkom's *Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. UNIV. L. REV. 579, 579 (2002) (making the claim with regard to the 20th century but there was no equivalent period beforehand nor has there been one since 2002). On the other landmark 1985 cases, see *infra* notes 216, 240, 321-22 and related discussion.

7 http://www.djcl.org/ (accessed Oct. 20, 2014).

This Article will indeed look backwards. The focus, however, will not be on a particular notable case. Instead, the scope will be broader. The corporate governance arrangements of publicly traded companies have been transformed over the past four decades, illustrated by the fact that the term "corporate governance" was largely unknown beforehand.[8] What will be considered in this Article is the nature and extent of Delaware's contribution to the development of corporate governance, with particular reference to judgments of the Delaware courts.

Various observers have suggested that Delaware has had a major impact on corporate governance. Martin Lipton and Paul Rowe, in a 2002 reply to Professor Gilson's Pileggi lecture, suggested that "unprecedented takeover activity of the early 1980s required Delaware to devise a new model of corporate governance."[9] In a 2004 article Hillary Sale observed "For many years people have regarded Delaware as the place where corporate governance practices emanated."[10] A *Wall Street Journal* report the same year said of the Delaware Court of Chancery, "Decisions from the Delaware court have had great influence on corporate governance…."[11] Norman Veasey, former Chief Justice of the Delaware Supreme Court, concurred in 2005, saying that "Delaware judges have had a substantial role in shaping

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8 Brian R. Cheffins, *The History of Corporate Governance* in THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE 46, 47 (Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev, eds., 2013). A 1962 book has been identified as offering the first extended discussion of corporate governance: LAURA F. SPIRA & JUDY SLINN, THE CADBURY COMMITTEE: A HISTORY xx (2012), citing RICHARD EELLS, THE GOVERNMENT OF CORPORATIONS (1962).

9 Martin Lipton and Paul K. Rowe, *Pills Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 3 (2002).

10 Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 457 (2004).

11 Kara Scanell, *Judge Decides Some Directors Are More Liable*, WALL ST. J., Oct. 12, 2004, C1.

best practices in corporate governance."[12] Steven Ramirez asserted in 2007 that "Historically, corporate governance in the U.S. has been left to the states, and Delaware has appropriated the role of providing corporate governance standards for about half of all American publicly held companies."[13]

Delaware obviously has not had the field to itself. The federal Securities and Exchange Commission (SEC) first brought corporate governance on to the official reform agenda in the mid-1970s.[14] The Sarbanes-Oxley Act of 2002 (SOX),[15] which Congress enacted in response to high-profile corporate scandals involving companies such as WorldCom and Enron, contained numerous provisions relevant to corporate governance.[16] The Dodd-Frank Act of 2010, despite focusing primarily on the regulation of banks, contained a sub-title entitled "Strengthening Corporate Governance" applicable to all issuers falling under the SEC's jurisdiction.[17] Private actors such as the Business Roundtable and the American Law Institute weighed in as debates concerning corporate governance began in earnest in the late 1970s and the 1980s.[18] Institutional shareholders also lobbied for corporate governance changes, urging companies in the late 1980s to dismantle anti-takeover devices

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12 E. Norman Veasey and Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1404 (2005).

13 Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. REG. 313, 320 (2007).

14 Cheffins, *supra* note 8, 47.

15 Pub.L. 107-204, 116 Stat. 745.

16 For a succinct summary, see Alton B. Harris and Andrea S. Kramer, *Corporate Governance: Pre-Enron, Post-Enron* in CORPORATE AFTERSHOCK: THE PUBLIC POLICY LESSONS FROM THE COLLAPSE OF ENRON AND OTHER MAJOR CORPORATIONS 49, 72-74 (Christopher L. Culp and William A. Niskanen eds., 2003).

17 Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (hereinafter Dodd-Frank Act), Pub. L. 111-203, Title IX, Sub-title G., encompassing §§ 971-72.

18 Cheffins, *supra* note 8, 49-52.

and pressing companies thereafter to enhance the monitoring capabilities of boards and increase usage of equity-based executive compensation.[19]

For various reasons, the timing is opportune to reflect upon Delaware's contribution to the development of corporate governance. First, assuming that there is not another batch of Enron/WorldCom-style corporate governance scandals brewing and that a fresh financial crisis is not imminent, the governance arrangements of U.S. public companies are unlikely to change substantially over the next few years. Second, those seeking to understand corporate governance will benefit from awareness of the forces that supported the evolution of governance practices. There is within the extensive discourse on corporate governance a tendency to focus exclusively on the present,[20] which can obscure key features of importance governance mechanisms. Third, debates continue to the present day about the implications of various legal rules relevant to the historical development of corporate governance, such as § 203 of the Delaware General Corporation Law (DGCL).[21] This antitakeover provision, the constitutionality of which is widely debated today,[22] may have helped to reconfigure corporate governance by contributing to the end of a 1980s takeover wave.[23] Fourth and finally, while Delaware has been referred to in historically-oriented literature on U.S.

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[19] Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P500*, 65 BUS. LAW. 1, 9 (2009).

[20] James D. Cox, *How Delaware Law Can Support Better Corporate Governance* in PERSPECTIVES ON CORPORATE GOVERNANCE 335, 335 (F. Scott Kieff and Troy A. Paredes eds., 2010).

[21] Del. Code Ann., tit. 8.

[22] See, for example, Guhan Subramanian, Steven Herscovici and Brian Barbetta, *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988-2008*, 65 BUS. LAW. 685, 686 (2010); A. Gilchrist Sparks and Helen Bowers, *After Twenty-Two Years, Section 203 of the Delaware General Corporation Law Continues to Give Hostile Bidders a Meaningful Opportunity for Success*, 65 BUS. LAW. 761 (2010); Guhan Subramanian, *Delaware's Choice*, 39 DEL. J. CORP. L. 1 (2014).

[23] See *infra* Part V.C.

corporate governance,[24] there has yet to be a systematic appraisal of Delaware's contribution to the corporate governance transformation which U.S. public companies have experienced over the past 40 years. This Article endeavours to provide that.

The assessment offered here indicates that any analysis of the historical development of corporate governance would be seriously incomplete without taking Delaware into account. Still, Delaware has not been a consistently dominant player. Delaware's impact has instead varied from substantial to marginal, depending on the corporate governance topic involved. Moreover, in the areas where Delaware has been influential its contribution has generally been to reinforce trends already present rather than move matters in a radically different direction. This is hardly surprising, given that Delaware courts have done much more to influence corporate governance than the Delaware legislature and given that courts have, as compared to legislative bodies, restricted scope to overhaul the law applicable to particular activities.

Parts II and III of the Article set the scene for the ensuing assessment of Delaware's contribution to the transformation of U.S. corporate governance. Part II describes how the corporate governance model that currently prevails in U.S. public companies differs from that in place prior to corporate governance coming on to the agenda and in so doing introduces the corporate governance topics the article focuses on, namely the board of directors, takeovers, shareholder activism and executive compensation. Part III discusses the key Delaware corporate law players – the legislature and the courts – and identifies institutional features that might be expected to influence the impact each has had on U.S. corporate governance.

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[24] See, for example, Cheffins, *supra* note 19, 7-8; Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STANFORD L. REV. 1465, 1481, 1485, 1489, 1523-27 (2007).

Parts IV to VII of the Article examine Delaware's contribution to the transformation of corporate governance in particular contexts. Part IV focuses on the board. Key points made here are that rulings by Delaware courts reinforced a trend that moved independent directors to the corporate governance forefront and provided incentives for boards to be attentive and to put in place suitable internal reporting and compliance mechanisms. Part V discusses takeovers, noting that rulings by the Delaware courts likely helped to curtail freewheeling takeover tactics popularized in the the 1980s and in so doing may have helped to foster a shift in emphasis away from an external mechanism potentially bolstering managerial accountability (the market for corporate control) in favor of "internal" corporate governance mechanisms. Parts VI and VII analyze shareholder activism and executive pay respectively and show that in these areas of corporate governance Delaware's influence was less pronounced than was the case with boards or takeovers. Part VIII concludes.

II. THE TRANSFORMATION OF CORPORATE GOVERNANCE

A. The Received Legal Model and a Changing Corporate Landscape

Corporate governance may have been transformed over the past four decades but this occurred without a major change to the formal allocation of power and responsibility within corporations. Melvin Eisenberg's well-known 1976 book *The Structure of the Corporation* illustrates the point.[25] He sought in his book "to develop new and more highly articulated models of corporate structure."[26] As a departure point he described the "well known" outlines of "the received legal model of the corporation", saying

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25 MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976). On the book's prominence, see David A. Skeel, *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1519 (2004); William Bratton and Michael Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 145 (2008).

26 EISENBERG, *supra* note 25, 6.

> "Under this model, the board of directors manages the corporation's business and makes policy; the officers act as agents of the board and execute its decisions; and the shareholders elect the board…."[27]

While Eisenberg stressed that "the received legal model" did not accurately describe at the time how corporations functioned in practice,[28] the model remains intact. For instance, provisions in the 1967 Delaware General Corporation Law that vest the board with the authority to manage the company, provide for the appointment of corporate officers and give shareholders the power to elect directors have not been altered materially in the decades since.[29]

William Bratton and Michael Wachter remarked in 2008 upon the continuity of "the received legal model" while at the same time saying that since Eisenberg wrote in 1976 "the corporate landscape changed dramatically."[30] They summarized the changes as follows:

> "Hostile takeovers came and went, bringing to the fore new conflicts between the management and shareholder interest. Institutional shareholders emerged as active governance players, disrupting power relationships….(M)anagement incentives became a primary structural concern while internal controls became a primary legal concern. Through all of this, the board's makeup, processes, and performance loomed larger than ever."[31]

The changes were accompanied by a new nomenclature. Eisenberg's *The Structure of the Corporation* dealt extensively with core corporate governance topics such as the composition

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27 *Id.*, 1.

28 *Id.*, 3-5.

29 Del. Code Ann., tit. 8, §§ 141(a), 142(a), (b), 211(b).

30 Bratton and Wachter, *supra* note 25, 145.

31 *Id.*

and structure of the board of directors, shareholder voting rights and the significance of institutional investors such as pension funds and mutual funds as shareholders.[32] Nevertheless, reflecting the fact that "corporate governance" was only just emerging as part of the corporate lexicon in the mid-1970s,[33] Eisenberg did not deploy the term even once in his book.[34] Linguistic habits would soon change substantially. By the end of the 1990s "corporate governance" had become the term of art most typically used to characterize analysis of boards, executive pay and shareholder involvement in publicly traded companies.[35]

Bratton and Wachter's summary of the transformation of the corporate landscape in the decades following the 1976 publication of *The Structure of the Corporation* is correct as far as it goes. Their assessment of what changed nevertheless is too succinct to provide a suitable basis for evaluating Delaware's contribution to the transformation of corporate governance in U.S. public companies. Correspondingly, the remainder of this Part provides a more detailed historical overview, with boards being the first topic.

B. Boards

Changes to the composition of boards designed to foster directorial monitoring of executives accompanied corporate governance's emergence as a prominent topic. The obvious role for boards to play from a governance perspective is to keep executives in check and individuals independent from management stand out as the most obvious candidates to

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[32] Indeed, a 1978 review of the book indicated "Eisenberg's criticisms and proposals are of central importance to an understanding of corporate governance": Donald E. Schwartz, *In Search of Corporate Soul*, 87 YALE L.J. 685, 687 (1978).

[33] Cheffins, *supra* note 8, 47-49.

[34] Search done using search feature of Google books: http://books.google.co.uk/books/about/The_Structure_of_the_Corporation.html?id=-Lpp_0heJVwC (accessed August 12, 2014).

[35] Brian R. Cheffins, *The Corporate Governance Movement, Banks and the Financial Crisis*, working paper available at http://ssrn.com/abstract=2365738, 6 (2014).

foster accountability.[36] Eisenberg suggested in *The Structure of the Corporation* that this sort of independence was not a strong point of public company boards, saying "The most striking of the compositional elements is the degree to which the typical board includes persons who are economically or psychologically dependent upon or tied to the corporation's executives, particularly its chief executive."[37] By the mid-1970s, however, enhancing the independence of directors was emerging as a core element of the fledgling corporate governance reform agenda.[38] A by-product was that the proportion of directors of public companies who were at least nominally "independent" increased from one-quarter in 1970 to three-quarters in 2005.[39]

The changes to the composition of the board were accompanied by structural alterations oriented around board committees. While only about one-fifth of large companies had an audit committee during the late 1960s such committees were ubiquitous by 1980 and were mandatory for all public companies by the early 2000s.[40] There was a similar, if somewhat belated, trend with nominating committees charged with responsibility to vet and select director candidates. The proportion of public companies with such a committee increased from one-fifth at the end of the 1970s to 95% by the early 1990s.[41] The pattern was similar with compensation committees vested with responsibility for setting executive pay.[42]

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36 BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 605 (1997).

37 EISENBERG, *supra* note 25, 144-45.

38 Kenneth B. Davis, *Structural Bias, Special Litigation Committees, and Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1306 (2005); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 449 (2008).

39 Gordon, *supra* note 24, 1474.

40 *Id.*, 1491-29; EISENBERG, *supra* note 25, 207 (data on 1960s).

41 Gordon, *supra* note 24, 1492, 1498; Roy J. Harris, *"Independent" Panels of Corporate Boards to Tap New Directors are Proliferating*, WALL STREET J., Feb. 15, 1979, 14 (indicating that the proportion of public companies with nominating committees increased form 19% in 1977 to 37% in 1978).

42 Gordon, *supra* note 24, 1492.

Changes concerning board composition and structure were accompanied by increased attentiveness by outsider directors. The boards of publicly traded companies of the late 1960s and early 1970s reputedly were largely passive management dominated "rubber stamps."[43] Myles Mace, in a widely cited 1971 study of boards of public companies, reported that only a few boards asked discerning questions, evaluated and measured the performance of top management in a meaningful way and would contemplate dismissing an underperforming CEO in the absence of a serious crisis.[44]

Matters seemingly changed substantially over the next two decades. Ira Millstein, a prominent advocate of corporate governance reform, contrasted in a 1993 interview the public company board of that era with its 1949 forerunner. He said the difference was "day and night", partly because "directors oversee management" rather than being "parsley on the fish."[45] A 1995 *New York Times* article with the headline "A Quiet Board Room Revolution: Power Shifts to Outside Directors"[46] implied the same sort of shift. Ronald Gilson said in the law review article based on his 1999 Pileggi lecture "Directors are now energized."[47] Jay Lorsch, a Harvard Business School professor and author of a 1989 book on boards entitled *Pawns and Potentates*,[48] suggested in 2001 that during the 1980s directors "were more like the pawns. Today they are more like the potentates."[49] Law professors Marcel Kahan and Ed

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43 Charles M. Elson and Christopher J. Gyves, In Re Caremark: *Good Intentions, Unintended Consequences*, 39 WAKE FOREST L. REV. 691, 693 (2004).

44 MYLES L. MACE, DIRECTORS: MYTH AND REALITY 206 (1971).

45 *Who's Watching the Watchers?*, ACROSS THE BOARD, Nov./Dec. 1993, 23. Irving Olds, chairman of the board of U.S. between 1940 and 1952 has been credited with initially characterizing directors as "parsley": ARTHUR FLEISCHER, GEOFFREY C. HAZARD AND MIRIAM Z. KLIPPER, BOARD GAMES: THE CHANGING SHAPE OF CORPORATE POWER 3 (1988).

46 Judith H. Dobrzynski, *A Quiet Board Room Revolution: Power Shifts to Outside Directors*, N.Y. TIMES, May 25, 1995, D1.

47 Gilson, *supra* note 1, 513.

48 JAY W. LORSCH, PAWNS AND POTENTATES (1990).

49 *The Professor: Jay Lorsch*, DIRECTORS & BOARDS, Fall 2001, 18, 18.

Rock argued the following year that the available evidence indicated outside directors "exert more power in the boardroom than they did previously" and "are not mere lackeys of management."[50] Boardroom failings occurring concurrently at Enron and WorldCom indicated independent boards did not guarantee proper governance,[51] but the lapses involved occurred in a context where expectations of boards had grown considerably.[52]

B. Takeovers

While the structure, composition and operation of boards began changing substantially in the 1970s, with another facet of corporate governance – the market for corporate control – the 1980s was pivotal. During the 1960s, when Henry Manne coined the term,[53] hostile takeovers taking the form of tender offers were used quite often to secure control of medium-sized public companies.[54] The market for corporate control, however, did not extend in practice to large firms.[55] This changed in the 1980s as bidders relied on aggressive, innovative financial and legal techniques to offer generous premiums to shareholders of a wide range of target companies to secure voting control.[56]

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50 Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 882, 883 (2002).

51 Rodrigues, *supra* note 38, 452. For a description of boardroom lapses at Enron and WorldCom, see Bernard Black, Brian Cheffins and Michael Klausner, *Outside Director Liability*, 58 STANFORD L. REV. 1055, 1120-22, 1126-28 (2006).

52 For a more skeptical assessment, see *Replacing the Board*, ECONOMIST, Aug. 16, 2014, 56 (arguing that the Enron and WorldCom scandals and alleged failings of bank boards prior to the 2008 financial crisis indicated that boards had changed little over the past hundred years).

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

54 Brian R. Cheffins, *Introduction,* THE HISTORY OF MODERN U.S. CORPORATE GOVERNANCE ix, xxii (Brian R. Cheffins, ed., 2011).

55 *Id.*

56 *Id.*

Takeover activity fell into abeyance as the 1990s got underway.[57] Merger activity surged later in the decade but the free-wheeling deal-making of the 1980s did not return. Corporations carrying out strategically motivated acquisitions drove the 1990s merger wave rather than "raiders" seeking out targets underperforming due to poor management.[58] Hostile takeovers did continue to occur and the success rate for those launched was much the same as in the 1980s.[59] Acquisitions of this type were, however, considerably less prevalent[60] and less controversial than had been the case in the 1980s.[61]

C. Shareholder Activism

Increased activism by shareholders has been an additional feature of the transformation of corporate governance occurring since the mid-1970s. A dramatic reorientation of stockholding in U.S. public companies set the scene. In the decades

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57 John Pound, *After Takeovers, Quiet Diplomacy*, WALL ST. J., June 8, 1992, A10.

58 Cheffins, *supra* note 8, 52; James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFFALO L. REV. 249, 265-72, 310 (2001).

59 John C. Coates, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?* 24 J. CORP. L. 837, 855 (1999) (providing annual data on hostile takeovers for 1988-98); ROBERT N. MCCAULEY ET AL, DODGING BULLETS: CHANGING U.S. CORPORATE CAPITAL STRUCTURE 71-72 (1999) (discussing success rates).

60 Bevis Longstreth, *Reflections on the State of Governance*, 57 BROOKLYN L. REV. 113, 114 (1991) (providing statistics on the proportion of bids that were hostile for 1982, 1989 and 1990); G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder*, 55 J. FIN. 2599, 2609, 2611 (2000) (setting out data on the number of hostile takeover bids, 1975-96); Omesh Kini, William Kracaw and Shehzad Mian, *The Nature of Discipline by Corporate Takeovers*, 59 J. FIN. 1511, 1515 (2004) (indicating that for a sample of successful tender offers occurring between 1979 and 1998, the percentage that was hostile was significantly higher in the 1980s than the 1990s); Gregg A. Jarrell, *A Trip Down Memory Lane: Reflections on Section 203 and Subramanian, Herscovici and Barbetta*, 65 BUS. LAW. 779, 785 (2010) (citing data from Thomson Financial SDC Platinum showing that both the number of hostile bids and the percentage of bids which were hostile were considerably lower between 1990 and 1993 than between 1986 and 1989); Michael Ryngaert and Ralph Schoten, *Have Changing Takeover Defense Rules and Strategies Entrenched Management and Damaged Shareholders? The Case of Defeated Takeover Bids*, 10 J. CORP. FIN. 19 (2010) (reporting that based on a sample of defeated takeover bids, the number of hostile bids was considerably higher per annum in the 1980s than it was in the 1990s).

61 Kahan and Rock, *supra* note 50, 899.

immediately following World War II the prospects for shareholder activism were bleak because retail investors lacking both the appetite and aptitude to intervene in corporate affairs collectively owned the vast majority of shares.[62] For instance, Bayless Manning, in a 1958 review of J.A. Livingston's *The American Stockholder,*[63] said Livingston's account of "a virtually omnipotent management and impotent shareholdership" would surprise few.[64]

The outlook for shareholder intervention became more promising when during the closing decades of the 20th century institutional shareholders steadily displaced retail investors as owners of shares in public companies.[65] With activism, however, progress would be halting.[66] While Eisenberg identified institutional investors in *The Structure of the Corporation* as providing at least some hope of a check on management, citing the growing proportion of shares they owned and "their power and sophistication," he conceded that their default setting was "promanagement".[67] While by the early 1990s public pension funds had emerged as vocal advocates of corporate governance reform,[68] the reluctance of other "mainstream" institutional investors – most prominently mutual funds and private pension funds – to take a "hands on" corporate governance role compromised shareholder activism's impact.[69] Over the past decade, though, support mainstream institutional shareholders have increasingly afforded to "activist" hedge funds specializing in buying up sizeable stakes in

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62 Cheffins, *supra* note 54, xix.

63 J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958).

64 Bayless Manning, *Book Review,* 67 YALE L.J. 1477, 1485 (1958).

65 For data see Cheffins, *supra* note 54, xix.

66 See, for example, Stuart Mieher, *Shareholder Activism, Despite Hoopla, Leaves Most CEOs Unscathed*, WALL ST. J., May 24, 1993, A1 ("To hear some people tell it, corporate chieftains are on the run….But in contrast to the 1980s takeover binge, which cut through hundreds of companies like a sharp scythe, shareholder activism seems more like a scalpel, and a dull one at that.')

67 EISENBERG, *supra* note 25, 53, 57, 61-62.

68 Cheffins, *supra* note 8, 54.

69 Cheffins, *supra* note 54, xx.

target companies and agitating for change has meant that the activist agenda has had an increasingly pronounced influence in the boardroom.[70]

D. Executive Pay

A major overhaul of executive pay is a final noteworthy legacy of the transformation of corporate governance occurring over the past 40 or so years. From the late 1930s through to the mid-1970s the pay executives received declined both on an inflation-adjusted basis and relative to other occupations.[71] Linking pay to performance, moreover, was not a priority.[72] As Eisenberg said in *The Structure of the Corporation* "insofar as monetary rewards are concerned direct compensation is commonly much more significant to managers than gains in their shareholder capacities, and direct compensation is usually not tied to earnings."[73]

Matters began changing significantly in the late 1980s and early 1990s. Pressure built on companies to stop paying their executives like "bureaucrats" and to strengthen the link between pay and performance.[74] Companies responded by using much more equity-based compensation – most prominently stock options – and pay/performance sensitivity increased

70 Brian R. Cheffins, *The Team Production Model as a Paradigm*, SEATTLE UNIV. L. REV. 5, 44-46 (forthcoming; working paper version available at http://ssrn.com/abstract=2463086).

71 WILBUR G. LEWELLEN, EXECUTIVE COMPENSATION IN LARGE INDUSTRIAL CORPORATIONS 162-75 (1968); David Kraus, *The "Devaluation" of the American Executive*, HARV. BUS. REV., May-June 1976, 84; Michael J. Dutka, *Executive Compensation and Selected Professional Incomes*, CHIEF EXECUTIVE OFFICER COMPENSATION 76 (Harold L. Wattel, ed., 1978).

72 David H. Ciscel, *Determinants of Executive Compensation* 40 SOUTHERN ECON. J. 613 (1974); K.R. Srinivasa Murthy and Malcolm S. Salter, *Should CEO Pay Be Linked to Results*?, HARV. BUS. REV., May-June 1975, 66; William Emigholz, *Chief Executive Compensation and Profits*, CHIEF EXECUTIVE, *supra* note 71, 176; Bruce Schwartz, *Relative Stock Prices and Chief Executive Officer Compensation*, CHIEF EXECUTIVE, *supra* note 71, 318.

73 EISENBERG, *supra* note 25, 31.

74 Cheffins, *supra* note 54, xvii; Michael C. Jensen and Kevin J. Murphy, *CEO Incentives – It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, 138.

tenfold for chief executive officers (CEOs) between 1980 and 1998.[75] This trend was accompanied by sky-rocketing managerial pay.[76] The dramatic surge in executive compensation generated sufficient controversy to prompt the SEC in the early 1990s to bolster substantially disclosure requirements and to persuade Congress to provide to shareholders via the Dodd-Frank Act of 2010 an advisory "say on pay" vote at least once every three years and to require public companies to establish compensation committees staffed by independent directors.[77]

E. Explaining the Transformation

What prompted the transformation of the corporate governance landscape occurring over the past four decades? Delaware, as we will see, played a significant role. There was, however, much else going on. A couple of factors have already been identified. One was corporate scandals such as Enron and WorldCom that prompted a federal regulatory response.[78] Changing patterns of share ownership was another. Institutional investors were not ideal shareholder activists[79] but were better resourced than the retail investors they progressively replaced. They also became more strongly motivated to take corrective action due to the increased prevalence of share ownership stakes sufficiently large to preclude

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75 Bengt Holmstrom and Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, (2001) 15 J. ECON. PERSPECTIVES 121, 133.

76 Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?* 113 Q.J. ECON. 653, 661 (1998) (reporting an inflation-adjusted increase of 209% on average between 1980 and 1994).

77 Cheffins, *supra* note 54, xvii-xviii; Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, §§ 951-52.

78 *Supra* note 16 and accompanying text.

79 *Supra* notes 66-67 and related discussion.

exercising the "Wall Street Rule," which entails selling out promptly when a company is underperforming.[80]

Dramatic changes affecting the manner in which U.S. public companies conducted business also likely contributed to the transformation of corporate governance. As the 20th century drew to a close senior executives were in charge of larger companies than their mid-20th century predecessors, measured in terms of revenue, stock market capitalization and number of employees.[81] With more being at stake for investors managerial accountability would have moved up the priority list. Due to deregulation, changes in employment relations and improved access to finance, executives of the 1980s and 1990s also had greater managerial latitude than their predecessors.[82] This enhanced discretion could potentially be exercised in a manner prejudicial to shareholders. In this new milieu, enhanced corporate governance could provide a salutary check on public company executives.[83]

Despite numerous lapses, such as the high-profile corporate scandals occurring in the early 2000s, a case can be made that due to improved corporate governance standards of managerial accountability in U.S. public companies have now largely caught up with changes to the business environment. Law professor Ed Rock argued, for instance, in a 2013 article that "the central problem of U.S. corporate law for the last eighty years--the separation of ownership and control--has largely been solved."[84] Others are less sanguine. Nell Minow, a

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[80] Cheffins, *supra* note 35, 7; George Melloan, *Big Funds Swing More Weight in Proxy Wars*, WALL ST. J., April 18, 1989, A25; Pat Widder, *Corporate Makeovers*, CHI. TRIB., June 25, 1989, E1.

[81] Cheffins, *supra* note 35, 11-13.

[82] Cheffins, *id.*, 13-15; Neil Fligstein and Taek-Jin Shin, *The Shareholder Value Society: A Review of the Changes in Working Conditions and Inequality in the United States, 1976 to 2000*, SOCIAL INEQUALITY 401, 402-3 (Kathryn M. Neckerman ed., 2004).

[83] Cheffins, *supra* note 35, 15-17.

[84] Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1909 (2013).

persistent advocate of corporate governance reform, argued in the wake of the 2008 financial crisis that the crisis proved that the "need for better corporate governance has never been more clear or more pressing."[85] More recently, Carl Icahn, a high-profile activist investor, called for a radical shake-up of governance arrangements, saying

> "Too many companies in this country are terribly run and there's no system in place to hold the chief executives and boards of these inadequately managed companies accountable….Our current system of corporate governance protects mediocre chief executives and boards that are mismanaging our companies and this must be changed."[86]

Corporate governance mechanisms no doubt could be more robust in U.S. public companies.[87] Nevertheless, there undeniably have been major changes over the past four decades. Moreover, it seems inconceivable the old order will be re-established. Correspondingly, it is an appropriate time to assess Delaware's contribution to the transformation of corporate governance. We will begin by considering why the judiciary rather than the legislature is the appropriate focal point with such an inquiry but will also identify institutional limitations likely to compromise the courts' impact on corporate governance trends.

III. DELAWARE'S CORPORATE GOVERNANCE "PLAYERS"

It is not surprising various observers have suggested Delaware has had a substantial influence on corporate governance trends.[88] More than 60% of all U.S. public companies are

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85 Quoted in *Corporate Constitutions*, ECONOMIST, Oct. 30, 2010, 84.

86 Quoted in Katherine Rushton, *Carl Ichan Attacks Companies That Protect "Unfit" Chief Executives*, TELEGRAPH (London), Aug. 13, 2014.

87 It is unclear how beneficial more robust corporate governance would in fact be. See, for example, *Corporate Constitutions, supra* note 85.

88 *Supra* notes 9-13 and related discussion.

incorporated under Delaware corporate law, including 80% of public companies that incorporate outside their headquarters state.[89] Moreover, Delaware has provided for many decades a *de facto* "national" U.S. corporate law court system, with judges in other states often citing and following Delaware jurisprudence.[90] When, however, the nature of Delaware's key corporate governance "players" – the legislature and the courts[91] – are borne in mind it quickly becomes evident that expectations concerning Delaware's impact on corporate governance need to be kept in check.

A. Delaware General Assembly

As law professor Lawrence Hamermesh has observed, "At the formal apex of the structure of Delaware corporate law is the Delaware General Corporation Law."[92] It might seem to follow that the Delaware General Assembly, comprised of the Delaware Senate and House of Representatives, would be the lead player in Delaware's contribution to the development of corporate governance. This, however, would be an incorrect inference to draw. The last major revision of the DGCL occurred in 1967,[93] which was before corporate governance had become the subject of meaningful debate. In the years since the statute has

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89 Lucian Ayre Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 567 (tbl. 2), 578 (tbl. 5) (2002).

90 John Armour, Bernard Black and Brian Cheffins, *Delaware's Balancing Act*, 87 IND. L.J. 1345, 1398-99 (2012).

91 In the corporate law area, Delaware has refrained from vesting an administrative agency with rule-making powers: Marcel Kahan and Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1615 (2005) (noting that Delaware has no parallel to the federal SEC). Correspondingly, the making of corporate law has fallen by default to the state legislature and the courts: Brian R. Cheffins, Steven A. Bank and Harwell Wells, *The Race to the Bottom Recalculated: Scoring Corporate Law Over Time*, working paper available at http://ssrn.com/abstract=2475242, 14.

92 Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1752 (2006).

93 Delaware General Corporation Law 1967, §§ 101-398.

been modified only incrementally.[94] The basic organization and content has remained unchanged,[95] even in the wake of the Enron and WorldCom scandals that prompted a swift legislative response from the federal government in the form of SOX.[96] Correspondingly, the Delaware legislature was destined to be little more than a bit player as corporate governance developed over the past 40 years.

The DGCL has not been entirely irrelevant in the corporate governance context. However, even with potentially relevant amendments, with respect to promoting more robust corporate governance they have had a mixed effect. 2009 amendments to §§ 112 and 113 of the DGCL that authorized a Delaware corporation to adopt bylaws making it easier for a shareholder to rely on the corporation's proxy machinery to secure election of a dissident slate of directors were congruent with a governance agenda oriented around bolstering director accountability and enhancing shareholder rights.[97] On the other hand, the 1986 enactment of § 102(b)(7), which authorizes Delaware corporations to include a provision in their certificates of incorporation that limits or eliminates for directors personal liability arising from breaches of the duty of care, cut against the standard corporate governance agenda because inattentive directors were less likely to face adverse personal consequences. Likewise, Delaware's principal legislative response to the takeover boom of the 1980s[98] -- the 1988 antitakeover statute codified in § 203 of the DGCL that encumbered the ability of a

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94 William J. Carney and George B. Shepherd, *The Mystery of Delaware's Continuing Success*, [2009] U. ILL. L. REV. 1, 62 (saying of changes to the DGCL between 1992 and 2005, they were "quite modest and (had) not led to radical changes in corporate practice.")

95 Hamermesh, *supra* note 92, 1752.

96 Jeffrey D. Hern, *Delaware Courts' Delicate Response to the Corporate Governance Scandals of 2001 and 2002: Heightening Judicial Scrutiny on Directors of Corporations*, 42 WILLAMETTE L. REV. 207, 215 (2005).

97 Del. Code Ann., tit. 8, §§ 112-13; Bo Becker and Guhan Subramanian, *Improving Director Elections*, 3 HARV. BUS. L. REV. 1, 20-22, 32 (2013).

98 Kahan and Rock, *supra* note 50, 894.

successful takeover bidder to cash out shareholders who did not accept the bidder's tender offer -- was criticized on the basis that it would compromise a market for corporate control that enhanced managerial accountability.[99]

The Delaware legislature in fact always was an unlikely candidate to transform corporate governance. A 1981 article by law professor George Dent foreshadowed this.[100] Dent maintained that "(t)he theory of corporate governance underwent a revolution in 1970s" because of wide acceptance of the proposition that boards of directors should be made up largely of outside directors who would not seek to manage the corporation but instead would monitor management's performance.[101] He acknowledged the theoretical possibility that market forces could prompt widespread adoption of this monitoring model of the board but maintained that legal reform would be required for it to reach its full potential.[102] He said, though, that it was highly improbable that the shift would occur due to amendments to state corporate law because this would entail a departure from a persistent trend among state legislatures to refrain from using corporate legislation to impinge on managerial prerogatives by imposing mandatory governance requirements.[103]

Dent identified "the race to the bottom" phenomenon, which he characterized as "an alleged attempt by many states to reduce regulations in order to attract corporations to incorporate there," as a factor that plausibly contributed to a reticence on the part of the states

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99 Subramanian, Herscovici and Barbetta, *supra* note 22, 698 (discussing opposition to enactment of the provision); Jarrell, *supra* note 60, 782 (explaining why the author opposed Delaware's adoption of § 203 in hearings preceding its enactment).

100 George W. Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 BOSTON UNIV. L. REV. 623 (1981).

101 *Id.*, 623.

102 *Id.*, 638.

103 *Id.*, 642.

to regulate by way of corporate law statutes.[104] He noted that the reluctance of states to use corporate law to impose affirmative requirements on management could also be attributed to a belief that affording corporations wide flexibility under corporate legislation was sound public policy.[105] Whatever the underlying motivation, there could be little doubt that the Delaware legislature subscribed to the managerially-deferent regulatory philosophy Dent cited. Ernest Folk, who was closely involved with the enactment of the Delaware General Corporation Law of 1967, said in 1968 of Delaware's approach "We do not seek to protect shareholders, creditors or others; rather we limit their rights and remedies. We constantly enlarge the rights and freedom of management."[106] Or as Brett McDonnell observed in 2007, "Delaware legislators…will be particularly attentive to managerial interests."[107] Given this pro-managerial orientation, the Delaware legislature was unlikely to amend the DGCL to impose substantial affirmative governance obligations on directors and officers governed by the statute.

Drafting style was another aspect of Delaware's statutory philosophy that made it unlikely that amendments to the Delaware General Corporation Law would make a substantial contribution to the development of corporate governance. On this count, a statutory dichotomy Leo Strine, now Chief Justice of the Delaware Supreme Court, developed in a 2001 law review article, is instructive. He said there were two paradigmatic models for corporation law, with one being a "Mandatory Statutory Model" which was "quite

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104 *Id.*, noting in so doing that the phrase had been coined by William Cary (see n. 111, citing William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 666 (1974)).

105 Dent, *supra* note 100, 643.

106 Ernest L. Folk, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. B.J. 409, 415 (1968). On Folk's role in the lawmaking process, see Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 865-68 (1969).

107 Brett H. McDonnell, *Recent Skirmishes in the Battle Over Corporate Voting and Governance,* 2 J. BUS. TECH. L. 349, 352 (2007).

detailed and prescriptive" that "would limit choices and require certain procedures" and "dictate how things would happen."[108] Statutory provisions prescribing governance arrangements plausibly could be accommodated quite readily under this model.

Chief Justice Strine's other paradigmatic model was the "Delaware Model", oriented around a statute that "provides corporate boards with a substantial amount of leeway to govern their corporations as they see fit" and to that end is "largely enabling and provides a wide realm for private ordering."[109] The bias against prescriptive measures means this model would be much less amenable to the imposition of governance standards than the Mandatory Statutory Model. Chief Justice Strine's "Delaware Model" nomenclature leaves no doubt about where he thought the DCGL fits in. If there was any doubt, observations by other distinguished observers make the point clear. According to William Allen, Chancellor of the Delaware Court of Chancery from 1985 to 1997, "The Delaware law proudly proclaims itself to be an enabling statute."[110] Or as Professor Hamermesh said in offering in 2006 a self-proclaimed Delaware native's articulation of the policy foundations of Delaware corporate law, "There has been a strong tendency in Delaware corporate policymaking to broaden…room for private ordering."[111] It follows that due either to a potential pro-managerial bias or a disinclination to be detailed and prescriptive, there was little reason to

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108 Leo E. Strine, *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahan & Kamar's* "Price Discrimination in the Market for Corporate Law", 86 CORNELL L. REV. 1257, 1260 (2001).

109 *Id.*

110 William T. Allen, *20th Century Evolution and Growth of Delaware Corporation Law*, DEL. LAW., Winter 1999/2000, 16, 18.

111 Hamermesh, *supra* note 92, 1783; on his perspective, see at 1750-51. See also Sean J. Griffith and Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 8-9 (2005) (citing Delaware specifically in footnote 45 when saying "The state law approach to regulating corporate governance…is to enact an enabling statute with very few mandatory terms, thus preserving the largest possible space for private ordering.")

expect the Delaware legislature to make statutory reforms that would bolster corporate governance. So it proved.

B. The Courts

The fact that the Delaware legislature was an unlikely candidate to help to foster the corporate governance transformation U.S. public companies experienced from the mid-1970s onwards did not foreclose the possibility of a notable Delaware contribution. Instead, as we will see now, in various ways Delaware courts were well-positioned to play a significant role. In particular, the division of labor between Delaware's legislature and its courts, a willingness on the part of the Delaware judiciary to impinge on managerial prerogatives in at least some circumstances and a growing public profile of Delaware judges set the stage nicely for Delaware's courts. Still, expectations concerning the impact of Delaware's courts on corporate governance have to be tempered due to constraints judges face as standard-setters.

1. The Division of Labor Between the Legislature and the Courts

Under what Chief Justice Strine calls the "Delaware Model" of corporate law boards have "a substantial amount of leeway to govern corporations as they see fit."[112] Still, the discretion is judicially circumscribed. As Chief Justice Strine said when describing the model, "Aside from the corporate electoral process mandated by the Delaware statute, the ultimate protection provided to investors by Delaware law is the guarantee that its courts will hold directors responsible for living up to their fundamental duties of care and loyalty."[113] The scope that Delaware courts have to define and apply directorial duties in turn creates scope for the judiciary to contribute significantly to the development of corporate governance arrangements in public companies. As Robert Thompson has observed, "Fiduciary duty is

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112 Strine, *supra* note 108, 1260.

113 *Id*.

the principal means by which the Delaware judiciary decides questions of corporate governance."[114]

Even though the Delaware General Corporation Law is theoretically the apex of Delaware corporate law it would not be anomalous in any way for Delaware courts to play a greater role in shaping corporate governance than the Delaware legislature. According to Marcel Kahan and Ed Rock, "The most noteworthy trait of Delaware's corporate law is the extent to which important and controversial legal rules are promulgated by the judiciary, rather than enacted by the legislature."[115] This is an arrangement to which the Delaware legislature assents. Professor Hamermesh has said of Delaware that "the legislative preference for flexibility and private ordering is ultimately dependent on what we believe to be a well-founded view the courts will police overly opportunistic conduct on the part of those in control."[116] Judicial dominance in setting corporate governance standards follows in turn. As Myron Steele, a former justice of the Delaware Supreme Court, said in a 2005 article co-written with Sean Griffith, "State 'regulation' of corporate governance is a function performed primarily by judges, and the judiciary's basic tool for regulatory intervention is the background principle of fiduciary duty."[117]

The treatment of independent directors under Delaware law illustrates the division of labor. While independent directors are a crucial element of corporate governance,[118] the

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114 Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779, 786 (2004).

115 Kahan and Rock, *supra* note 91, 1591.

116 Hamermesh, *supra* note 92, 1784; see also Veasey and Di Guglielmo, *supra* note 12, 1413 (saying that there was "no discernible movement in Delaware to develop a codified model" of governance).

117 Griffith and Steele, *supra* note 111, 9.

118 *Supra* note 36 and related discussion.

DGCL does not refer once to them.[119] Hence, to the extent that Delaware law has shaped the role of independent directors this must have been due to judicial action.[120] Consider for instance formulation of the definition of independence for the purpose of Delaware law. The process has been left to the courts, which have used a contextual approach to define independence rather than adopting "bright line" *ex ante* standards such as the presence or absence of a material relationship with the company.[121] Chief Justice Strine, writing as Vice-Chancellor of the Chancery Court, explained why in a 2003 case, saying

> "even the best minds have yet to devise across-the-board definitions that capture all of the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy but with the compensating benefit that independence determinations are tailored to the precise situation at issue."[122]

2. A Willingness to Intervene

While the division of labor between the legislature and the courts meant that under the Chief Justice Strine's Delaware Model judges were more likely than legislators to contribute to the development of corporate governance, it could not be taken for granted that the Delaware judiciary would capitalize on the opportunity. Theoretically, a pro-managerial orientation could have imposed a substantial check on the judiciary's contribution to the

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119 Rodrigues, *supra* note 38, 465 (indicating that the DCGL refers only to the narrower concept of "interested directors").

120 Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 687 (2009).

121 Rodrigues, *supra* note 38, 453-55, 465-67, 483-84, 493; Claire Hill and Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 911-12 (2011).

122 *In re* Oracle Corp. Derivative Litigation, 824 A.2d 917, 941 (Del. Ch., 2003); see also Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 105 (2007) (saying the Delaware judiciary had stressed the advantages of a case-by-case analysis on the issue on various occasions).

promotion of more robust corporate governance, in that Delaware judges might have been reluctant to issue rulings that would impinge upon managerial prerogatives. The possibility of bias of this sort was topical just prior to corporate governance first coming to prominence in the mid-1970s.

William Cary famously argued in a 1974 *Yale Law Journal* article that Delaware was prevailing in a counter-productive corporate "race to the bottom".[123] In so doing, he claimed Delaware's judges were part of a "tight little club" implementing the "public policy" of Delaware to create a "'favourable climate' for management" by watering "the rights of shareholders vis-à-vis management down to a thin gruel."[124] Cary drew attention to various cases to substantiate his argument,[125] including *Graham v. Allis-Chalmers Manufacturing Co.*[126] Cary said of this 1963 case where the directors of a company embroiled in a price-fixing scandal were found not to have breached their duty of care that "a state less hospitable than Delaware might have imposed upon directors the duty of installing an internal control system to prevent repeated antitrust violations."[127] To the extent Cary's indictment of Delaware jurisprudence was correct, the state's judges were unlikely candidates to issue rulings imposing the sort of constraints on directors and senior officers that would reshape corporate governance.

Cary's criticism of Delaware judges was strongly contested at the time he made it.[128] Even if it is true, however, that the Delaware cases of the 1950s,[129] 1960s[130] and early

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[123] Cary, *supra* note 104.

[124] *Id.*, 666, 670, 692.

[125] *Id.*, 672-84.

[126] 182 A. 2d 328 (Ch. 1962), *aff'd*, 188 A.2d 125 (1963).

[127] Cary, *supra* note 104 at 684.

[128] See, for example, S. Samuel Arsht, *Reply to Professor Cary*, 31 BUS. LAW. 1113 (1976).

1970s[131] betrayed, in Cary's words, a tendency to "adhere to minimal standards of director responsibility,"[132] any such predisposition seemingly had largely dissipated as corporate governance came on to the agenda in the late 1970s and 1980s. Sidney Silverman, a New York lawyer, referred to three 1977 Delaware decisions as widely acknowledged "high water marks of enlightened judicial treatment on the subject of corporate governance."[133] Law professor Daniel Fischel argued in 1982 that Delaware courts were taking "a far more activist role in regulating corporate internal affairs."[134] He cited cases such as *Singer v. Magnavox Co.*[135] and *Zapata Corp. v. Maldonado*[136] as evidence that Delaware courts had "gone a long way toward limiting the discretion of managers and controlling shareholders while increasing the power of minority shareholders."[137] *Forbes*, likewise citing these two cases, was prompted to ask why "have so many decisions in the Delaware Supreme Court been going against corporations recently?"[138]

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129 American Hardware Corp. v. Savage Arms Corp. 136 A.2d 690 (1957) (Del. Ch.), discussed by Cary, *supra* note 104 at 675-77.

130 Cases from this era Cary discussed included Cheff v. Mathes, 199 A.2d 548 (1964) (Del. Ch.) (Cary, *supra* note 104 at 673-75); Hariton v. Avco Electronics Inc., 188 A.2d 123 (1963) (Del. Ch.) (Cary, *supra* note 104 at 679).

131 Cases from this era Cary discussed included Sinclair Oil Corp. v. Levien, 282 A.2d 188 (Del. Ch. 1971) (Cary, *supra* note 104 at 680); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970) (Cary, *supra* note 104 at 681-82).

132 Cary, *supra* note 104 at 672.

133 Sidney B. Silverman, *An Outsider Looks at Chancery*, DEL. LAW., Spring 1984, 50, 51. He did not identify the cases.

134 Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 944 (1982).

135 380 A.2d 969 (Del. 1977).

136 430 A.2d 770 (Del. 1981).

137 Fischel, *supra* note 134, 923; see also at 914 (saying the Delaware Supreme Court had "strengthened considerably the power of minority shareholders vis-à-vis management".)

138 Anthony Baldo, *Delaware Rocks the Boat*, FORBES, April 8, 1985, 126.

Fischel suggested that the change in approach was a counter-reaction by Delaware courts to the judicial bias charges Cary and similar critics levied.[139] Jack Coffee, in a 1987 article, concurred.[140] While he stressed that Delaware judges were unlikely to have been materially biased prior to Cary's 1974 article, he suggested Cary's claims "may well have made Delaware judges more sensitive, at least for a time, to issues of fairness."[141] Regardless of the precise reason for whatever change of heart Delaware judges underwent,[142] the reticence they might have had to intervene in corporate affairs or impinge on managerial prerogatives would not preclude Delaware courts from issuing decisions that would help to foster the transformation of corporate governance that began in the mid-1970s.

3. Delaware Courts Move Into the Limelight

A growing public profile was an additional factor that contributed to the Delaware judiciary's development of a corporate governance legacy. As debates about corporate governance gathered pace in the late 1970s and early 1980s, it was well-known that Delaware courts had a nationwide impact on the development of corporate law.[143] Nevertheless,

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139 Fischel, *Race*, *supra* note 134, 923.

140 John C. Coffee, *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759 (1987). This interpretation of Delaware decisions did not command universal acceptance, however. See, for example, S. Samuel Arsht, *In Staunch Defense of Delaware* in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1978 238, 242 (Donald E. Schwartz, ed., 1979) (saying that the roots of the 1977 decision in Singer v. Magnavox Co. extended too far into the past for it to be credible that the decision was a counter-reaction to Cary's criticism of Delaware).

141 Coffee, *supra* note 140, 765.

142 Ralph Ferrara and Marc Steinberg attributed the change of heart to awareness on the part of Delaware judges that they should take on increasingly protective role because a 1977 decision of the U.S. Supreme Court (Santa Fe Industries v. Green 430 U.S. 462) meant that the likelihood of federal regulation in the area of managerial malfeasance had been reduced: Ralph Ferrara and Marc Steinberg, *A Reappraisal of* Santa Fe: *Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263, 277 (1980).

143 See, for example, Donald E. Schwartz, *The Delaware Chancery Court: A National Court of Corporate Law*, DEL. LAW., Spring 1984, 54.

Delaware judges were not in the limelight in the way they would be soon. A 1984 *Wall Street Journal* article on the Delaware Court of Chancery labelled the court as "sedate" and "militantly informal, and small."[144] The *Baltimore Sun* referred to the Chancery Court in 1985 as "unassuming", noting that its courtrooms were "two smallish rooms furnished from the 1950s" "tucked away behind City Hall."[145] The *New York Times* said of the same court in 1986 that it was "little-known".[146]

While a "little-known" court might be poorly positioned to have a substantial influence on the development of corporate governance, the Delaware judiciary's circumstances were changing fast. The *Baltimore Sun* quoted in its 1985 article a lawyer who had quit practice to set up a newsletter on Delaware court developments as saying "It's incredible, the interest developing in these courts."[147] The *New York Times* noted similarly in its 1986 article:

> "The clout wielded by the Delaware courts has never been more visible than over the 18 months, when the justices handed down rulings that in some cases made takeovers more difficult to carry out and in others imposed more responsibilities – and potential financial liability – on directors."

Delaware courts continued to garner media attention thereafter. Cases associated with newsworthy, high-profile transactions were particularly likely to receive media coverage.[148] *Newsweek* noted in 1989 that while given Delaware's size the Court of Chancery was "the

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144 Mary Williams, *Delaware's Sedate Chancery Court Is a Major Corporate Battleground*, WALL ST. J., May 10, 1984, 33.

145 Ellen L. James, *Tiny Delaware is Battlefield of Big Business*, BALT. SUN, Nov. 10, 1985, 1D.

146 Lindsay Gruson, *Tiny Delaware's Corporate Clout*, N.Y. TIMES, June 1, 1986, F6.

147 James, *supra* note 145, (quoting Stephen Spiller, founder of *Delaware Corporate Law Update*.)

148 Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1064, 1067 (1997).

unlikely focus of a major takeover fight," its "five judges have become the arbiters of corporate warfare, deciding the fate of megacompanies and the movement of billions of dollars."[149] Decisions from Delaware generated headlines in national newspapers in the late 1980s such as "Ruling Seen Curtailing 'Poison Pills'"[150] and "Ruling Gives Managers Another Ace in the Hole."[151]

Media coverage of Delaware decisions attracted considerable attention. As a transactional lawyer said in a 1997 article by Ed Rock on the emergence of corporate norms "We're not afraid of what the Delaware courts say. We're afraid of what the press says."[152] The publicity afforded to Delaware judgments would soon extend to Delaware judges. For instance, Delaware Supreme Court judge Andrew Moore was quoted at length in a *Chicago Tribune* story prior to a much-publicized July 1989 Delaware court hearing concerning a hostile bid by Paramount for Time Inc.[153] He took the opportunity to argue that in the wake of *Smith v. Van Gorkom,* a 1985 Delaware Supreme Court case where outside directors were held personally liable for failing to exercise due care in relation to a takeover bid, [154] the world for directors changed. According to Moore, "The director who believes his role is to come to the meeting once a month and never challenge (management) or ask the hard

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149 Richard Sandza, *Time's Next Battleground*, NEWSWEEK, July 19, 1989, 31.

150 *Ruling Seen Curtailing "Poison Pills"*, WALL ST. J., Nov. 2, 1988, D7 (discussing the ruling subsequently reported as City Capital Associates Limited Partnership v. Interco Inc., 551 A.2d 787 (Del. Ch., 1988)).

151 Bill Sing, *Ruling Gives Managers Another Ace in the Hole*, L.A. TIMES, July 15, 1989, 59, discussing Re Time Inc. Shareholders Litigation (Paramount Communications Inc. v. Time Inc.), [1989 Transfer Binder] Fed. Sec. L. Rep. ¶ 94514 (Del. Ch. July 14, 1989), aff'd. 565 A.2d 280 (Del. 1989).

152 Rock, *supra* note 148, 1068.

153 Pat Widder, *Time Inc. Case Another Test for Outside Directors*, CHI. TRIB., July 9, 1989, 95.

154 488 A.2d 858 (1985).

questions, those directors are going to end up with a problem."[155] The Time/Paramount litigation also provided the platform for extensive profiles of Chancellor Allen in the *New York Times* and the *Washington Post*.[156] The *New York Times* subsequently referred to Allen when he retired as Chancellor in 1997 as "a giant figure in corporate law."[157]

Delaware judges raised their public profile still further through extra-judicial outreach. Allen kicked the process off by publishing a number of law review articles on corporate law during his time as Delaware Chancellor.[158] Ed Rock, in his 1997 article on corporate norms, characterized one such article as a "relatively explicit attempt – delivered from the podium rather than the bench – to induce better behavior by managers."[159] Norman Veasey, for his part, wrote about corporate governance on various occasions during his 1992 to 2004 tenure as Chief Justice of Delaware.[160] By the mid-2000s, Delaware judges were collectively renowned as prolific authors on corporate law matters and as speakers and participants in conferences for academics and practitioners.[161]

D. Institutional Constraints

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155 Widder, *supra* note 153.

156 Stephen Labaton, *Judge is Focus of Time Inc. Contest*, N.Y. TIMES, June 26, 1989, D1; Charles Storch, *Judge in Time-Paramount Suit Called Hard to Pigeonhole*, WASH. POST, July 11, 1989, D1.

157 James Traub, *John Sexton Pleads (and Pleads and Pleads) His Case*, N.Y. TIMES, May 25, 1997, SM27.

158 See, for example, William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992); William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395 (1993).

159 Rock, *supra* note 148, 1070, discussing William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055 (1990).

160 See, for example, E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices – Or Vice Versa?*, 149 U. PA. L. REV. 2179 (2001); E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics, and Federalism*, 152 U. PA. L. REV. 1007 (2003); E. Norman Veasey, *Policy and Legal Overview of Best Corporate Governance Principles*, 56 SMU L. REV. 2135 (2003).

161 Kahan and Rock, *supra* note 91, 1603-4; Hamermesh, *supra* note 92, 1759-60.

Though a willingness to intervene and an increasingly public profile meant that in certain respects Delaware's judiciary was well-situated to have an impact on corporate governance, various generic features of courts that disadvantage them as standard-setters were also relevant.[162] For instance, while a legislative body has substantial scope to set its own agenda judges can only act after litigants have commenced court proceedings. Also, while a statute a legislative body promulgates can readily be given a broad regulatory ambit, judicial orders technically only bind litigants. In addition, while a legislature can at least theoretically open up a whole field of endeavor for re-examination, sweep away existing legal doctrines and introduce a thoroughgoing, coherent revision of the law, for judges constraints of doctrine and precedent can impede major change.

In the case of Delaware's judiciary, various factors ameliorate at least partially the institutional constraints courts face as standard-setters. First, even though judges normally only get to issue rulings of lasting import when parties commence lawsuits, state and federal courts have had since 1984 the right to certify questions of Delaware law to the Delaware Supreme Court and the Securities and Exchange Commission has had the same option available to it since 2007.[163] Second, corporate law cases involving publicly traded companies – the sort of litigation most likely to have a bearing on corporate governance – are filed often in Delaware courts. Robert Thompson and Randall Thomas examined all complaints filed in the Delaware Court of Chancery in 1999 and 2000 and found 640 were filed per year that dealt with corporate matters.[164] The vast majority of these involved

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162 On these features of courts, see CHEFFINS, *supra* note 36, 191; David L. Shapiro, *Courts, Legislatures and Paternalism*, 74 VA. L. REV. 519, 551-53 (1988).

163 Del. Const. art. IV, 11(8); Delaware Supreme Court Rules, Rule 41; Henry duPont Ridgely, *Avoiding the Thickets of Guesswork: The Delaware Supreme Court and Certified Questions of Corporate Law*, 63 SMU L. REV. 1127, 1131–32 (2010).

164 Robert B. Thompson and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 166-67 (2004).

publicly traded corporations,[165] the type of companies for which corporate governance is primarily relevant.[166]

Third, while formally rulings by a court only bind the litigants, the Delaware judiciary often has a broader audience in mind when they craft their judgments. Delaware judges, mindful of the state's pre-eminent status in the corporate law realm, treat offering guidance on appropriate directorial and managerial conduct as part of their job description.[167] Hence, when they hear corporate law cases they will typically be more willing than other judges to go beyond the confines of the matter at hand when giving reasons for judgment so as to articulate norms applicable to boards and executives.[168] The Delaware judiciary's enthusiasm for offering extracurricular commentary on corporate law topics[169] provides additional opportunities to express views on matters litigants have not specifically raised.

Fourth and finally, legal doctrine and case law precedent likely do less to tie the hands of the Delaware judiciary dealing with corporate-oriented litigation than is the judicial norm. Given that corporate law cases brought in Delaware are often characterized by a high degree of fact specificity and given that many such cases will be governed by broadly cast fiduciary duty principles, Delaware judges often have as a practical matter substantial scope to be innovative.[170] For instance, with cases that William Cary cited to substantiate his claim that Delaware judges were biased in favor of management many were no longer good law 20

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165 Thompson and Thomas do not state specifically what percentage of the claims filed involved public companies but they report most of the claims filed alleged breaches of fiduciary duty and more than 90% of these claims related to publicly traded companies – *id.*

166 Brian R. Cheffins, *Teaching Corporate Governance*, 19 LEGAL STUD. 515, 517 (1999).

167 Rodrigues, *supra* note 38, 488.

168 Strine, *supra* note 108, 1280; Kahan and Rock, *Symbiotic, supra* note 91, 1599; Rock, *supra* note 148, 1016.

169 *Supra* notes 158-61 and related discussion.

170 Griffith and Steele, *supra* note 111, 11.

years after he published his article.[171] Likewise, Marcel Kahan and Ed Rock have said doctrines Delaware courts have developed to complement core fiduciary duties "show the great comfort on the part of Delaware's judiciary…for having the courts expand the scope of judge-made law to address novel problems, rather than waiting for the legislature to act."[172]

While the institutional constraints affecting courts may not be as binding for Delaware courts as they are for other judges, they still operate, and do so in a way that means the scope Delaware judges have to engage in standard setting has distinct limits. Consider, for instance, control of the agenda, or lack thereof. A 2001 article in *Fortune* discussing the question whether shareholders could unilaterally pass a bylaw despite opposition from the board said the matter was open at that juncture because of the lack of a decision on point "from the big kahuna of American corporate law, Delaware's five-judge Court of Chancery," explaining "you can't have a decision without a case, and the court hasn't received one."[173] Delaware judges not surprisingly are fully aware of the situation. Chancellor Allen and Chief Justice Strine, writing in 2002 with Jack Jacobs, a Vice Chancellor of the Delaware Court of Chancery, acknowledged that "(t)he case-by-case mode of decisionmaking forces judges to answer only the questions posed to them by the parties, within the limited context of a record the parties themselves create."[174]

Moreover, while a large number of corporate law-related complaints are filed annually in Delaware the opportunities Delaware courts have to issue opinions that could potentially influence corporate governance remain limited. The available evidence suggests

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[171] William W. Bratton and Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 679, n. 304 (2006).

[172] Kahan and Rock, *supra* note 91, 1594.

[173] Geoffrey Colvin, *Shareholders Of The World: Sue!*, FORTUNE, March 19, 2001.

[174] William T. Allen, Jack B. Jacobs and Leo E. Strine, *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 60 U. CHI. L. REV. 1067, 1069 (2002).

complaints filed are highly skewed in favor of one type of case, these being a class action challenging actions directors took in relation in an acquisition.[175] This filing bias limits the areas of corporate governance where pronouncements of Delaware judges can have an impact.

Opportunities for Delaware judges to resolve cases are also not as numerous as the aggregate filings data implies. It is commonplace for multiple filings to occur in relation to the same impugned transaction and the consolidation that typically results reduces considerably the number of instances where a Delaware court will be called on to adjudicate.[176] Furthermore, a decision can only have an impact on corporate governance if "users" of Delaware law became aware of it and on only a minority of occasions where a court makes a ruling will an opinion be crafted for distribution on the Delaware Court of Chancery website and on Lexis and Westlaw.[177] Cases where directors of a Delaware public company are named as defendants are perhaps the most likely to have corporate governance ramifications and in a typical year there are unlikely to be more than 20 Delaware court decisions of this type reported on Lexis or Westlaw.[178]

Constraints of doctrine and precedent remain salient as well for Delaware judges. They indeed may have greater scope to maneuver than other judges. Nevertheless they shy away from identifying rulings issued as marking a dramatic shift in approach and instead

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[175] Thompson, *supra* note 114, 786, summarizing data from Thompson and Thomas, *supra* note 164.

[176] Thompson and Thomas, *supra* note 164, 168-69 (indicating that of 1048 complaints filed in their dataset involving claims of breach of fiduciary duty, as a result of consolidation there were 348 "lead complaints").

[177] Armour, Black and Cheffins, *Delaware's*, *supra* note 90, 1355.

[178] *Id.*, 1354, Fig. 1 (providing annual data on the number of lawsuits involving Delaware public companies decided by Delaware courts where directors were named defendants in a lawsuit arising under corporate law and an opinion was disseminated on Westlaw, Lexis or the Delaware Court of Chancery website).

commonly explain their decisions in terms of existing case law.[179] Correspondingly, development of Delaware's decisional law tends to be incremental in nature.[180] This is no accident. Chancellor Allen explicitly acknowledged in a 1995 article that "judges are not agents of change."[181] He, together with Vice Chancellor Jacobs and Chief Justice Strine, elaborated in their 2002 article, saying that "Most judges worry about the legitimacy of their policymaking authority."[182] Correspondingly, "Reticence to express an adjudicative decision as a policy choice comes naturally with the acceptance of the judicial role."[183]

Given the constraints of doctrine and precedent, Delaware judges are not surprisingly reluctant to acknowledge explicitly the role they can potentially play as promoters of good corporate governance.[184] Even when they do concede they make a contribution, they avoid hyperbole. For instance, Chancellor Allen, interviewed for a 2001 issue of *Directors & Boards* focusing on major players in the transformation of corporate governance occurring in the U.S. over the previous quarter century, acknowledged that he had "played some role in bringing to people's attention what they ought to do" but said that he "was way down on the list of forces acting on directors to get them to know what their duty was."[185] This does not mean, as we will see in the remainder of the Article, that Delaware judges have been merely

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179 Roy Harris, *Delaware Rules*, CFO, Aug. 2004, 54, 57; Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 429 (2007); see also Veasey and Di Guglielmo, *supra* note 12, 1415 (identifying rendering of "decisions that are stable in the overall continuum" as a key obligation of courts).

180 Jill E. Fisch, *Leave it to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 742 (2013).

181 William T. Allen, *The Evolution of Corporate Boards*, CORP. BOARD, July/Aug. 1995, 1.

182 Allen, Jacobs and Strine, *supra* note 174, 1070.

183 *Id.*

184 Harvey Gelb, *Corporate Governance Guidelines – A Delaware Response*, 1 WYOMING L. REV. 523, 551 (2001), quoting Brehm v. Eisner, 746 A. 2d 244, 256 (Del. 2000).

185 *The Judge: William Allen*, DIRECTORS & BOARDS, Fall 2001, 42, 43.

peripheral to the development of corporate governance. Nevertheless, institutional features of courts must be borne in mind when formulating expectations concerning their contribution.

IV. THE BOARD OF DIRECTORS

Corporate governance's emergence as a significant topic in the 1970s and 1980s was accompanied by major changes to the composition, structure and functioning of boards in public companies.[186] Delaware court decisions did not set this process in motion. In the 1980s and 1990s, however, rulings by Delaware judges indicating that decisions made by independent directors would be subjected to less intense scrutiny than otherwise would be the case consolidated the position of such directors and committees staffed by them.[187] As Marcel Kahan and Ed Rock said in 2005, rather than using "the stick of mandated requirements, Delaware law use(d) the carrot of granting greater legal protection to properly constituted boards."[188] Judgments handed down by Delaware courts also provided guidance to directors of public companies by drawing attention to practices well-functioning boards would be prudent to adopt. We will now consider in turn these contributions to corporate governance, focusing initially on decisions that had an impact on the structure and composition of boards.

A. Structure and Composition

1. General Trends

[186] See Part II.B *supra*.

[187] Claire Hill and Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. BUS. L. REV. 333, 345 (2009) (referring to state law generally but citing Delaware cases.)

[188] Kahan and Rock, *supra* note 91, 1608.

During the 1970s the proportion of board seats of publicly traded companies "insiders" (typically executives) held fell considerably.[189] As the end of the decade approached most public companies had in place an audit committee and a compensation committee staffed primarily if not exclusively by outside directors.[190] A substantial minority of such firms also had nomination committees despite such committees being rare as late as the 1960s.[191]

These trends reflected an emerging consensus concerning the desirability of oversight by outside directors and of a board environment offering ample scope for disinterested decision-making.[192] The New York Stock Exchange, which had since 1956 obliged listed companies to have at least two independent directors, amended its listing rules in 1977 to require all listed companies to have an audit committee comprised of such directors.[193] Also, the Business Roundtable, a group established in 1974 to represent the views of 180 chief executive officers of major corporations, issued in 1978 a statement on "The Role and Composition of Directors of the Large Publicly Owned Corporation" that indicated boards of public companies should typically be composed of a majority of non-management directors

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189 Gordon, *supra* note 24, 1473, n. 9 (citing data indicating that the proportion of inside directors fell from 41% in 1970 to 33% in 1980); Marshall Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1356 (1979) (reporting that the number of industrial companies with a board composed of a majority of outside directors increased from 63% in 1967 to 83% in 1977); Barry D. Baysinger and Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 571 (1984) (reporting that the "executive component" of boards of public companies fell from 65% in 1970 to 54% in 1980).

190 Small, *Evolving*, *supra* note 189, 1358; William C. Greenough and Peter C. Clapman, *The Role of Independent Directors in Corporate Governance*, 56 NOTRE DAME L. REV. 916, 921 (1980) (audit committees).

191 Small, *Evolving*, *supra* note 189, 1358.

192 *Id.*, 1357, 1360.

193 Thompson, *supra* note 114, 795-96.

and should establish audit, compensation and nomination committees outside directors dominated.[194]

The increased emphasis on independent monitoring in the board context generated skepticism in some quarters. The doubters suggested "efforts to revive the board of directors (were) simply anachronistic,"[195] characterized proposals to bolster the role of independent directors as akin to illusory "Potemkin village"-style reform,[196] and referred to "the independent director movement" as "silly stuff".[197] Nevertheless, various rulings by Delaware courts would soon make it clear that, as Chief Justice Strine said in 2002, "the independent director carrie(d) much water in American corporation law."[198] The Delaware courts thereby helped to solidify independent directors and board committees comprised of such individuals as core elements of the U.S. system of corporate governance.[199]

2. Board Committees

In 1981 the Delaware courts provided their initial boost for committees composed of independent directors by approving the use of such committees for terminating derivative litigation stockholders might bring.[200] In *Zapata v. Maldonado* the Delaware Supreme Court

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194 Business Roundtable, *The Role and Composition of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2107-10 (1978).

195 Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope – Faint Promise?*, 76 MICH. L. REV. 581, 583 (1978).

196 Victor Brudney, *The Independent Director – Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1981).

197 NICHOLAS WOLFSON, THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION 87 (1984).

198 Leo E. Strine, *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1384 (2002); see also *In re* Cox Communications Inc. Shareholders Litigation,879 A.2d 604, 647 (Del. Ch., 2005) (acknowledging "the strong role that our law gives to independent directors").

199 Rodrigues, *supra* note 38, 456 ("In the 1980s, Delaware courts issued opinions that privileged the decisions of an independent board, adding fuel to the independence fire.")

200 Allen, *supra* note 159, 2058.

followed the lead *Auerbach v. Bennett*, a 1979 New York decision,[201] had set and ruled that a court would be strongly inclined to dismiss a derivative suit if a special litigation committee struck by the board recommended against the case proceeding and the corporation demonstrated the independence, good faith and reasonable diligence of the committee.[202] *Zapata* was less deferent to independent litigation committees than *Auerbach* as the Delaware Supreme Court said a court should review the substantive decision of the committee using its own independent judgment before ruling on a motion to dismiss.[203] Nevertheless, *Zapata* helped to elevate the importance of the independent director in the corporate governance realm.[204]

In the 1983 case of *Weinberger v. UOP Inc.*[205] the utility of independent directors was underscored in a different context, namely a "freezeout" where a corporation's controlling shareholder aims to acquire the remaining shares.[206] In the case, plaintiff UOP shareholders successfully challenged steps taken by majority shareholder Signal Companies Inc. to cash out UOP's other shareholders but the Delaware Supreme Court indicated that "the result could have been entirely different if UOP had appointed an independent negotiating committee of outside directors to deal with Signal at arm's-length."[207] Subsequent Delaware cases confirmed that with mergers involving a corporation and its controlling shareholder a well-functioning committee of independent directors could in resultant litigation shift the

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201 Auerbach v. Bennett, 393 N.E. 994 (N.Y., 1979).

202 Zapata v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

203 *Id.* at 788-89 (characterizing matters as a two-step test); E. Norman Veasey, *New Insights Into Judicial Deference to Directors' Business Decisions: Should We Trust the Court?*, 39 BUS. LAW. 1461, 1468 (1984). Professor Jack Coffee even described this aspect of the decision as a "bombshell" for many corporate lawyers: Baldo, *supra* note 138.

204 Marc I. Steinberg and Matthew D. Bivona, *Disney Goes Goofy: Delegation and Corporate Governance*, 60 HASTINGS L.J. 201, 229, n. 205 (2008)

205 Weinberger v. UOP Inc., 457 A.2d 701 (Del. 1983).

206 Rodrigues, *supra* note 38, 476-77.

207 457 A.2d 701, 709, n. 7.

burden of proof in a direction favorable to the controlling shareholder.[208] Delaware companies took the hint and began establishing regularly independent negotiating committees to address potentially contentious facets of merger transactions.[209]

3. Composition of the Board

Cases such as *Zapata* and *Weinberger* did not speak directly to the overall composition of boards. Instead, a board dominated by inside directors could theoretically establish the types of committee identified in *Zapata* and in *Weinberger* when the situation called for it and staff the committee with sitting directors who merely qualified as independent with respect to the matter in question or with directors freshly appointed with committee duty in mind.[210] Other Delaware cases, however, had significant implications for how entire boards were configured. Delaware Supreme Court justice Randy Holland, in a 2008 lecture where he stressed that "Delaware courts…(emphasize) the interests of shareholders by preserving the integrity of the corporate governance process," explicitly acknowledged the point, saying that a series of rulings relating to takeovers made in the 1980s created incentives for corporations to have a majority of independent directors on their boards.[211]

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208 For a summary of the case law, see Veasey and Di Guglielmo, *supra* note 12, 1480-81; Rodrigues, *supra* note 38, 477. The *Weinberger* framework has only been applied consistently with cash freezeout transactions: Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 649 (2004). It is not clear if it operates more broadly with transactions involving controlling shareholders: Hill and Brett McDonnell, *supra* note 121, 923-24.

209 Rodrigues, *supra* note 38, 477, n. 165; Allen, *supra* note 159, 2058.

210 Rodrigues, *supra* note 38, 492.

211 Holland, *supra* note 120, 685. On when the lecture was given, see *id.*, 675. See also Rodrigues, *supra* note 38, 481.

The Delaware Supreme Court's 1985 decision in *Unocal Corp. v. Mesa Petroleum Co.* provided the departure point.[212] Unocal's board, confronted with an unwelcome takeover bid by Mesa Petroleum, controlled by well-known corporate raider T. Boone Pickens, countered by authorizing a self-tender offer that was discriminatory in the sense that shares Mesa tendered would not be accepted. Mesa sued, challenging the self-tender offer on the basis that the board had violated fiduciary duties owed to Mesa and other Unocal shareholders. The Delaware Supreme Court ultimately ruled in favor of Unocal's board. In so doing, however, it indicated that due to the conflict of interest a target board faces when a hostile takeover bid occurs directors taking defensive action would only be able to rely on the protection the business judgment rule affords to a board if they had reasonable grounds for believing there was a danger to corporate policy or effectiveness and the defense adopted was reasonable in relation to the threat posed.[213]

Part V will discuss *Unocal*'s implications for the market for corporate control. For present purposes, the key point is that the Delaware Supreme Court indicated that the likelihood of defensive steps taken meeting the standard of review set down would be materially enhanced if a majority of a target company's board consisted of outside independent directors.[214] The implicit logic was that a board of this nature merited "bonus points" because concerns about self-interest on the part of the board would be at least partly assuaged.[215]

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[212] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[213] *Id.* at 955.

[214] *Id.*; Andrew G.T. Moore, *The Birth of* Unocal – *A Brief History*, 31 DEL. J. CORP. L. 865, 883 (2006); Lawrence E. Mitchell and Dalia T. Mitchell, *The Financial Determinants of American Corporate Governance: A Brief History* in CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE 19, 31 (H. Kent Baker and Ronald Anderson, eds., 2010).

[215] R. Franklin Balotti, Gregory V. Varallo and Brock E. Czeschin, UNOCAL *Revisited: Lipton's Influence on Bedrock Takeover Jurisprudence*, 60 BUS. LAW. 1399, 1411-12 (2005).

The Delaware Supreme Court soon drew upon this feature of *Unocal* in another 1985 decision, *Moran v. Household International Inc.*[216] In this case, the first where Delaware courts were called upon to assess the validity of a poison pill,[217] the Supreme Court noted approvingly that a majority of the target company's directors were independent, that the directors deliberated extensively before adopting the pill and that most of the independent directors supported adoption.[218] These favorable circumstances helped to ensure that the board could satisfy the *Unocal* framework, meaning the introduction of the poison pill was upheld as an exercise of business judgment.[219]

The *Unocal* reasoning concerning independent directors was deployed subsequently by Delaware courts in other 1980s cases, most prominently in *Paramount Communications v. Time Inc.*[220] This high-profile 1989 decision of the Delaware Supreme Court,[221] also discussed in more detail in Part V, indicated boards of Delaware companies had ample scope to "just say no" to unwanted takeover bids.[222] The court specifically cited the fact that twelve of Time's sixteen directors qualified as outside and independent in rejecting Paramount's contention that under the *Unocal* framework Time's board had failed to consider adequately

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216 500 A.2d 1346 (Del. 1985).

217 Dosung Choi, Sreenivas Kamma and Joseph Weintrop, *The Delaware Courts, Poison Pills, and Shareholder Wealth*, 5 J.L. ECON. & ORG. 375, 378 (1989).

218 500 A.2d 1348, n. 2, 1356.

219 *Id.*, 1356.

220 Paramount Communications v. Time, 571 A.2d 1140 (Del. Ch., 1990). See also Polk v. Good, 507 A.2d 531, 537 (Del., 1986), discussed on this point by Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 38-40 (1987).

221 While the written decision delivered on February 26, 1990 and revised on March 9, 1990, the Delaware Supreme Court issued its decision on July 24, 1989.

222 Subramanian, Herscovici and Barbetta, *supra* note 22, 705; Gordon, *supra* note 24, 1525; Richard E. Kihlstrom and Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523, 525 (2003). Not all observers agree that this is a correct interpretation of the case. See, for example, Bainbridge, *supra* note 2, 849-50.

whether Paramount's hostile takeover offer was a threat to corporate policy.[223] The case correspondingly indicated that the board of a Delaware target company had wide discretion to reject a hostile tender offer so long as the board was composed primarily of independent directors and opted after reasonable investigation to oppose the bid.[224] Jeffrey Gordon, in a 2007 study of the "rise" of the independent director between 1950 and 2005, explained how *Unocal* and decisions such as *Paramount* following its logic contributed to the trend he documented:

> "The lesson to a planner was clear. The price of the power to 'just say no' to a hostile bidder was a board that consisted of a majority independent directors and a process that would call on those directors to exercise (at least the appearance of) independent judgment.[225]

4. Regulatory Consolidation

A dozen or so years after *Paramount Communications* scandal-induced federal regulatory initiatives would consolidate trends concerning independent directors Delaware courts had helped to foster. Chief Justice Strine, when he indicated in 2002 that the independent director carried much water in U.S. corporate law, was speculating on the implications of the Enron debacle for regulatory reform.[226] Writing prior to the enactment of SOX later that year, he predicted that Enron would "ignite a fiery debate centered upon the so-called 'independent director'" and said state-based policymakers would not block their

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[223] 571 A.2d at 1154; on this aspect of the judgment, see Marc I. Steinberg, *Nightmare on Main Street: The* Paramount *Picture Horror Show*, 16 DEL. J. CORP. L. 1, 21 (1991).

[224] Marcel Kahan, Paramount *or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583, 587 (1994)

[225] Gordon, *supra* note 24, 1526; see also ROY C. SMITH & INGO WALTER, GOVERNING THE MODERN CORPORATION: CAPITAL MARKETS, CORPORATE CONTROL AND ECONOMIC PERFORMANCE 91-92 (2006).

[226] Strine, *supra* note 198.

ears to arguments for reform.[227] In fact, with respect to the composition of the board federal policymakers would take the lead in a way that illustrated the limits of what Chief Justice Strine refers to as the Delaware Model of corporate law as a source of corporate governance reform.

Despite Chief Justice Strine's 2002 prediction, the Delaware state legislature essentially stood pat with respect to corporate governance in the wake of Enron, WorldCom and other corporate governance scandals.[228] This perhaps was not surprising given that in Delaware there is a general tendency to "trust" directors and given that considerable emphasis is placed on stability and judicially-led incremental change.[229] Still, the contrast with the federal response was striking.

The governance scandals of the early 2000s and the resulting outcry prompted from the federal side swift and substantial changes to the regulation of board composition and structure as part of what was for U.S. corporate governance "something like a hundred year flood of reform."[230] SOX, when it was enacted in 2002, required the SEC to direct national stock exchanges to adopt listing rules precluding the listing of any company that did not have an audit committee comprised entirely of independent directors.[231] The same year, following prompting by the SEC, the New York Stock Exchange and NASDAQ promulgated listing

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227 *Id.*, 1373.

228 Bratton and McCahery, *supra* note 171, 686; Robert B. Thompson, *Delaware's Disclosure: Moving the Line of Federal-State Corporate Regulation*, [2009] U. ILL. L. REV. 167, 178.

229 *Supra* notes 105-7, 109-17 and related discussion.

230 Thompson, *supra* note 114, 791; see also Hern, *supra* note 96, 213-14 (emphasizing the swiftness of the federal government's response).

231 Sarbanes Oxley Act of 2002 § 301, amending § 10A(m)(3) of the 1934 Securities and Exchange Act. This requirement was not entirely novel; NYSE and NASDAQ listing rules had since 1999 imposed the same requirement Vidhi Chhaocchharia and Yaniv Grinstein, *The Changing Structure of US Corporate Boards: 1997-2003*, 15 CORP. GOV. INT'L. REV. 1215-16 (2007).

rules the SEC approved in 2003 that intruded further upon Delaware's corporate governance "space" by dealing with aspects of board structure and composition upon which Delaware law was silent.[232] The NYSE's revised listing rules required listed companies to have boards with at least a majority of "independent" directors and to have compensation and nominating committees staffed entirely by independent directors, with independence being defined by the board in accordance with factors the listing rules prescribed.[233] NASDAQ's listing rule amendments were similar, if less prescriptive in some respects,[234] but the Dodd-Frank Act of 2010 subsequently required the SEC to direct all major stock exchanges to preclude listing by companies lacking a compensation committee staffed by independent directors.[235]

Though with respect to boards federally driven post-Enron/WorldCom reforms were a "sea change" from a regulatory perspective,[236] the reforms made largely conformed to corporate governance norms already in place.[237] As of 2000 it was commonplace for larger public companies to have a majority of independent directors and to have audit, nomination and compensation committees staffed entirely by independent directors.[238] Delaware case

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232 Thompson, *supra* note 114, 792-93, 796. On the chronology, see Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy*, [2007] BYU L. REV. 1, 9, n. 30.

233 NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303A(1), (2), (4), (5). For an overview, see Grossman, *supra* note 179, 420; Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYOMING L. REV. 129, 156-57 (2006).

234 On pertinent differences between the revised NYSE and NASDAQ listing rules, see Clarke, *supra* note 122, 89-91; William B. Chandler and Leo E. Strine, *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 965, n. 22 (2003).

235 Dodd-Frank Act of 2010, ¶ 952; Z. Jill Barclift, *Governance in the Public Corporation of the Future: The Battle for Control of Corporate Governance*, 15 CHAPMAN L. REV. 1, 11 (2011).

236 Gordon, *supra* note 24, 1482.

237 Lisa Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 137 (2010).

238 Chhaocchharia and Grinstein, *supra* note 231, 1217-18 (Tables 1, 2) (90% of S&P 500 companies had boards with a majority of independent directors as of 2000, 62% had an

law from the 1980s was a significant element of the corporate governance norm structure that yielded these outcomes, meaning that despite the post-Enron/WorldCom wave of federal regulation Delaware jurisprudence contributed substantially to changes to board structure and composition as the 20th century drew to a close.

B. Attentiveness

1. *Smith v. Van Gorkom*

Delaware case law relating to directors was significant from a governance perspective not only because it influenced board composition and structure but also because it provided those in the boardroom with incentives to be attentive when acting on behalf of the corporation and to establish internal reporting mechanisms that could help to uncover conduct that was potentially detrimental to the corporation. With respect to the attentiveness of directors, given various bold claims that have been made concerning the governance impact of *Smith v. Van Gorkom*,[239] this case provides the obvious departure point. As was the case with *Unocal* and *Moran*, the Delaware Supreme Court delivered this judgment in the watershed year of 1985.[240]

Van Gorkom has been described as "the first key governance case."[241] It has been suggested similarly that with the ruling the Delaware Supreme Court "engaged in its own reform of corporate governance"[242] and that the decision "stands as the apogee in the reach of

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independent audit committee, 45% had an independent nomination committee and 79% had an independent compensation committee). See also Fairfax, *Uneasy*, *supra* note 237, 137.

239 488 A.2d 858 (1985).

240 *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 137 (2000).

241 Sale, *supra* note 10, 464.

242 Marianne M. Jennings, *Why Corporate Boards Don't Work*, 12 J.L. & COMM. 85, 106 (1992).

judicial corporate governance via fiduciary duty."[243] Ira Millstein, a prominent advocate of stronger corporate governance, even argued at a 2000 roundtable marking the case's 15th anniversary that the case was "the *Brown vs. Board of Education* in corporate governance."[244] This, as Millstein acknowledged might be the case, was an overstatement.[245] *Van Gorkom* was important but likely not as important as it appeared at the time.

In *Van Gorkom* Trans Union's board, acting under a tight deadline, recommended after a two-hour board meeting that a merger proposal the company's CEO had negotiated be submitted to the shareholders for approval.[246] The board's endorsement of the proposed merger was not tainted in any way by self-dealing or by a conflict of interest.[247] The price offered also incorporated a sizeable control premium.[248] Nevertheless the Delaware Supreme Court held Trans Union's directors were not protected by the business judgment rule because they had been grossly negligent and correspondingly should be held liable. The damages agreed upon in a subsequent settlement exceeded the policy limit of Trans Union's directors' and officers' insurance policy,[249] which meant that for Trans Union's outside directors this was one of only a tiny handful of occasions where an outside director of a publicly traded

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243 Elson and Thompson, *supra* note 6, at 580.

244 *Roundtable: The Legacy of "Smith v. Van Gorkom"*, DIRECTORS & BOARDS, Spring 2000, 28, 44 (citing Brown v. Board of Education, 347 U.S. 483 (1954)).

245 *Id.*

246 On the nature of the time pressure, see Jonathan R. Macey, Smith v. Van Gorkom: *Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW. UNIV. L. REV. 607, 614 (2002).

247 *Id.*, 608.

248 The premium was between 39% and 62%, depending on the method of calculation: Stephen A. Radin, *"Smith v. Van Gorkom" on its 15th Anniversary*, DIRECTORS & BOARDS, Spring 2000, 24, 24.

249 David Eisner, *Ruling In, Jury Still Out on Trans Union*, CHI. TRIB., Feb. 8, 1987, G3.

company faced "out-of-pocket" liability in a case arising under corporate or securities law.[250] With instances where directors of business corporations had been held liable without engaging in self-dealing having been "few and far between"[251] the case reputedly "exploded a bomb"[252] that "shook the foundations of the corporate world."[253] The *Chicago Tribune* said of the case that it would "have a chilling – some would say therapeutic – effect on corporate governance" and had left "Some of Chicago's leading corporate faces"…"red with shock,

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[250] The Pritzker family, which bought Trans Union ultimately paid most of the outside directors' damages and Trans Union's CEO paid the rest: Eisner, *supra* note 249. On the "out-of-pocket" liability angle, see Black, Cheffins and Klausner, *supra* note 51, 1067.

[251] Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095 (1968); see also Krishnan Chuttur, *The Corporate Director's Standard of Care: Past, Present and Future*, 10 J. CORP. L. 505, 505, 512 (1985).

[252] Bayless Manning, *Reflections and Personal Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 1 (1985).

[253] Sarah Helene Duggin and Stephen M. Goldman, *Restoring Trust in Corporate Directors: The Disney Standard and the "New" Good Faith*, 56 AM. UNIV. L. REV. 211, 231 (2006). See also Lawrence A. Cunningham and Charles M. Yablon, *Delaware Fiduciary Duty Law After* QVC *and* Technicolor: *A Unified Standard (and the End of* Revlon *Duties?)*, 49 BUS. LAW. 1593, 1597 (1994) ("sent shock waves through the corporate world"); Christopher J. Bebel, *Why the Approach of* Heckmann v. Ahmanson *Will Not Become the Prevailing Greenmail Viewpoint: Race to the Bottom Continues*, 18 TEXAS TECH L. REV. 1083, 1111 ("The *Van Gorkom* decision has shocked the business community…."); Edward Rock and Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. UNIV. L. REV. 650, 650 (2002) ("People were shocked by *Smith v. Van Gorkom*"); Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUSTON L. REV. 393, 411 (2005) (citing sources indicating "The decision shocked the business community…").

Despite *Van Gorkom* supposedly being a shock to the corporate community, issuance of the judgment did not have a statistically measurable impact on the value of the shares of publicly traded Delaware companies: Michael Bradley and Cindy A. Schipani, *The Economic Importance of the Business Judgment Rule: An Empirical Analysis of the Trans Union Decision and Subsequent Delaware Legislation* in THE BATTLE FOR CORPORATE CONTROL: SHAREHOLDER RIGHTS, STAKEHOLDER INTERESTS, AND MANAGERIAL RESPONSIBILITIES 105, 116-19 (Arnold W. Sametz, ed., 1991). On possible explanations why, see William T. Allen, *Law and Markets as Social Products: Comments on Chapter 7* in BATTLE, *op. cit.*, 147, 148-49.

anger and embarrassment" (Trans Union was Chicago-based despite being incorporated in Delaware).[254]

Widespread take-up by Delaware companies of the option created by the 1986 enactment of § 102(b)(7) of the Delaware General Corporation Law to include a provision in their charters precluding director liability for breaches of the duty of care did much to cancel out the increased risk of out-of-pocket liability *Van Gorkom* implied.[255] Nevertheless, the case has been credited with sensitizing the business community to the fact that boards had meaningful deliberative responsibilities.[256] A 1988 review of a book on directors said that as a result of *Van Gorkom* "American directors began to document and deliberate as never before."[257] Various observers reflecting on the case's 15th anniversary remarked on how primitive the deliberations of the Trans Union board were compared with the standards of their day and attributed the change partly to *Van Gorkom*.[258] Charles Elson even suggested in a 1997 article where he identified the ten most prominent corporate law cases of all time that *Van Gorkom* had more impact on director behavior than any other judicial ruling made during the second half of the 20th century.[259]

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254 Bill Banhart and Sally Saville Hodge, *Aftershocks Linger in Wake of Trans Union Temblor*, CHI. TRIB., Nov. 13, 1985, B1. Trans Union was headquartered in Lincolnshire, a Chicago suburb: *Suit Seeks to Block Bid of Marmon*, CHI. TRIB., Dec. 23, 1980, B5.

255 Elson and Thompson, *supra* note 6, at 583; Black, Cheffins and Klausner, *supra* note 51, 1090-91; Radin, *supra* note 248, 27. The enactment of § 102(b)(7) has been described as a response to *Van Gorkom* (e.g. Sale, *supra* note 10, 466) but the case likely was only one of a number of factors contributing to reform: Radin, *supra* note 248, 27; James L. Griffith, *Director Oversight Liability: Twenty-First Century Standards and Legislative Controls on Liability*, 20 DEL. J. CORP. L. 653, 688 (1995).

256 Charles W. Murdock, *Corporate Governance – The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 101 (1993).

257 Wayne Welch, *Caveat Director*, N.Y. TIMES, Oct. 23, 1988, BR51.

258 *Roundtable*, *supra* note 244, 30, 40; Macey, *supra* note 246, 607.

259 Charles M. Elson, *Courts and Boards: The Top 10 Cases*, DIRECTORS & BOARDS, Fall 1997, 26, 26.

While *Van Gorkom* no doubt was an important case, its significance for corporate governance has been exaggerated at least to some degree.[260] The decision did initially catch the attention of directors unlike any other case,[261] but this notoriety was based on liability fears that should have been rendered largely moot for Delaware companies by § 102(b)(7).[262] By 2000, in the absence of additional noteworthy instances of personal liability of outside directors, the name recognition of the case had diminished considerably.[263] Moreover, given that *Van Gorkom* provided a road map of steps boards could take to help to meet the relevant legal standards,[264] such as consult investment bankers and review systematically key terms of a proposed transaction,[265] the case may well have done more to foster the introduction of formalistic procedures to "paper" transactions than elicit genuinely increased attentiveness by directors.[266] Given these caveats, to the extent that directors became more diligent post-*Van Gorkom* the case likely was only one of several factors that encouraged them to do so.[267]

2. The Disney Litigation

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260 *Cf.* Kahan and Rock, *supra* note 50, 900 ("Van Gorkom may have been a major case *ceteris paribus*, but turned out largely insignificant *mutatis mutandis*.")

261 *Roundtable, supra* note 244, 34; Macey, *supra* note 246, 625.

262 On fears of personal liability explaining the case's notoriety, see *Roundtable, supra* note 244, 34-35; *Lawsuits Take Appeal From Director's Job*, CHI. TRIB., Dec. 28, 1986, F4 (describing how the personal liability of the directors "frightened directors all over the country.")

263 Elson and Thompson, *supra* note 6, at 586.

264 William Prickett, *An Explanation of* Trans Union *to "Henny-Penny" and Her Friends*, 10 J. CORP. L. 451, 461 (1985); Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 100-1 (1989).

265 Manning, *supra* note 252, 9, 13.

266 Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CINN. L. REV. 649, 682-87 (1995); see also Jonathan R. Macey and Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L.J. 127, 141 (1988) (indicating that the authors, like "the majority of commentators", believed the benefits of increased deliberation would be small due to a formalistic response).

267 MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 61 (1995).

Shareholder derivative litigation arising from the Walt Disney Company's mid-1990s hiring of Michael Ovitz as a senior executive and his abrupt dismissal on very generous terms shortly thereafter provided Delaware courts with a fresh opportunity to adjudicate upon incentives directors of public companies had to be attentive. The litigation that culminated in what some heralded as "the corporate governance 'case of the century'"[268] elicited some forceful judicial rhetoric. Ultimately, however, the outcome in the case muted its impact considerably.

While initial preliminary rulings in the Disney litigation preceded the Enron and WorldCom scandals,[269] additional preliminary rulings and the trial and ensuing appeal which culminated the protracted litigation occurred after.[270] Various observers anticipated that the Delaware judiciary would respond to the scandals and the federal intervention in the states' corporate governance space signalled by SOX by requiring more from directors.[271] The ongoing Disney litigation was an obvious weathervane for a possible change in approach. A 2003 preliminary ruling by Chancellor Chandler in the Disney litigation did seem to show a willingness to find breaches of duty in the case and indicated that the plaintiffs could potentially by-pass the liability bar Disney's § 102(b)(7) charter provision imposed by proving a breach of a duty of good faith oriented around an intentional or conscious disregard

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268 H. Stephen Grace and John E. Haupert, *Governance Lessons from the Disney Litigation*, BUS. LAW TODAY, Sept. 2011, 1, 1; see also Duggin and Goldman, *supra* note 253, 247 ("the most celebrated, and widely-reported, corporate governance trial in American history").

269 See, for example, *In re* Walt Disney Co. Derivative Litig. 731 A.2d 342 (Del. Ch. 1998); *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

270 *In re* Walt Disney Co. Derivative Litig. 907 A.2d 693 (Del. Ch. 2005); *aff'd* 906 A.2d 27 (Del. 2006).

271 See, for example, Fairfax, *supra* note 253, 418-19; Amy Borrus, *Less Laissez-Faire in Delaware*, BUS. WEEK, March 22, 2004, 80; Mirelle Bahri, *The Magic of* Disney: *Turning Best Practices into Standards of Performance*, 37 SETON HALL L. REV. 1075, 1076, 1086 (2007).

of duty.[272] This ruling prompted former Chancellor William Allen to say "it would not be unreasonable to assume that the Delaware courts are responding to the Enron and WorldCom headlines and the intrusion, so to speak, of the federal government into the internal governance of corporations."[273] Expectations, however, that the Disney litigation would provide the departure point for an ambitious new stance on director liability ultimately went unfulfilled.

Chancellor Chandler in his 2003 judgment in the Disney litigation referred to the Disney board as "ostrich-like" and accepted for the purposes of that stage of the proceedings the plaintiff's allegation that the board behaved "blindly."[274] At trial he indicated that Disney's directors had not complied with boardroom best practice and implied the case was an instance where "an imperial CEO" (Michael Eisner) was operating largely unchecked by a "supine or passive board."[275] Nevertheless Chancellor Chandler held at trial that whatever deficiencies may have been present with respect to deliberations by the Disney board the plaintiffs' case should be dismissed because there had not been gross negligence or a conscious disregard of duty.[276] This ruling was upheld on appeal.[277]

Chancellor Chandler did take the opportunity in his judgment following the Disney trial to provide guidance to board members on how they could meet what he called "(a)spirational ideals of good governance practices" that went "beyond the minimal legal

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272 Fairfax, *supra* note 253, 418 discussing *In re* Walt Disney Co. Derivative Litig. 825 A.2d 275 (Del. Ch., 2002).

273 Quoted in Fairfax, *supra* note 253, 418.

274 825 A.2d 275, 277, 288-89, quoted in Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 22 (2005).

275 907 A.2d 693, 697, 761, n. 487 (Del. Ch. 2005). The Delaware Supreme Court agreed with Chancellor Chandler on the Disney board's failure to act in accordance with best practice: 906 A.2d 27, 55-56 (Del. 2006).

276 907 A.2d 693, 760, 772 (Del. Ch. 2005).

277 906 A.2d 27 (Del. 2006).

requirements" satisfied by the Disney board.[278] For instance, he implied that a board should not leave a CEO, as Disney's board seemingly had done with Eisner, to enthrone "himself as the omnipotent and infallible monarch of his personal Magic Kingdom."[279] Chancellor Chandler also urged directors to inform themselves fully using all available resources before making crucial decisions affecting the company and to document fully their deliberations.[280]

While in the Disney litigation the Delaware courts criticized aspects of the company's corporate governance and in so doing provided guidance on good practice, the outcome in the case nevertheless muted the litigation's subsequent impact. With corporate boards watching the Disney litigation fearfully[281] a ruling in favor of the plaintiffs likely would have sent a "chilling message" to directors[282] and "shock waves through the nation's boardrooms."[283] Instead, the outcome was a "relief"[284] that helped to ease fears of directors becoming skittish about Delaware courts and growing liability risks.[285] The case also indicated that litigation in Delaware courts was not a promising route for challenging governance arrangements compromised by a domineering CEO[286] and led some to wonder whether Delaware courts were prepared in controversial cases to develop and apply meaningful corporate governance

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[278] 907 A.2d 693, 745, n. 399; see generally Bahri, *supra* note 271, 1097.

[279] 907 A.2d 693, 763.

[280] *Id.*, 764-65.

[281] Patti Waldmeir, *Directors Face a Disney Doomsday*, FIN. TIMES, Oct. 25, 2004.

[282] Laura M. Holson, *Ruling Upholds Disney's Payment in Firing of Ovitz*, N.Y. TIMES, Aug. 10, 2005, A1.

[283] *Regulating Fantasyland*, N.Y. TIMES, Aug. 12, 2005, A18.

[284] Stephanie Kirchgaessner, *Relief Over Milestone Disney Ruling*, FIN. TIMES, Aug. 11, 2005, 25.

[285] Mark A. Stein, *Corporate Boards to Investors: Let Them Eat Doughnuts*, N.Y. TIMES, Aug. 12, 2005, C3; Sandra Rubin, *No Magic Change in Director Liability: Disney Ruling Bound to Disappoint Activists Seeking More Accountability*, NATIONAL POST, Aug. 17, 2005, FP09; David Marcus, *Does Del. High Court's Disney Ruling Return the Status Quo?*, DEL. LAW WEEKLY, July 5, 2006, D1.

[286] Z. Jill Barclift, *Corporate Governance and CEO Dominance*, 50 WASHBURN L.J. 611, 626 (2011).

standards.[287] This does not mean that the case was wrongly decided[288] nor that the outcome, given the institutional constraints under which Delaware courts operate,[289] was particularly surprising. Nevertheless, the absence of director liability meant the Disney litigation was not the landmark corporate governance event it potentially could have been.

C. Monitoring -- *Caremark*

While with the Disney/Ovitz litigation the fact that there was neither a breach of duty nor directorial liability likely reduced its impact, a 1996 ruling by Chancellor Allen in derivative litigation involving health care provider Caremark indicates that an adverse outcome for directors was not mandatory for a case to have important corporate governance implications.[290] *Caremark*, which has been described "as one of the most significant decisions in Allen's remarkable tenure as Delaware chancellor,"[291] also illustrates that while case law precedents reduce the scope for judicial creativity in the corporate governance realm[292] the constraint is not binding in all circumstances.

In *Caremark* Chancellor Allen was called upon to approve a settlement in a derivative suit arising from allegations that Caremark had been exposed to substantial liability risk because inadequate board oversight and the absence of appropriate internal compliance mechanisms had provided Caremark employees with broad scope to engage in illicit kickback

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287 Steinberg and Bivona, *Disney, supra* note 204, 230; Griffith, *supra* note 274, 71 (saying of the 2005 Delaware Court of Chancery opinion that it indicated Delaware courts were "No longer seeking to forge new ground in corporate law jurisprudence…").

288 Claire A. Hill and Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 863 (2007).

289 *Supra* Part III.D.

290 *In re* Caremark Int'l Derivative Litig. 698 A.2d 959 (Del. Ch., 1996); Hill and McDonnell, *supra* note 288, 862 ("*Caremark*…became highly influential notwithstanding the court's pronouncement that the directors were almost certainly not liable for breach of duty.")

291 Cox, *supra* note 20, 343.

292 *Supra* notes 162, 179-83 and related discussion.

schemes and billing practices.[293] Chancellor Allen signed off on the settlement, which provided for undertakings by Caremark concerning the manner it would conduct its business in the future but no damages payments.[294] In so doing, he issued a judgment that distinguished between potential director liability for board decisions resulting in a loss to the corporation and for unconsidered inaction.[295] In relation to the latter, Chancellor Allen indicated that directors could find themselves in breach of duty if they failed to assure themselves that reporting systems were in place that were reasonably designed to provide timely, accurate information that would permit management and the board to reach informed judgments concerning the corporation's performance and compliance with the law.[296]

While there was no finding of director liability in *Caremark* and while Chancellor Allen indicated that only "an utter failure" to establish a reasonable information and reporting system would establish the absence of good faith required for there to be directorial liability,[297] in corporate governance circles the case was hailed as a significant extension of the responsibilities of directors.[298] Practitioners in turn relied on Chancellor Allen's judgment to urge boards of public companies to upgrade substantially existing internal reporting and compliance programs.[299] A sizeable increase in the size and scope of reporting

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[293] For a helpful overview of the background to the case, see H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 DEL. J. CORP. L. 1, 16-20 (2001).

[294] *Caremark*, 698 A.2d at 965-66, 972.

[295] *Id.* at 967-68.

[296] *Id.* at 970.

[297] *Id.* at 971.

[298] Dean Starkman, *Compliance Ruling May Shield Directors*, WALL ST. J., Dec. 24, 1996, B5.

[299] Bahri, *supra* note 271, 1089; Edward B. Rock and Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1674-75 (2001).

and compliance systems reputedly followed.[300] It is unclear whether these developments prompted more effective board oversight or reduced violations of the law.[301] Nevertheless, it would seem that *Caremark* had a significant impact on governance arrangements without the shock factor of director liability.

Caremark was also doctrinally innovative and correspondingly shows Delaware judges could sidestep seemingly inconvenient case law precedent to issue rulings which influenced corporate governance. The Delaware Supreme Court explicitly acknowledged for the first time in 1963 in *Graham v. Allis-Chalmers*[302] that directors seeking the protection of the business judgment rule would be held to a duty of care as well as a duty of loyalty.[303] The case also indicated, however, that directors of Delaware companies were not obliged in a general way to monitor a corporation's compliance with the law and had no obligation to ferret out wrongdoing absent some cause for suspicion.[304]

Graham, which involved a claim that directors should be held liable for failing to monitor adherence by subordinates to antitrust law, potentially could, as a Delaware Supreme Court decision, have been binding as a matter of *stare decisis* on Chancellor Allen. He side-stepped the case, however, by indicating it only stood for the proposition that a corporation's directors could rely on the honesty and integrity of the officers and employees unless there

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300 Elson and Gyves, *supra* note 43, 701.

301 Compare Bahri, *supra* note 271, 1089 (arguing that *Caremark* "heightened the level of attention directors pay to their oversight responsibilities….") with Elson and Gyves, *supra* note 43, 702 (arguing that fraud and other illegal activities were not deterred because the changes which occurred established protection against liability and correspondingly elevated form over substance).

302 188 A.2d 125 (Del. 1963).

303 Henry R. Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 985-87 (1994).

304 Brown, *supra* note 293, 27.

were grounds for suspicion.[305] He also said that even if the holding in *Graham* in fact was that directors were not obliged to ensure that appropriate information and reporting systems were in place, due partly to the Delaware Supreme Court having recognized in cases such as *Van Gorkom* and *Paramount* the "seriousness" of the role of the board in managing corporations, the Supreme Court would not have accepted this proposition during the mid-1990s.[306]

In *Stone v. Ritter*, a 2006 case, the Delaware Supreme Court confirmed Chancellor Allen's prediction, acknowledging in so doing that he had narrowly construed *Graham* and endorsing his characterization of the law by saying that *Caremark* "articulate(d) the necessary conditions for assessing director oversight liability."[307] Chancellor Allen's judgment in *Caremark* was not vindicated entirely in *Stone v. Ritter*. He said that while the obligation of directors to monitor a corporation's affairs to protect against violations of the law was part of the duty of care, there would only be a breach of duty in this context in the absence of good faith.[308] In *Stone v. Ritter* the Delaware Supreme Court similarly treated the duty to monitor as falling within a duty of good faith but characterized good faith as a component of the duty of loyalty rather than the duty of care and in so doing may have partly undermined the duty to monitor by introducing a scienter requirement.[309] Nevertheless, Chancellor Allen's *Caremark* judgment stands out as an example of a Delaware court ruling that had a

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305 *Caremark*, 698 A.2d at 969; discussed on this point by Brown, *supra* note 293, 27; Elson and Gyves, *supra* note 43, 700.

306 *Caremark*, 698 A.2d at 970, discussed on this point by Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 724 (2009/10).

307 Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 368, 370 (Del. 2006).

308 *Caremark*, 698 A.2d at 967-68, discussed on this point by Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 WAKE FOREST L. REV. 1131, 1157 (2006).

309 *Stone*, 911 A.2d at 370 ("(i)mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations"); Pan, *supra* note 306, 732-33 (discussing the implications).

significant impact on the development of corporate governance despite potentially inconvenient prior jurisprudence and an absence of directorial liability.

V. TAKEOVERS

The market for corporate control, which encompasses the process by which outside teams take control of companies from incumbent directors and managers,[310] has been in operation in the U.S. since at least the start of the 20th century.[311] It went into overdrive, however, in the 1980s. "The Deal Decade" was exemplified by bidders who relied on aggressive, innovative financial and legal techniques to secure voting control of larger-than-ever target companies by offering generous terms to shareholders of the targets.[312] Delaware courts were in the center of the action, primarily due to adjudicating cases where legal challenges followed after boards of targeted Delaware-incorporated public companies took defensive measures to derail unwelcome takeover approaches. As David Skeel said in his 2005 book *Icarus in the Boardroom*, "Raiders made their bids, the target company resisted, and then everyone packed up their bags and went to Delaware, where many of the target companies were incorporated, to see if the defenses would be permitted."[313]

When shareholders used litigation to challenge the deployment of defensive tactics, as we will see now, Delaware's judiciary did not give boards *carte blanche* but generally upheld steps taken. The stance taken by Delaware's courts may well have ultimately helped to bring

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310 *Cf.* OECD, *Glossary of Statistical Terms*, available at http://stats.oecd.org/glossary/detail.asp?ID=3255 (accessed Aug. 26, 2014) ("the term 'market for corporate control' refers to the process by which ownership and control of companies is transferred from one group of investors and managers to another.")

311 John Armour and Brian Cheffins, *The Origins of the Market for Corporate Control*, U. ILL. L. REV. (forthcoming), working paper version available at http://ssrn.com/abstract=2324427.

312 *Supra* note 56 and related discussion; Cheffins, *supra* note 8, 52.

313 DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 124-25 (2005)

the Deal Decade to a close. To the extent this was the case, rulings by Delaware courts likely contributed to an increased emphasis on potentially key "internal" corporate governance mechanisms, namely the board of directors, shareholder activism and incentivized executive pay.

A. The Cases

1. Takeover Defenses -- Contending Schools of Thought

Ronald Gilson suggested in his 1999 Pileggi lecture that "the hostile takeover wave of the 1980s subjected the traditional structure of corporate law to the equivalent of a stress test."[314] On the one hand, when a takeover bid was made for a public company for the target board evaluation of the terms was "the quintessential business judgment."[315] The situation, however, also created for directors – particularly executives on the board facing potential dismissal if the bid succeeded – an inherent conflict of interest.[316]

With respect to how the stress test should play out there was two contending points of view. One school of thought, which had lawyer Martin Lipton as its most prominent proponent, was that board decisions relating to hostile takeover bids should be governed by the business judgment rule in the same manner as board decisions concerning other acquisition proposals.[317] The opposing point of view was that decisions concerning the fate of tender offers, a popular hostile takeover technique that involves a bidder extending an offer directly to shareholders to buy their shares, should be reserved solely for the

[314] Gilson, *supra* note 1, 495. He made the point originally in Ronald J. Gilson, *The Fine Art of Judging: William T. Allen*, 22 DEL. J. CORP. L. 914, 914 (1997).

[315] Gilson, *supra* note 1, 495.

[316] *Id*.

[317] *Id*.; Moore, *supra* note 214, 870; Michael L. Wachter, *Takeover Defense When Financial Markets are (Only) Relatively Efficient*, 151 U. PA. L. REV. 787, 789-90 (2003).

shareholders as owners of their shares.[318] This school of thought included academics such as Professor Gilson, Frank Easterbrook and Daniel Fischel, who characterized the hostile bid as an important corporate governance device that served to enhance managerial accountability.[319]

2. 1985

In a series of three takeover cases handed down during the "watershed year" of 1985 – *Unocal,*[320] *Moran v. Household International Inc.*[321] and *Revlon Inc. v. MacAndrew & Forbes Holdings, Inc.*[322] -- the Delaware Supreme Court chose a middle ground between the two contending points of view on takeover defenses.[323] *Revlon* indicated that if events meant the sale of a target company was inevitable a board should act as auctioneer and could only deploy takeover defenses to maximize the price for the shareholders.[324] Otherwise, director action in response to a takeover bid would be subject to what became known as "the *Unocal* intermediate standard" of review.[325]

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318 Moore, *supra* note 214, 871.

319 Gilson, *supra* note 1, 495; Bainbridge, *supra* note 2, 793-95; Ronald J. Gilson and Reinier Kraakman, *Takeovers in the Boardroom: Burke Versus Schumpeter*, 60 BUS. LAW. 1419, 1424, 1426 (2005).

320 Unocal Corp. v. Mesa Petroleum, 493 A.2d 946 (Del. 1985).

321 500 A.2d 1346 (Del. 1985).

322 506 A. 2d 173 (Del. 1986). The oral decision in this case was issued November 1, 1985 and the written opinion was distributed on March 13, 1986. Lipton and Rowe have characterized *Revlon* as being part of "key choices Delaware made in 1985": *Pills, supra* note 9, 11.

323 Gilson, *supra* note 1, 496; see also *The Case of the Poison Pill*, ECONOMIST, Dec. 11, 2004, 72 ("uncertain compromise").

324 506 A. 2d 173, 182, discussed on this point by Mark J. Lowenstein, *Toward an Auction Market for Corporate Control and the Demise of the Business Judgment Rule,* 63 SO. CAL. L. REV. 65, 78 (1989); John Armour and David A. Skeel, *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1756 (2007).

325 Gilson, *supra* note 1, 496.

In *Unocal* the Delaware Supreme Court explicitly rejected the proposition that boards should remain passive in the takeover context,[326] a point substantiated by the fact that the court upheld the target board's use of a self-tender offer. Being aware, however, that there was an "omnipresent specter" of potentially self-interested entrenchment when a board adopts defensive measures in the takeover context,[327] the Delaware Supreme Court did not go to the opposite extreme and treat adoption of defensive tactics as being fully protected from review under the business judgment rule. Instead, the Supreme Court deployed for the first time a standard of review standing between the traditional business judgment rule and the fairness test associated with the duty of loyalty.[328] Under this intermediate standard the business judgment rule would only be applied to the adoption and deployment of a defensive measure if the board showed there were reasonable grounds for believing that there was a danger to corporate policy and effectiveness and the defensive tactic was reasonable in relation to the threat posed.[329]

In *Household* the Delaware Supreme Court deployed the *Unocal* intermediate standard of review to rule in favor of defendant directors who had deployed a "preferred share purchase rights plan", a species of poison pill.[330] Of the key 1985 takeover decisions, this is the one that arguably had the greatest practical impact because it helped to prompt widespread adoption of poison pills.[331] Martin Lipton invented the rights plan poison pill in

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326 *Unocal*, 493 A.2d 946, 955, n. 10. For background on why the court was inclined to require the board to be passive, see Moore, *supra* note 214, 881-82.

327 *Unocal*, 493 A.2d 946, 954; Moore, *supra* note 214, 883.

328 *Unocal*, 493 A.2d 946, 955; on the novelty of the intermediate standard, see Moore, *supra* note 214, 883.

329 This characterization comes from *Paramount Communications*, 571 A.2d 1140, 1152.

330 *Moran*, 500 A.2d 1346, 1348, 1350, 1354.

331 Lipton and Rowe, *supra* note 9, 12.

1982,[332] with the first adoption taking place in 1983.[333] A mere seven companies adopted a poison pill in 1984 and only 40 did so the following year.[334] Not even 5% of publicly traded *Fortune* 500 companies had such a mechanism in place when *Household* was decided.[335]

The legality of poison pills was being tested in various courts at the time and the resulting ambiguity at least partly explained the slow take-up.[336] *Household* was destined to set the tone both as the first challenge to a poison pill in Delaware and as a decision of the Delaware Supreme Court.[337] The judicial blessing of the poison pill in *Household* was said to be a "seminal event"[338] that "unleashed a flood of poison pill adoptions."[339] The number of

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[332] Martin Lipton, *Twenty-Five Years After* Takeover Bids in the Target's Boardroom: *Old Battles, New Attacks and the Continuing War*, 60 BUS. LAW. 1369, 1372 (2005).

[333] Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand or No Hand Pills*, 29 J. CORP. L. 1, 8 (2003).

[334] Mark R. Wingerson and Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, [1992] COLUM. BUS. L. REV. 223, 236.

[335] Gerald F. Davis, *Agents Without Principles? The Spread of the Poison Pill Through the Intercorporate Network*, 36 ADMIN. SCI. Q. 583, 587 (1991).

[336] *Id*.

[337] *Supra* note 217 and related discussion (identifying *Household* as the first such case in Delaware); Gavin Stevenson, *A Poison Pill That's Causing a Rash of Lawsuits*, BUS. WK., Apr. 1, 1985, at 54, 58, (quoting a former chairman of the Business Roundtable as saying "This is probably the single most important corporate law case to come before the courts in years" and indicating, quoting Jerry Peppers, a securities lawyer, "Legal challenges (to the pill) have proliferated…But the [*Household*] case in Delaware is the crucial one. Because so many companies are incorporated there, and because the court is widely respected, 'its decision will set the tone for rulings in other state and federal courts….'"

[338] BRETT COLE, M&A TITANS: THE PIONEERS WHO SHAPED WALL STREET'S MERGERS AND ACQUISITIONS INDUSTRY 155 (2008) (quoting Morris Kramer, a lawyer at Wall Street firm Skadden); see also Lucian A. Bebchuk, John C. Coates and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STANFORD L. REV. 887, 905 (2002) ("the seminal case upholding the poison pill");

[339] Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21, 43 (1988); see also John Gorman, *How Lethal is Household's Poison Pill?*, CHI. TRIB., Oct. 11, 1985 (indicating that "numerous corporations" adopted a pill after the Delaware Court of Chancery decision in the case); Larry Fish, *Poison Pills: More to Come*, CHI. TRIB., Nov. 24, 1985, D9 (saying of *Household* "Corporate directors now have a clearer license to prescribe 'poison pills' to ward off unfriendly takeover attempts, after a key court decision last week.")

companies adopting pills did indeed accelerate markedly to 302 in 1986, 142 in 1987 and 332 in 1988.[340] The trend, moreover, extended to the very largest companies. As of 1986, 35% of publicly traded *Fortune* 500 companies had implemented a pill and 60% had done so by the end of 1989.[341]

3. *Paramount*

Unocal and *Household* made it clear that boards of Delaware companies were not required to be passive in the takeover context and instead had at least a threshold role as a gatekeeper.[342] Nevertheless, hostile takeover bids continued throughout the remainder of the 1980s, with the Delaware Supreme Court acknowledging in 1989 that the continuing "spate of takeover litigation…readily demonstrates such 'poison pills' do not prevent rival bidders from expressing their interest in acquiring a corporation."[343] There were also a few instances in the late 1980s where the Delaware Chancery Court struck down takeover defenses,[344] which suggested that courts were becoming less trustful of target boards seeking to derail unwelcome bids.[345] The Delaware Supreme Court's 1989 ruling in *Paramount* was

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340 Wingerson and Dorn, *supra* note 334, 236.

341 Davis, *supra* note 335, 587.

342 Lipton, *supra* note 332, 1372, 1374.

343 Barkan v. Amsted Industries, Inc., 567 A.2d 1279, 1287 (Del. 1989). Consistent with this observation, it appears that the rate of hostile takeover activity actually increased in the years immediately following the introduction of poison pills: Matthew D. Cain, Stephen B. McKeon and Steven Davidoff Solomon, *Do Takeover Laws Matter? Evidence from Five Decades of Hostile Takeovers*, unpublished working paper, available at http://ssrn.com/abstract=2517513, 19-20 (2014).

344 Choi *et al.*, *supra* note 217, 389-90, citing City Capital Associates Limited Partnership v. Interco, 551 A.2d 587; Mills Acquisition Co. v. MacMillan Inc., Fed. Sec. L. Rep. ¶ 94,071, also reported at 14 DEL. J. CORP. L. 772 (1989). See also Grand Metropolitan PLC v. The Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988).

345 Lowenstein, *supra* note 324, 105; Tim Smart, *For Managers, Delaware Isn't the Haven it Used to Be*, BUS. WK., Dec. 19, 1988, 33 ("In recent months (Delaware's) courts have issued a torrent of stern warnings about entrenched managements' efforts to keep their jobs at all costs and have even dispensed some poison-pill antidotes to corporate raiders.")

associated with a reversal on both counts and as such may have had significant corporate governance ramifications beyond the market for corporate control.

The case arose when Paramount Communications, which had responded to news of an agreed-upon but not finalized merger between Time Inc. and Warner Communications Inc. by making a hostile tender offer to Time's shareholders, sued the directors of Time after they pressed ahead with a restructured Time/Warner acquisition scheme rather than consider the last-minute Paramount bid.[346] The Delaware Supreme Court ruled in favor of the Time directors, applying *Unocal* in so doing.[347] It has been said that "with the court's 1989 opinion…, Delaware finally went anti-takeover."[348] More precisely the Delaware Supreme Court afforded boards, as compared with prior post-*Unocal* cases, considerably greater discretion to determine whether there were reasonable grounds for believing that there was a danger to corporate policy and effectiveness and to assess whether defensive measures taken were reasonable in relation to the threat posed.[349] With the business judgment rule correspondingly coming into operation in a considerably wider range of circumstances,

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[346] Two other groups of plaintiffs who were Time shareholders also challenged the steps Time had taken: *Paramount*, 517 A.2d 1140, 1141-42.

[347] *Paramount*, 517 A.2d 1140, 1152. The court also rejected a claim by the shareholder plaintiffs that *Revlon* duties had been triggered because a change of control was inevitable – at 1150-51.

[348] Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 631 (2003).

[349] Steinberg, *supra* note 223, 20; Floyd Norris, *Managers Win One*, N.Y. TIMES, July 16, 1989, 22 (saying of the Delaware Court of Chancery's judgment in *Paramount*, which the Delaware Supreme Court upheld, "In the area of corporate takeovers, courts in Delaware, the nation's unofficial corporate capital, seem to be changing course and making it easier for managers to fight off hostile takeovers….). Experts quoted in the press divided when they predicted the outcome in the Paramount/Time litigation, at least at the Chancery Court level. See, for example, John Crudele, *Predicting the Future of Time*, WASH. POST, July 2, 1989, H7 (citing Prof. Michael Bradley's prediction that Time would lose); David B. Hilder, *Paramount Faces Uphill Bid to Block Time Warner's Purchase, Experts Say*, WALL ST. J., July 7, 1989, A3 (citing Prof. Bernard Black's prediction that Time would prevail). When the case was appealed a consensus appeared to develop that Time would win: Charles Storch, *Experts See Case Going Time's Way*, CHI. TRIB., July 24, 1989, C1.

boards had much greater scope to "just say no" in the takeover context than many had thought was the case.[350]

Subsequent events demonstrated *Paramount* was not an anomaly. Instead it would turn out to be the most prominent facet of a general trend where Delaware courts "drifted fairly steadily toward even greater deference to directors in the takeover context."[351] The Delaware Supreme Court ruled against the board of Paramount in a high profile 1993 case where the board failed to give equal consideration to a hostile bidder in a bidding contest with a preferred merger partner.[352] Two years later, however, in *Unitrin Inc. v. American General Corp*. the same court indicated that boards could deploy defensive tactics so long as the measures in question were not "draconian" and a proxy contest for board control was not "mathematically impossible or realistically unattainable."[353]

While *Paramount* was part of a broader jurisprudential trend, various contemporary observers tagged the case as a corporate governance milestone. One commentator said "((t)he decision may be the most significant that the Delaware Supreme Court has handed down. It fundamentally affects corporate governance, delineating the expansive authority

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350 SKEEL, *supra* note 313, 138; Bebchuk, Coates and Subramanian, *supra* note 338, 906; Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931, 1936-45, 1947 (1991); *cf*. Steinberg, *supra* note 223, 19, 24-25, 28 (agreeing that *Paramount* signaled that the business judgment rule would operate broadly with takeover defenses and may well have endorsed a "just say no" defense but suggesting the "cosmetic" nature of *Unocal* review could have been anticipated).

351 Balotti, Varallo and Czeschin, *supra* note 215, 1416; see also Bainbridge, *supra* note 2, 861; Gordon, *supra* note 24, 1527.

352 Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1993). On the high-profile nature of the case, see Martin Dickson, *Barbarians Wait at the Gate*, FIN. TIMES, Dec. 9, 1993, 17 ("The case is the most significant since the landmark Time-Warner judgment four years ago.") Viacom, QVC's preferred merger partner, ultimately prevailed: BLAIR, *supra* note 267, 67.

353 Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1387, 1389 (Del. 1995). For a critique of the preference for director elections the case exemplifies, see Gilson, *supra* note 1, 500-6.

that boards of directors possess."[354] Another argued that "In the history of corporate governance, the *Paramount* decision is what Babe Ruth is to home runs."[355] A third predicted the *Paramount* "decision may be one of the signal economic events of the 1990s."[356] These claims presupposed that *Paramount* would do much to marginalize that hostile takeover bid and that this transformation of the market for corporate control would have significant corporate governance implications. To what extent did matters unfold in this manner? We consider these points next.

B. The Deal Decade's Demise and Corporate Governance

Paramount coincided both chronologically and functionally with the end of the Deal Decade. Merger and acquisition activity tailed off dramatically as soon as the 1980s drew to close and while the U.S. experienced a new merger wave during the mid- and late 1990s the hostile takeover's role was much less prominent than it had been in the 1980s.[357] The side-tracking of hostile takeovers, as we will see now, had significant corporate governance consequences. As sub-section C. describes, the contribution of *Paramount* and Delaware law more generally to the hostile takeover bid's (partial) retreat is less clear.

With the disciplinary effects of takeovers receding, the demise of the Deal Decade promptly generated speculation concerning the sufficiency of mechanisms fostering managerial accountability in public companies. For instance, the *New York Times* noted in February 1990 that "Many of the raiders who once struck terror in the hearts of chief executives are on the sidelines….," attributing their retirement partly to the bankruptcy filing of Drexel Burnham Lambert Inc., whose popularization of the junk bond had provided "the

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[354] Steinberg, *supra* note 223, 11.

[355] ALAN MURRAY, REVOLT IN THE BOARDROOM: THE NEW RULES OF POWER IN CORPORATE AMERICA105 (2007) (quoting Joe Grundfest from a 2001 article in *Fortune*.)

[356] Gordon, *supra* note 350, 1932.

[357] *Supra* notes 57-61 and related discussion.

financial fuel for corporate raiders and hostile takeovers…."[358] This, according to the *Times,* had potentially disturbing implications for U.S. public companies:

> "Many see the firm's disappearance as another sign that the pressures that have kept American business on its toes in the 1980s are on the wane. Unless other catalysts for change emerge or replace those debt-financed raiders, the argument goes, corporate America could slack off again, further damaging its global competitive position."[359]

The *New York Times* was by no means alone in expressing concerns about the governance ramifications of the takeover retreat. The *Washington Post*, having noted in a 1990 article that "the takeover artists have all but disappeared" indicated that there was apprehension "that, without the raiders standing in the shadows, a key force has disappeared that had served to keep U.S. business lean, energetic and resourceful."[360] Similarly, a *Newsweek* columnist discussing Drexel Burnham Lambert's demise referred to outside directors and institutional shareholders and then observed "The threat of a takeover, however distant, substituted for these more explicit controls on management. The threat is now vanishing."[361] Likewise, Bevis Longstreth, a lawyer and former SEC commissioner, argued in 1990 that "(m)ajor changes are occurring in managerial control…that weaken managerial accountability to shareholders", emphasizing that while takeovers were the most effective form of corporate accountability mechanism "the value of this tool has been eroded."[362]

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358 Sarah Bartlett, *Life in the Executive Suite After Drexel*, N.Y. TIMES, Feb. 18, 1990, F1.

359 *Id.*

360 Kathleen Day and Robert McCartney, *Who's Minding the Managers?*, WASH. POST, Aug. 19, 1990, H1.

361 Robert J. Samuelson, *The Demise of Drexel*, NEWSWEEK, March 5, 1990, 43.

362 Bevis Longstreth, *Takeovers, Corporate Governance, and Stock Ownership: Some Disquieting Trends*, J. PORTFOLIO MGMT., Spring 1990, 54, 54, 55. See also Pound, *supra* note 57 ("Gone is oversight through all-or-nothing takeover activity"); Peter J. Henning, *Corporate Law After the Eighties: Reflections on the Relationship Between Management,*

The 1990 *New York Times* article drew upon a study authored by several executives from the consulting firm McKinsey to identify a potential solution to the problem the demise of the corporate raider posed, quoting the study as saying "Most of what raiders do could be done as well or better by corporate managements themselves."[363] But what would motivate executives to unlock value if the threat of being taken over had all but disappeared? The *New York Times* identified two possibilities. Boards were one, with the logic being "Whether companies follow through in the 1990s with the lessons gleaned from the 1980s may depend on the assertiveness of the directors."[364] Institutional shareholders were the other, with the *New York Times* citing business school professor Jay Lorsch as saying "the onus for change would fall on institutional investors, like pension funds and mutual funds."[365]

Alfred Rappaport, a pioneer of a nascent shareholder value movement that would become highly influential in the 1990s,[366] similarly identified institutional shareholders as a potential substitute for the diminished market for corporate control. He argued in a 1990 *Harvard Business Review* article that "What most public companies lack, and what institutions must work to create, is a governance system that provides effective monitoring of

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Shareholders, and Stakeholders, 36 SAINT LOUIS UNIV. L.J. 519, 603 (1992) ("The decline in the market for corporate control and the increase in institutional ownership of stock refocuses the tension between shareholders and management away from the hostile offer as a means of disciplining management and towards reforming the system of corporate governance");; *Getting Rid of the Boss*, ECONOMIST, Feb. 6, 1993, 11 (encouraging shareholder activism and greater vigilance by boards because with the demise of takeover "American bosses were becoming accountable to no one….").

363 Bartlett, *supra* note 358.

364 *Id.*

365 *Id.* See also Leo Herzel and Richard W. Sherpo, *Delaware Supreme Court Boosts Powers of Takeover Targets Boards*, FIN. TIMES, March 22, 1990, 16 (arguing that due in part to legal changes the takeover market was in decline and observing "In the future, the chief constraint on managers' self-interested behaviour may have to be more aggressive institutional shareholders and independent boards of directors.")

366 Cheffins, *supra* note 54, xiii-xiv.

and checks on managerial authority."[367] In describing what this governance system would look like, Rappaport drew attention to a device that could be deployed to enhance managerial accountability the *New York Times* did not mention, this being executive pay. He criticized compensation arrangements in place at that time on the basis that the focus was on accounting-based targets rather than shareholder returns and argued "The most direct way to persuade managers to act like shareholders is to increase their equity stake…."[368]

Across each of these dimensions – boards, shareholders and executive pay -- changes would indeed occur promptly in the wake of the demise of the Deal Decade. For instance, as we have already seen, outside directors became "energized" in the 1990s, at least as compared to previous decades.[369] The trend became evident very shortly after the retreat of the takeover bid. The *Wall Street Journal* proclaimed in March 1991 "Outside directors are in."[370] The *Washington Post* said the following year that "corporate directors…(were) pushing CEOs harder than ever before to justify their decisions on strategy and operations."[371]

CEO turnover was the most prominent manifestation of changes in the boardroom in the early 1990s. In 1991 the *Wall Street Journal* drew attention to a growing tendency of boards of public companies to dismiss chief executives, referring to the forced resignation of the chairman and CEO of Goodyear Tire and Rubber Co. as "just the latest casualty of the

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[367] Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb., 1990, 96, 103.

[368] *Id.*

[369] *Supra* notes 45-50 and related discussion.

[370] Timothy D. Schellhardt, *More Directors Are Recruited from Outside*, WALL STREET J., March 20, 1991, B1.

[371] Mark Potts and Frank Swoboda, *CEOs Turn a Cold Shoulder to Heat Dished Out by Shareholders*, WASH. POST, May 11, 1992, A6.

executive-suite exodus, 1990s style."[372] Over the next two years board-driven executive turnover would occur at prominent companies such as Westinghouse, American Express, General Motors, IBM, and Kodak.[373]

Institutional shareholders did much to prompt the change in approach in the boardroom. The California Public Employees Retirement System (Calpers), the U.S.'s largest pension fund for public employees,[374] got the ball rolling in 1990 when it secured the backing of the board in lobbying against succession plans of General Motors' departing CEO Roger Smith.[375] Richard Koppes, then general counsel at Calpers, said subsequently "this was one of the real turning points in the evolution of corporate governance."[376] At Calpers' urging, General Motors adopted a corporate bylaw the following year mandating that a majority of GM's board consist of independent directors.[377] The change was largely symbolic, in the sense that 15 of GM's 20 directors were already classified as independent, but was still considered to be a breakthrough for activist institutional shareholders.[378]

Shareholder instigation of change at the board level was not restricted to Calpers and GM. With the spate of CEO dismissals that occurred in the early 1990s, institutional

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[372] Joann S. Lublin, *More Executives Are Being Forced Out by Tougher Boards*, WALL STREET J., June 6, 1991, A1.

[373] Martin Dickson, *Big Blue Soothes its Big Investors*, FIN. TIMES, Sept. 24, 1993, 14

[374] James A. White, *Calpers' Chief Wields Big Stick for Institutional Shareholders*, WALL STREET J., April 3, 1990, C1.

[375] *The Institutional Investor: Richard Koppes*, DIRECTORS & BOARDS, Fall 2001, 31, 32. Koppes indicates that the events he discussed occurred in 1991 but Smith in fact retired in 1990: James A. White, *GM Bows to California Pension Fund by Adopting Bylaw on Board's Makeup*, WALL STREET J., Jan. 31, 1991, A6; Joseph B. White, *Behind Revolt at GM, Lawyer Ira Millstein Helped Call the Shots*, WALL STREET J., Apr. 13, 1992, A1.

[376] *Institutional Investor: Richard Koppes*, *supra* note 375.

[377] White, *supra* note 375; Richard W. Stevenson, *Large Foot in Board-Room Door*, N.Y. TIMES, June 6, 1991, D1.

[378] White, *supra* note 375.

shareholder lobbying frequently helped to provide the impetus for board action.[379] Shortly thereafter the Council of Institutional Investors (CII), an association of public pension funds Calpers launched in the mid-1980s, and TIAA-CREF, a pension fund for educators, promulgated and publicized policy statements intended to function as best practice benchmarks for boards.[380]

Putting pressure on boards represented an expansion of the agenda of institutional shareholders. When institutional investors began pursuing a corporate governance agenda during the Deal Decade the market for corporate control was the initial target.[381] Institutional investors often disposed of substantial blocks of shares in takeovers, typically at a sizeable profit, and fund managers mindful of their responsibilities to clients and beneficiaries to secure healthy risk-adjusted returns, wanted to protect the option to sell stock in response to a premium-priced bid.[382] Correspondingly, public pension funds campaigned, albeit not with much success, against poison pills and other mechanisms management proposed that might inhibit takeovers.[383]

The demise of the Deal Decade prompted an expansion of the agenda of institutional shareholders interested in governance.[384] There was awareness as the 1980s ended that

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379 *Getting Rid*, *supra* note 362; Potts and Swoboda, *supra* note 371; Steve Lohr, *Big Business in Turmoil*, N.Y. TIMES, Jan. 28, 1993, A1.

380 John C. Wilcox, *A 10-Year Quest for Director Accountability*, DIRECTORS & BOARDS, Fall 1997, 46.

381 Cheffins, *supra* note 8, 52.

382 *Id.*, 53; A.A. Sommer, *Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. CINN. L. REV. 357, 360 (1990).

383 Michael W. Miller, *Common Defense Against Takeovers Faces New Hurdle*, WALL STREET J., Nov. 4, 1986, 26; Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 33-34 (1987); Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1144, 1152-55 (1991).

384 *Cf.* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STANFORD L. REV. 857, 865 (1993) (focusing primarily on proposals by academics).

relying on the market for corporate control to correct corporate governance defects was not a viable strategy going forward.[385] Institutional shareholders, left to fend for themselves when hostile takeovers subsided, correspondingly contemplated substitute strategies to deploy to foster managerial accountability.[386] Putting pressure on boards was one such step.

The expansion of the governance agenda of institutional shareholders extended additionally to the promotion of shareholder cooperation and interaction. Calpers, for instance, kicked off in 1989 debates that ultimately prompted the SEC to amend its rules on the solicitation of proxies in 1992 to relax restrictions on communication between shareholders.[387] Executive pay also came into institutional shareholders' sights. Graef Crystal, a compensation consultant who became an academic, suggested in 1991 that "institutions are discovering that executive compensation is the soft underbelly of corporate governance."[388] Institutional shareholders followed up by pressuring companies to strengthen the independence of compensation committees.[389] They also lobbied companies to overhaul existing executive compensation arrangements to replace a traditional bias in favor of "pay-for-size" with compensation schemes oriented around pay-for-performance.[390] The message got through, as a dramatic increase in equity-based compensation – most prominently the awarding of stock options – would soon increase markedly CEO pay-to-performance sensitivity (as well as executive pay levels).[391] This change in practice did

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385 Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STANFORD L. REV. 863, 871 (1991).

386 *Id*.; Steinberg, *supra* note 223, 301.

387 Cheffins, *supra* note 8, 54; Wilcox, *supra* note 380, 47.

388 Quoted in Robert J. McCartney, *When Mega-Pay and Mini-Profits Collide*, WASH. POST, March 24, 1991, H1.

389 *Id*.

390 Frank Dobbin F. and Dirk Zorn, *Corporate Malfeasance and the Myth of Shareholder Value*, 17 POLITICAL POWER & SOCIAL THEORY 179, 189 (2005).

391 *Supra* notes 75-76 and accompanying text; Gordon, *supra* note 24, 1530-31.

much to prompt executives of the 1990s to assimilate the norm that they should strive to maximize shareholder value.[392]

C. Did Delaware Courts Bring the Deal Decade to an End?

There is substantial academic support for the notion that "internal" corporate governance mechanisms such as the board of directors, shareholder activism and incentivized executive compensation moved to the forefront at the beginning of the 1990s because the external control market waned as a means for enhancing managerial accountability.[393] To the extent this interpretation of events is correct, it can be argued plausibly that Delaware case law affording incumbent management substantial latitude to fend off takeovers had a major collateral effect on corporate governance, namely helping to prompt a switch in emphasis from external to internal governance. Various commentators have indeed made this point.[394]

Delaware case law logically could only prompt a switch in emphasis in favor of internal corporate governance mechanisms if the jurisprudence in fact sideswiped the hostile takeover bid. This is a plausible conjecture. As we have seen, the Delaware Supreme

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392 Gordon, *supra* note 24, 1529-30; Bratton and McCahery, *supra* note 171, 689; Mary O'Sullivan, *What Opportunity is Knocking? Regulating Corporate Governance in the United States* in GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION 335, 351 (Edward Balleisen and David Moss, eds, 2010).

393 See, for example, Kahan and Rock, *supra* note 50, 881-84, 896-97, 915; O'Sullivan, *supra* note 392, 350 ("With the demise of the financial (takeover) market, institutional investors turned to different means to enforce their demands for higher returns….); Mark R. Huson, Robert Parrino and Laura T. Starks, *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265 (2001) (making the point empirically by indicating that CEO turnover levels were similar in the 1980s and 1990s).

394 Kahan and Rock, *supra* note 50, 878 ("Merger and acquisition activity declined sharply around the time of the *Time-Warner* decision…."), 896 ("market participants principally adjusted to Delaware takeover law through adaptive devices"); Daniel P. Sullivan and Donald E. Cohon, *Crisis and Transition in Corporate Governance Paradigms: The Role of the Chancery Court of Delaware*, 31 LAW & SOC. REV. 713, 753 (1997) (focusing on the Delaware Court of Chancery and saying the "ruling in *Time* catalyzed the current crisis in current corporate governance….(and, together with other rulings) opened up lines of debate that, for the first time in more than 30 years, did not take their cue from the hostile takeover offer.")

Court's endorsement of the poison pill in *Household* likely helped to foster widespread adoption of this prominent form of takeover defense.[395] A *Washington Post* columnist said in the immediate aftermath of *Paramount* that the case "signified that, as a practical matter, corporate chieftains had finally succeeded in barricading themselves against most takeover offers."[396] Numerous observers remarking on the abrupt fall in hostile takeover activity as the 1990s began concurred with this assessment.[397] As the *Economist* said in 1993, "Time's bosses were free 'to just say no' to unwanted offers. Paramount's bid failed, Time's shareholders lost a fortune and hostile bids all but disappeared."[398]

While it is certainly plausible that a collateral effect of Delaware case law concerning takeovers was to foster a switch in emphasis in favor of internal corporate governance mechanisms, the point cannot be taken for granted. For instance, with the market for corporate control deep freeze that occurred as the 1990s began, changing market conditions were of key importance.[399] A marked tightening of credit markets was of particular significance. Crucially, the junk bond market that helped to provide the "financial fuel" for corporate raiders deteriorated in tandem with Drexel Burnham Lambert's disappearance.[400] The market for junk bond issuances collapsed as investors reacted adversely to a sharp spike in defaults by companies that struggled in the midst of a nascent economic recession to

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395 *Supra* notes 337-41 and related discussion.

396 Robert J. Samuelson, *The Entrenching of Management*, WASH. POST, Aug. 9, 1989, A21. See also Robert J. Cole, *Court Back Right of Boards to Deny Takeover Offers*, N.Y. TIMES, Feb. 28, 1990, D2 (saying when the Delaware Supreme Court issued its written reasons in the case "Wall Street lawyers maintained that the decision would have an exceptionally broad impact in helping corporations to fight off unwanted takeovers.")

397 See, for example, Longstreth, *supra* note 362, 55; Grundfest, *supra* note 384, 858-59.

398 *Of Paramount Importance*, ECONOMIST, Dec. 18, 1993, 74.

399 This was well-known to observers seeking to explain at the time why the threat hostile bids posed had receded. See, for example, Bartlett, *supra* note 358.

400 See, *supra* note 358 and accompanying text; Day and McCartney, *supra* note 360; Lohr, *supra* note 379; Gilson and Kraakman, *supra* note 385, 871.

service the high-yield debt.[401] Bank lending, which helped to underpin many of the successful tender offers of the 1980s, also contracted markedly.[402] Banks only returned to acquisition lending after the recession ended and even then they would only work with public companies executing strategic mergers as opposed to financial buyers with a raider orientation.[403]

Even to the extent that law helped to bring the Deal Decade to a close, Delaware jurisprudence was only one component of a legal matrix that worked to the disadvantage of hostile bidders. Anti-takeover legislation was another important facet. Some 35 states enacted anti-takeover laws during the late 1980s and early 1990s.[404] This meant that for a prospective bidder targeting a non-Delaware company the legal regime was typically as inhospitable as it was in Delaware and quite often was more so.[405] As of the late 1980s, approximately half of publicly traded companies did not operate under Delaware corporate

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401 MCCAULEY ET AL, *supra* note 59, 48-53; BRUCE WASSERSTEIN, BIG DEAL: 2000 AND BEYOND 154-55 (2000).

402 Robert Comment and G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Statutes*, 39 J. FIN. ECON. 3, 8-9 (1995).

403 Brian R. Cheffins and John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 48 (2008).

404 Lohr, *supra* note 379. By 2000 the number had increased to 44 – Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1828 (2002) (see Table 3).

405 Steinberg, *supra* note 223, 29 (comparing Delaware with other states by reference to shareholder protection); Subramanian, *supra* note 404, 1862 (indicating that "while the typical antitakeover statutes may have (at most) mild substantive bite the severe antitakeover statutes substantially shut down the market for corporate control as a disciplinary device"); Lucian A. Bebchuk and Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 413 (2005) (saying that some states, unlike Delaware, adopted statutory measures specifically endorsing the adoption of poison pills and indicating that since 1990 there had not been under any state's law a single court decision invalidating or requiring the redemption of a standard poison pill).

law[406] and thus were not governed directly by the Delaware case law credited with side-tracking hostile bids.[407] Those offering a legally oriented explanation for the sideswiping of the hostile takeover in the early 1990s often drew attention to the promulgation of state anti-takeover laws as well as to Delaware case law developments[408] and likely appropriately so.

Delaware enacted its own anti-takeover legislation in 1988 with what became § 203 of the DGCL. Section 203 was a "business combination" provision that precluded a bidder who failed to acquire with a tender offer 85% or more of the shares of the target from buying out the remaining shareholders until three years had gone by unless the target's board gave advance clearance or the board gave its approval after the fact with the backing of two-thirds of the votes of disinterested shareholders.[409] To what extent did this measure derail takeovers? Was this an instance where, contrary to the general trend, Delaware legislation was more important than case law from a corporate governance perspective?

There is some evidence to suggest that Delaware's adoption of § 203 was significant. T. Boone Pickens, the noted corporate raider, argued at the time the provision was being enacted that the measure would "sound the death knell" for hostile bids.[410] Moreover, only a tiny handful of bidders would in fact subsequently achieve the § 203 85% threshold in a single tender offer after the provision was enacted.[411] This implied the provision was

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406 Paul M. Barrett, *Delaware Moves Closer to Adopting Law to Deter Hostile Takeovers,* WALL STREET J., Dec. 9, 1987, 41 (reporting that 45% of NYSE companies were incorporated under Delaware law).

407 Delaware case law would have been influential in those cases where a state's courts opted to follow 1980s Delaware jurisprudence in the takeover context. The reception to Delaware takeover jurisprudence in other states was mixed: Cain, McKeon and Davidoff Solomon, *supra* note 343, 13.

408 MCCAULEY ET AL, *supra* note 59, 66-68; Day and McCartney, *supra* note 360; Lohr, *supra* note 379.

409 MCCAULEY ET AL, *supra* note 59, 117 (identifying as well additional exceptions).

410 Barrett, *supra* note 406.

411 Subramanian, Herscovici and Barbetta, *supra* note 22, 715-16.

"incredibly effective" at reducing the threat of hostile takeovers for Delaware companies.[412] Section 203 has indeed been referred to as "by far the most important antitakeover law in the United States."[413] It would seem to follow that to the extent that Delaware law sideswiped the market for corporate control § 203, not Delaware case law, was the true culprit.

The general consensus in fact is that § 203 was a side-show. Jack Coffee argued when § 203's enactment was being debated that it was "a deliberately and sensibly weak law."[414] Dale Oesterle said in a 1988 commentary on § 203 that of the anti-takeover "business combination" acts various states had adopted Delaware's was the mildest and drew attention to the fact that Delaware, unlike numerous other states, had not "layered" its anti-takeover statute with other forms of anti-takeover legislation.[415] Academics subsequently assessing the impact of § 203 said it "lacked substantive bite"[416] and was "largely moot by the time it was enacted."[417]

Why, despite Pickens' stark assessment, would § 203 turn out to be largely moot? The broad discretion Delaware companies would acquire under Delaware case law to adopt and deploy poison pills was pivotal. In the key circumstance where an otherwise successful bidder could be caught out by § 203, this being where the bidder secured voting control without acquiring at least 85% of the shares, the target company's board could simply stop

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412 Jarrell, *supra* note 60, 786.

413 Subramanian, Herscovici and Barbetta, *supra* note 22, 686.

414 Quoted in Barrett, *supra* note 406. See also Herzel and Sherpo, *supra* note 365 (saying Delaware "passed one relatively mild compromise measure early in 1988)."

415 Dale A. Oesterle, *Delaware's Takeover Statute: Of Chills, Pills, Standstills, and Who Gets Iced*, 13 DEL. J. CORP. L. 879, 880, 883 (1988). On the "layering" point see also Subramanian, *supra* note 404, 1828 (providing evidence in tabular form that shows that while Delaware only enacted a "business combination" antitakeover statute, numerous states enacted various types of antitakeover measures). Oesterle did point out, however, that a "business combination" statute such as Delaware's was more intrusive than some other types of antitakeover legislation – *op. cit.*, 881-82.

416 Subramanian, *supra* note 404, 1845.

417 Kahan and Rock, *supra* note 50, 894.

matters from reaching that point by using the pill to derail the bid before a majority stake was obtained.[418] Section 203 therefore became largely superfluous in practical terms for managers of potential targets concerned about a takeover bid.

Given that a poison pill could render § 203 moot it would seem to follow that the *Household* decision, by sparking widespread adoption of poison pills,[419] played a decisive role in side-tracking the hostile bid. Given that the Deal Decade still had a few years to run when this 1985 decision was handed down, history suggests otherwise. While *Household* bolstered the popularity of poison pills it was only when the Delaware Supreme Court made its 1989 ruling in *Paramount* that it became clear how wide the discretion was boards had to use poison pills to "just say no".[420] But does that mean *Paramount* and cases of a similar ilk ultimately were decisive in legal terms for Delaware companies? The answer is that the jurisprudence mattered, but not in isolation.

A key potential limitation with a poison pill is its impermanence -- the board of a corporation that has adopted a pill can subsequently remove it. In the context of a hostile takeover, the most obvious way for this to happen will be for a bidder to commence a proxy contest for board control promising in the event of success that the reconfigured board will

[418] Subramanian, Herscovici and Barbetta, *supra* note 22, 705.

[419] *Supra* notes 337-41, 395 and related discussion.

[420] Subramanian, Herscovici and Barbetta, *supra* note 22, 705; see also *supra* notes 349-50 and related discussion.

dismantle takeover defenses in place.[421] Given this possibility a poison pill can be thought of, in isolation, as "relatively harmless."[422]

While the prospect of post-proxy contest dismantling mutes the potency of poison pills, the odds against this occurring lengthen markedly if a target company has a "staggered" board. While due to § 211(b) of the DGCL the default rule is that directors of Delaware companies will stand for election at each annual shareholder meeting, § 141(d) provides that a corporation may by way of its charter or a by-law approved by the shareholders group the directors into classes with each class (there typically will be three) being elected at successive annual meetings.[423] When board elections have been staggered in this way, a bidder otherwise well situated to win a proxy contest where board seats are at stake could be forced to wait for two consecutive annual shareholder directorial elections to replace a majority of the incumbent directors.[424]

A staggered board which has been adopted by way of a bylaw will be "ineffective" in the takeover context because a bidder who is able to acquire a sufficiently large number of shares to win a shareholder vote can orchestrate without board involvement shareholder passage of a bylaw dismantling the staggered board.[425] In contrast, a staggered board incorporated in a corporation's charter will be "effective" because charter amendments must

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421 Bebchuk, Coates and Subramanian, *supra* note 338, 905, 907 (noting as well that efforts to eliminate for a bidder the option of pursuing a proxy contest by way of "no hand" "slow hand" and "dead hand" poison pills failed due to decisions of the Delaware courts in the late 1990s, citing Carmody v. Toll Bros. Inc., 723 A.2d 1180 (Del. 1998); Quickturn Design Sys., Inc., v. Shapiro, 721 A. 2d 1281 (Del. 1998) – *op. cit.* at 898, 905.

422 Marcel Kahan and Edward Rock, *Embattled CEOs*, 88 TEXAS L. REV. 987, 1007 (2010).

423 Del. Code Ann., tit. 8, §§ 141(d), 211; Bebchuk, Coates and Subramanian, *supra* note 338, 893.

424 Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STANFORD L. REV. 1325, 1353 (2013).

425 *Id.*, 1353, n. 110.

be proposed by the board, meaning that even with full shareholder backing a bidder cannot unilaterally declassify the board.[426] Even an effective staggered board will in isolation, however, be only a weak takeover defense.[427] A bidder who uses a tender offer to acquire a majority shareholding in a target with an "effective" staggered board can be confident of ultimately gaining full board control by directorial elections.[428] Moreover, in practice a successful bidder likely would not have to take two board elections to prevail. Given that the incumbent directors would struggle to accomplish anything against the will of the controlling shareholder and given the dubious legitimacy of a board lacking the backing of that shareholder those directors likely would resign.[429] This would clear the way for the controlling shareholder to take full control of the target company.

Where the effective staggered board comes into its own as a takeover defense is when it operates in combination with the poison pill.[430] As a practical matter, hostile bidders never "break through" a poison pill by pressing onwards after suffering the dilution associated with triggering the pill to buy enough shares to acquire a majority stake.[431] Correspondingly, for a corporation with an effective staggered board/poison pill combination it is highly unlikely that a putative bidder will be able to gain sufficient voting clout to guarantee winning

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426 Del. Code Ann., tit. 8, § 242(b)(1); Bebchuk, Coates and Subramanian, *supra* note 338, 894 (defining an "effective" standard board).

427 Wayne H. Mikkelson and M. Megan Partch, *Managers' Voting Rights and Corporate Control*, 25 J. FIN. ECON. 263, 264 (1989) (finding based on data from 1972 to 1987, largely before poison pills became popular, that classified boards had "no reliable association with the occurrence of control events…(and did) not appear to deter outsiders' interest in takeover activity….).

428 Bebchuk, Coates and Subramanian, *supra* note 338, 903.

429 *Id.*, 903-4; John C. Coates, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 326 (2000) (indicating that a particular type of hostile tender offer, the hostile two-tier bid, disappeared in the 1990s).

430 Bebchuk, Coates and Subramanian, *supra* note 338, 912-13, 924; Klausner, *supra* note 424, 1352-53, 1365; Coates, *supra* note 429 at 326.

431 Bebchuk, Coates and Subramanian, *supra* note 338, 904-5.

consecutive directorial elections. Indeed, it appears that there has yet to be a hostile acquisition where a bidder seeking to gain control of a target with a staggered board has persevered and waged two successful proxy contests to gain directorial control and then removed a poison pill.[432] *Moore v. Wallace Computer*, a 1995 federal court decision involving a Delaware company,[433] illustrated the post-*Paramount* effectiveness of the poison pill/staggered board combination. The court ruled, relying on *Paramount* and *Unitrin*,[434] that incumbent directors serving on a staggered board could keep a poison pill in place that was blocking a hostile bid even though the bidder had won one-third of the board seats in a proxy contest.

While the combination of a poison pill and an effective staggered board created a substantial obstacle to hostile takeovers in the wake of *Paramount*, this does not mean that Delaware jurisprudence was the primary reason that the Deal Decade ended, thereby fostering the operation of internal corporate governance mechanisms. The poison pill/effective staggered board combination that *Paramount* fortified was only going to be decisive in a subset of corporations, namely Delaware companies with effective staggered boards. It might be thought a pill would have to be in place as well but by virtue of *Paramount* and similar cases the directors of a Delaware corporation had wide discretion to adopt one whenever that might convenient.[435]

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[432] Klausner, *supra* note 424, 1365, citing Air Prods. & Chems. Inc. v. Air Gas Inc. 16 A.3dd 48, 105 (Del. Ch. 2011).

[433] Moore v. Wallace Computer Services Inc., 907 F. Supp. 1545 (D. Del., 1995).

[434] *Id.*, 1557-58.

[435] Coates, *supra* note 429, 286-87 (saying of a bidder, “Unless there is something unusual about the target, the target will have the ability to – and almost certainly will – adopt a pill as soon as you start your bid”); Klausner, *supra* note 424, 1351 (explaining why the actual adoption of a pill was a “nonevent”).

As of the mid-1990s approximately three out of five U.S. public companies had staggered boards,[436] a majority of which were "effective".[437] Assuming that the proportion was the same for Delaware companies, which again comprised in the 1980s about half of all public companies,[438] this means Delaware companies with the potent anti-takeover defensive scheme in place fortified by *Paramount* constituted a minority within the entire population of publicly traded companies. It follows that in order for the market for corporate control to be side-tracked in the way it was at the beginning of the 1990s, factors other than Delaware case law must have come into play, with the tightening of credit markets being the most obvious contender.[439] Correspondingly, while the *Paramount* decision may indeed have helped to prompt the switch of emphasis in favor of internal corporate governance mechanisms at the beginning of the 1990s, it was by no means a controlling or decisive factor. As Chancellor Allen and Chief Justice Strine said in 2005 when assessing the practical impact of Delaware case law concerning the poison pill "Judicial decisions, after all, are important, but in the end only weakly control fundamental economic forces."[440]

VI. SHAREHOLDER ACTIVISM

436 Bebchuk, Coates and Subramanian, *supra* note 338, 895 (discussing a sample of 2,421 large public companies drawn from 1993 to 1998 volumes of IRRC Corporate Defense Takeover Defenses databooks). Most of the companies with staggered boards in place by this time introduced their staggered board regime prior to 1990, with a majority of these being implemented after 1984 – *id.*, 941.

437 Bebchuk and Cohen, *supra* note 405, 413 (indicating a minority of staggered boards were not fully effective).

438 *Supra* note 406 and related discussion.

439 MCCAULEY ET AL, *supra* note 59, 73 (evaluating the impact of the *Paramount* case on the market for corporate control and concluding "the practical effect of the *Time* decision is questionable.")

440 William T. Allen and Leo E. Strine, *When the Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton's Vision of the Corporate Law*, 60 BUS. LAW. 1383, 1392 (2005).

Decisions of Delaware courts may indeed have contributed to the transformation boards underwent as corporate governance grew in prominence and helped to foster the development of internal governance mechanisms by discouraging hostile takeover bids. In other respects, however, Delaware's impact on corporate governance was marginal. For example, aside from the boost *Paramount* may have provided by prompting institutional shareholders to shift their attention away from takeovers, neither Delaware legislation nor case law had a marked impact on shareholder activism.

Shareholder activism has come a long way in recent decades. In 1983 law professor Donald Schwartz argued that "promotion of shareholder welfare" would "impose restraints on all manner of abuse of by managers" but conceded that "most sophisticated observers" assumed "that shareholder participation is not capable of working well because of its impracticability and because of the rational indifference of shareholders to participation in corporate affairs."[441] Thirty years later the *Financial Times*, focusing on activism campaigns hedge funds had been launching, proclaimed that "Corporate America and activist investors have had a war; the activists have won."[442] Correspondingly, as a *Wall Street Journal* columnist observed in 2014, activist investor priorities "hardened into the default boardroom agenda."[443]

Changing ownership patterns do much to explain the shareholder activism surge. Throughout much of the 20th century individual "retail" investors owned most of the shares in publicly traded U.S. companies. Due to pronounced collective action problems and a lack of relevant expertise they were ill-suited to step forward and keep executives of public

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441 Donald E. Schwartz, *Shareholder Democracy: A Reality or a Chimera?*, 25 CALIF. MGMT. REV. 53, 55, 65 (1983).

442 *Carl Icahn, Web Mogul*, FIN. TIMES (London), Oct. 26, 2013, 24.

443 Denis K. Berman, *For Activists There are No More Worlds to Conquer*, WALL ST. J., April 23, 2014, B1.

companies in check.[444] A dramatic shift in favor of institutional shareholding created more congenial conditions for activism and indeed in the 1990s public pension funds pressed for changes concerning takeover defenses, boardroom composition and executive pay.[445] Due, however, to reluctance on the part of mutual funds and private pension funds to pursue a corporate governance agenda actively, the impact of institutional shareholders was not as dramatic as optimistic observers anticipated.[446] Over the past decade, though, backing received from mainstream institutional shareholders has boosted substantially interventions by activist hedge funds.[447]

Legal change at the federal level contributed to the surge in shareholder activism. The reforms the SEC introduced in 1992 in response to the lobbying effort Calpers commenced in 1989 to facilitate interaction between shareholders reduced the range of situations where there had to be compliance with requirements securities regulation imposed on parties seeking change through the use of proxy voting.[448] Though ultimately activism by mainstream institutional shareholders failed to fulfil optimists' expectations those inclined to step forward did begin to take advantage almost immediately of the 1992 rule changes.[449] The 1992 reforms also provided activist hedge funds with discretion to communicate with other shareholders that would serve them in good stead when they began pursuing their agenda in earnest in the early and mid-2000s.[450]

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444 Cheffins, *supra* note 54, xix; see also *supra* note 62 and related discussion.

445 *Supra* notes 19, 65, 374-92 and accompanying text.

446 Cheffins, *supra* note 8, 54.

447 Cheffins, *supra* note 70, 44-46.

448 Brian R. Cheffins and John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 90 (2011).

449 BLAIR, *supra* note 267, 72.

450 Cheffins and Armour, *supra* note 448, 90-91.

There were no equivalent developments in Delaware. A 2009 amendment to the DGCL that authorized the adoption of bylaws facilitating the use of a corporation's proxy machinery in board elections by dissident shareholder could assist activist investors.[451] The change was not transformative, however, given that the hedge fund activism surge U.S. public companies have experienced was well underway when the law was changed.

Rulings of Delaware courts also generally had little direct impact on shareholder activism trends. Chancellor Allen's 1988 decision in *Blasius Industries Inc. v. Atlas Corp.*[452] stands out as a possible exception. The case, both with respect to the outcome and the rhetoric Chancellor Allen deployed, affirmed the significance of shareholder voting at a time when it was thought to have only a minor role in disciplining management.[453] The case arose when Atlas Corp.'s board sought to increase its size and appoint two of its own nominees to fill the new vacancies. Chancellor Allen struck down the move, indicating that the Atlas board had failed to provide the compelling justification that was required when steps were taken that impeded the effective exercise of the shareholder vote.[454] Chancellor Allen, in making this ruling, underscored "the transcending significance of the franchise to the claims to legitimacy of our scheme of corporate governance."[455] The decision was hailed subsequently as "a milestone in defining board responsibility to the shareholders' right to vote."[456]

While Chancellor's Allen vindication of shareholder voting rights in *Blasius* was consistent with the promotion of shareholder activism, it was not part of a more general trend.

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451 *Supra* note 97 and related discussion.

452 564 A.2d 651 (Del. Ch. 1988).

453 Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 736 (1992).

454 *Blasius*, 564 A.2d 651, 661, 663.

455 *Id.*, 662.

456 ROBERT A.G. MONKS AND NELL MINOW, POWER AND ACCOUNTABILITY 89 (1991).

Instead, the shareholder activism agenda was rarely adjudicated upon in Delaware as it gathered momentum. Chief Justice Veasey made the point in a 1997 law review article, saying "There is a long checklist of issues regularly raised by institutional investors. Many of these issues may never become issues in litigation."[457] Among the examples he cited were the splitting the roles of CEO and chairman of the board, ensuring the presence of a lead independent director on the board and fostering the use of incentivized remuneration for outside directors.[458] Shareholder activism trends correspondingly illustrate how the judiciary's lack of control of the issues they address in cases can compromise the impact courts have on corporate governance.[459]

The Disney/Ovitz litigation provided a rare example of a situation where institutional shareholders sought to pursue their activist agenda in Delaware courts and indicated that the Delaware judiciary was not particularly sympathetic to such endeavours. In 2000 the Council of Institutional Investors filed an Amicus Curiae brief with the Delaware Supreme Court in an appeal made in relation to a pre-trial motion in the Disney litigation.[460] The CII, having emphasized in the brief its significant interest in corporate governance issues and having stressed that independent directors were a cornerstone of Delaware's system of corporate governance, urged the Delaware Supreme Court to adopt in the case a workable definition of "independent director" that took into account corporate governance realities.[461] Despite referring to the CII as an eminently prestigious corporate governance organization[462] the

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457 E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 402 (1997).

458 *Id.*

459 On the courts' lack of control of the agenda constituting a constraint in this context see *supra* notes 162, 174-75 and related discussion.

460 Gelb, *supra* note 184, 534.

461 *Id.*, 534-35.

462 *Brehm*, 746 A.2d 244, 256, n. 30.

Delaware Supreme Court declined to rule on the its request on the basis that doing so was unnecessary to resolve the case.[463] The court also took the opportunity to emphasize that board composition was an issue for shareholders, not courts, to address, saying

> "The inquiry here is not whether we would disdain the composition, behavior and decisions of Disney's Old Board or New Board as alleged in the Complaint if we were Disney's stockholders. In the absence of a legislative mandate, that determination is not for the courts. That decision is for the stockholders…."[464]

This stance – not surprising given the institutional limitations under which judges operate – helped to ensure Delaware courts played at best a tangential role with shareholder activism as it grew in prominence in U.S. public companies from the 1980s onwards.

There are indications that to the extent that rulings of Delaware courts do influence the ability of shareholders to intervene in corporate affairs, the impact may be negative. Chief Justice Strine, for instance, offered a somewhat skeptical appraisal of shareholder activism in a 2014 law review article, saying in reference to institutional shareholder opposition to poison pills that there was a "need for the now powerful institutional investor community to mature, and to strike a more sensible balance for those they represent."[465] He did so in a milieu where a growing number of boards are seeking to bolster leverage in dealings with activist investors by amending corporate by-laws to introduce a new generation of poison pill that kicks into operation at a lower threshold (typically around 10%) for shareholders who have disclosed an intention in federal securities law filings to be

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463 *Id.*, 258, n. 40.

464 *Id.*, 256.

465 Leo E. Strine, *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 498 (2014).

"active."[466] In a 2014 case the Delaware Court of Chancery upheld the validity of this sort of poison pill in a case involving auction house Sotheby's and activist Daniel Loeb's Third Point.[467] Given that Sotheby's, despite its courtroom victory, subsequently agreed to endorse Third Point's three nominees as directors it is uncertain how much impact poison pills targeting hedge fund activists will have.[468] Nevertheless, while it is not clear how much of a setback the 2014 Chancery Court ruling was for shareholder activism, it was a setback nevertheless.

VII. EXECUTIVE PAY

Executive pay, as is the case with shareholder activism, is an important area of corporate governance where Delaware had a marginal impact as corporate governance was transformed. Largely due to changes occurring in the late 1980s and throughout the 1990s, executive compensation grew dramatically and was tied more closely to corporate performance, measured primarily in terms of shareholder returns.[469] The CEO pay surge provoked dissatisfaction, which in turn provided the impetus for the SEC to bolster disclosure rules in the early 1990s and for the 2010 Dodd-Frank Act to introduce "say on pay" votes by shareholders and require public companies to establish compensation committees staffed by independent directors.[470] Delaware, in contrast, largely sat out the reconfiguration of executive pay that accompanied the transformation of corporate governance.

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466 Liz Hoffman, *Bitter Medicine in Store for Activists*, WALL ST. J., January 29, 2014, C1; Liz Hoffman, *"Poison Pill" Gets a Bit More Toxic*, WALL ST. J., May 8, 2014, C1; John C. Coffee, *Hedge Fund Activism: New Myths and Old Realities*, N.Y.L.J., May 15, 2014, 5.

467 Third Point LLC v. Ruprecht, C.A. No. 9469-VCP, memo. op. (Del. Ch. May 2, 2014).

468 Cheffins, *supra* note 70, 39.

469 *Supra* notes 75-76, 391 and related discussion.

470 *Supra* note 77 and accompanying text.

Other than authorizing the board of a Delaware corporation to set director compensation the DGCL is silent on executive pay.[471] Regulation of executive pay under Delaware corporate law has correspondingly been left to the courts but their rulings had little impact on changes to executive pay that accompanied corporate governance's rise to prominence. Chancellor Chandler and Chief Justice Strine acknowledged the point in a 2003 law review article.[472] Having recognized that there had been "huge Argentina-like inflation in executive compensation in more recent decades" they conceded "Delaware's common law was perhaps slower than ideal in adapting to the new realities, which seem to many to cry out for a deeper and more skeptical judicial inquiry" but explained "The common law accretes knowledge, but not always at an optimal pace."[473]

Chancellor Chandler had the opportunity in one particularly high-profile context to deploy the common law to impose a check on executive pay, this being the Disney/Ovitz litigation. The plaintiffs challenged the $140 million severance package Disney paid to Ovitz on his departure from the company and the Delaware Supreme Court, in ruling in favor of the plaintiffs on a preliminary motion, observed that "there is an outer limit" to the board's discretion to set executive compensation "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."[474] This might have appeared to be a precursor to an interventionist approach to executive pay but Chancellor Chandler said at trial "the standard for waste is a very high one that is difficult to meet" and held that, even though he had said at an earlier stage in the

471 Del. Code Ann., tit. 8, § 141(h).

472 Chandler and Strine, *supra* note 234, 1001.

473 *Id.*

474 *Brehm*, 746 A.2d 244, 262, n. 56.

proceedings that the payment to Ovitz was "extraordinary,"[475] the plaintiffs had indeed failed to make their case.[476] The Delaware Supreme Court concurred, indicating that the plaintiffs "had not come close to satisfying the high hurdle required to establish waste."[477]

An inference that could be drawn from the severance package ruling in the Disney/Ovitz litigation was that "the corporate waste doctrine seemed all but abandoned,"[478] which implied in turn that Delaware courts had little appetite to address the controversies that had arisen concerning executive pay. This could be too simplistic. In the appeal arising from the Disney trial the Delaware Supreme Court did take the opportunity to stipulate what procedures a compensation committee would follow in a "best case" scenario.[479] This may have been an instance where utterances of Delaware judges had norm-generating value.[480] Moreover, a 2009 decision by Chancellor Chandler to deny a preliminary motion to dismiss a case alleging that a generous retirement package paid by Citigroup to its departing CEO Charles Prince constituted waste signalled there indeed may be a meaningful "outer limit" to a board's discretion to set executive pay.[481] Nevertheless, as was the case with shareholder activism, the fact remains that with respect to executive pay's contribution to the transformation of corporate governance that began in the mid-1970s, Delaware had only a marginal impact.

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475 *Walt Disney*, 731 A.2d 342, 350. On what Chancellor Chandler meant in this context, see Steinberg and Bivona, *supra* note 204, 221.

476 *Walt Disney*, 907 A.2d 693, 759, see also at 748-49.

477 *Walt Disney*, 906 A.2d 27, 75.

478 Steven C. Caywood, *Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 MICH L REV. 111, 119 (2010).

479 *Walt Disney*, 906 A.2d 27, 56.

480 Fisch, *supra* note 180, 749.

481 *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 138 (Del. Ch. 2009), discussed by Fisch, *supra* note 180, 750.

VIII. CONCLUSION

Over the past four decades the corporate governance landscape in the United States has been transformed. Not only did the term "corporate governance" emerge from obscurity but boards were reconfigured in tandem with growing expectations, shareholder activism became more prominent and executive compensation ostensibly tied more closely to share performance increased dramatically. In seeking to account for this reconfiguration of the corporate landscape, Delaware is an obvious place to look. It can be thought of as the home of corporate America, with two-thirds of U.S. public companies being incorporated under Delaware corporate law, with Delaware courts deciding a large proportion of major corporate law cases and with courts in other states often applying Delaware case law. Delaware indeed has been identified as a pivotal player in the corporate governance realm.[482]

What in fact has been Delaware's contribution to the development of corporate governance in the United States over the past four decades? The answer, briefly put, is substantial but not decisive. Delaware had only a marginal impact on changes relating to executive pay and shareholder activism. On the other hand, with boards a series of well-known cases in the mid-1980s reinforced emerging trends and Delaware jurisprudence contributed to the demise of the Deal Decade, which in turn likely prompted a shift in emphasis from the market for corporate control to "internal" corporate governance mechanisms.

Given institutional constraints applicable to Delaware lawmakers it is not surprising that the state's impact on the transformation of corporate governance was not profound. Under what Chief Justice Strine has referred to as the "Delaware Model" of corporate law,[483] it was never likely that the Delaware General Corporation Law would have a decisive

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482 *Supra* notes 9-13 and related discussion.

483 *Supra* note 109 and related discussion.

influence. Moreover, while features of courts that can compromise the standard-setting ability of the judiciary were not as pronounced in Delaware as potentially can be the case, they were in play nevertheless. This does not mean, however, that Delaware was a bit player with respect to the transformation of corporate governance. Delaware courts in particular issued a series of judgments that contributed substantially to governance changes affecting U.S. public companies. Correspondingly, any systematic historical account of the corporate governance transformation the United States has experienced over the past four decades would be seriously incomplete if Delaware's significant role was neglected.[484]

[484] On key aspects of this transformation see, for example, HISTORY OF MODERN U.S. CORPORATE GOVERNANCE, *supra* note 54; GERALD F. DAVIS, MANAGED BY THE MARKETS: HOW FINANCE RESHAPED AMERICA 62-63, 81-101 (2009); MARK S. MIZRUCHI, THE FRACTURING OF THE AMERICAN CORPORATE ELITE 204-18 (2013).

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