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Corporate Takeovers and Corporate Law: Who's in Control?

Lyman Johnson*
David Millon**

[B]oth corporate governance and the judicial administration of corporate law entail heavy responsibilities to society at large.¹

Geoffrey C. Hazard, Jr.

Director, The American Law Institute

Part VI does not reflect a judgment on the economic, social and political issues posed by hostile takeovers.²

*American Law Institute,
Principles of Corporate Governance
Analysis and Recommendations*

Introduction

Like members of other social groups, people in corporate law tell stories about themselves. These narratives about the past—about the group's origins, traditions, special challenges, and defining moments—instill group identity and deepen its sense of cohesiveness.

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1. Geoffrey C. Hazard, Jr., *Foreword to AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* x (Proposed Final Draft 1992) [hereinafter Proposed Final Draft].

2. *Id.* Part VI introductory note, at 517.

These accounts, which are much more than intellectual “paradigms,” also subtly but powerfully shape and validate the future endeavors of the group, dictating what are and are not proper matters for group attention.

The tale told most often about corporate law over the past several decades has been the saga of failed efforts to restore balance to the shareholder-manager relationship.³ The story is a sort of ongoing lamentation punctuated with recurrent, but always short-lived, claims of breakthrough.⁴ One response to this Sisyphean tale is to admire the sheer intellectual tenacity and tough-mindedness displayed in the face of chronic failure, while lamely urging, as to a winless team, that “next time will be different.”

A more renegade response is to suggest that the prevailing corporate law chronicle needs to be revised. We believe that the conventional account no longer does justice to evolving conceptions of what corporate law ought to concern itself with. On the one hand, the startling rise to prominence of institutional shareholders, and their increasing activism,⁵ seems to herald at long last closure of the separation between ownership and control. According to this view, corporate law’s longstanding preoccupation with the seemingly intractable accountability problem may finally be reaching

3. The Reporters for Part VI of the American Law Institute’s (ALI) *Principles of Corporate Governance (Principles)* express the central task of corporate law as follows:

The challenge for corporate law is to facilitate the development of a corporate structure that allows management the discretion to utilize its expertise on behalf of shareholders, but at the same time establish safeguards in situations in which management might utilize that discretion to favor itself at the expense of shareholders.

Id. Part VI introductory note, at 519; see Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 878-80 (1990) (describing the narrow province of modern corporate law).

The central theme of the traditional tale of corporate law is Berle and Means’ well-known observation of the separation of ownership and control in the public corporation. ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). The upshot of this tale is that managers possess such enormous discretion that they are insufficiently accountable to shareholders.

4. See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992); Lilli Gordon, *New Deal for Shareholders*, WALL ST. J., Feb. 4, 1993, at A18.

5. For scholarship describing the renewed interest of institutional shareholders in corporate governance, see ROBERT A.G. MONKS & NELL MINOW, *POWER AND ACCOUNTABILITY* 230-38 (1991) (tracing the steady increase of institutional shareholders’ efforts to influence corporate activities); Black, *supra* note 4, at 814-20 (advocating legal reform to achieve limited institutional oversight of corporate managers); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 522-25 (1990) [hereinafter Black, *Shareholder Passivity*] (analyzing the possibility of shareholder monitoring); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 896-98 (1992) (arguing that institutional oversight could remedy the shortfalls in corporate performance); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1280-90 (1991) (evaluating the risks associated with increased institutional control of corporate performance); John M. Conley & William M. O’Barr, *The Culture of Capital: An Anthropological Investigation of Institutional Investment*, 70 N.C. L. REV. 823, 823-27 (1992) (analyzing the manner in which culture affects the management of pension funds); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452-53 (1991) (arguing that the benefits of increased institutional activism will be offset by increased agency costs).

obsolescence.⁶

On the other hand, however, there has been a widespread, though not universal, rejection of the shareholder primacy norm⁷ on which the Berle and Means story,⁸ as well as institutional shareholder activism,⁹ are premised. State legislatures and courts have rewritten corporate law so as to bring nonshareholder interests within its compass in the hostile takeover area, and perhaps also more generally.¹⁰ Each of these two new stories aims to displace the standard but now inadequate narrative. Competition between their proponents will shape the corporate law landscape in important new ways in the years to come.

We believe that genuine reform on the key substantive issue in corporate law—the issue of participation and control, by institutional investors as well as nonshareholders, in the governance of business enterprises—will come about only after the key political issue in corporate law—the issue of participation and control in defining the scope and thrust of corporate law, what we call storytelling—is confronted. The orthodox account of what is going on in corporate law—*i.e.*, a prolonged tug of war between shareholders and managers¹¹—is so narrow and problematic precisely because those who construct the contours of corporate law's agenda are few in number and are unrepresentative of the multitudes in society whose interests are affected critically by corporate activity.¹² Current disenchantment with the story of corporate law reflects disenchantment with the story-tellers of corporate law. Because of who the story-tellers are, they are telling the wrong tale. The democratization of corporate governance so as to encompass a broader set of community interests within its intellectual sphere is unlikely to occur

6. See, e.g., Black, *supra* note 4, at 813-14; Coffee, *supra* note 5, at 1279-80; Conley & O'Barr, *supra* note 5, at 842-43.

7. The shareholder primacy norm holds that in discharging its responsibilities, management should assign priority to the interests of shareholders, as opposed to the interests of the corporation's other constituent groups. See, e.g., BERLE & MEANS, *supra* note 3, at 333.

8. *Id.* at 333-39.

9. See, e.g., Black, *supra* note 4, at 817.

10. See, e.g., *infra* Part II.A.1.

11. See *supra* note 3.

12. See Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1862-65, 1878-81 (1989) [hereinafter Johnson & Millon, *Misreading*] (stating that state legislatures are concerned with takeovers that "threaten jobs, established customer and supplier relationships, tax revenues, charitable contributions, and other economic and social benefits provided by resident companies to local communities"); Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846, 848 (1989) [hereinafter Johnson & Millon, *Missing the Point*] (noting that state takeover statutes are designed to protect nonshareholders by "pursu[ing] objectives that are largely inconsistent with shareholder welfare"); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 201 (discussing the view that "corporate activity has broad social and political ramifications").

until the storytelling function in corporate law—the power to say what are and are not proper matters for group attention—is itself democratized.

We aim in this Article simply to reveal that the ALI's¹³ treatment of the most important development in corporate law in the last twenty-five years—the hostile takeover—reflects both the inadequacy of the reigning corporate law story and the enormous unlikelihood of existing storytellers constructing a new one. We argue in Part I of this Article that careful examination of the ALI's treatment of hostile takeovers shows this treatment to be flawed and, in some ways, puzzling. Yet we also argue that the true significance of Part VI of the *Principles* is not to be found in close scrutiny of its details, but in its startlingly explicit interjection of nonmanagement, non-shareholder interests into the main story of corporate law. This apparent widening of corporate law's domain mirrors judicial and legislative sanctioning of target management authority to consider a broad array of interests in responding to hostile overtures, a development that was instrumental in blunting tender offers in the late 1980s.¹⁴ Paradoxically, the sudden demise of hostile takeovers abruptly turned corporate reform efforts of the 1990s toward encouraging the now-voguish—and radically proshareholder—activism of institutional investors. It turns out, however, that the ALI's attempt to acknowledge the legitimacy of nonshareholder interests is inadequate—while at the same time failing to do justice to its asserted endorsement of the standard management-shareholder narrative that has so long dominated thinking about corporate law.

Part II of this Article argues that the ALI's effort to bring non-shareholders into management's decisionmaking calculus reflects the current uncertainty about the viability of corporate law's conventional story. Nevertheless, the ALI Reporters characterize their work in terms of the standard story's basic problem: its myopic focus on the management-shareholder nexus. Rather than successfully forging a new synthesis of the apparently irreconcilable claims of institutional shareholders and nonshareholders, however, the ALI in Part VI of the *Principles* presents a limp, incoherent amalgam that succeeds only in conferring on target company management a degree of discretion to protect its own interests that is as great or even greater than the discretion that state law currently provides.

The claims of nonshareholder groups on business enterprises—and society's endorsement of those claims—are considerable and must be remembered by those who zealously advocate an enhancement of shareholder rights. These claims—the nature and reach of

13. As of May 1990, the date of its 67th annual meeting, the ALI had 878 elected members. It also had 117 special class members and 42 ex officio members who were not also regular members. As of that same date, the ALI also had 53 members of the Council, 9 emeritus council members, 11 Consultants to the Corporate Governance Project, 46 Advisers to the Corporate Governance Project, and 6 Reporters for the Corporate Governance Project. 67 A.L.I. PROC ii-iii, xi-xxv, 759-61 (1990).

14. See Lyman Johnson, *Sovereignty over Corporate Stock*, 16 DEL. J. CORP. L. 485, 522-38 (1991).

which require greater theoretical development—must also be remembered by those management groups who earlier invoked nonshareholder interests in successfully resisting a singularly proshareholder vision of corporate law in the 1980s. To avoid an intolerable gulf between the project of corporate law reform in a posttakeover world and the larger social expectations of corporate activity,¹⁵ nonshareholder claimants must be permanently etched into the framework of modern corporate law. Proponents of institutional shareholder activism need to appreciate that nonshareholders are here to stay. Meaningful recognition of nonshareholder interests is best achieved, however, not simply by consigning these interests to being bit characters in one chapter of a corporate law story told by others, but, as argued in Part III, by finding ways to include them as makers and tellers of the ongoing corporate law tale, a role the current storytellers now deny them. In short, the ALI's failure in Part VI of the *Principles* to offer a compelling solution to corporate law's turmoil points up the need to democratize its law reform activities.

I. The ALI's Treatment of Control Transactions and Tender Offers

A. An Introduction to the Failed Architecture and Hidden Normativity of Part VI

The title of Part VI—Role of Directors and Shareholders in Transactions in Control and Tender Offers¹⁶—is at once misleading and revealing. The title misleads because Part VI does not address many matters germane to control and tender offers. The title also reveals the ALI's apparent belief that, in keeping with orthodoxy, the only issue for corporate law on the subject of control transactions and takeovers is the relative say of directors and shareholders. This narrow depiction of corporate law's task is in obvious tension with the ALI's own recognition that, particularly with respect to hostile tender offers, these large-scale transactions have immense economic, social, and political significance.¹⁷ To formulate corporate law principles on these subjects at a time of serious disagreement about their societal ramifications is either to believe that these wide-ranging considerations are simply alien to corporate law principles or to concede that the key corporate law decisionmakers are being assigned roles having no sure grounding in the larger political economy.

15. See Millon, *supra* note 12.

16. Proposed Final Draft, *supra* note 1, Part III introductory note, at 517.

17. *Id.* Part VI introductory note, at 517 ("Part VI does not reflect a judgment on the economic, social and political issues posed by hostile takeovers.").

If the ALI believes that the larger landscape is irrelevant to corporate law principles governing the rapid acquisition of public companies, then the law's narrow province is overly insular, and its self-fashioned story centered on the interplay between business executives and capital financiers needs serious rethinking. Who can seriously contend after the tumultuous 1980s that the law of corporate governance ought to bear no relationship to the manner in which corporate behavior affects the rest of society?¹⁸ Deep concern about socially irresponsible behavior by large corporations in the 1970s was, in fact, one important reason for the ALI's undertaking of its Corporate Governance Project.¹⁹

If, on the other hand, the ALI considers the larger social sphere to be relevant to corporate law—although there is as yet no consensus as to the manner in which it is relevant—then the project of imbuing certain persons with specified authority seems premature and necessarily carries disguised policy and normative thrust simply in its manner of assigning discretion. The Reporters for Part VI do not address expressly this baseline problem of whether and how to accommodate multiple factors because the discipline of corporate law itself has not come forthrightly to terms with it. Failure to grapple openly with normative issues, however, does not mean that the ALI is not making normative assessments, and the very act of allocating decisive authority over economically and socially significant takeover transactions belies the assertion that Part VI—and corporate law generally—have a narrow compass.

Part VI of the Project, reciting nonetheless the standard story that corporate law's modest task on the issue of takeovers, as on other issues, is to reconcile discretion in managers with fidelity to shareholder well-being,²⁰ consists of two subparts that aim to resolve this dilemma. The first subpart, section 6.01,²¹ deals with consensual, negotiated transactions to which the corporation is a proposed party. It provides that the decision to proceed with or decline such transactions lies, initially, within the ordinary business judgment of

18. For an argument that corporate law must more consciously attend to the social aspects of economic activity, see Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) and ROBERT N. BELLAH ET AL., *THE GOOD SOCIETY* (1991)). See also Millon, *supra* note 12 (emphasizing the public aspect of corporate activity).

19. See COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1978, at 20-23, 246 (Donald E. Schwartz ed., 1979). The ALI *Principles* Project began in May 1978 as an outgrowth of four regional symposia on corporate governance held in 1977 and 1978. *Id.* at ix.

20. See *supra* note 3.

21. The text of § 6.01 of the *Principles* reads as follows:

Role of Directors and Holders of Voting Equity Securities with Respect to Transactions in Control Proposed to the Corporation

(a) The board of directors, in the exercise of its business judgment [§ 4.01(c)], may approve, reject, or decline to consider a proposal to the corporation to engage in a transaction in control [§ 1.38].

(b) A transaction in control of the corporation to which the corporation is a party should require approval by the shareholders [§ 1.02].

Proposed Final Draft, *supra* note 1, § 6.01.

the directors.²² Of course, the enormous latitude the business judgment standard accords directors could be abused by their rejection of attractive acquisition offers that shareholders might favor. The second subpart, section 6.02,²³ dealing with non-negotiated (hostile) tender offers, is therefore said to serve as an "outer limit" on the exercise of managerial discretion aimed at denying shareholders the opportunity to evaluate directly the merits of such offers.²⁴

Plausible as it may appear, this effort to harmonize the fundamental tension between managers and shareholders fails. It turns out that under section 6.02, managers can fairly easily preclude shareholders from ever having an unimpaired option to tender their stock to a hostile bidder, however attractive an offer might be—a result that stems both from section 6.02's failure to address critical aspects of hostile takeovers and from its decidedly promanagement procedural barriers and substantive standards.²⁵ Managerial discretion is thus only apparently more narrow under section 6.02 than under section 6.01. The net effect is that the promise that hostile takeovers may be a disciplinary antidote for abuse of managerial discretion under section 6.01 (and more generally) is no more realized in section 6.02 than it is in existing state corporate law favoring target company managers—and perhaps even less so.²⁶

Within the design of Part VI and, more important, within the conventional story of corporate law, what is the rationale for endowing

22. *Id.* § 6.01(a).

23. The text of § 6.02 of the *Principles* reads as follows:

Action of Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers

(a) The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer [§ 1.39], if the action is a reasonable response to the offer.

(b) In considering whether its action is a reasonable response to the offer:

(1) the board may take into account all factors relevant to the best interests of the corporation and shareholders including, among other things, questions of legality and whether the offer, if successful, would threaten the corporation's essential economic prospects; and

(2) the board may, in addition to the analysis under § 6.02(b)(1), have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders.

(c) A person who challenges an action of the board on the ground that it fails to satisfy the standards of Subsection (a) has the burden of proof that the board's action is an unreasonable response to the offer.

(d) An action that does not meet the standards of Subsection (a) may be enjoined or set aside, but directors who authorize such an action are not subject to liability for damages if their conduct meets the standard of the business judgment rule [§ 4.01(c)].

Id. § 6.02.

24. *Id.* Part VI introductory note, at 522.

25. See *infra* Part I.B.

26. See, e.g., *Paramount Communications, Inc. v. Time Inc. (In re Time Inc. Shareholder Litig.)*, 571 A.2d 1140 (Del. 1989).

directors with the freedom unilaterally to rebuff high-premium hostile tender offers? One argument is that shareholders face collective-action barriers that managers can surmount on their behalf.²⁷ This argument may justify sufficient discretion to impede a bid so as to extract a higher premium, but it does not justify empowering managers completely and routinely to thwart tender offers. Except disingenuously, director discretion of such a magnitude that it might thoroughly stifle takeovers can only be justified by reference to considerations other than shareholder welfare. In fact, section 6.02 both obliquely and directly interjects nonshareholder interests into the range of factors directors may consider in responding to a hostile bid.²⁸ The upshot of section 6.02, in spite of the Reporters' recitation of the traditional two-party corporate law story in their conceptual overview of Part VI,²⁹ is thus to introduce some new characters into corporate law. The effect of weakening the focus on shareholder welfare is, in various ways, to invest broad discretion in a group—incumbent management—who generally are avowedly opposed to hostile takeovers. Were Part VI enacted into positive law, the outcome would be a probable shutdown in hostile takeover activity, even though Part VI supposedly takes no position on the social utility of such activity.

The rules governing hostile takeovers, then, as with other legal rules, can never be free of normative tilt. Inevitably, the operative rules on such an important social phenomenon as hostile takeovers reflect the deep value judgments about the subject of those persons—in this case, the members of the ALI—who are authorized to write the rules.³⁰ The dissonance between the conventional story that corporate law is aloof from underlying social currents and the reality that it is unavoidably embedded in those currents is plainly visible in Part VI's regulation of high-stakes financial transactions. This dissonance will be examined in greater detail in Part I.B. Part II will then elaborate the ways in which this lesson about corporate law's necessary grounding in social consensus provides a critical perspective on the ALI's reform efforts, while Part III will sketch the manner in which the ALI's failure should prompt efforts to broaden both the story and the composition of the storytellers of corporate law in the coming era of institutional shareholder activism.

B. *A Closer Look at Part VI*

The ostensible overall design of Part VI is simple. The ability of a

27. See Proposed Final Draft, *supra* note 1, Part VI introductory note, at 522.

28. See *infra* Part I.B.2.c.

29. See Proposed Final Draft, *supra* note 1, Part VI introductory note, at 517-21.

30. Professor Carl Auerbach made this Holmesian point at the 1990 ALI annual meeting, where the initial draft of Part VI was discussed heatedly:

I think it is very difficult to discuss these various specific issues . . . except by having some general notion . . . as to whether this merger-takeover movement has done any good for the economy or not, because we can't conceive of the rules in this regard apart from their function and effect on the society as a whole.

67 A.L.I. PROC. 65, 109-10 (1991) (statement of Carl A. Auerbach).

board of directors to reject an offer to acquire the corporation under section 6.01 is supposedly constrained under section 6.02 by limitations on the board's ability to interfere with a later hostile tender offer made directly to shareholders by the spurned bidder. Both because of what is and is not done in Part VI, however, section 6.02 provides only illusory protection for shareholders, the assumed beneficiaries of directorial efforts. At the same time, it offers unintended, if precarious, protection to nonshareholders threatened by hostile bids.

1. *Matters Outside the Scope of Part VI*

Part VI does not treat several matters that might bear on the hostile acquisition of corporate control. For example, Part VI does not address the power of directors to alter or deflect efforts to acquire relative control within a corporation by adopting or modifying by-laws in a manner that changes the structure and make-up of the board.³¹ Thus, the interim goal of hostile bidders seeking ultimately to redeploy corporate assets—to attain control of the target company board of directors—can be frustrated in a manner that might discourage the initial launching of a tender offer. Nor does Part VI address the extent to which a corporation's charter may specify rules covering negotiated and hostile control transactions.³² Corporations are thus free to include relatively mild or quite formidable antitakeover provisions in their organic documents—provisions that may vary substantially from prevailing doctrinal principles. Sections 6.01 and 6.02 also do not cover (and thus do not prohibit) the adoption of shareholders' rights—or “poison pill”—plans.³³ Although not specifically addressed, implementation of these plans is assumed, as the comments note, to be within the directors' authority to engage in defensive planning in advance of an unsolicited tender offer.³⁴

Part VI also does not prohibit states from enacting antitakeover statutes that cover all chartered corporations except those expressly electing to “opt out” of coverage.³⁵ Nor are corporations prohibited from “opting in” to coverage afforded by antitakeover statutes providing protection only to chartering corporations electing such coverage.³⁶ Part VI furthermore takes no position with respect to the relevant judicial standard of review of defensive measures taken

31. Proposed Final Draft, *supra* note 1, § 6.01 cmt. d, at 530.

32. *Id.* § 6.01 reporter's note 4, at 541.

33. *Id.* § 6.01 cmt. d, at 530; *id.* § 6.02 cmt. c(10), at 571-72.

34. *Id.* § 6.02 cmt. c(10), at 571-72.

35. *Id.* § 6.02 cmt. a, at 554-55.

36. *Id.*

by a board pursuant to such statutes.³⁷

In short, Part VI does not address a variety of matters that are properly regarded as corporate defensive measures. Alone or together, these matters excluded from the coverage of Part VI confer awesome power on incumbent managers to rebuff hostile overtures. For example, the sort of protection the various potent antitakeover provisions of Pennsylvania's corporate statute³⁸ afford to Pennsylvania corporations makes a successful hostile acquisition of those companies virtually impossible. Part VI's treatment of only judicial takeover doctrines therefore is not only incomplete,³⁹ it is unnecessary surplusage in states having such fierce statutes.

The Reporters seem aware that the very breadth of matters excluded from the coverage in Part VI potentially can undermine hostile bids altogether and thereby preclude application of the purportedly heightened standard of review set out in section 6.02.⁴⁰ Nevertheless, the Reporters do not fully resolve the tension between subjecting to heightened review *all* corporate actions that might impede takeovers and subjecting, as Part VI does, only a *subset* of such actions to such review, thus leaving all corporate actions outside the purview of section 6.02 either unaddressed or subject only to the ordinary business judgment review of section 6.01. An example will clarify this point.

Suppose a company is incorporated in a state with the most formidable antitakeover statutes now in existence. Suppose, too, that the board of directors, long before a hostile bid is made, implemented a shareholders' rights plan—an action section 6.02 “assumes” the board can take without specifying a review standard.⁴¹ Suppose also that upon being approached to engage in a negotiated transaction to sell the company, the board declines the offer because a sale is not consistent with its preexisting plans and policies for the enterprise. Its decision is entitled to ordinary business judgment review, as set out in section 6.01.

Suppose now that the spurned offeror launches an all-cash, all-shares hostile tender offer directly to the shareholders of the target company, contingent only upon the target board opting out of all statutory antitakeover provisions and rescinding the shareholders' rights plan. Under what standard should the directors' decision neither to talk to the bidder nor to comply with either condition be reviewed—the ordinary business judgment standard of section 6.01, or the heightened standard of section 6.02?

Much of Part VI suggests that the answer is the ordinary business judgment standard. The text of section 6.02(a) states that a “response” to an unsolicited tender offer must be reasonable.⁴² In the

37. *Id.* § 6.02 cmt. a, at 555.

38. 15 PA. CONS. STAT. ANN. §§ 2571-76 (1992).

39. Professor Carl Auerbach made this point at the 1990 ALI annual meeting on the prior draft of Part VI. 67 A.L.I. PROC. 65, 143-44 (statement of Carl A. Auerbach).

40. *See* Proposed Final Draft, *supra* note 1, § 6.02(c).

41. *Id.* § 6.02 cmt. c(10), at 571-72.

42. *Id.* § 6.02(a).

example, adoption of the rights plan and coverage by the statute, both of which preceded the bid, are not "responses" to the bid. Possibly, however, the directors' decision neither to talk to the bidder nor to comply with the two conditions of the bid—that is, to do nothing at all—is itself a "response" that must be reasonable. If so, then one standard—ordinary business judgment—would apply to decisions to adopt defensive measures in advance of a bid and a different standard—heightened review under section 6.02—would apply to post-bid decisions to adhere to prebid decisions. This outcome might be warranted by a concern with director self-interest in takeovers of the sort that led the Delaware Supreme Court in 1985 to adopt a modified business judgment standard when reviewing defensive measures.⁴³ Are perceptions of directors' self-interest once a bid is launched, however, more valid than concerns with self-interest when prebid measures are first implemented? In possibly setting up disparate standards for reviewing the prebid adoption of and post-bid retention of rights plans, Part VI has a view of when directors act out of self-interest that is both psychologically fuzzy and at odds with Delaware law.⁴⁴

Further support for applying ordinary business judgment review under the circumstances in this example is implicit in comment (c) to section 6.01, which states that

management does not necessarily have an obligation even to consider a proposed transaction in control. . . . [A] policy decision by the directors that the shareholders would be best served by management concentrating its attention on operating the corporation's business, rather than on selling it, would be reviewed under the business judgment rule. Management need not act as if the business of the corporation is at all times up for sale.⁴⁵

If a spurned bidder is persistent and wishes to present its bid to shareholders, a board's refusal to dismantle its long-standing defensive measures—a refusal aimed at protecting its policy decision not to sell the company so as to further its plans for the enterprise—seems, as a matter of logic, to be no less entitled to deference than the initial decision to implement the measures. It is possible that comment (c) to section 6.01 is meant to support this view, especially as bolstered by comment (c)(6) to section 6.02, which states that the

43. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) (requiring directors to show reasonable grounds for adopting takeover defense mechanism); see *infra* text accompanying notes 61-64.

44. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (applying *Unocal* modified business judgment standard in analyzing prebid adoption of shareholders' rights plan).

45. Proposed Final Draft, *supra* note 1, § 6.01 cmt. c, at 527; see also Lyman Johnson & David Millon, *The Case Beyond Time*, 45 *BUS. LAW.* 2105, 2120-25 (1990) (pointing out the current tension in Delaware case law on this point).

target corporation does not need to alter preexisting plans simply because a bid is launched.⁴⁶ If carrying out the preexisting plan can only be accomplished by ignoring the bidder, and the bidder can only be ignored by leaving long-standing defensive measures in place, then are directors in so proceeding simply exercising “business judgment”? If so, is this “ordinary” business judgment? Comment (c)(6) to section 6.02 also includes hedging language to the effect that if such a plan has a “blocking” effect, then the higher standard of “reasonableness” is implicated.⁴⁷ This language, however, is irreconcilably at odds with according deference to a board’s decision to adhere to its business plans. Furthermore, comment (a) to section 6.02 states that the section “does not place on directors who are responding to an unsolicited tender offer the duty to conduct an auction of the corporation’s business.”⁴⁸ Once the rights plan and statutory protection are abandoned, however, a sale of the company would appear to be inevitable. In this case, shareholders would gain from an auction. To say, then, that no auction is necessary may mean, at bottom, that no sale is necessary; and to say that no sale is necessary is to condone continued deployment of antitakeover measures.

Comment (a) to section 6.02, moreover, states explicitly that “[s]ection 6.02 takes no position with respect to the appropriate standard of review applicable to the exercise of discretion by the board of directors under such [antitakeover] statutes.”⁴⁹ This statement indicates that, at least insofar as a board decision not to honor a bidder’s condition that the target disavow coverage by the applicable antitakeover statute is concerned, Part VI expresses no view as to whether ordinary business judgment or heightened review of the sort found in section 6.02 is applicable. Because the prevalence of antitakeover statutes means that the appropriate standard of review is almost always at issue, resolution of this issue is too important for the Reporters to remain silent. Why not, at the same time, be crystal clear about the applicable standard for refusing to deactivate the widely utilized rights plans?

Recalling the conceptual design of Part VI—supposedly preserving shareholder ability to respond to hostile bids nixed by the board under section 6.01—one might argue that to honor that larger aim, board refusal to comply with the hostile bidder’s conditions—as distinguished from the board’s initial prebid action—must be examined under the higher standard of section 6.02 lest hostile bids essentially be precluded altogether and never reach shareholders. With respect to shareholders’ rights plans, comment (c) to section 6.02, in contrast to its refusal to address the standard for board actions under antitakeover statutes, states that a board “negotiating

46. Proposed Final Draft, *supra* note 1, § 6.02 cmt. c(6), at 563. The comment goes on, however, to speak of the board’s actions in terms of “reasonable response”—the language of § 6.02. *Id.*

47. *Id.*

48. *Id.* § 6.02 cmt. a, at 553.

49. *Id.* § 6.02 cmt. a, at 555; *see also id.* § 6.02 reporter’s note 5, at 583.

with [a] bidder when a tender offer is actually made” would have its refusal to eliminate shareholder rights reviewed under the higher standard of section 6.02.⁵⁰ Here, the Reporters seem to be saying that a standard higher than ordinary business judgment applies. Is that true, however, only if and when the target board begins “negotiating with” the bidder, as opposed to the case, as in our example, where the target board steadfastly refuses to negotiate at all because of the earlier policy decision not to sell the company?⁵¹ This important issue of what standard of review applies to a board decision to “just say no” to a hostile offer is further muddled in Reporter’s Note 5 to section 6.02, which states that if, after a bid was made, the directors “then acted” to block the bid, section 6.02 would apply.⁵² What if the directors did not “then act” to block the bid, but simply left in place an already-implemented rights plan?

The larger point is that the underinclusive approach of Part VI to defensive measures, although commendably modest, in fact leaves open key avenues that undermine its conceptual edifice for ultimately putting tender offers to a shareholder decision unless directors can meet a heightened review standard. The most obvious manner in which this occurs is through its conscious ignoring of state antitakeover legislation. Another example is alteration of organic documents to include potent defensive measures. The methods by which shareholders’ rights plans, properly adopted as preplanning devices, either alone or in conjunction with efforts to protect “no-sell” or other business plans, are to be reviewed under the two-step scheme of Part VI is also unclear. The text of section 6.02 appears, in short, to be rather narrowly aimed at those defensive actions taken only as postbid “responses to the offer.” This slender ambit reduces the range of defensive measures brought within the higher scrutiny of section 6.02 and puts an obvious premium on acting long before a hostile overture is made. These puzzling failings of underinclusiveness and ambiguity are not, however, the greatest shortcomings of Part VI. Instead, the fact that section 6.02 accords managers broad discretion that may circumvent “heightened” scrutiny, even as to measures clearly within that section, is the chief way in which the conceptual design of Part VI is unrealized.

2. *Matters Within Director Discretion Under Part VI*

The original version of section 6.02 did not appear until 1990,

50. *Id.* § 6.02 cmt. c(10), at 571.

51. For a discussion of Delaware law on this point, see Johnson & Millon, *supra* note 45, at 2121-22.

52. Proposed Final Draft, *supra* note 1, § 6.02 reporter’s note 5, at 583.

relatively late in the life span of the Project, because takeover activity steadily increased and took new forms throughout the 1980s. Delaware's law of takeovers was in a continual state of flux during this period⁵³ while, in the larger society, takeovers became a contentious subject.⁵⁴ When the first draft of section 6.02 (other than discussion drafts) finally appeared, it was severely criticized and hotly debated at the ALI annual meeting.⁵⁵ The revised version bolsters director discretion in ways that go beyond the first draft. Before describing how it does so, and how its treatment of nonshareholder interests bears on the larger project of corporate law, two other features of section 6.02—the substantive standard for directors' defensive measures and the burden of proof—first must be examined.

a. The Substantive Standard for Defensive Responses

The substantive standard directors must meet in responding to an unsolicited tender offer is, according to section 6.02(a), that the action "is a reasonable response to the offer."⁵⁶ Section 6.02(d) provides, however, that the standard of "reasonableness" need be met only in a proceeding seeking injunctive relief.⁵⁷ In a damages action, director behavior need not be "reasonable"; it is sufficient that it meet the business judgment standards of section 4.01, including the lesser requirement that the director "rationally" believed his action was in the best interest of the corporation.⁵⁸

Section 6.02 thus differentiates the applicable substantive standard based on whether the plaintiff seeks equitable or legal relief—a distinction that the Reporters state is "central to the approach of section 6.02 to the conduct of hostile takeovers."⁵⁹ Delaware case law does not make this distinction, although, by statute, a company's certificate of incorporation may eliminate or limit the personal legal liability of directors for breaching their duty of care.⁶⁰

The notion of a "reasonable response" in section 6.02(a) is a direct outgrowth of Delaware's *Unocal* test. In *Unocal Corp. v. Mesa Petroleum Co.*,⁶¹ the Delaware Supreme Court articulated an intermediate business judgment standard for reviewing a target board's adoption of defensive measures. This heightened judicial scrutiny involves a preliminary two-step inquiry before a decision of the directors is accorded traditional business judgment review. The target company directors bear the burden of demonstrating first, the existence of reasonable grounds for believing that a hostile bid represents "a danger to corporate policy and effectiveness," and second, that their response was "reasonable in relation to the threat

53. See Johnson, *supra* note 3, at 910-33.

54. *Id.* at 867-71.

55. See 67 A.L.I. PROC. 65, 93-128 (1990).

56. Proposed Final Draft, *supra* note 1, § 6.02(a).

57. *Id.* § 6.02(d).

58. *Id.*; see *id.* § 6.02 cmt. a, at 549.

59. *Id.* Part VI introductory note, at 523; see also *id.* § 6.02 cmt. a, at 552.

60. DEL. CODE ANN. tit. 8, § 102(b)(7) (repl. vol. 1991).

61. 493 A.2d 946 (Del. 1985).

posed.”⁶² Comment (a) to section 6.02 states that only the second step of the *Unocal* inquiry is expressly adopted in section 6.02(a) because the first inquiry—which the *Unocal* court said reduced to an inquiry into whether the board acted in good faith and made a reasonable investigation⁶³—is incorporated already in section 4.01(c) and therefore impliedly is applicable to behavior reviewed under section 6.02.⁶⁴ Thus, the Reporters claim, despite apparent textual differences, section 6.02 mirrors the Delaware approach to reviewing antitakeover actions.

One problem with this claim, beyond the desirability of making more clear in the text the applicability of the section 4.01(c) factors to a request for injunctive relief on the ground that section 6.02(a) was violated, is the Delaware Supreme Court’s 1989 decision in *Paramount Communications, Inc. v. Time Inc.*⁶⁵ In *Time*, the court initially repeated the *Unocal* formulation of the first step as simply an inquiry into good faith and reasonable investigation.⁶⁶ Then, however, the court significantly amplified that inquiry by stating that, under the first prong of *Unocal*—a threat to corporate policy and effectiveness—directors may consider a wide variety of factors, including nonshareholder interests.⁶⁷

In *Unocal* itself, these factors appeared only in the court’s discussion of the second prong, reasonable response.⁶⁸ In *Time*, the Delaware Supreme Court simply may have been careless in drawing a variety of factors from *Unocal*’s second step into the initial threat to corporate policy inquiry. It is possible, however, that inserting these factors into the first prong was a deliberate and sound effort to expand the range of considerations relevant to the threshold issue of whether a bid represents a “threat” to the corporate enterprise. Not only is the effect of a directors’ response on shareholder and nonshareholder interests a proper matter of concern—as embodied in *Unocal*’s second prong and in section 6.02—but the effect of the

62. *Id.* at 955.

63. *Id.*

64. Proposed Final Draft, *supra* note 1, § 6.02 cmt. a, at 549.

65. *Paramount Communications, Inc. v. Time Inc. (In re Time Inc. Shareholder Litig.)*, 571 A.2d 1140 (Del. 1989).

66. *Id.* at 1152.

67. *Id.* at 1153.

68. 493 A.2d 946, 955 (Del. 1985). In *Unocal*, the Delaware Supreme Court joined the “threat” analysis and the “response” analysis in a way that sometimes is overlooked, and which laid the foundation for *Time*. The court stated that the response must be “reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise.” *Id.* The many factors enumerated by the court in the next sentence thus more accurately should have been placed in the court’s discussion of the first prong. The *Time* decision does do this, thereby emphasizing that director responses necessarily will vary depending on the nature of the threat to the enterprise.

bid itself on such interests is, after *Time*, rightly part of the relevant inquiry under the first prong of *Unocal*.

This interpretation makes sense. It equates the set of concerns that should guide the directors' "threat" analysis with those that should guide their decision, and the court's review thereof, to make a "reasonable" response linked to the identified threat. Section 6.02, however, mutes—if it does not drop altogether—this phased inquiry by formally adopting only the second step of *Unocal*. The effect is twofold. In spite of the Reporters' assertion that section 6.02 follows Delaware's approach to judicially reviewing defensive measures, section 6.02 does not in fact adopt Delaware's more nuanced mode of analysis. Moreover, consistent with its philosophical entrapment within the traditional two-party (director and shareholder) scheme of corporate law, Part VI ends up focusing on nonshareholder interests only as affected by director actions, not bidder actions, which may themselves be enormously disruptive to the corporate enterprise. The ALI's clumsier approach to this issue is troublesome when Delaware courts, state legislators, and the ALI membership have all signalled that such interests should be made more visible and given greater prominence in corporate law.

b. The Burden of Proof

Section 6.02(c) provides that a person claiming that the directors failed to comply with the substantive standard of section 6.02(a) has the burden of proving, in an injunction proceeding, that the action was an unreasonable response to the offer.⁶⁹ The claimant must establish "both that the action has the foreseeable effect of blocking an unsolicited tender offer, and that the directors' response to the offer is unreasonable."⁷⁰ The first element, a kind of causation requirement, is met by proving that the directors' conduct "precluded shareholders from being able to take advantage of a tender offer."⁷¹ It is not sufficient simply to show preclusion; the plaintiff must show that the directors' actions were the reason for preclusion.

In requiring the challenger to bear the burden of proof, section 6.02 again deviates from Delaware law. Delaware places the initial burden of establishing compliance with the two-step *Unocal* test on the target company directors.⁷² Upon the directors' demonstration of such compliance, Delaware law provides that the usual presumption of business judgment protection operates—a presumption that the challenger must overcome.⁷³

69. Proposed Final Draft, *supra* note 1, § 6.02(c).

70. *Id.* § 6.02 cmt. c(1), at 557.

71. *Id.* § 6.02 cmt. e, at 574. The statement in comment (e) that the burden of proof is carried by showing that the directors actually "precluded" the opportunity to tender is subtly but significantly different from the statement in comment c(1), *see supra* text accompanying note 70, to the effect that the burden is carried by showing that the directors' action had the "foreseeable effect" of blocking a tender offer.

72. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). The Reporters acknowledge this break with Delaware law. Proposed Final Draft, *supra* note 1, § 6.02 cmt. a, at 551.

73. *Unocal*, 493 A.2d at 555.

The policy of section 6.02(c), in not requiring challenged directors to carry either production or persuasion burdens, is clearly to give strong credence to determinations made by a board of directors. The effect, especially given the range of factors directors can consider under section 6.02(b) in deciding what is a “reasonable response,” is to immunize director decisionmaking from attack almost as completely as if ordinary business judgment review were the applicable substantive standard. This outcome shows more than a healthy built-in tension between sections 6.01 and 6.02; it shows the subduction of section 6.02’s heightened review by section 6.01’s ordinary business judgment review.

c. The Interests of the Corporate Enterprise, Shareholders, and Nonshareholders

The heart of Part VI is section 6.02(b)’s articulation of those factors and interests that a target company’s board may consider in fashioning a “reasonable response” to an unsolicited tender offer.⁷⁴ The *Principles* describe two categories of interests, but the line between them is not particularly clear.

Directors “may,”⁷⁵ pursuant to section 6.02(b)(1), first take into account “all factors relevant to the best interests of the corporation and shareholders.”⁷⁶ The *Principles* focus here on two interests—corporate well-being and shareholder interests—much as section 2.01 emphasizes both corporate profit and shareholder gain as objectives of business activity.⁷⁷ The clear premise of section 6.02, as with section 2.01, is that “shareholder interests” are not equivalent to, and are to be distinguished from, “corporation interests.” Although section 6.02(b)(1) states that “all factors” relevant to corporate and shareholder interests may be considered by a target board, two factors are mentioned explicitly. These are “questions of legality” and “whether the offer, if successful, would threaten the corporation’s essential economic prospects.”⁷⁸

Directors may, pursuant to section 6.02(b)(2), also consider “interests or groups (*other than shareholders*) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders.”⁷⁹ Under

74. Proposed Final Draft, *supra* note 1, § 6.02(b)(1), (2). Although not stated, presumably a board could consider these same factors when adopting defensive measures—such as a shareholders’ rights plan—in advance of a hostile bid, as the board did in the *Time* case.

75. *Id.* § 6.02(b)(1). The *Principles*’ use of this permissive standard apparently imposes no obligation on the directors.

76. *Id.*

77. *Id.* § 2.01(a).

78. *Id.* § 6.02(b)(1).

79. *Id.* § 6.02(b)(2) (emphasis added).

this subsection, directors are expressly authorized to consider the interests of nonshareholders if one condition is met: The corporation must have a legitimate concern for that interest or group.⁸⁰ If that condition is met, regard for a nonshareholder interest or group is still subject to a limitation: The regard must not “significantly disfavor” long-term shareholder interests.⁸¹

Just as section 6.02(b)(1) differentiates shareholder and corporate interests, the separate mention of nonshareholder interests in section 6.02(b)(2) seems to differentiate these from “corporate” interests as well. If nonshareholder interests were encompassed within the interests of the corporation, they would require no distinct mention. Yet, if they are to be specifically distinguished from the interests of the corporation and not merely from those of shareholders, what content does the term “corporation” have, now apparently meaning neither shareholder nor nonshareholder interests?

One way to resolve or avoid this philosophical quandary is to view section 6.02(b)(2) as a component of, and not an addition to, section 6.02(b)(1). Thus, the nonshareholder interests highlighted in section 6.02(b)(2) might be seen as a subcategory or special case of the corporation’s interests that may be considered by the board under section 6.01(b)(1), subject to the condition and qualification described earlier. Alternatively, the definitional problem may simply be ignored in favor of pragmatically emphasizing section 6.02(b)(2)’s distinct focus on the pertinence of interests not categorized traditionally as either “shareholder” or “corporate” in nature.

However the relationship between sections 6.02(b)(1) and (b)(2) is regarded, and notwithstanding some probable overlap of these two subsections,⁸² several things are clear. Directors do not have a single constituency of shareholders. Directors may instead consider the broader interests of the corporate enterprise—thereby revitalizing that notion, as did the *Time* decision⁸³—as well as those specific nonshareholder interests affiliated with, or dependent on, the business in some fashion. These interests include “environmental and other community concerns,” and “employees, suppliers and customers.”⁸⁴

Authority to consider nonshareholder interests means that directors never have a duty to engage in a *Revlon*-style auction aimed at

80. Whether the *Principles* require that the legitimate concern be preexisting or whether a contemplated concern is permissible is unclear.

81. Proposed Final Draft, *supra* note 1, § 6.02(b)(2).

82. *See id.* § 6.02 cmt. c(2), at 559.

83. *See* Johnson & Millon, *supra* note 45, at 2120.

84. Proposed Final Draft, *supra* note 1, § 6.02 cmt. c(2), at 559. Significantly, the *Principles* do not refer to creditors. In this regard, compare *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Dec. 30, 1991) (noting that the directors of a corporation in the vicinity of insolvency owe a duty to the “community of interests” comprising the corporate enterprise, including creditors).

obtaining an immediate share price premium by selling the company to the highest bidder,⁸⁵ even if—as seems inconceivable under either section 6.02 or *Time*—a break-up sale of the company is, as was the case in *Revlon*, “inevitable.”⁸⁶

The phrase “best interests of the corporation” in section 6.02(b)(1) means, more generally, that the offer of a premium over the market price of the stock does not prevent directors from resisting the bid.⁸⁷ The appropriate time frame incorporated in the phrase “best interests” is the long-term well-being of the corporation and its shareholders.⁸⁸ Directors therefore clearly are entitled to conclude that the stock market price, even with a premium, understates the corporation’s expected long-term value—another blow to the simplistic penetration of the efficient capital market hypothesis into corporate law.⁸⁹

More pointedly, the section 6.02(b)(1) long-term “best interests of the corporation” standard expressly recognizes the interests of nonshareholders, which mainstream corporate law storytellers traditionally view as foreign to corporate governance. Directors thus may thwart an attractive high-premium bid that shareholders favor on the ground that success of the bid will adversely affect vital relationships with employees or other nonshareholder groups. This authority is potently antishareholder. Language in comment (c) to section 6.02 badly understates this power in asserting that directors can resist a higher premium offer in favor of a lower one that better protects employees if the price is not “significantly lower.”⁹⁰ In fact, neither offer needs to be accepted if directors believe nonacceptance best protects employees. This is because the size of the premium differential is completely irrelevant to the long-term analysis.

The only limitation on this power is section 6.02(b)(2)’s statement that regard for nonshareholder interests may not “significantly disfavor” the long-term interests of the shareholders.⁹¹ In practice, this constraint is no limitation at all. A complaining shareholder, upset at the loss of a substantial immediate premium, faces several formidable hurdles.

First, the shareholder has the entire burden of proof on the claim

85. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

86. *Id.* at 182.

87. Proposed Final Draft, *supra* note 1, § 6.02 cmt. c(2), at 558-59.

88. *Id.*

89. See *Johnson & Millon*, *supra* note 45, at 2106-09 (describing Chancellor William Allen’s treatment of this issue in the Chancery Court’s *Time* opinion).

90. Proposed Final Draft, *supra* note 1, § 6.02 cmt. c(8), at 568.

91. *Id.* § 6.02(b)(2). This limitation causes one to wonder what happened to the interests of the “corporation” mentioned in § 6.02(b)(1).

that the substantive standard was breached.⁹² Second, it is not sufficient to allege and prove that the shareholder lost a substantial premium as a result of the directors' actions. The issue is whether the shareholder's long-term interests were disfavored. "Long-term" is a notoriously amorphous notion when it comes to asserting and proving now that in the distant future someone will be worse off. Third, the complaining shareholder must prove that he or she will be "significantly" disfavored in the long-term. The shareholder therefore must demonstrate a necessarily speculative assertion about future shareholder welfare to prove that the action is "significantly" adverse. This is like telling shareholders to prove the improvable—and to do it convincingly. It would be a rare judge who confidently believed that anyone could carry that burden. The history of corporate law doctrine reveals the potency of the "long-term" notion as a promanagement shield against judicial intervention.⁹³ Finally, a defending board might pick up the suggestion made earlier that nonshareholder interests rightly can be considered as part of the "corporation's" best interests under section 6.02(b)(1), as they are considered under Delaware law. Under that subsection, there is no limitation of the sort imposed by the "significantly disfavored" language of section 6.02(b)(2). The comments to the subsection give some support to this argument.⁹⁴

These considerations reveal that section 6.02(b)(2) goes beyond doctrinal statements that regard for nonshareholders is proper so long as there is some "reasonable relationship" to long-term shareholder interests.⁹⁵ This formulation of Delaware law grants plenty of discretion to directors as it is, but section 6.02(b)(2) explicitly goes even further in validating the propriety of director regard for nonshareholder interests.

The effect of section 6.02 is to grant to directors enormous discretion—a discretion that, if enacted into law, likely would be used to resist takeovers. Section 6.02 unavoidably aligns the ALI, notwithstanding its protestation,⁹⁶ with an antitakeover position. Not only does Part VI's codification thereby reflect a definite policy thrust, but the overarching purported conceptual architecture of Part VI is dismantled also—section 6.02 is not an effective proshareholder counterpoise to the grant of generous discretion to directors under section 6.01. Although section 6.02 formulaically is different and more verbose than section 6.01, the two sections do not, in the end, differ markedly in conferring broad discretion on directors. This discretion simply is not tightly checked anywhere within Part VI.

Advocates of shareholder primacy in corporation law, whether achieved by market-driven mechanisms or imposed by judicial fiat,

92. See *supra* Part I.B.2.b.

93. See Johnson, *supra* note 3, at 899-903.

94. Proposed Final Draft, *supra* note 1, § 6.02 cmt. c(2), at 560 (stating that nonshareholder interests "may be considered under 6.02(b)(1) in determining what is in the best interests of the corporation and shareholders").

95. *Id.* § 6.02 reporter's note 2, at 578.

96. See *supra* text accompanying note 2.

should surely regret the outcome in Part VI. The story of corporate law, full of great promise of a resurgence in shareholder well-being in the takeover frenzy of the 1980s, now seems in the ALI, as with positive law, to revert once more to the old refrain of director domination of this oft-told tale. Defenders of directorial prerogative may have emerged from the 1980s more scarred than in earlier frays, but the ALI ensures that they remain triumphant nonetheless. The mere invocation of nonshareholder interests as a reason—or pretext—to deplore takeovers is sufficient to ward off shareholder challenges to strong antitakeover tactics. Once the bidder's threat is beaten back, however, and shareholder outcries have died down, there is no continuing duty in the traditional scheme of corporate governance to give such interests much further thought. Not providing this continuing duty is the great void in corporate law. Nonshareholder interests make a one-time appearance in corporate law—in the law of hostile takeovers—only to be hauled from the stage when the play goes on. The story of the takeover-riddled 1980s and Part VI of the ALI thus would seem to end were it not for one development that came hot on the heels of the shutdown of the takeover market—institutional shareholder activism. Parts II and III of this Article address how corporate law's stormy experience with hostile takeovers might bear more enduringly on that incipient movement and on the future telling of the corporate law story.

II. Who's in Control of the Corporation?

A. Nonshareholders vs. Institutional Investors

By purporting to be nothing more than a new chapter in the traditional shareholder-manager story, Part VI of the *Principles* ignores recent developments that seem to signal a rejection of that story in favor of an alternative. On the one hand, state statutes and judicial decisions suggest a rejection of the shareholder primacy norm on which the standard story is premised. On the other hand, the recent rise of institutional shareholder activism seems to herald a new departure of a different sort. Although at first glance efforts to promote a new, more dynamic role in corporate governance for these large and therefore potentially powerful shareholders may seem only to be a continuation of the accountability narrative, the implications may be more profound. If the advocates of institutional shareholder activism have their way, the gap between shareholders and management—Berle and Means' heralded separation of ownership and control—may be closed once and for all.⁹⁷ That closing, of

97. Greater institutional investor involvement in formulating (and objecting to) corporate policy lies at the heart of what today is called "relationship investing" or "relational investing." Gordon, *supra* note 4, at A18. A conference on Relational Investing

course, would involve closing the book on corporate law's traditional story.

1. *Legal Recognition of Nonshareholders*

The hostile takeover boom of the 1980s occasioned a widespread political and legal backlash against an unregulated market for corporate control and its shareholder primacy foundation. The basis for this response was a broadly held perception that hostile takeovers—however beneficial to shareholders—imposed excessive, uncompensated costs on various nonshareholder constituencies because of plant closings or radical financial restructurings that often seemed to coincide with takeover bids.⁹⁸ Affected constituencies included employees, creditors, suppliers, and customers whose relationships with target firms—or firms fearing that they were potential targets—were disrupted, as well as local communities dependent on the continued healthy presence of these firms.

The backlash was most evident in state legislatures, most of which enacted at least one version of the several standard forms of more or less potent antitakeover legislation.⁹⁹ After the initial enactment of these antitakeover statutes, many states—so far, thirty—passed statutes that expressly redefine management's responsibility by authorizing regard for nonshareholder considerations even at the expense of shareholder financial interests.¹⁰⁰ Though they arose in heady excitement generated by the takeover boom and its perceived excesses, these statutes generally do not limit this newly minted managerial discretion to the takeover context.¹⁰¹ At the same time that these apparently radical statutory developments were taking place, state judges—led by Delaware—seemed to be groping, albeit in fits and starts, toward a notion of directorial responsibility tethered to the welfare of the overall corporate enterprise—including all of its constituent elements—rather than simply to that of the shareholders.¹⁰² This series of decisions culminated in the *Time* decision's blessing of managerial foreclosure of a clearly attractive takeover offer for the sake of vaguely articulated long-run, corporate enterprise¹⁰³—or even public interest¹⁰⁴—concerns.

Despite the excitement that these developments have generated

held in New York City on May 6-7, 1993, was sponsored by The Institutional Investor Project of the Center for Law and Economic Studies at the Columbia University School of Law.

98. See Johnson & Millon, *Missing the Point*, *supra* note 12, at 848.

99. See generally Johnson & Millon, *Misreading*, *supra* note 12, at 1868-82 (discussing control share acquisition and business combination statutes); Johnson & Millon, *Missing the Point*, *supra* note 12, *passim* (discussing the impact of various state antitakeover statutes on nonshareholders).

100. See generally David Millon, *Redefining Corporate Law*, 24 *IND. L. REV.* 223 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 *TEX. L. REV.* 579 (1992).

101. Millon, *supra* note 100, at 246.

102. See generally Johnson, *supra* note 3.

103. See Johnson & Millon, *supra* note 45, at 2106.

104. See Millon, *supra* note 12, at 251-61.

among sympathizers and critics alike, it is too soon to say that corporate law has jettisoned its traditional shareholder primacy norm. At best, all we have so far is a rough outline of a new story, and it is not certain that this new story will be written. This uncertainty is caused by a new phenomenon—the prospect of institutional shareholder activism—that has intruded itself, and promises—or threatens, depending on one’s point of view—to breathe new life into shareholder primacy just when it seemed poised for banishment to the archives.

2. *The Rise of Institutional Investors*

Increased concentration of stock ownership in the hands of large institutions¹⁰⁵ is a phenomenon that has been noted from time to time at least since the 1950s.¹⁰⁶ By the late 1980s, institutional shareholdings had risen to startling levels. A survey of 900 publicly traded domestic corporations estimated that institutional holdings accounted for an average of fifty percent of outstanding stock.¹⁰⁷ In the largest corporations, institutions may well own substantially more of the outstanding stock—as much as sixty or even eighty percent.¹⁰⁸ Moreover, as Professor Bernard Black points out, these holdings are concentrated in a relatively small number of hands.¹⁰⁹ By 1989, even greater concentration had taken place. The fifty largest institutions owned twenty-seven percent of the entire United States stock market, with the largest thirteen of these institutions owning over half of this percentage share.¹¹⁰ Institutional shareholders often hold as much as two or three percent of a single public company’s stock—a position that may be worth several hundred million dollars—and even larger holdings exist despite regulatory disincentives.¹¹¹ In light of earlier experience, it is likely that the current status of institutional shareholders is part of a larger trend that seems certain to continue.¹¹²

105. There are, as Professor Bernard Black has noted, “many different types of institutions: corporate pension plans; public pension plans; mutual funds; commercial banks; insurers; investment banks; foundations and endowments.” Black, *supra* note 4, at 815.

106. See, e.g., SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 64, 92D CONG., 1ST SESS. PT. 3 (1971); SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88TH CONG., 1ST SESS. PT. 3 (1963); LEWIS H. KIMMEL, SHARE OWNERSHIP IN THE UNITED STATES (1952).

107. See *Business Week Investment Outlook Scoreboard*, BUS. WK., Dec. 25, 1989, at 155, 155.

108. See *id.* at 155; Brett D. Fromson, *The Big Owners Roar*, FORTUNE, July 30, 1990, at 66, 78.

109. Black, *Shareholder Passivity*, *supra* note 5, at 567-68.

110. *Id.*

111. *Id.* at 568. Regulatory disincentives include significant disclosure and filing requirements.

112. In comparison to the 50% estimate for the 900 firm sample for 1989, aggregate

What this trend means for corporate governance is that meaningful opportunities now exist for shareholders, working together, to flex their muscles on questions of corporate policy and performance. This development is important because it threatens to alleviate shareholder impotence and the consequent lack of managerial accountability that follows from widely dispersed ownership. Impotence owing to this dispersion is, of course, the central dynamic in the standard shareholder-management story.¹¹³ Concentrated ownership promises to relieve shareholder impotence by sharply reducing the costs of collective shareholder action on which effective monitoring of the public corporation depends.¹¹⁴ The costs of organizing a substantial block are far lower, because fewer shareholders need to be involved. In addition, the potential benefits to institutional shareholders are much higher than they would be to the typical individual investor, because these institutions hold larger positions. Lacking a realistic “exit” option because of the illiquidity of their holdings, institutions now possess the ability as well as the incentive to exercise “voice.”

Obstacles still remain to significant institutional shareholder control. Legal rules discourage institutions from acquiring larger holdings.¹¹⁵ Professor Black has documented the variety of regulatory hurdles that stand in the way of effective monitoring activity,¹¹⁶ though here, too—recent SEC proxy reforms being an example¹¹⁷—change is taking place. Free rider tendencies presumably persist, and it is also questionable whether those who actually manage institutional holdings possess the appropriate incentives to play an active monitoring role.¹¹⁸

Nevertheless, there are clear indications that institutional investors are finding it possible to make their preferences known and to provoke appropriate responses from corporate managers.¹¹⁹ In so acting, institutional investors are discarding the passivity that has characterized their approach to governance questions in the past. Like the political efforts to develop protections for nonshareholder constituencies, here, too, the hostile takeover boom of the 1980s was the motivating force. Institutions found it necessary to oppose

institutional holdings of all corporate stock comprised 42.7% in 1986 and only 38.5% in 1981. *Id.* at 567.

113. *See id.* at 522-25 (paraphrasing the standard “shareholder passivity story”).

114. *Id.* at 575-91; Rock, *supra* note 5, at 453-63.

115. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991).

116. Black, *Shareholder Passivity*, *supra* note 5, at 530-66.

117. *See infra* note 124 and accompanying text.

118. *See* Rock, *supra* note 5, at 452-53 (hypothesizing that “[m]oney managers . . . have precious few economic or legal incentives to discipline corporate management actively, while facing substantial disincentives”). Free rider problems may be lower than expected because managers of large institutional investors may be a sufficiently small group that peer and subculture social pressures may serve to discipline those not pulling their weight. This dynamic may be the analog at the shareholder level of the so-called “structural bias” earlier said to induce directors to uncritically acquiesce in management’s decisions.

119. *See* Black, *Shareholder Passivity*, *supra* note 5, at 570-75; Rock, *supra* note 5, at 479-90.

managerial antitakeover measures that deprived them of the possibility of substantial gains. Accordingly, they have played a leading role in challenging management-sponsored antitakeover charter amendments ("poison pills" and the like).¹²⁰ With the demise of takeovers in the early 1990s, institutions have also expanded the scope of their activities to include promotion of their governance proposals, such as advocacy of cumulative voting, secret ballots, shareholder committees, and separating the chairman and chief executive offices.¹²¹ Activism need not take the form of an outright proxy challenge, though such contests have occurred.¹²² As Professor John Pound has documented, other mechanisms are being developed that allow institutional investors to influence management decisionmaking without engaging in head-to-head confrontation.¹²³

Legal reforms may well facilitate even greater activism. The SEC's recent amendments to the proxy rules are forthrightly designed to encourage open communication among institutional shareholders about management performance.¹²⁴ These amendments should facilitate efforts to mobilize opposition to management policies or, more affirmatively, to allow institutional investors jointly to develop proposals for submission to management. Additional reforms also are being advocated.¹²⁵ In short, meaningful institutional shareholder activism is already a fact of corporate life, and it is likely to increase in intensity as legal impediments are further reduced.

The suddenly hopeful prospect of institutional activism closing the accountability gap between shareholders and managers raises important questions that the proponents of increased activism have largely failed to address. First, just what is meant by "monitoring"? To what extent does it imply a direct role in managerial decision-making? Is this a task that institutional shareholders are qualified to undertake? Second, the specter of control—or, at a minimum, enormous influence—over our largest corporations resting in the hands of a small group of pension fund managers should predictably result

120. Black, *supra* note 4, at 828; Black, *Shareholder Passivity*, *supra* note 5, at 571.

121. Black, *Shareholder Passivity*, *supra* note 5, at 571.

122. Black, *supra* note 4, at 829; Black, *Shareholder Passivity*, *supra* note 5, at 571-72.

123. See John Pound, *Beyond Takeovers: Politics Comes to Corporate Control*, HARV. BUS. REV., Mar.-Apr. 1992, at 83; see also Gordon, *supra* note 4, at A18.

124. See Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992).

125. Professor Black advocates changes in the SEC rules promulgated under § 13(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(d) (1988 & Supp. III 1991) (as amended). See Bernard S. Black, *Next Steps in Corporate Governance Reform: 13(d) and Control Person Liability*, in MODERNIZING U.S. SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES 197 (Kenneth Lehn & Robert W. Kamphuis eds., 1992); see also Black, *supra* note 4, at 829-30.

in political resistance. Surely the legitimacy of massively concentrated corporate wealth has rested in large part on the fact that its ownership—and therefore ultimate control over its deployment—has been dispersed broadly among members of the general public. Will Americans tolerate concentrated control without corresponding efforts to render exercise of control somehow publicly accountable? Third, what are the consequences of institutional oversight likely to be for corporate strategy? Because of the illiquidity of their holdings, institutions generally are forced to take a long-term approach to their investment portfolios.¹²⁶ This illiquidity, however, does not mean that they will encourage or even tolerate a long-term approach by their individual portfolio companies. To the contrary, pressures for current income—for example, to heed demographics and respond to a swelling number of pension fund beneficiaries—may lead to institutional shareholders insisting, at least at times, on corporate maximization of current income. This pressure could in turn result in a tendency to neglect investments with longer-term pay-offs, such as in capital equipment and research and development, that many think are crucial to the revival and future viability of American industry. And finally, what changes in the existing legal framework for corporate governance and in legal principles and doctrines will be necessary to accommodate heightened investor activism? Will states—traditionally promanagement—respond with necessary changes? Will managers seek, as they did in the 1980s with takeovers, the imposition (and resistance to removal) of legal obstacles to successful investor voice? If so, will investors seek relief from the more sympathetic SEC, thereby raising, again as in the 1980s, the issue of the scope of SEC authority in corporate governance and the overarching federalism concern?

The recent rise to prominence of institutional shareholders, and the extensive attention respected academic and legal professional commentators are giving to this phenomenon, suggest that a new story for corporate law is now in the works. This story would no longer focus on solutions to the problems generated by the separation between ownership and control, because the possibility of effective shareholder control (or at least highly influential oversight) would be deemed to have been solved. This new story would instead need to concern itself with different sorts of questions, such as those just suggested. As the focus of corporate law changes to embrace a newly perceived agenda, new ways of legitimating that agenda will need to be developed.

Before a new story—one centered on the role of institutional investors in corporate governance—can receive general acceptance, however, it will need to overcome its rival, the nonshareholder constituency narrative currently being developed by a different set of storytellers with a quite different normative agenda. In important respects, these two alternatives to the traditional story are now in

126. See Black, *Shareholder Passivity*, *supra* note 5, at 572-73.

direct competition with each other. The objectives of institutional shareholders—maximization of the value of their investments—threatens conflicting nonshareholder interests whenever significant strategic or operational adjustments are required to improve corporate performance. Such adjustments inevitably affect at least some nonshareholder constituencies in some way, not only with respect to cost-cutting measures but also with respect to innovative efforts to reorganize the workplace and improve productivity. Decisions inevitably need to be made about how costs are to be allocated or gains are to be shared among all the actors involved in the production process. The clash of opposing interests that these sorts of decisions implicate is the immediate legacy of the hostile takeover boom of the 1980s, and, more broadly, of the heightened global competition to which American firms are now subject. How this conflict is to be resolved is now the central normative problem facing corporate law. The manner of its resolution will mark the new direction that corporate law will take in the years to come.

B. Whose Side Is the ALI on?

In its effort to harmonize shareholder and nonshareholder interests, Part VI bears the imprint of this normative tension. To its credit, its unwillingness to take a knee-jerk shareholder primacy approach to the hostile takeover problem indicates that the ALI is not oblivious to the broader controversies that currently shape debate and discussion in corporate law. Nevertheless, as we should do of anyone who speaks out on important corporate law questions, we need to ask where the ALI stands with respect to the larger debate. The answer can only be that, in Part VI at least, the ALI tries to have it both ways. The result is a product that must disappoint partisans of either of the new alternatives to the traditional story.

It is hard to imagine that shareholders—institutional or individual—could approve the approach the ALI takes in section 6.02. In most situations it is clear that the optimal rule from the point of view of target company shareholders would be one that mandates sufficient managerial resistance to enlarge the stock price premium while not completely defeating the bid. Yet, as we have seen, managers are empowered to thwart bids that they deem to be unwelcome, and, most importantly, strict fidelity to shareholder preferences—including preferences for immediate access to takeover premiums—need not be the sole criterion guiding such decisions.¹²⁷ Furthermore, Part VI of the *Principles* takes no position on management-implemented pretakeover devices or optional statutorily created obstacles that render companies effectively immune

127. See *supra* Part I.

from hostile bids. Institutional shareholders have made it clear where they stand on such issues. Part VI clearly cannot be read as an effort to promote their new vision of corporate law.¹²⁸

If not written for the benefit of institutional investors, is Part VI another one of recent efforts to bring nonshareholders into the fold of corporate law? Into a framework, both within Part VI and throughout the *Principles*, that asserts adherence to the traditional norm of shareholder primacy, the ALI abruptly interjects nonshareholders. Moreover, by according nonshareholder interests potentially decisive force, the ALI allows them onto the stage at precisely the moment—an irresistibly handsome tender offer—that matters most to shareholders. Does Part VI therefore signal a rejection of shareholder primacy in favor of a governance model that expressly incorporates nonshareholder as well as shareholder (and “corporate”) interests? Has the ALI joined the revolution?

Not surprisingly, there are several reasons not to view Part VI as an element of this larger, potentially revolutionary movement in corporate law. In stating its intentions, section 6.02 at least pays lip service to the priority of shareholder interests (even if limited to those that are vaguely “long-term”) over those of nonshareholders. The claims of employees and other nonshareholder groups to board solicitude evidently are not supposed to trump shareholder interests. Moreover, nonshareholders make a direct appearance only in the limited—though undeniably important—ambit of Part VI. There are few indications of revolutionary rumblings anywhere else in the *Principles*.

The potentially powerful subversive significance of section 6.02 becomes apparent only when one looks at its likely operative effect, as we have done in Part I of this Article. As a practical matter, however faithful they are supposed to be to shareholder preferences, directors are empowered to block unwelcome takeover bids to protect nonshareholder interests.

Is this cause for rejoicing among partisans of nonshareholder participation in corporate law? Surely not. Most obviously, the ALI’s recognition of nonshareholder interests is restricted to the hostile takeover situation. One might respond that this is not just a matter of letting the camel’s nose intrude itself under the edge of the tent. Hostile tender offers are, after all, the one area in which shareholders would seem to have the most to gain from a strict regime of shareholder primacy and the most to lose from its dilution. Thus, by letting in nonshareholders here, the ALI has let in a lot more

128. Is it possible that the Reporters for Part VI believe that institutional shareholder activism is potent enough to render its formulation insignificant in any event? In other words, institutions are powerful enough already (or soon will be, as holdings increase in size and legal reform efforts proceed) so that the question of managerial discretion in the takeover context is basically unimportant: Management will do the shareholders’ bidding in any event. One can question this assessment as a matter of prediction (are institutional investors really that powerful already?). One should also doubt that the entire exercise of Part VI, obviously involving a great deal of work and thought, is nothing more than a cynical charade.

than just the camel's nose. A large part of its body is inside the tent already, and it would not seem too big a deal to go ahead and let him bring his tail in out of the cold as well. In other words, given the importance of hostile takeovers, it seems exceedingly difficult to prevent, on conceptual grounds, recognition of nonshareholder interests in hostile takeovers from spilling over into the rest of corporate law—perhaps in the form of a newly conceived, general or institution-specific fiduciary duty to nonshareholders as well as to shareholders.

Nevertheless, the limited endorsement of nonshareholder interests in the takeover context is surely a disappointment to those who hope to redefine management authority to embrace nonshareholder considerations across the entire range of managerial decisionmaking.¹²⁹ Even within the takeover context, however, there is still ample reason for nonshareholder advocates to contain their enthusiasm. First, Part VI does not alter the basic authority structure within the corporation. The board of directors, dominated by senior management, remains at the top of the corporate governance hierarchy. If the well-being of nonshareholders is to enter the decisionmaking calculus at all, it will do so only if and to the extent that the board chooses. From the perspective of nonshareholders, management's role is at best that of "trustee," just as it traditionally (if not entirely accurately) has been defined in relation to shareholder interests. Under this model, of course, there is no room for the beneficiaries to participate directly in decisions affecting their interests. Although nonshareholders may here be accepted into the polity, they have yet to attain the right to participation—even the largely symbolic participation involved in the corporate franchise—that citizenship would seem to imply. However harmful a takeover may be to employees or other nonshareholder constituencies, they must depend on management to look after their interests.

Reliance on management as trustee would not be entirely unsatisfactory if there were identifiable constraints on its ability to ignore nonshareholder interests. The language of section 6.02(b)(2), however, is merely permissive.¹³⁰ Further, section 6.02(b)(2) fails to define the sorts of nonshareholder interests "with respect to which the corporation has a legitimate concern."¹³¹ When are widespread layoffs, for example, legitimate corporate concerns? Section 6.02 would seem to leave nonshareholders as effectively unprotected as

129. For examples of scholars who favor consideration of nonshareholder interests, see Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991), Millon, *supra* note 100, Mitchell, *supra* note 100, at 579, and Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991).

130. See *supra* notes 79-81 and accompanying text.

131. Proposed Final Draft, *supra* note 1, § 6.02(b)(2).

are shareholders, who can cling only to protection against “significant” infringements of “long-term” interests.¹³²

Even apart from its merely permissive and severely vague formulation, there is little reason to believe that target management can be counted on to carry out section 6.02’s mandate in a manner that will be consistently beneficial to nonshareholders. Management and nonshareholder interests may be naturally aligned in hostile takeovers. Both want to resist: managers so that they can keep their jobs and other nonshareholders so that they can avoid the various sorts of disruptions that predictably follow from sudden changes in control motivated by an intention to increase corporate profitability or to break up the firm and liquidate its pieces. This natural alignment, however, will not always be the case. Arrangements may be in place—substantial golden parachutes, for example—or may be negotiated with the bidder that make a change in control palatable or even attractive to the small number of senior executives with the power to call the shots. Management then may choose to allow a bid to go forward that would be blocked by nonshareholders if they had the power to do so.

Section 6.02 thus cannot be read as a serious effort to incorporate nonshareholder interests in the law governing responses to hostile takeovers. In this respect, section 6.02 is no more satisfactory to those who seek that objective than it is to those who advocate a strict fidelity to the interests of shareholders. Apparently aiming to appease both camps, Part VI fails to pacify either one.

C. *An Effective Synthesis?*

The opposing visions for corporate law’s future both enjoy enough support to raise doubts about whether a complete victory for one side or the other is realistically attainable. Some kind of compromise ideally would seem to be necessary. Can Part VI be defended as a thoughtful and creative effort to harmonize the conflicting tendencies now afoot in corporate law discourse?

On a general level, such an accommodation would seem to require two elements. First, the standards that are to guide management in assessing and then balancing the respective interests of shareholders and nonshareholders in particular situations need to be spelled out with at least a reasonable degree of specificity.¹³³ What interests are properly cognizable? How are they to be weighted among all other interests? Second, the accountability problem that characterized shareholder-management relations under the traditional story is no less real when nonshareholders enter the picture. Indeed, a requirement of attention to multiple constituencies with conflicting interests only compounds the accountability difficulty. In short, substantive norms are not enough.

132. See *supra* text accompanying notes 92-94.

133. For a very preliminary effort to sketch some basic principles applicable both within and beyond the takeover context, see Millon, *supra* note 100, at 265-700.

Mechanisms need to be devised that will give the intended beneficiaries of these norms some reason to believe that management will actually pay attention to them whenever it counts, and to impose sanctions when managers do not.

Even a cursory glance at section 6.02 reveals that it fails on both grounds. Normative guidance is almost pathetically vague. Enforcement by shareholders is hard enough; nonshareholders have no means whatsoever to challenge management decisions that improperly disregard their interests.

The bottom line is that the board would enjoy extremely expansive discretion under section 6.02. Accountability to the shareholders in responding to hostile takeovers is diluted even beyond its current thin attachments in positive law, not only by the inclusion of nonshareholder considerations in the decisionmaking process, but also by the other factors discussed in Part I of this Article. There is, however, no corresponding accountability to the nonshareholders whose interests this provision claims to validate. Whatever protection nonshareholders may gain is more likely to be merely incidental to management's self-seeking behavior than it is to be motivated by sincere regard or deliberate adherence to legal requirements.

As an effort to harmonize the conflicting interests of nonshareholders and shareholders in an important area of corporate law, section 6.02 is a spectacular failure. Nobody ought to like this story.

III. Who is in Control over Corporate Law Storytelling?

Virtually from its inception, the Project has been explicitly normative. It never seriously claimed to be a mere restatement of existing law. Instead, the *Principles* were originally conceived as a combination of restatement and recommendation.¹³⁴ Since its inception, the *Principles'* emphasis on restatement has apparently shrunk: Although Tentative Draft No. 1 was titled "Restatement and Recommendations," the Project's most recent incarnation describes itself as "Analysis and Recommendations."¹³⁵ Part VI—especially the centrally important section 6.02—is openly normative, if for no other reason than that, as the Reporters note, "[e]xisting judicial decisions do not offer a clear or consistent guide to directors in responding to unsolicited tender offers."¹³⁶ In other words, the ALI is offering its views of what the law in this area ought to be.

Once the ALI departs from merely restating existing law, its efforts immediately raise a crucial question. Simply put, on what

134. AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS viii-ix (Tentative Draft No. 1, 1982).

135. See *supra* note 1.

136. Proposed Final Draft, *supra* note 1, § 6.02 cmt. a, at 548.

ground can the ALI lay claim to speak authoritatively to the rest of the legal profession and, more generally, to society? When a legislature proposes changes in the law, it does so on the basis of an electoral mandate. Judges enjoy the legitimacy of official status, however problematic the exercise of interpretive discretion may be from the point of view of political theory. The ALI, however, is just a private body. Distinguished as its membership may be, it is entirely the creature of private activity, and its composition is self-determined.

The failure of Part VI to offer an agenda worthy of implementation graphically demonstrates the inevitable shortcomings of efforts by the ALI, as it is currently constituted, to propose rather than merely to restate. The issues Part VI addresses are now at the center of major political controversy, and many constituencies have a stake in how this controversy is to be resolved. These interested groups include shareholders, both individual and institutional (and perhaps also the beneficiaries of the latter's investment activities), as well as the various nonshareholder components of the corporate enterprise: employees (blue collar as well as managerial), creditors, customers, suppliers, and local communities in which the corporation is located. A broad range of people is actively involved. In addition to lobbyists and publicists for the various constituencies, state legislators and judges are working through the issues presented by corporate takeovers, and the SEC, of course, continues to labor on behalf of its single constituency. We even hear rumblings that the new administration's Secretary of Labor, Robert Reich, is interested in questions of corporate governance as they relate to productivity.

The takeover question—which is only a subpart of the broader question of the appropriate goals and beneficiaries of corporate law and corporate activity—is difficult and controversial precisely because it implicates so many interests and so many actors are on the stage. The Project's Reporters, Consultants, and Advisers do not mirror this diversity at all. These men and women (and there are few of the latter) are distinguished academics, mostly from elite law schools, and eminent corporate lawyers, mostly from leading firms in the largest cities.¹³⁷ It is unclear how they define for themselves the values or interests that their law reform efforts are supposed to serve. Certainly it is absurd to imagine that they are chosen as proxies for the various interested parties, and, given their current positions within the legal profession, it is fanciful to suppose that they represent the breadth of current opinion about takeovers and, more generally, the various stories that corporate law might choose to tell about itself.

Of course, the participants in the *Principles*, like the membership of the ALI, presumably include a reasonable measure of diversity with respect to political outlook. Nevertheless, one guesses that the breadth of opinion about the basic premises of corporate law is a

137. See *id.* at v-vii.

good deal more narrow. The starting point is a more or less reflexive adherence to shareholder primacy. This threshold norm is combined with a reasonably vigorous tolerance for managerial discretion, on grounds of expertise, efficiency, and, perhaps, high personal regard for the individuals in charge of our largest corporations.

This narrow perspective on corporate law's underlying foundations goes a long way toward explaining the shortcomings of Part VI. Not only does Part VI fail to take seriously the claims of non-shareholder constituencies for substantive protections and for more direct empowerment, it also disregards the claims of shareholders to meaningful safeguarding of tender offer opportunities. What is left is a diluted endorsement of shareholder primacy in the context of almost unbounded managerial discretion. The basic approach taken in Part VI therefore should not surprise anyone. It is probably what one should expect from this group of individuals. What is perhaps surprising is the extreme breadth of discretion that the ALI appears eager to confer on target company management. One almost expects to see leading members of the Business Roundtable listed among the Project's Advisers. They are not there, of course, but perhaps some of their lawyers are.¹³⁸

The ALI is in a unique position to do much better than this. The two proposed alternatives to the traditional shareholder-management story point in opposing directions. Each commands broad support, though in different quarters. Neither seems powerful enough—as yet, at least—to trump the other decisively. Nonshareholders and institutional investors are not going to abandon the battlefield any time soon. Therefore, a serious attempt needs to be made again to develop approaches to corporate governance that harmonize these two conflicting agendas.¹³⁹ The most obvious institutional arenas in which this might occur probably are not up to the task. Predictably, state legislatures have been particularly attentive to the claims of local nonshareholder interests and willing to disregard those of typically nonresident shareholders. The SEC, in

138. One of Part VI's Co-Reporters, Professor Ronald Gilson, has written compellingly about the possibilities for more effective monitoring by institutional investors. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991). The evident dissonance between this position and that taken in Part VI would seem to indicate the extent to which the product reflects the views of the ALI rather than those of its drafters.

139. One such effort is a symposium to be held at the Washington and Lee University School of Law in November 1993 on "New Directions in Corporate Law." The aim of the symposium is to draw on a variety of intellectual and moral discourses to invigorate this harmonizing task.

contrast, views itself as having shareholders as its single constituency. Congress, despite a good deal of posturing, has seemed unwilling seriously to tackle basic questions of corporate governance.

In contrast, the ALI need not be beholden to any particular interest group. It ought to be able to take a broad, unbiased stance on these important issues, and its stature within the legal profession means that its pronouncements carry automatic weight. If it is to do a better job than it has in Part VI, however, it needs to make changes in the composition of its working groups. Who participates in the process makes a difference in the final product.¹⁴⁰ One step might be to enlarge its membership to include practitioners and academics whose views depart from the mainstream. More important, perhaps the ALI can devise a mechanism so that interested constituencies can provide direct input. Ideally, the various parties might engage each other in actual dialogue, so that constructive movement might be made in the direction of solutions that are optimally attractive to all involved. There is no assurance of success, of course, but the product of such a process is more likely to reflect the values and preferences of those who would be affected by it.

Equally important, a more democratic approach to the ALI's law reform efforts would earn it a degree of legitimacy that it does not now deserve. Elite law professors and eminent practitioners are no doubt well qualified to restate the law. Once they step out of this mode of action and into a much more overtly normative one, however, they are no longer entitled to our deference. Law reform in a democracy ought to be conducted democratically.

Conclusion

Corporate law is at a crossroads. Its standard story, since Berle and Means' 1932 landmark, has centered on the separation between ownership and control and the perennially intractable problem of managerial accountability to shareholders. Two recent events—the rise of institutional shareholder activism and legal recognition of nonshareholders as a result of the takeover boom of the 1980s—have shaken the factual and normative foundations of that story. The accountability gap seems to be closing and may even be on the verge of elimination. The idea of shareholder primacy, however, no longer commands general respect. In the years to come, corporate law inevitably will be striking off in a new direction. The currently available alternatives are clear, though the eventual outcome—perhaps a new synthesis—cannot be predicted.

Part VI of the ALI's long-awaited Project fails to offer a satisfactory resolution to the current controversy. Its muddled reference to nonshareholder interests indicates an awareness of the potential changes now in the air, but ultimately section 6.02 fails to please

140. For an argument to this effect with respect to legal interpretation, see David Millon, *Objectivity and Democracy*, 67 N.Y.U. L. REV. 1 (1992) (advocating diversity within the legal profession as a means of achieving democracy in law-making).

anyone except incumbent directors eager to retain their prerogatives. Management, rather than institutional investors or nonshareholders, seems, at least in Part VI, to be more firmly in control than ever.

For politically acceptable and democratically legitimate law reform to occur, the current membership of the ALI needs to abdicate some of its control. The ALI needs to listen to voices that are now heard only faintly and from a distance. It needs to promote dialogue among conflicting interest groups. One way or another, a new story for corporate law is going to be constructed in the near future. The ALI could perform a genuine service by providing a neutral forum for the development of corporate governance recommendations that are genuinely responsive to current law reform agendas. Part VI, however, is not such a recommendation. Whatever direction the corporate governance narrative takes in the years to come, Part VI will not be part of the story.