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Takeovers in the Boardroom: Burke versus Schumpeter

Ronald J. Gilson and Reinier Kraakman*

We are delighted to participate in a 25th anniversary assessment of Martin Lipton's 1979 article, *Takeover Bids in the Target's Boardroom*.¹ This is a remarkably prescient article that demonstrates an uncanny ear for an emerging issue. From his vantage point inside targets' boardrooms -- and, we assume, also from inside the nearby offices of investment bankers -- Lipton spotted a gathering storm on the horizon and sought to channel the emerging issue of takeover policy in a direction that accorded with his own fundamental convictions as well as the interests of his clients. As every academic knows, early intervention is the surest way to influence the path of a debate. And as Lipton's career-long commitment to scholarship demonstrates, he has always had a good bit of the academic in him.

We begin by examining the worldview behind *Takeover Bids*. What exactly did Lipton see from the windows of boardrooms on the upper floors of New York skyscrapers? When viewed in its original setting, we believe, Lipton's article gives rise to a profound irony. *Takeovers Bids* reflects a deep disquiet with the market for corporate control. It is a Burkean take on a messy Schumpeterian world that, during the 1980s, reached its apex in Drexel Burnham's democratization of finance through the junk bond market. But the irony is that today, long after the Delaware Supreme Court has adopted many of Lipton's views, there is a new market for corporate control that no longer poses the threats -- or supports the opportunities -- that the market of the 1980s created. Today's strategic bidders and their targets share the same boardroom views. And for precisely this reason, "just say no" is no longer the battle cry that it once was. It stirred the crowds in the past precisely because hostile takeovers could be credibly depicted as a sweeping threat to the status quo -- a claim that no one would make about today's strategic bidders.

Today's hostile bidders no longer possess the disruptive Schumpeterian spirit of the 1980s that animated the early purveyors of, to use Lipton's phrase, "two-tier, front-end-loaded, boot-strap, bust-up, junk-bond, hostile tender offers."² The market for corporate control today is a process of peer review, rather than an instrument of systemic change. What is lost as a result is just what, in the conservative view, has been gained: the capacity of the market for corporate control to ignite the dynamism that in our view has served the U.S. economy so well.

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¹ Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) [hereinafter *Takeover Bids*].

² See, e.g., Martin Lipton, *Mergers: Past, Present and Future* 3 (Jan. 10, 2001), http://www.wrhambrecht.com/comp/ma/guest_column/lipton_merger.pdf (last visited Mar. 15, 2005).

We undertake our assessment of Lipton's boardroom view with trepidation. We are reminded of a scene in the movie, *Annie Hall*, in which Woody Allen and Diane Keaton, waiting in line to see *The Sorrow and the Pity*, become a captive audience for a self-important bore intent on impressing his date by loudly lecturing her on Marshall McLuhan's work. In fulfillment of all of our fantasies, Marshall McLuhan then appears himself to tell the self-anointed expert that he has got it all wrong. We run an analogous risk in this essay. We fully expect Lipton to disagree with much of what we say about his views, and we will even forego the post-modern defense that the readers, not the author, are the final arbiters of a work's meaning.³ Instead, we resort to a lesson from cognitive psychology (a discipline Lipton has viewed positively in the past⁴), namely, that our current positions powerfully shape our recollections of the past – or, put differently, where we were yesterday depends on where we are today.

In the discussion that follows, Part I places *Takeover Bids* in its historical context. Part II then tracks the post-*Takeover Bids* development of Delaware takeover law, with particular emphasis on the ongoing dialogue between the Delaware Supreme Court and the Chancery Court, which we characterize as a continuing debate between conservatism and pragmatism. Finally, Part III assesses where takeover law now stands, and resurrects our perennial optimism that the Chancery Court's pragmatism will ultimately prevail over the Supreme Court's ideology. We conclude, however, that although Lipton may still lose today's battle to allow targets to just say no to intra-establishment takeovers, he will still have won the larger war. For now, at least, boardrooms are insulated from much of the force of a truly Schumpeterian market in corporate control of the sort we briefly glimpsed during the 1980s.

I. Lipton's Counter-Revolutionary Manifesto

The world was a very different place in 1979, the year that *Takeover Bids* was published. The economy was just emerging from a decade of dismal performance. Interest rates were high (although they would soon go higher), and the Dow was still below 900. Hostile takeovers were increasing, albeit gradually, as they had since 1974, the first year in which a prominent investment bank advised an acquirer in a hostile takeover.⁵ Drexel had not yet begun to finance takeovers with junk bonds, and the poison pill had yet to be invented. But many of the players who would come to dominate the

³ We note, however, that the use of scholarship by courts makes the post-modern position descriptively accurate, as we learned from the Delaware Supreme Court's changing utterly the meaning of our term "substantive coercion." Compare Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW 247 (1989) with *Paramount Communications, Inc. v. Time-Warner*, 571 A.2d 1140 (Del.1990). Vice Chancellor Strine has noted the disconnect between our definition of the term and the manner in which the Supreme Court has used it, despite the court's acknowledgment of the source of the phrase. See *Chesapeake Corp. Shore*, 2000 Del. Ch. LEXIS 20 (2000).

⁴ Martin Lipton & Paul Rowe, *Polls, Pills and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 23-24 (2002).

⁵ Morgen-Stanley advised International Nickel Company of Canada on its acquisition of ESB. Ron Chernow, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* 596 (1990).

hostile financial deals of the next decade were already active, including T. Boone Pickens, Ronald Perelman, Felix Rohaytn, Joseph Flom, and, of course, Martin Lipton.⁶

In *Takeover Bids*, Lipton recognized – perhaps more clearly than anyone else at the time – just how important the takeover phenomenon would become during the next decade. *Takeover Bids* also articulated the central features of a deeply conservative, even Burkean, view of hostile takeovers, which appears to have informed much of what Lipton has written -- and the Wachtell, Lipton firm has stood for -- during the ensuing twenty-five years.

In our view, *Takeover Bids* should be read as a bold manifesto for the committed rather than as a cautious argument to convince the agnostic. But as a call to arms, it has proven to be more potent than any ordinary law review article could hope to be. Although *Takeover Bids* makes many particular arguments, its core is contained in a paragraph that occurs early in the article:

It would not be unfair to pose the policy issue [of whether to permit boards to oppose hostile bids] as: *whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares?* The overall health of the economy should not in the slightest degree be made subservient to the interests of certain shareholders in realizing a profit on a takeover. (Italics in original)⁷

The striking feature of this perspective is that it is at once abstract and deeply conservative. Nothing less than the health of the entire economic system is at stake. But what is the mechanism by which takeovers jeopardize the health of the economic system? How do speculators and raiders acquiring less than one percent of U.S. public companies in hostile deals (and far less than one percent in 1979⁸) threaten the entire economic system? We suspect that *Takeover Bids* describes a mechanism just clearly enough to inform those who need to know -- but not quite so clearly as to invite critique.

⁶ The early players in the mid-1970s world of hostile takeovers are described retrospectively in Chernow, *supra* note 5, at 596-603; the same world is described contemporaneously in Steven Brill, *The Tough Lawyers in the Tender-Offer Game*, NEW YORK MAGAZINE, June 21, 1976, at 52-61. Lincoln Caplan recounts that the legendary rivalry between Wachtell, Lipton and Skadden, Arps can be traced to their first encounter on opposite sides of a proxy contest in 1959. Lincoln Caplan, SKADDEN: POWER, MONEY, AND THE RISE OF A LEGAL EMPIRE 59 (1993).

⁷ *Takeover Bids*, *supra* note 1, at 104. This paragraph contains the article's only italicized sentence.

⁸ There were only seventy-three successful contested tender offers in which the target was a public company and either the target or the acquirer was listed on the New York or American Stock Exchanges during the *entire* 1970s. Gregg A. Jarrell & Annette B. Poulsen, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, FIN. MGMT, Aug. 1989, at 15.

Consider first how hostile takeovers do *not* endanger the economy. They do not threaten the economic system by harming shareholders or raising the costs of outside equity capital (although Lipton argues that they may harm long-term shareholders). Indeed, *Takeover Bids* reiterates at several points that the case for allowing boards to defeat hostile bids does *not* turn centrally on the consequences for shareholder interests.⁹

Nor does it seem likely that Lipton's vision of a threat to the economy could have been rooted in the direct costs that hostile bids might impose on corporate stakeholders other than shareholders. Accepting for the moment that significant harm occurs, as Lipton argues,¹⁰ the numbers of deals were much too small to have economy-wide consequences during the 1970s. Since we doubt that Lipton was exaggerating his concerns, harm to stakeholders couldn't have been their principal source. Moreover, if stakeholder interests had been key to Lipton's concerns, takeover policy would not have been the answer. The problem would have been management opportunism vis-à-vis stakeholders, and the remedy would be to curb the power of all boards, acquirers and targets alike, to restructure companies at the expense of their stakeholders. For this purpose, it matters little to employees whether they are fired by incumbent management or by a hostile bidder.

What, then, is there about hostile takeovers that could shake corporate capitalism to its foundations, even before the takeover surge of the 1980s? The answer, *Takeover Bids* suggests, is the demoralizing effects of takeovers on corporate managers and directors.

At least two forms of perverse incentives arising from takeover pressures are discussed in *Takeover Bids*. One is that managers who fear takeovers might no longer engage in serious long-term planning,¹¹ apparently out of concern that their plans might be lost in a hostile takeover or, worse yet, end up lining the pockets of a raider. The other is that an uncontrolled takeover market would dissipate a boardroom sense of social responsibility that had slowly accreted over the previous five decades of legal and social evolution. Faced with an apparent endorsement of takeovers, directors would conclude that the law's ultimate value was market price and the interests of speculators, rather than the responsible treatment of stakeholders or good corporate governance more generally.¹² Put differently, the real costs of open takeovers would accrue not in the minority of companies that were actually acquired but through a pervasive change of values and temporal perspective within the boardrooms of the vast majority of companies that were *not* acquired.¹³

⁹ See, e.g., *Takeover Bids*, *supra* note 1, at 115, 119-20.

¹⁰ The empirical evidence would cause one to be skeptical of the factual claim. See RONALD J. GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* ch. 13 (2d ed. 1995).

¹¹ See *Takeover Bids*, *supra* note 1, at 109, 115.

¹² *Id.* at 119.

¹³ Here Lipton is making the same kind of general deterrence argument that is proffered by pro-takeover advocates except that for Lipton the externality is negative.

In short, *Takeover Bids* was a call to arms in the defense of an economic order built on the honor, perspicuity, and civility of the officers and directors of America's corporations. The system and its concomitant culture had developed organically over the preceding five decades.¹⁴ In Lipton's view, it had functioned well to ensure that America's corporate resources were invested rationally, and that the proceeds of growth were distributed equitably between shareholders and stakeholders. Now, however, the system was put at risk by "ad hoc consortiums" of selling shareholders who, although they might purport to exercise choice, were actually manipulated by raiders and speculators. The danger was not that every company would fall to raiders, but that America's top managers would lose their vocation as trustees and descend to the short-sighted, cut-throat capitalism of the raiders. And worse yet, this process of erosion was being legitimated by empty slogans, such as "shareholder choice."

It is not hyperbolic to call *Takeover Bids* "Burkean" because, like Edmund Burke's *Reflections on the Revolution in France*,¹⁵ it is an impassioned defense of *ancient regime* authored by a powerful mind. And like *Reflections on the Revolution in France*, *Takeover Bids* is remarkably prescient, published several years before the full import of the takeover revolution became obvious. Nor do the similarities end there. Where Burke celebrates the French monarchy, aristocracy¹⁶ and clergy as the architects of France's prosperity, Lipton celebrates the moral and economic leadership of America's CEOs, board members, and investment bankers. Where Burke decries stock jobbers, speculators, and mobs, Lipton's targets are raiders, speculators, and "ad hoc consortiums" of shareholders. And where Burke rejects "popular election" as "the sole lawful source of authority,"¹⁷ Lipton rejects shareholder choice as the sole basis for deciding the outcome of hostile tender offers. Even the short-term perspective and lack of attachment to particular companies that Lipton sees as characteristic of raiders and arbitrageurs resembles Burke's earlier critique of France's revolutionary leaders.¹⁸

Finally, like Burke, Lipton never shrank from criticizing the *philosophes* of the academy. Although Henry Manne's work¹⁹ is not mentioned explicitly in

¹⁴ The five-decade time span suggests that the origin of the system was in the reforms of New Deal legislation in Lipton's view, although *Takeover Bids* does not make this explicit.

¹⁵ Edmund Burke, *REFLECTIONS ON THE REVOLUTION IN FRANCE* (Frank M. Turner ed., 2003) (1790).

¹⁶ Of the French aristocracy threatened by the Revolution, Burke observes:

Of my best observation, compared with my best inquiries, I found [the French] nobility for the greater part composed of men of high spirit, and of a delicate sense of honour, both with regard to themselves individually, and with regard to their whole corps, over whom they kept, beyond what is common in other countries, a censorial eye.

Id. at 115.

¹⁷ *Id.* at 23.

¹⁸ Of the French revolutionary leaders, Burke observes, "The attachment to their country itself is only so far as it agrees with some of their fleeting projects; it begins and ends with that scheme of polity which falls in with their momentary opinion." *Id.* at 75.

¹⁹ Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

Takeover Bids -- and Frank Easterbrook and Daniel Fischel,²⁰ Lucian Bebchuk,²¹ and one of us²² -- had not yet written our first articles on the market for corporate control, some aspects of the economic case for an open takeover market were already familiar when *Takeover Bids* was published.

A well-known article by Frank Easterbrook and Daniel Fischel published two years after *Takeover Bids*²³ is the best counterpoint to Lipton's article. Although Easterbrook and Fischel's contribution was far more linear and analytical than Lipton's (in the fashion of the *philosophes*), its abstract approach and systemic claims matched Lipton's level of discourse perfectly. As modern *philosophes* to Lipton's Burkean rhetoric, Easterbrook and Fischel emphasized managerial agency costs as the central problem of corporate governance, and embraced the hostile takeover as the market's ultimate disciplinary tool. Far from demoralizing officers and directors, however, the risk of a takeover on this view serves to discipline them and minimize agency losses that shareholders would otherwise bear. The legal implication is boards should have *no* discretion to respond to hostile takeovers -- the mirror image of the legal conclusion that Lipton reached. And, as in *Takeover Bids*, the justification was systemic. What mattered for Easterbrook and Fischel was not the quality of individual takeover bids, but the implications of takeover policy for the market as a whole and, in particular, for the incentives of raiders to discover poorly managed companies and the incentives of managers to maximize shareholder value to avoid a hostile bid.

Of course, Lipton's rhetorical struggle with modern *philosophes* has a different ending than Burke's struggle with the defenders of the French Revolution. Burke's views did not prevail (at least in France), while, as we argue below, Lipton succeeded in blunting the revolutionary edge of hostile takeovers that first appeared in the 1970s and early 1980s. Moreover, Lipton succeeded, we will argue, precisely because he was able to best the *philosophes* on their own turf, by casting the issue of defensive tactics as a matter of general principle, to be decided on the basis of system-wide costs and benefits. On this view, we must choose to trust boards or shareholders, market prices or internal evaluations, CEOs or raiders. Neither Lipton's approach nor its mirror image, the systemic analysis of Easterbrook and Fischel, left much room to discriminate among hostile takeovers and defensive tactics. The logic of Lipton's position was to preclude all hostile bids; the thrust of Easterbrook and Fischel's was to preclude none, at least when the bid price exceeded the market price of the target's stock. In this sense, both Lipton and the *philosophes* abandoned the particularistic, fact-sensitive analysis that is the hallmark of Delaware corporate law in other contexts. And precisely by diverting the debate outside the usual plane of analysis in Delaware

²⁰ Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

²¹ Lucian Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982).

²² Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1982).

²³ Easterbrook & Fischel, *supra* note 20.

corporate law, Lipton (with the unintended aid of the *philosophes*) won an enormous rhetorical advantage. If the only alternatives were those presented by *Takeover Bids* and Easterbrook and Fischel respectively, Delaware's choice – and America's choice – was never even close.²⁴

II. Takeovers in the Boardroom and the Courts: Ideology versus Pragmatism

If, as we argue, *Takeover Bids* made a Burkean claim that takeovers erode the foundations of the U.S. economy, it is hardly surprising that its argument does not require a close parsing of the experiences of particular takeover battles. Indeed, it is striking how little the facts about individual control contests and their consequences matter to Lipton's position. As Lipton put it, "even if there were no real evidence, but only suspicion, that proscribing the ability of companies to defend against takeovers would adversely affect long-term planning and thereby jeopardize the economy, the policy considerations in favor of not jeopardizing the economy are so strong that not even a remote risk is acceptable."²⁵ Moreover, the paucity of factual detail did not handicap Lipton's efforts to shape the development of Delaware takeover law. As is well-known, Lipton's conservative ideology ultimately prevailed in the Delaware Supreme Court, albeit not without creating a tension between the Supreme Court and the Chancery Court that survives in Delaware corporate law to this day.

Matters didn't start out this way, or at least they didn't seem to. In the beginning, the Supreme Court's approach to the modern wave of hostile takeovers seemed to be more pragmatic and fact sensitive than based on abstract principles and systemic reasoning. But appearances are deceiving. The nice irony of the history is that the inter-court tension seems to have grown out of the fact that in *Unocal* the Supreme Court sandbagged Chancery. *Unocal* instructed Chancery that the lawfulness of takeover defenses depends on the facts by inviting it to examine the nature of the "threat" posed by a hostile offer and the proportionality of the target's defensive response.²⁶ But when the Chancery Court developed a takeover jurisprudence based on a fact-sensitive investigation, the Supreme Court announced that the facts mattered very little. Instead, matters such as the possible confusion of target shareholders and as the disruption of the incumbent board's business strategy were threats sufficient to support preclusive takeover defenses.²⁷ By this point, however, the die was cast. Having been repeatedly exposed to the facts, the Chancery Court could not ignore the reality of the transactions before it. Simply deferring to the Supreme Court's post-*Unocal* embrace of managerial discretion and Liptonian ideology was no longer completely possible.

As we suggested in Part I, *Takeovers Bids* anticipated the new class of bidders that would dominate the market for corporate control in the 1980s. *Unocal* provided the

²⁴ Lipton's attack on the *philosophes* continues to the present. See Client Letter from Martin Lipton, No Substitute for Good Judgment, Wachtell, Lipton, Rosen & Katz (March 24, 2005).

²⁵ *Takeover Bids*, *supra* note 1, at 104-05.

²⁶ See Gilson & Kraakman, *supra* note 3.

²⁷ See, e.g., *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

Delaware Supreme Court its first opportunity to confront the new wave of hostile takeovers, fittingly an effort by T. Boone Pickens to profit by restricting an oil company's misuse of free cash flow.

The court acted against the background of what had become a heated debate.²⁸ Takeover defense lawyers advanced the position championed by Lipton in *Takeover Bids*. Board decisions with respect to hostile takeovers should be treated like any other acquisition proposal: the business judgment rule should operate to allocate the decision-making role to directors. As Lipton put it, “[o]nce the directors have properly determined that a takeover should be rejected they may take any reasonable action to accomplish this purpose.”²⁹ Like the business judgment rule, the court's deference to managers derives from broad principle, not from the particular defensive tactic or the takeover.

Academics took the opposite side of the argument. Lipton would accord target management deference to defeat a takeover because stability encouraged proper management conduct; academics would restrict that discretion because from their perspective, hostile takeovers played a disciplinary role. “Speculators” could displace both bad managers and managers who stood in the way of economic change. Depending on the individual academic, the *philosophe* position was that target managers should either be passive – the Easterbrook and Fischel position we revisited in Part I – or that these managers should seek out a better deal.³⁰ In the end, however, the dominant academic position accorded shareholders the final decision with respect to a takeover proposal, which, like Lipton's analysis, was a position based on broad principle and systemic effects.

In *Unocal*, the Delaware Supreme Court took the middle path, appearing to reject a resolution of the issue based on abstract principle by allocating decision-making responsibility neither entirely to shareholders nor entirely to managers. Rather, the court adopted a proportionality test geared to the facts. The Chancery Court was directed to determine whether the particular hostile bid presented a threat – was there a real danger or was the board simply parroting Lipton's litany of possible concerns? If there was a threat, was management's defensive response proportional to the threat – a balance that presumably turned on the details of the particular threat and defensive response

As originally framed, the trial court was cast as the final arbitrator between good and bad defensive tactics, making a substantive judgment concerning the presence of a threat and the proportionality of the response rather than simply deferring to the board's or shareholders' decision based on abstract principle.³¹ The balance called for the

²⁸ Ronald J. Gilson, *UNOCAL Fifteen Years Later (and what we can do about it)*, 26 DEL. J.CORP. L. 491, 493-97 (2001)

²⁹ *Takeover Bids*, *supra* note 1, at 123.

³⁰ See Gilson, *supra* note 22; Bebchuk, *supra* note 21.

³¹ In hindsight, we might have read *Unocal* a little more closely. The Supreme Court was explicit in rejecting Easterbrook & Fischel's passivity principle—it was not, the court stated forcefully, the law of Delaware. In contrast, the court was kinder to Lipton, rejecting his broad principle implicitly rather than explicitly as with Easterbrook and Fischel, and referring favorably to Lipton's catalogue of possible threats. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 964, 955 & n.10 (Del. 1985).

exercise of a pragmatism informed by experience. The business judgment rule is premised in significant part on the fact that the balance of experience on day-to-day affairs broadly favors the institutional competency of the board over that of the court; deference does not depend on the circumstances of the particular case. In hostile takeovers, however, that balance was reversed. The Chancery Court saw a great many more transactions than could any single board and, in addition, there was a problem of self-interest. For these reasons deference would depend on a careful parsing of the facts.

To be sure, one could (and we did) have a healthy skepticism whether the Supreme Court really meant what it seemed to say in *Unocal*. Shortly after *Unocal*, we followed Lipton's choice of journals and wrote an article for the *Business Lawyer* that asked whether there was "substance to proportionality review."³² Ever the optimists, we outlined how the Chancery Court might operationalize *Unocal*'s seemingly pragmatic premise that, once immersed in the facts, the court could distinguish between good and bad defensive tactics.

For a time, that optimism seemed appropriate. In a series of cases highlighted by *Anderson, Clayton*,³³ *Interco*,³⁴ and *Pillsbury*,³⁵ the Chancery Court developed a doctrinal framework that took *Unocal*'s call for a pragmatic balance seriously, both at the level of the threat and at the level of the proportionality test. In *Anderson, Clayton*, the court concluded that a defensive response that coerced shareholders was not proportional to a hostile bid that did not. In *Interco* and *Pillsbury*, blocking an offer, in contrast to providing shareholders with a better alternative, was not proportional to the threat that shareholders would differ with management's assessment of the price offered in the hostile bid – what the Supreme Court would come inaccurately to call "structural coercion."

The central feature of the Chancery Court's conception of proportionality review was its fealty to *Unocal*'s apparent rejection of abstract principle in favor of particularized fact finding. Was the hostile offer coercive? Did target management's response seek "to explore or create alternatives or attempt to negotiate on the shareholders' behalf"?³⁶ The result was the development of a pragmatic takeover jurisprudence in the Chancery Court that proved extremely difficult to suppress. Pragmatism was the only plausible response if the trial judge was to take seriously what was being presented in the courtroom. Only a commitment to Lipton's abstract ideology, not dependent on "real evidence but only on suspicion,"³⁷ could cause a court to credit, for example, Bruce Wasserstein's ratchet valuations in *Interco*,³⁸ or the breadth of his

³² Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).

³³ A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986).

³⁴ City Capital Assocs. v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988).

³⁵ Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988).

³⁶ City Capital Associates v. Interco Inc., 551 A.2d 787, 799-800 (Del. Ch. 1988).

³⁷ *Takeover Bids*, *supra* note 1, at ___.

³⁸ *Interco*, 551 A.2d at 729-93, 798-99.

valuation of the post-transaction Time Warner.³⁹ A blanket license to “just say no” in response to an unsupported claim that the offered price was too low cannot survive an inquiry that depends on the facts; to allow such a claim to stand is ideology, not the fact finding approach that the Supreme Court seemed to mandate in *Unocal*.

In short, the Chancery Court took *Unocal* seriously and constructed a pragmatic takeover jurisprudence. The sandbag came in *Time Warner*⁴⁰ and *Unitrin*,⁴¹ where the Supreme Court retreated to ideology. While one may criticize these decisions on a variety of grounds,⁴² for present purposes their critical characteristic is that they substitute an abstract principle for the court’s obligation to actually assess the facts of the bid and response before them. In *Time Warner*, plaintiffs claimed that Paramount’s offer – a cash offer for all outstanding shares, non-coercive because the minority would be frozen out at the same price – could not support a defensive tactic that blocked shareholder consideration. The court responded by simply accepting the target company’s assertion that shareholders would mistakenly accept the bid; the court demanded no evidence of why the shareholders would systematically err or why efforts to educate them would fail. As Lipton boldly advanced in *Takeover Bids*, suspicion alone was sufficient, without any factual inquiry into the likelihood or source of shareholder error. This is ideology, not pragmatism; Burke not Holmes.

Any remaining uncertainty about the Supreme Court’s commitment to a factually based proportionality test disappeared in *Unitrin*.⁴³ In that case, the Chancery Court simply determined that on the facts – among other things, the target already had a pill in place – the creation of further defensive barriers could not possibly be proportionate to a threat that had already been disarmed.⁴⁴ As the Chancery Court put it, “because the only threat to the corporation is in the inadequacy of an opening bid made directly to the board, and the board had already taken actions that will protect the shareholders from mistakenly falling for a low ball negotiating strategy, a repurchase program that intentionally provides members of the board with a veto of any merger is not reasonably related to the threat posed by [the bidder’s] negotiable all shares, all cash offer.”⁴⁵

³⁹ *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,514 *13 (Del Ch. 1989) (noting that Wasserstein provided several valuations, including one of \$208 to \$402 per share in 1993, described by the Chancellor as “a range that a Texan might feel at home on”).

⁴⁰ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990).

⁴¹ *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

⁴² As a matter of doctrine (as opposed to principle), both opinions are opaque in their reasoning. In *Time-Warner*, for example, the Supreme court rejects “*Interco* and its progeny” for substituting the court’s judgment for that of the board concerning what is a better deal. *Time*, 571 A.2d, at 1153. But the Chancery Court opinion in *Interco* involved at most substituting the shareholders’ judgment – not the court’s – for that of the board. *Unitrin* was also doctrinally opaque. The *Unitrin* framing – a defensive tactic was not unlawful, even if it precluded a hostile bid, if it did not make the bidder’s winning of a proxy fight “mathematically impossible or realistically unattainable” – had the effect, which the Supreme Court made no effort to explain, of preferring that control changes take place by means of proxy fights than tender offers. *Unitrin*, 651 A.2d at 1388-89; see also Gilson, *supra* note 25, at 501-02.

⁴³ *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

⁴⁴ See Gilson, *supra* note 25, at 499-500.

⁴⁵ Quoted in *Unitrin*, *supra* note 38, at 1377.

The Delaware Supreme Court reversed, remanding to the Chancery Court to determine whether the target's repurchase program was "within a range of reasonable defensive measures."⁴⁶ One might think that, had the Supreme Court accorded the Chancery Court any degree of deference, it would have accepted the Chancery Court's finding that the repurchase program was not "reasonably related to the threat posed" because the threat was so mild as implying that the defensive tactic fell outside a "range of reasonable defensive measures," as the Supreme Court's reframed the *Unocal* formulation in *Unitrin*. However, the opinion provides evidence that the Supreme Court was rejecting the entire inquiry, as opposed to merely the factual conclusion. Immediately following *Unitrin*'s direction on remand is a citation to, of all cases, *Cheff v. Mathes*⁴⁷ as in accord with the court's conclusion. *Cheff*, it will be recalled, was a case in which the Supreme Court declined to examine the board's justification for defensive tactics at all, and whose lack of content presumably gave rise to the need to address defensive tactics in *Unocal*.⁴⁸ *Cheff* also was the case Lipton cited in *Takeover Bids* to support a broad grant of discretion to boards.⁴⁹

So the Chancery Court was sandbagged. It was told in *Unocal* to apply an intermediate standard, somewhere between the business judgment rule and the entire fairness test, and make its own factual determination of whether a defensive tactic was reasonably related to the threat posed by the particular offer as a trigger to whether the board or the shareholders would resolve the fate of a hostile bid. Then in *Time-Warner* and *Unitrin* it was admonished for doing precisely that. The Supreme Court's and Lipton's ideology displaced the Chancery Court's pragmatism.

But what was the Chancery Court to do then? Responding to the Supreme Court's direction in *Unocal*, Chancery had seen in a number of cases that target companies systematically overreached on defensive tactics. Yet it was rebuffed by the Supreme Court for following directions laid down by the Supreme Court itself in light of the facts of the cases. It is easy to imagine the development of tension between the appellate court's pronouncement of abstract principles and a trial court's observation of the harsh facts of defensive tactics. In our view, *Time-Warner* and *Unitrin* created rather than dissipated that tension. From time to time it resurfaces in response to particularly egregious target company behavior, as in *Chesapeake Corp. v. Shore*,⁵⁰ or in response to

⁴⁶ *Id.* at 1390.

⁴⁷ 199 A.2d 548 (Del.Ch. 1964).

⁴⁸ In *Cheff* the Supreme Court held that a threat to change the target board's unique product distribution system was sufficient to justify defensive action without any inquiry into the nature of that distribution system to allow the court to assess the seriousness of the threat. That unique distribution system involved using door to door salesmen who dismantled the furnaces of elderly homeowners pursuant to an offer of a free inspection, and then refused to reassemble them, telling the homeowner that the furnace was too dangerous. Of course, being left without a furnace often led to the sale of a new furnace. This strategy was held to be fraudulent by the FTC, and the company's failure to follow a consent order led to a prosecution for criminal contempt. *See In re Holland Furnace Co.*, 341 F.2d 548 (7th Cir. 1965).

⁴⁹ *Takeover Bids*, *supra* note 1, at 104 n.9.

⁵⁰ 2000 Del. LEXIS 20 (Feb. 7, 2000). Vice-Chancellor Strine's surgical dissection of *Unitrin* in this opinion highlights at least his reluctance to follow the Supreme Court down the *Unitrin* path. The Vice-Chancellor acknowledges "that there is some tension between some of my analysis and the reasoning in *Unitrin*."

particularly exaggerated conduct by lawyers, as in the Chancery Court's admonition in *Pure* that "[i]f our law trusts stockholders to protect themselves in the case of a [non-coercive] controlling stockholder tender offer . . . , this will obviously be remembered by advocates in cases involving defenses against similarly non-coercive third-party tender offers."⁵¹ For better or for worse, Lipton (and *Takeover Bids*) deserve both the credit and the blame for this tension. Lipton ultimately persuaded the Supreme Court that the problem of allocating discretion between the board and shareholders in hostile takeovers could be resolved by abstract principles -- but only after the Chancery Court was so far down the road to a pragmatic takeover jurisprudence that it could no longer turn a blind eye to the facts.

III. Where Are We Now? Burke versus Schumpeter

It is now 25 years since *Takeover Bids*, 20 years since the *Unocal/Household International/Revlon* trilogy, and 10 years since *Unitrin*. What standard governs target management's discretion to deploy defensive tactics now?

A familiar answer is that legal rules no longer matter. Over the period spanned by these milestones, the capital markets have changed more dramatically than the law. A majority of the outstanding stock of most public corporations is now held by institutional investors. The voting policies of at least two large segments of those investors are transparent. Large public pension funds openly challenge defensive tactics that, in effect, go beyond the scope allowed as permissible by the Chancery Court in *Interco*. Review of the voting policies of mutual funds, now available on each fund's website, make apparent that the policies of mutual funds on defensive tactics, though less public, do not differ in substance from those of the public pension funds. It is not far fetched to claim that, were a shareholder vote to be required, very few firms now could secure approval of a broadly framed poison pill.

Put simply, the argument is that the capital market will no longer tolerate a just say no defense, so whether the Delaware Supreme Court will allow it is irrelevant. So posed, this analysis is a powerful counterpoint to that of Part II. There we acknowledged that Lipton won the legal battle. While leaving the Chancery Court somewhat sullen and potentially rebellious, the Supreme Court bought Lipton's Burkean platform hook, line and sinker -- "just say no" survived at least rhetorically. Today, however, it is sometimes argued that Lipton's victory was a hollow one. As Chief Judge David Bazelon once characterized a focus on the slogan rather than the outcome, "while the generals are designing a new insignia for the standard, the battle is being lost in the trenches."⁵² Which view is right?

This assessment requires looking a little harder at the types of takeovers involved. The takeovers Lipton anticipated with such dismay in 1979 would be driven by outsiders -- Drexel's development of the junk bond market to fund takeovers expanded the range of both bidders and targets and, as a result, expanded the range of possible transactions. The

⁵¹ *In re Pure Resources, Inc. Shareholder Litigation*, 808 A.2d 421, 446 n.50 (Del.Ch. 2002).

⁵² *U. S. v. Brawner*, 471 F.2d 969, 1012 (D.C. 1972) (Bazelon, C.J. concurring).

new bidders were outsiders – think of the Rales brothers in *Interco*. The new targets were old line companies who had become conglomerates – think of pre-takeover Revlon having expanded into health care. And the new transactions involved breaking up the target, in effect dismantling conglomerate organizations that proved to be inefficient. Ron Perelman bought Revlon for \$2.3 billion, and then sold off the health care and other non-cosmetic businesses for \$2.06 billion. He also received an offer for the remaining cosmetic business of \$905 million.⁵³

What we saw, and what Lipton feared, was Schumpeter's "perennial gale of creative destruction."⁵⁴ For Schumpeter, the essence of capitalism is not the ordinary competition that goes on within an existing industry structure – incremental changes in prices, quality or products that leave the underlying marketplace unchanged. Rather, economic progress comes from revolutionary changes that subvert the "ancient regime." As Schumpeter put it, "the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them."⁵⁵ From this perspective, 1980s junk bond financed, bust up takeovers reversed in record time a decade of bad acquisitions – outsider, not insider capitalism.⁵⁶

And what of today's hostile takeovers, those in which the market is said to render defensive tactics irrelevant? At the risk of over simplification, these are Burkean takeovers, strategic transactions involving market or product extensions effected by establishment companies or, like Wachtel, Lipton's unusual venture on behalf of a bidder in a hostile takeover, ATT's effort to revitalize its computer expertise by acquiring NCR. If the 1980s hostile takeovers were the gale of creative destruction, today's hostile takeovers are just a process of peer review.

So where does that leave us? Did the market snatch back Lipton's legal victory? We fear not. The answer turns on a prediction about whether legal rules would trump the market if the character of the bidder reverted to the outsiders of the 1980s. It is one thing to see Oracle succeed in a hostile bid for PeopleSoft, quite another if the takeovers are intended to restructure an entire industry from the outside. Steven Fraidin, a perceptive and experienced observer of the takeover market, has argued, in effect, that Lipton has won even if judicially sanctioned defensive tactics cannot block peer review takeovers.

The issue is Burke versus Schumpeter. For Lipton the problem is not hostile takeovers, but only hostile takeovers that transmit the gale of creative destruction, that represent a threat to the established order. Fraidin's view is that incumbent managers may be able to buck the market if the bidder is a genuine outsider, and that the legal rules as envisioned, if not ever quite stated, by the Delaware Supreme Court, would give target managers virtually unlimited discretion to just say no to whoever will be the new millennium's equivalent of T. Boone Pickens. Put somewhat differently, suppose

⁵³ Andrei Shleifer & Robert Vishny, *The Takeover Wave of the 1980s*, 249 *SCI.* 745, 746-747 (1990).

⁵⁴ Joseph A. Schumpeter, *CAPITALISM, SOCIALISM AND DEMOCRACY* 84 (Harper Torchbooks, 1950).

⁵⁵ *Id.*

⁵⁶ See Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 *FORDHAM L. REV.* 161 (1992).

outsider bidders like the Rales brothers sought to acquire a major corporation today. If the consideration was partially junk bonds and the bidders had no experience running a major corporation, would blocking the bid be within *Untrin*'s range of reasonableness and would establishment directors be willing to take the heat from the market?

It may be that we will have the chance to learn the answer. A new generation of takeover outsiders, in the form of hedge funds, appears to be on the horizon. The recent bid for Circuit City by a hedge fund,⁵⁷ as well as the reported heavy involvement of hedge funds in the contest between Qwest and Verizon for MCI,⁵⁸ may presage a replay of the 1980s.⁵⁹ And then the Supreme Court will have to consider its options yet again. Will it line up with Burke and serve as the protector of the business aristocracy, or will it make some room for the creatively destructive transactions that, for Schumpeter, were at the core of a successful capitalism?

IV. Conclusion.

The decade from late 1970s to the late 1980s was a period of profound movement toward the market in the culture, politics, and economics of America as well as the rest of the world. In the United States, the resurgence of market-friendly values led to the deregulation movement and contributed to the Reagan revolution in politics. In the wider world, markets enjoyed a renaissance in the popular imagination during this period, with the collapse of socialism in former Eastern-block countries and the spread of “creeping capitalism” throughout the developing world. Much of this activity was truly revolutionary. And one important aspect of the rise of markets in the U.S. was the surge of hostile takeovers and leveraged buyouts that washed away so many of the failed conglomerates that had coalesced during the previous decade. This was “creative destruction” in the best sense of the phrase.

As Burke knew full well, however, revolutions are profoundly unsettling not least because their endpoints are difficult to predict. They can easily spill over from creative destruction to what some would say is destruction pure and simple. The 1980s threatened entrenched elites around the world. In some jurisdictions, the threat was fully realized. Thus, entire generations of managers simply vanished in formerly socialist countries, as the market restructured the economic landscape. In other jurisdictions including the United States, surges in the market for corporate control were tamed and channeled after they had achieved much-needed restructuring, but well before they could seriously threaten the established economic elite. For better or worse, Martin Lipton – and the positions first developed in *Takeover Bids* – played an important role in reigning in market forces that were briefly unleashed during the 1980s. Few lawyers – and few articles – have had anything like this effect. Burke would have approved.

⁵⁷ Gary McWilliams & Gregory Zuckerman, *Circuit City Draws \$3.25 Billion Bid: Highfield Offer Signals New Shareholder Influence by Hedge Fund Managers*, WALL ST. J., Feb. 16, 2005, at A3.

⁵⁸ Jesse Eisenger, *Subplot in Contest for MCI: Fast Money vs. the Long Term*, WALL ST. J., Mar. 9, 2005, at C1.

⁵⁹ Lipton himself raises the possibility of private equity funds fueling a new wave of outsider hostile takeovers. See Client Letter from Martin Lipton, Wachtel, Lipton, Rosen & Katz (Dec. 27, 2004).

