Shareholders as Principals

by

Deborah A. DeMott*

Introduction

[5.1] It seems natural to think that shareholders are principals and that directors act as their agents. The relationships among shareholders and directors result from consensual association, as do relationships that fall within the common-law definition of agency. Shareholders choose a corporation's directors by electing them to office. Once installed in office, directors hold discretionary management power over the corporation and thus make decisions that affect the economic well-being of shareholders. In exercising their managerial power, directors are subject to fiduciary duties, as are agents when acting within the scope of the agency relationship. The object of fiduciary duties is assuring loyal service to the interests of the corporation, conventionally defined by the interests of its shareholders, or by the interests of an agent's principal. That fiduciary duties are not self-enforcing creates a risk of divergence between the use that directors or agents may make of their powers and the use that would best serve the interests of shareholders or principals. These similarities underlie conventional aca-

*David F Cavers Professor of Law, Duke University School of Law. I am grateful to Professor Paul Davies for his comments on an earlier draft.

demic terminology. In analyzing the structure of relationships among directors and shareholders, economists and many academic lawyers use as commonplace terminology terms like "agency problem," "agency cost," and "agent-principal relationship."[1]

Despite these similarities, the relationship between shareholders and directors is not one of common-law agency. Reasoning by analogy on the basis of observed similarities is, of course, a conventional source of insight. Passing too quickly over dissimilarities leads to confusion, not insight. Contemporary corporate law does not treat directors as shareholders' agents other than in a loose or metaphorical sense. If fully applicable to directors' relationships to shareholders, the common law of agency would destabilize the legal consequences that contemporary corporate law facilitates. Although this point is basic, it is also a potentially rich source of insight into differences between corporate law

[1]See, eg, Michael C Jensen & William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *J Fin Econ*, Vol 3, 1976, p 308; Frank H Easterbrook & Daniel R Fischel, *The Economic Structure of Corporate Law* (1991). Some of this work defines as relationships of agency ones that would fall outside the definition of common-law agency. See, eg, Jensen & Meckling at 308 (defining an "agency relationship" as a "contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."). Judicial opinions occasionally use agency terminology in this generalised sense as well. See, eg, *Blasius Indus, Inc v Atlas Corp* (Del Ch 1988) 564 A2d 651 at 660 ("a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance....Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent toward his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment."). For a thoughtful discussion of the role the law of agency plays in defining relationships within firms, see Eric W Orts, 'Shirking and Sharking: A Legal Theory of the Firm', *Yale L & Pol'y Rev*, Vol 16, 1998, p 265.

in the United States and the Anglo-Commonwealth jurisdictions and into relationships between corporation-law statutes and common-law doctrines. It also affords a useful starting point for analyzing a current and controversial issue in the United States, which is whether shareholders have or should have power to give binding instructions to directors to redeem a poison pill or condition the circumstances under which directors may adopt or renew a poison pill. Finally, the basic point also provides a start for understanding limits on the efficacy of shareholder voting as a device to exonerate directors against claims for breach of fiduciary duty. In the United States, the relationship between shareholders and directors comes closest to one of common-law agency when the directors' action could not rationally serve any corporate purpose.

[5.2] This paper begins by with a brief explication of the consequences of characterising a relationship as one of common-law agency. It then sketches the complex relationships between corporation-law statutes and extra-statutory doctrines drawn from the common law and equity. Against this background the paper next analyzes implications to be drawn from the structure of contemporary corporation statutes for the allocation of power as between shareholders and directors. The paper then develops the import of this analysis when shareholders seek to compel the redemption of a poison pill by directors, contrasting developments in the United States with the United Kingdom and Australia. The basic point is that the metaphorical association with common-law agency is generally not helpful, given the structure of contemporary corporation statutes, and may be affirmatively misleading.

The common-law definition and its consequences

[5.3] It is helpful to begin with a brief sketch of consequences that would follow were the relationship between a corporation's shareholders and its directors treated as an instance of common-law agency, for ousting many of those consequences is a major accomplishment of contemporary corporate law. As defined by the Restatement of Agency, "[a]gency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."[2] The definition requires that the agent act subject to the principal's control. Within the common law of agency, control is a loosely-structured concept for which specific meanings vary with context.[3] Conventionally, though, control encompasses a principal's power to give interim instructions to an agent, even when the principal has previously agreed not to do so.[4]

[5.4] Three other consequences of immediate note follow once a relationship falls within the common-law definition. First, the principal, whether or not disclosed, becomes a party to transactions and subject to other obligations entered into by the agent within the scope of the agent's actual or apparent authority. Second,

[2]See Restatement Third, Agency §1.01 (Tentative Draft No 2, 2001).

[3]See *id* § 1.01, Comment f.

[4]See *id.* The power to dominate or influence is not identical to the concept of control for purposes of determining whether a relationship is one of common-law agency. See *id.* Nor do declarations by parties determine how a court should characterise a relationship. See *id* § 1.02; accord, *South Sydney District Rugby League Football Club Ltd v News Ltd* [2000] FCA 1541 at ¶¶ 131-67.

assets managed by the agent on behalf of the principal become vulnerable to claims asserted by the principal's creditors, whether or not the claims are related to the assets or to the agent's activity.[5] Third, the principal may revoke the agent's actual authority at any time by making a manifestation to that effect to the agent, even though the revocation contravenes the terms of a contract between principal and agent.[6]

[5.5] The first two of these consequences of common-law agency are neatly side-stepped by the basic consequence of forming a corporation. Once formed, a corporation is itself a juridical person that holds rights and becomes subject to obligations, thereby insulating its shareholders from individual liability as well as insulating its assets from claims asserted by shareholders' individual creditors. It may be less immediately evident why the third consequence is so important. A principal's power to revoke an agent's authority is a fundamental means by which the principal exercises control and self-protects against the risks present in a relationship in which another person's actions directly affect the principal's legal relations with third parties.[7]

Suppose each shareholder had an individual relationship of common-law agency

[5]For an extended discussion of the relative significance of these two points, see Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law', *Yale LJ*, Vol 110, 2000, p 387.

[6]See Restatement Third, Agency § 3.10 (1). Likewise, an agent has power to renounce actual authority although the renunciation contravenes an agreement with the principal. See *id.* English law is to the same effect. See Francis Reynolds, 'When is an Agent's Authority Irrevocable?', in *Making Commercial Law: Essays in Honour of Roy Goode* 259 (Ross Cranston ed 1997).

[7]See Restatement Third, Agency § 3.10, Comment b.

with each of the corporation's directors. Each shareholder would then be situated as a co-principal in an agency relationship with multiple co-agents and would hold power to revoke each director's authority, regardless of any agreement to the contrary.[8] Moreover, a shareholder's death or loss of capacity would terminate the directors' authority. Directors would as a consequence lack the ability to deal on a reliable footing with third parties, who could not prudently commit to be bound by a transaction without direct confirmation from each of the shareholders. Indeed, even the otherwise-robust doctrine of apparent authority might not assist third parties seeking to enforce a liability incurred by a director on behalf of the shareholder-principals if reasonable people would be aware of the fragility of directors' authority. This is because the doctrine of apparent authority does not protect a third party who acts on the basis of an unreasonable belief that an agent has authority. Thus, treating a corporation as itself the principal that is bound by actions taken by its directors, officers, employees, and other agents overcomes what would otherwise be serious practical problems that would, at a minimum, delay the formation of mutually binding contracts.

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Nor are these problems successfully overcome by treating a majority of share-

[8]See *id* §§ 3.07(2) and 3.08(1). This feature of agency law differentiates it from contract law. For an examination of the stability that mutually enforceable contracts may create, see E Allan Farnsworth, *Changing Your Mind: The Law of Regretted Decisions* (1998).

holders as a single "principal," as opposed to positing that an individual relationship of agency exists between each shareholder and each director. Shareholders take action collectively on the basis of voting through which the outcome is determined by some variant of majority rule, which could encompass a plurality of votes cast, a majority of a specified proportion of votes cast, or a majority of shares outstanding. A third party seeking to confirm a director's authority to take action could do so only by inquiry to shareholders, an aggregate body of potentially fluid membership, a majority of whose members at any time would constitute the "principal." Moreover, if the director acted with authority in entering into a transaction, who would become a party to the transaction as a consequence? All of the shareholders? Or only a specifically assenting majority? Thus, deeming a majority of a corporation's shareholders to constitute the "principal" would not result in a stable or predictable outcomes.

The evolution of shareholders' powers

[5.6] In an earlier era, corporate law treated shareholders as principals in a more than metaphorical sense by empowering shareholders to exercise control over directors by giving binding instructions. Directors were "subject to the superior control of the proprietors assembled in general meetings,"[9] expressed in resolutions that shareholders adopted by majority vote at the meeting. Over time, commercial opinion rejected this structure, legislatures responded, and courts "elevated the board from being merely agents to being a primary organ,"[10]

[9] *Foss v Harbottle* [1843] 67 ER 189, 2 Hare 461. See also Jennifer Hill, Visions and Revisions of the Shareholder, 48 *Am J Comp L* 39, 42-44 (2000).

[10] H A J Ford, R P Austin, and I M Ramsay, *Ford's Principles of Corporations Law* 217 (10th ed 2001).

an instrumentality of governance holding management power that is distinct from shareholders. In the United States, this transformation was accomplished through

corporation statutes that articulate specific powers held by shareholders and otherwise allocate managerial power to directors, thereby eliminating the power previously held by a majority of shareholders to give binding instructions to directors through the mechanism of adopting a resolution.[11] For example, section 141(a) of Delaware's corporation statute provides that "[t]he business and affairs of every corporation organized under this [statute] shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this [statute] or in its certification of incorporation." Contemporary corporation statutes in the United States also specify instances in which a shareholder vote is necessary; these include electing directors at an annual meeting, as well as amending the corporation's certificate of incorporation and approving fundamental transactions, each initiated by a resolution adopted by directors. [5.7] As stated recently by the Delaware Supreme Court in *Quickturn Design Systems v Mentor Graphics Corp*, "[o]ne of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation."[12] Delaware's corporate law is of particular significance because it has long been the dominant state

[11] See *Auer v Dressel* (NY 1954) 118 NE2d 590 (shareholders lack power to compel directors to re-hire corporation's former President; shareholders may properly adopt precatory resolution urging board to rehire former President).

[12] *Quickturn Design Sys, Inc v Mentor Graphics Corp* (Del 1998) 721 A2d 1281 at 1291.

for incorporations of public corporations; the Delaware Supreme Court, in the words of a prominent federal judge, is the "Mother Court" of corporate law.[13] But the Delaware structure, predominant throughout the United States, is not followed uniformly elsewhere. As discussed in [5.12], in the United Kingdom and Australia, directors do not hold managerial authority as the result of a direct statutory grant but instead as the result of provision made in a corporation's articles or constitution. Moreover, while shareholders in the United Kingdom and Australia have unilateral power to amend this document, shareholders in a Delaware corporation lack unilateral authority to amend its certificate of incorporation. See [5.10].

Delaware's Statutory Framework

[5.8] Surprisingly, it is controversial to what extent restrictions may be placed on the authority of directors in a Delaware corporation and how this may be done. To some extent this uncertainty is the consequence of a statutory drafting pattern that can be read to create tensions and arguable circularities, perhaps because the drafters appear in retrospect to have taken too much for granted. Although the statute reflects the assumption that directors hold power through conferral by the terms of the statute itself, not through a grant of authority delegated by shareholders,[14] the statute does not always draw clear bounds to demarcate the allocation of power as between shareholders and directors. Three

[13] *Kamen v Kemper Fin Servs* (7th Cir 1990) 908 F2d 1338 at 1343 (per Easterbrook, J), rev'd (1991) 500 US 90.

[14] See, eg, *Unocal Corp v Mesa Petroleum Co* (1985) 493 A2d 946 at 953 ("The board has a large reservoir of authority upon which to draw. Its duties and responsibilities proceed from the inherent powers conferred by 8 Del C, tit 8 § 141(a), respecting management of the corporation's 'business and affairs.'Additionally, the powers here being exercised derive from 8 Del C § 160(a), conferring broad authority upon a corporation to deal in its own stock.").

separate sections of the statute are relevant; two confer power explicitly, while the other specifies how such conferrals of power may be limited

[5.9] In *Quickturn Design,* the court went on to say that "any limitation on the board's authority" must be set out in the corporation's certificate of incorporation, the document that when duly filed commences the corporation's existence.[15] The section of the statute to which the court refers, § 141(a), states that "[t]he business and affairs of every corporation organised under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." Section 102(b) permits a corporation's certificate of incorporation to include "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision defining, limiting and regulating the powers of the corporation, the directors, and the stockholders...." provided, however, that "such provisions are not contrary to the laws of this State." Finally, section 109 provides that shareholders shall have power to adopt, amend, or repeal by-laws, which may "contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." The certificate of incorporation may also (and typically does) confer by-law power on directors, but so conferring by-law power "shall not divest the stockholders" of their power to adopt, amend, or repeal by-laws nor limit their power.

[15] 721 A2d 1291.

[5.10] As drafted, these provisions imply limits and priorities that resolve some initial questions about the import and scope of each. It is also helpful, and consistent with general conventions of statutory construction, to examine each discrete section in the context of the statute read as a whole and to attempt to ascertain a meaning for each section that does not negate the effect of others. First, to what extent does the statute permit certificate provisions that vary the statute's own conferral of powers on directors and shareholders? The conferral of management authority on directors in section 141(a) is subject to provision otherwise in the corporation's certificate of incorporation. Section 102(b), which specifically addresses such provisions, requires that they not be "contrary to the laws of this State." This limit should not include the otherwise-complete conferral of management authority on directors through section 141(a) because the reference in section 141(a) to limits imposed by certificate provisions would thereby be read out of the statute. Instead, an example of a certificate provision "contrary to law" is one that deletes a statutorily-mandated role for directors or shareholders in connection with a fundamental transaction or event, a category consisting of mergers, sales of all or substantially all of the corporation's assets, dissolutions, and amendments to the corporation's certificate of incorporation. The statutory provisions that define each fundamental transaction or event and specify how it may be effected require initiation of the transaction or event through a resolution adopted by a corporation's directors, followed by approval by shareholders. These statutory provisions make no reference to

provision otherwise in a corporation's certificate of incorporation.[16]

Despite the frequent references in these provisions to actions taken by shareholders at a meeting, §228 permits shareholders to take effective action without a meeting, and without prior notice, through a written consent to the action that is signed by at least the minimum number of holders of outstanding stock that would be necessary to take action at a meeting at which all outstanding shares were present and voting. A corporation may elect in its certificate of incorporation to make § 228 inapplicable. Thus, a certificate provision would be "contrary to" section 251, which deals with merger transactions, were it to eliminate the directors' role of initiation by placing sole authority in shareholders to commit the corporation to a merger transaction. Likewise, a certificate provision would be "contrary to" section 242, which states how a corporation may amend its certificate of incorporation, were the certificate provision to confer a unilateral power of amendment on shareholders.
Second, section 141(a) also expressly limits directors' managerial authority "as may be otherwise provided in this chapter." Does this reference encompass section 109's grant of by-law power to shareholders? If so, even absent any provision in a corporation's certificate that limited directors' management powers, that power would be subject to binding instructions given by shareholders acting through the vehicle of a by-law. Although a heroic reading of section 141(a) to this effect enjoys some academic support, its persuasiveness is doubtful. The reference to "otherwise provided" can be explained more simply and directly as a reference to provisions elsewhere in the statute that oust directors from managerial authority when an alternate organ of management is appointed, such

[16]See Del Code Ann, tit 8, §§ 242(b)(1) (amendment to corporation's certificate of incorporation requires that board of directors adopt a resolution setting forth proposed amendment, and vote at shareholder meeting approving amendment by a majority of the outstanding stock entitled to vote thereon, including approval by majority of outstanding stock entitled to vote as a class on the amendment); 251 (b) & (c) (merger or consolidation requires that board of directors of each corporation adopt a resolution approving agreement of merger or consolidation; agreement must be submitted to shareholder meeting and approved by vote of majority of outstanding stock entitled to vote thereon, subject to exceptions to requirement for shareholder approval stated in subsection (f)); 271(a) (corporation may sell, lease, or exchange all or substantially all of its assets on terms set by directors, when and as transaction is authorised by resolution adopted by holders of majority of outstanding stock entitled to vote thereon); 275(a) & (b) (corporation may dissolve by resolution adopted "to that effect by a majority of the whole board" and vote in favor of dissolution at meeting by majority of outstanding stock entitled to vote thereon).
It is significant that these sections require the affirmative support of a majority of the outstanding stock entitled to vote. Other actions may be taken by shareholders by the affirmative vote of a majority of the shares present or represented by proxy at a meeting at which a quorum is present. See *id* § 216. However, directors may be elected by a plurality of votes. *Id.* A corporation's certificate of incorporation or by-laws may prescribe a different number of shares that shall constitute a quorum, but that number may be no fewer than one-third of the shares entitled to vote. A corporation may also have a certificate provision that requires a larger portion of shares, or number of directors, to take any action, see § 102(b)(4); and may have by-laws that require a greater number of directors than a simple majority to constitute a quorum or to take action by vote at a meeting, see § 141(b).

as a receiver.[17] Moreover, the heroic reading of section 141(a) ignores the specific treatment of certificate provisions in section 102(b), discussed above. If shareholders had power to take action at any time in a fashion that reduced directors' managerial authority, what work is left for certificate provisions to do? Defenders of the heroic reading of section 141(a) rely on the Delaware cases articulating the "equal dignity doctrine," the proposition that a transaction validly effectuated under one section of the statute should not be additionally subject to requirements applicable under another statutory section that could be used to effect a transaction that is similar in economic or other respects.[18] However, this doctrine is not applicable unless the transaction is indeed "validly effectuated" under the statutory section defining the transaction, which it would not be if it did not comply with another section of the statute to which the defining section made explicit reference; the current dispute instead implicates sections of the statute that contain express cross-references establishing explicit as well as implicit hierarchies.[19]

To some extent, the heroic reading is invited by the structure of section 109 itself. This section confers by-law power on shareholders and permits it to be conferred on directors as well through a provision in the corporation's certificate of incorporation. However, section 109 does not prescribe any hierarchy as between actions taken by shareholders and by directors. Nor does the section specify any limits on what may constitute a "by-law." The section grants power to shareholders and directors that is parallel in scope and effect. Presumably the corporation's certificate may prescribe hierarchies to govern otherwise-circular exercises of the power. If the certificate is silent on the point, section 109's explicit parallelism creates the possibility that shareholders may exercise their power by adopting a by-law, to be followed by action by directors that amends or repeals the shareholder-adopted bylaw. Indeed, this scenario may follow even when the shareholder-adopted by-law provides that contrary action by directors shall be ineffective or specifies circumstances under which the by-law may be amended or repealed if the directors hold plenary power to "adopt, amend or repeal" by-laws that is not subject to a limitation imposed by the corporation's certificate. Some other states's statutes expressly address this possibility by insulating shareholder by-laws from contrary action taken by directors, or by enabling shareholders to add insulating features to the by-law itself, but the

[17] See Del Code Ann, tit 8, §§ 226 (appointment of custodian); 291 (appointment of receiver for insolvent corporation). Compare Lawrence A Hamermesh, 'Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?', *Tulane L Rev*, Vol 73, 1998, pp 409, 430 ("unless otherwise provided by law" should be read to refer to statutory provisions authorising appointment of custodians, trustees, and receivers who hold managerial authority in lieu of directors) with Jeffrey N Gordon, "'Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett', *Cardozo L Rev*, Vol 19, 1997, pp 511, 547 ("unless otherwise provided by law" could be read to include shareholder power created by §109).

[18] See Gordon, *supra* note 17, at 547; Ronald J Gilson, '*Unocal* Fifteen Years Later (And What We Can Do About It)', at 24 (June 2000) (unpubl working paper, available at <http://papers.ssrn.com/paper.taf?abstract_id=235417>).

[19] See Hamermesh, *supra* note 17, at 430, n 96.

Delaware statute does not do so.[20]

The Statutory Framework for Corporate Law

[5.11] At this point in the analysis, it is important to highlight the significance of underlying questions about the nature of corporation statutes and their relationship to extra-statutory doctrines. Although these questions do not appear to have received sustained attention in broader scholarly treatments of the relationship between statutes and the common law, the limited scope of this paper makes it impossible to examine these questions comprehensively here.[21] The preceding analysis implicitly reflects the view that a contemporary corporation is a creature of statute, not a common-law artifact. Provisions in the statute explicitly resolve many points in dispute. However, corporation statutes are also noteworthy for their omissions. To answer questions and resolve disputes, counsel and courts necessarily turn to extra-statutory doctrines.

Organisational statutes may be systematically different from other statutes in a basic way. An organisational statute enables private parties to create a legally-constituted person with distinct legal personality, which then, acting through its organs of internal governance (such as a board of directors) or through its employees and other agents, is empowered to take legally consequential action. Organisational statutes do not generally attempt to define or regulate such consequences in a wholehearted fashion, for example by supplanting the entirety of common-law doctrines of agency, contract, and torts. Put differently, even if corporation law is "largely the preserve of statutes,"[22] the legal consequences of acts done by corporations may fall outside the preserve of the corporation statute depending on the act and the specific legal consequence.

Organisational statutes may also omit coverage of topics more integral to their distinctive function. For example, the Delaware statute does not delineate the duties owed to corporations and shareholders by their directors and controlling shareholders, in contrast to the Revised Model Business Corporation Act, which contains a statement of directors' duties.[23] Moreover, neither statute addresses when a court should disregard a corporation's separate legal personality and impose individual liability for corporate obligations on shareholders. In contrast, provisions in some statutes eliminate what would otherwise be an "omission" by

[20] For example, the Model Business Corporation Act states explicitly that shareholders may, in adopting, amending, or repealing a by-law, provide that directors may not amend, repeal, or reinstate the by-law. Model Bus Corp Act § 10.20(b)(1).

[21] For a helpful discussion of general issues, see Jack Beatson, 'The Role of Statute in the Development of Common Law Doctrine', *Law Q Rev*, Vol 117, 2001, p 247. Professor Beatson's article is a searching critique of the view that statutes play no role in the development of the common law and the corollary view that statutes and codes are fundamentally different.

[22] See *id* at 250.

[23] Revised Model Bus Corp Act § 8.30. The Model Act reflects an approach that is "more directive and 'bright line"' with less left to the interstitial work of counsel and courts. This difference has been explained as "likely less attributable to differences in regulatory philosophy than to differences in the constituencies for the respective statutes" because states that adopt the Model Act lack the developed body of precedent resolving difficult questions under the Delaware statute. Michael P Dooley and Michael D Goldman, 'Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law', *Bus Law,* Vol 56, 2001, pp 737, 764-65.

specifying that the statute's treatment shall be exclusive in some respect. For example, under the Revised Model Business Corporation Act, a merger or other fundamental transaction triggers a statutory right in a shareholder to dissent and receive a cash payment based on the court's appraisal of the value of the shares held by the dissenter. Unlike the Delaware statute, the Model Act provides that those rights constitute the shareholder's exclusive remedy and that the transaction may not be challenged except on grounds that are specified by the statute.[24] A court may treat the statute's exclusivity provision as a source of principle or policy upon which to draw to resolve a question not expressly resolved by the statute itself.[25]

In contrast, questions about the scope of shareholders' bylaw power do not involve statutory "omissions" in the sense just discussed because the statute does not lack the content necessary to answer the questions. Several sections of the statute, read together, answer the questions. It is not necessary to resort to extra-statutory doctrines and concepts, like the analogy to common-law agency.

[5.12] As noted above, in the United Kingdom and Australia, the corporation's constitution or articles provides the source of directors' managerial power, not a direct statutory grant.[26] Moreover, the grant of managerial power is more

[24] Rev Model Bus Corp Act § 13.02(d). Delaware courts have not implied an exclusivity provision into the section of the Delaware statute that confers appraisal rights on shareholders. See Turner v Bernstein (Del Ch June 6, 2000) 2000 WL 776893 at *14. The policy rationale is it is desirable, when directors seek to argue that a shareholder's acceptance of merger consideration bars further relief, to place on directors the burden of showing that the stockholder received "all the information she needed to make a knowing and informed decision." *Id.* If the directors meet this burden, the shareholder loses. If the burden cannot be met, the directors must defend themselves against claims of breach of fiduciary duty, most likely to be viable if disloyalty led to the failure to make sufficient disclosure to shareholders. This is a purpose not served by actions for appraisal. *Id.*

[25] For example, in Galligan v Galligan the corporation did not comply with the notice requirements imposed by the Indiana Business Corporation Law. As a result, the shareholders did not submit their share certificates and the statutory timetable for an appraisal proceeding was not triggered. (Ind 2001) 741 NE2d 1217 at 1224. The statute does not specify the consequences if a corporation fails to initiate the process by notifying shareholders of their rights. The court held that the corporation's failure did not entitle shareholders to attack the underlying merger transaction through an action alleging fraud and breach of fiduciary duty seeking rescission and possibly punitive damages. The basis for the holding is the court's assessment that by providing for an exclusive appraisal remedy, the statute "sought to eliminate the opportunity created by broader decisional law to invoke broader remedies than a fair valuation of the shares." *Id* at 1225. The court thus restricted the shareholders to their statutory rights to appraisal. The court also recognised the need to provide incentives for corporations to comply with the statute; if shareholders are unaware of their statutory rights, they may be relegated to a "legal limbo" or be put to a significant expense not contemplated by the statute. Accordingly, the court held that the shareholders had a separate claim against persons responsible for the corporation's breach of statutory duty, for which the remedy could include losses stemming from delay, as well as any loss based on impairment of the corporation's financial capacity to make full payment of the appraised value, when the delay led to the impairment. *Id* at 1225-26.

[26] For Australia, see Corporations Law § 226A(1) (replaceable rule that "the business of the company is to be managed by or under the direction of the directors."). For the United Kingdom, see Companies Act 1985 § 8(1) (company may adopt for its articles the whole or any part of Table A) & Table A, art 70 ("Subject to the provisions of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company

fragile than in a Delaware corporation because corporations legislation in the United Kingdom and Australia confers on shareholders the unilateral power to amend the corporation's articles or constitution.[27] In contrast, as noted above [5.10] in a Delaware corporation, amendments to a certificate of incorporation require a resolution adopted by the board of directors as well as adoption by shareholders.

Thus, UK and Australian law deals shareholders a stronger hand, one strengthened by the power to remove directors by majority vote without showing cause for removal.[28] This leverage does not, however, translate into the power to give binding instructions to directors separate from the mechanisms of constitutional amendment.[29] Since early in the twentieth century, it has been assumed that, although shareholders may amend a corporation's articles, "where powers had been vested in the board, the general meeting could not interfere with their exercise."[30] To be sure, the line between constitutional amendment and interim interference with the exercise of managerial power may not be clear. A recent illustration is *NRMA, Ltd v Snodgrass*, in which the court held that members of an Australian company had power to vote at a general meeting on a proposed amendment to the company's constitution requiring the company to reimburse a member for legal costs he incurred in an earlier battle with the company.[31] The court characterised the provision as "strange," "unusual," and "in some ways perhaps. . . undesirable," but not invalid as a restriction on the management power otherwise vested in the company's directors.[32]

The Current Take-over Context

[5.13] Until recently, the significance of these points of statutory construction fell below the radar screens of both academic commentary and litigated controversy in the United States. As in *NMRA v Snodgrass*, one exception consisted of periodic disputes about whether proposals initiated by shareholders concerned matters that were not proper subjects for action by shareholders or fell within the category of "ordinary business." If so, the SEC's proxy rules permit the corporation to exclude the proposal from the proxy statement that public corporations must send to shareholders prior to their annual meeting.[33] These

shall be managed by the directors who may exercise all the powers of the company").

[27] Corporations Law § 136(2) (special resolution may alter constitution); Companies Act 1985 § 9 (special resolution may alter articles). A special resolution requires the support of holders of 75 per cent of the shares entitled to vote. See Corporations Law § 9; Companies Act § 378(2).

[28] See Corporations Law § 227 (notwithstanding anything in corporation's articles or constitution, shareholders of public company may remove any director or directors through an ordinary resolution); Companies Act 1985 § 303 (notwithstanding anything in its articles or in an agreement with a director, a company may by ordinary resolution remove a director).

[29] See Automatic Self-Cleansing Filter Syndicate Co v Cunninghame [1906] 2 Ch 34.

[30] See Paul L Davies, *Gower's Principles of Modern Company Law* 183 (6th ed 1997). Table A's Article 70 may not be entirely consistent with the caselaw because it appears to make the directors' exercise of management power subject to "any directions given by special resolution. . . ." To harmonise this provision with the caselaw, one would read it to address only directions curtailing power that directors may exercise in the future. *Id* at 185-86.

[31] *NRMA, Ltd v Snodgrass* [2001] NSWSC 76.

[32] *Id* at ¶ 13.

[33] Judicial opinions as well as administrative determinations by the SEC and its staff inter-

disputes did not, however, focus sustained attention on whether the statutory grant of by-power to shareholders empowers them to give binding instructions to directors. Instead, the question acquired its current salience as a consequence of how the structure of contested take-overs evolved.

[5.14] In contrast to UK take-over regulation, described below [5.20-.21], the applicable body of Delaware doctrine allocates a greater measure of unilateral discretion to directors of a target corporation to adopt measures that frustrate a bid the directors believe to be contrary to the interest of the corporation or its shareholders. Take-over defenses that involve an alternate transaction, such as a debt-funded restructuring of the target[34] or the acquisition of another corporation[35] may carry enduring financial and operational consequences for the target. These consequences explain the attractiveness of an alternate defensive tactic, within the unilateral control of directors, that does not necessarily entail these consequences. The "poison pill" works well in this respect. Specifically legitimated by the Delaware Supreme Court in 1985,[36] the poison pill is an instance of creative ingenuity brought to bear by corporate lawyers.[37] A poison pill consists of rights issued to a corporation's shareholders that entitle the holder of an issued right, upon the occurrence of specified trigger conditions, to purchase shares on bargain terms. If a poison pill has a "flip-in" feature, the shares that may be purchased are shares of the corporation that issued the purchase rights. If the pill has a "flip-over" feature, the purchase rights apply to shares of another corporation, for example a corporation that buys a stated percentage of shares in the corporation that issued the rights and subsequently proposes to merge with it. Although it is counter-intuitive that a corporation would have power to issue rights that create entitlements to acquire shares in another corporation, the power can be analogised to features of convertible debentures that protect the holder against the destruction of value in the event of subsequent transactions by creating exchange rights.[38] As a defensive tactic, a poison pill

pret the meaning of these concepts. On these developments, see, eg, Carol Goforth, 'Proxy Reforms As a Means of Increasing Shareholder Participation in Corporate Governance: Too Little But Not Too Late', *Am UL Rev,* Vol 43, 1994, p 379; Stewart J Schwab & Randall S Thomas, 'Realigning Corporate Governance: Shareholder Activism By Labor Unions', *Mich L Rev*, Vol 96, 1998, p 1018.

[34]See, eg, *Unocal Corp* 493 A2d at 950 (defensive transaction consisting of self-tender offer to exchange equity for senior debt securities would require target corporation to reduce exploratory drilling due to incurrence of over $6 billion in additional debt).

[35]See, eg, *Paramount Communications, Inc v Time, Inc* (Del 1990) 571 A2d 1140 at 1148 (target acquired stock of preferred merger partner through cash tender offer that required incurrence of $7-10 billion in additional debt).

[36]See *Moran v Household Int'l, Inc* (Del 1985) 500 A2d 1346.

[37]Credit for the invention is commonly given to the New York law firm of Wachtell, Lipton, Rosen & Katz. See John C Coates IV, 'Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence', *Tex L Rev,* Vol 79, 2000, pp 271, 271 n*.

[38]See *Moran* 500 A2d at 1352. In particular, debt and preferred equity securities that are convertible into common stock often contain "anti-destruction" clauses that, in the event of a merger transaction that will eliminate the stock of the issuing company, permit holders of the convertible securities to convert into the securities that will replace the stock of the issuer if the merger is effected. See, eg, *Broad v Rockwell Int'l Corp* (5th Cir 1981) 642 F2d 929 at 946. When an indenture or certificate designating the rights of preferred stock does not create

is effective because, if triggered, the pill creates the risk of substantial dilution, either of the target's equity or that of a hostile bidder.
The unilateral discretion that Delaware invests in directors in this context is not unlimited, however. Directors may not adopt a pill that is not redeemable because their fiduciary duties require that they be able to assess the interests of the corporation and its shareholders as against particular take-over proposals. Adopting a non-redeemable pill would eliminate the directors' ability to permit a bid to proceed if its terms are attractive by redeeming the pill and the threat of dilution it poses.[39] Whether to redeem a pill is a decision within the province of the target directors' business judgment, subject to the specific showing described below.
Moreover, the widespread adoption of poison pills stimulated the creative ingenuity of hostile bidders and their legal counsel. For example, a bidder might expressly make its bid subject to the condition that the target's directors redeem a poison pill they previously adopted. Many prospective bidders took an alternate route, which was to solicit proxies from shareholders to remove the corporation's incumbent directors and elect designated successors to the board, who could then redeem the pill.
[5.15] As a response, some poison pills were structured with a "dead-hand" feature, which disqualified directors from voting to redeem the pill unless they were directors when the pill was adopted or unless their election to the board was recommended or approved by the continuing directors. Delaware cases in the late-1990's invalidated "dead-hand" poison pills and pills that were expressly non-redeemable for any period of time.[40] *Carmody v Toll Brothers, Inc* held that a dead-hand feature impermissibly restricts the powers of newly-elected directors in the absence of any provision in the corporation's certificate prescribing such restrictions or discriminating among directors in the powers that directors shall hold.[41] Additionally, a dead-hand pill restricts the efficacy of

such a right of conversion, courts decline to imply one. See *id.*

[39] *Moran*, which legitimates the adoption of poison pills, also states explicitly that directors may not "arbitrarily" reject a request to redeem a pill so that a hostile bid may be made. See 500 A2d at 1354. Instead, "[t]hey will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to originally in approving the Rights Plan." *Id.* In *Quickturn Design*, the court specifically held invalid a provision in a poison pill that delayed the ability of a newly-elected board to redeem it by six months. See 721 A2d at 1292.

[40] The reaction in three other states is more hospitable to aggressively-structured poison pills. See *AMP Inc v Allied Signal, Inc* (ED Pa 1998) 1998 WL 778348 at *6 (upholding nonredeemable poison pill under Pennsylvania law), rev'd on other grounds, (3d Cir 1999) 168 F3d 649; *Invacare Corp v Healthdyne Techs, Inc* (ND Ga 1977) 968 F Supp 1578 at 1580 (upholding dead-hand poison pill under Georgia law); Md Code Ann Corps & Ass'ns § 2-201(c)(2)(ii) (1999) (authorising adoption of poison pill with nonredeemability provision limited to 180 days). In contrast, a form of deadhand pill was invalidated under New York law in 1988. See *Bank of New York v Irving Bank Corp* (Sup Ct 1988) 528 NYS2d 482 at 485 (invalidating poison pill because it discriminated, in the absence of a basis in the statute or the corporation's certificate of incorporation, between, on the one hand, continuing directors and directors elected by a super-majority vote of shareholders, and, on the other hand, directors validly elected by a plurality of votes cast).

[41] *Carmody v Toll Bros, Inc* (Del Ch 1998) 723 A2d 1180 at 1191-92.

the shareholders' voting franchise by coercing shareholders into voting for the incumbents, or candidates endorsed by the incumbents, when shareholders are inclined to vote otherwise.[42]

[5.16] As a consequence of these strategic moves, counter-moves, and judicial responses, hostile bidders may overcome intransigent opposition by a target's directors by mounting a proxy solicitation to elect new directors, who, once elected, may vote to redeem a poison pill. Moreover, Delaware cases insulate the shareholders' voting franchise from measures taken by directors that would thwart its efficacy. In *Blasisus Industries, Inc v Atlas Corp*, the Court of Chancery held that directors may not take steps to thwart a shareholder vote unless the directors can demonstrate a "compelling justification."[43] In *Blasius* itself, the target's directors responded to the delivery of a form of stockholder consent by a 9 per cent shareholder that, if joined in by holders of a majority of the stock, would increase number of directors on the board from seven to fifteen, which was the maximum number authorised by the target's certificate. The directors responded by adding two new directors to the board, which if effective would thwart the ability of a majority of the shares to elect a new majority to the board because, for reasons explained below [5.17], a majority of the shares would presumably have been unable to remove the incumbent directors.[44] Interestingly, the court conceded in *Blasius* that the directors may have acted in good faith because the 9 per cent shareholder's announced plan for the corporation consisted of an aggressively-structured leveraged restructuring that, if implemented, would in the opinion of the corporation's financial advisor leave the corporation with no chance of repaying its debt. However, the court held that the directors failed to satisfy the "compelling justification" standard because the corporation's shareholders "could view the matter differently than did the board. If they do, or did, they are entitled to employ the mechanisms of the corporation law and the. . . certificate of incorporation to advance that view."[45]

[5.17] In short, although Delaware cases empower directors to take unilateral measures that may thwart hostile take-overs, their power is subject to shareholders' power, insulated by cases like *Blasius* , to elect new directors. This resolution, in the view of a prominent academic commentator, reflects a preference for elections over markets as a mechanism for resolving contests for corporate control.[46] Of course, the contemporary corporate form itself means that shareholders do not act by simple fiat, unlike principals in a relationship of common-law agency; shareholder action, regardless of its subject, requires a mechanism for collective action, such as voting at a meeting or signing a written consent like that proposed in *Blasius.* Other patterns of takeover regulation,

[42] *Id* at 1193-94.

[43] (Del Ch 1988) 564 A2d 651 at 661.

[44] Directors on the target's board were elected for staggered terms, which under Del Code Ann § 141(k)(1) would require a showing of cause to effect removal. See 564 A2d at 655.

[45] *Id* at 663.

[46] See Gilson, *supra* note 18, at 2 (Delaware cases, beginning with *Unocal*, have developed "into an unexplained and, I think, inexplicable preference that control contests be resolved through elections rather than market transactions.").

discussed below, subject directors's defensive responses to hostile takeovers to a shareholder vote to ascertain approval or disapproval of the specific response, whereas Delaware confines shareholder power to choosing directors unless the statute or the corporation's certificate require otherwise.

As it happens, the proxy-fight route is potentially fraught with difficulty. Delaware permits directors to be elected for staggered terms as long as three years, and unless a corporation's certificate of incorporation expressly provides otherwise, directors on a staggered or "classified" board are not removable by a shareholder vote except upon a showing of cause.[47] Under the cases defining "cause," which admittedly are sparse, simple disagreement with fellow directors or with senior management does not constitute grounds for removal.[48] It is highly unlikely that disagreeing with a majority of the shareholders would constitute grounds for removal, either.[49] Thus, it may take two annual elections to elect a pro-bidder majority to the board, unless the carry-over directors resign, which they may well determine to do.[50] In the meantime, tensions between the incumbent directors and their new colleagues may be substantial. Additionally, the target corporation may attract the interest of another acquiror who offers to pay more than the initial bidder, or otherwise offers terms more attractive to the hold-over directors, who may redeem the poison pill in a manner that permits an acquisition by the favored party but not the initial bidder.[51]

Thus, it is not surprising that attention is now focused on the potential that shareholder-adopted by-laws may hold to overcome the ability of incumbent directors effectively to frustrate all but a determined bidder, especially when the directors on a corporation's board are insulated from removal except upon a showing of cause. Shareholder-adopted by-laws hold out the promise of affirmative and determinative action that shareholders may take, as opposed to the route of electing new directors, which one academic commentator characterises

[47]Del Code Ann, tit 8, § 141(k) (ii). Under § 141(d), a board may be classified by a provision in the corporation's certificate of incorporation, by an initial by-law, or by a by-law adopted by a vote of shareholders. Classifying the board through a by-law adopted only by the corporation's directors is not an option. In contrast, Maryland recently amended its corporation statute to permit directors to classify the board so long as the board so acting has at least three independent members. See Md Code Ann Corps & Assn's § 3-801(1999). As amended, the Maryland statute also authorises the adoption of poison pills with dead-hand features that are limited to 180 days. See *id* § 2-201(c)(2)(ii)(1999).

[48]The leading case is *Campbell v Loew's, Inc* (Del 1957) 136A2d 191.

[49]To treat disagreement with a majority shareholder as cause for removal would undercut the ability of directors to discharge their fiduciary duties to all of the corporation's shareholders, including minority or noncontrolling shareholders.

[50]Prior to the invention of the poison pill, directors on classified boards resigned from office once a bidder acquired majority stock ownership. See Coates, *supra* note 37, at 326, n 214 & 329 n 227; Ronald J Gilson, 'The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept', *Stan L Rev,* Vol 34, 1982, 775, 780. These sources do not address whether target directors in fact resigned less frequently once poison pills became widespread.

[51]See John C. Coffee, Jr., 'The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests', *U Miami L Rev,* Vol 51, 1997, pp 605, 606. This presumably is an outcome that the target's shareholders might favor, but the risk of its occurrence could deter some initial bidders.

as "essentially reactive and contingent."[52]

What is a by-law and what may it do?

[5.18] Section 109 (b) in the Delaware state, like its counterpart provisions in other corporation statutes, deals in general terms with the permissible contents of by-laws: a corporation's by-laws may contain any provision not inconsistent with law or with the corporation's certificate of incorporation "relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." Other sections of the statute explicitly contemplate the use of by-laws as vehicles by which to take specific actions. These including fixing the number and qualifications of directors, prescribing how officers shall be chosen and the terms of their offices, creating rights to indemnification, designating how the date and time of the annual shareholder meeting shall be determined, and designating authority to call special meetings of shareholders.[53] Other sections of the statute may be read to impose implicit limits on the potential scope of by-laws permitted by § 109(b) because they explicitly require that a matter be addressed in the corporation's certificate of incorporation. These include stating the business or purpose for which a corporation has been organised, requiring that action by shareholders be taken at a meeting in contrast to a written consent signed by holders of a majority of shares, and permitting removal of directors without a showing of cause when a board of directors has been classified.[54] One might, then, limit the scope of permissible by-laws under §109(b) to those matters that the statute elsewhere links to resolution through a by-law.[55] This carries the functional consequence that, although shareholders may adopt by-laws dealing with many procedural matters, they lack power to adopt by-laws that bind directors as to matters otherwise within the scope of the directors' general managerial authority.

[5.19] The sole reported case involving a shareholder-adopted by-law and a contested poison pill, *International Brotherhood of Teamsters General Fund v Fleming Cos*, held that shareholders in an Oklahoma corporation had power to adopt a by-law providing that the corporation may not adopt or maintain a poison pill without prior consent and that any pill presently in force must be redeemed.[56] The Teamsters apparently initiated the by-law campaign after 65% of Fleming's shares were voted in favor of a nonbinding resolution providing that the board should not adopt a poison pill without receiving prior assent from sharehold-

[52] *Id* at 605.

[53] See Del Code Ann, tit 8, §§ 141(a) (number of directors and qualifications of directors); 141(b) (manner of choosing officers and terms of office); 211(a) (date and time for annual meeting of shareholders); 141(d) (specifying person with authority to call special meeting of shareholders).

[54] See *id* §§ 102(a)(3) (nature of business or purposes to be conducted or promoted by corporation); 228(a) (action that may be taken at meeting of shareholders may be taken by signed consent unless otherwise provided in certificate of incorporation); 141(k) (shareholders may effect removal of directors on classified board only for cause unless certificate of incorporation provides otherwise).

[55] This is consistent with the limits on by-laws suggested in Hamermesh, *supra* note 17, at 480. The alternative is to specify functional limits, as is suggested in Coffee, *supra* note 51.

[56] (Okla 1999) 975 P2d 907.

ers.[57] Although the court notes that shareholders' role in corporate governance is "purposefully indirect," it locates a source of direct power for shareholders in cases and statutes that permit or require shareholders to approve the adoption of stock option plans, for example to cure the adoption of a plan by an interested board of directors. The court also notes that while some states have by statute expressly endorsed directors' authority unilaterally to adopt poison pills, Oklahoma has not done so.

Although Oklahoma's corporations statute bears close resemblance to Delaware's, the *Fleming* opinion should not be persuasive to a court applying Delaware law. For starters, the Delaware Supreme Court upheld directors' unilateral authority to adopt poison pills in the absence of an explicit conferral of specific statutory authority. Perhaps more important, the reasoning in *Fleming* is inconsistent with the implications of the analytic starting-point in many Delaware opinions, which is that the statute confers managerial authority on directors subject solely to restrictions imposed by the statute itself and corporation's certificate of incorporation. Amending the certificate is not an action shareholders may take unilaterally because the statute requires that a certificate amendment originate with a resolution adopted by directors.[58]

A comparative perspective on basic structural choices

[5.20] Viewed in somewhat broader perspective, these questions are inevitable consequences of basic structural features of the allocation of power as between a target's shareholders and its directors in the context of a hostile take-over. Delaware cases, most notably *Unocal Corp v Mesa Petroleum Co* in 1985, recognise that the target's directors are in a position of "inherent conflict" because they must, on the one hand, exercise business judgment to determine whether a pending takeover is in the best interests of the corporation and its shareholders while, on the other hand, facing temptations to act primarily in their own interests, for example to preserve their own positions.[59] As a consequence, these cases require directors to bear the burden of showing that they acted in good faith and on the basis of a reasonable investigation to respond to a perceived threat to the corporation. Directors must also be able to establish that the action taken was reasonable, proportionate to the perceived threat, and not "draconian."[60] If the target's directors make these threshold showings, the court does not further assess the merits of their decision and treats the decision

[57] See Coffee, *supra* note 51, at 605, n 2.

[58] Del Code Ann, tit 8, § 242(b)(1).

[59] See 493 A2d at 955.

[60] *Id* at 955-56. The court defined "draconian" in *Unitrin Inc v American General Corp* (Del 1995) 651 A2d 1361 at 1383-88 as a defensive measure that has the effect either of coercing shareholders or of precluding a proxy fight. If a defensive measure has neither effect, the court's focus is upon whether the measure falls within a range of reasonableness. *Id.* The standard of review shifts if a target's directors initiates a process to sell the corporation or that will lead to its break-up, or if sale or break-up otherwise becomes inevitable. The target's directors must then justify the actions they take against a criterion of maximising the value to be received by shareholders. See *Revlon, Inc v MacAndrews & Forbes Holdings, Inc* (Del 1986) 506 A2d 173 at 182. In contrast, *Unocal* explicitly permits the board to consider interests in addition to those of shareholders, including "creditors, customers, employees, and perhaps even the community generally. . . ." 493 A2d at 955.

as an exercise of the directors' business judgment. Conduct by target directors that does not satisfy these standards may culminate in a contract with a third party, typically an acquisition partner that is preferred by the target's directors. Contract rights acquired by the third party are unenforceable when they stem from breaches of fiduciary duty by the target's directors. Likewise, a third-party contract is invalid to the extend it purports to limit the target directors' fiduciary duties.[61]

Alternate structural choices are possible, of course, and it is illuminating to consider the system of take-over regulation in the United Kingdom in contrast to Delaware. The City Code on Mergers and Take-Overs, applicable to public companies, like Delaware allocates initial managerial control to a target's directors by requiring that an offer be put in the first instance to the offeree's board or to its advisers.[62] The board must obtain the advice of independent advisers[63] and must circulate its own assessment of the bid to the shareholders along with the substance of the advice it has received from its independent advisers.[64] Beyond that point, however, the City Code and Delaware diverge. Under the City Code, after a bona fide offer has been communicated to the board, or once the board has reason to believe that such an offer might be imminent, the board may not take action that could "effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits."[65] The target's directors may, however, take action that could frustrate a pending or imminent bid if they obtain the shareholders' approval, expressed through a resolution adopted by majority vote at a shareholders' meeting.[66] The Code's position is consistent with prior cases. For example, in *Hogg v Cramphorn*, in the face of a pending take-over bid, the target's directors issued a large block of shares to a trust created for the benefit of employees.[67] The court held that the

[61] See *Paramount Communications, Inc v QVC Network, Inc* (Del 1993) 637 A2d 34 at 51. In this case, the target's directors agreed to pay their preferred acquisition partner a termination fee of $100 million if another party acquired the target, as well as granting a put option to the preferred acquisition partner that entitled it to an amount of cash equal to difference between the purchase price as set by the deal and the market value of target's stock. The put option attained a value of around $500 million due to a hostile bid at a higher price. The court held that the preferred acquisition partner had not acquired enforceable contract rights because the option was part of an unreasonable and "draconian" defensive package. *Id.* The court also held that terms in the contract with the preferred merger partner, including a no-shop clause, were unenforceable because they purported to limit the target directors' ability to discharge their fiduciary duties. See *id.* See also *Revlon*, 506 A2d at 184 (affirming lower court's injunction prohibiting target from paying $25 million cancellation fee to preferred acquisition partner in face of hostile bid at higher price).

[62] City Code on Takeovers and Mergers, Rule 1.

[63] *Id*, Rule 3.1.

[64] *Id*, Rule 25.1.

[65] *Id*, General Principle 7.

[66] *Id*, General Principal 7.

[67] [1967] Ch 254. The directors also allocated 10 votes per share to the shares issued to the trust, which the court held to be without effect because the company's articles did not give the directors power to issue shares carrying more than one vote per share. It has been suggested that directors who fail to respect limits on their powers do not breach a fiduciary obligation. See Paul L Davies , *Gower's Principles of Modern Company Law* 605 (6th ed 1997). In contrast, a recent Delaware opinion holds that directors breached their fiduciary duties by

share issuance was voidable because the directors acted for an improper purpose but that the directors' action could be ratified by a majority of the pre-issuance shareholders.[68] [5.21] But the City Code does not leave directors bereft of defensive resources. The City Code rule itself does not reach measures taken by directors prior to the emergence or imminence of a concrete bid,[69] nor does it prohibit directors from informing shareholders that if they reject the bid, the directors will take a stated action, such as selling assets and distributing the proceeds to the shareholders. Finally, in submitting a proposed defensive measure to shareholders, directors have tactical advantages, including control over the corporation's proxy machinery and the date of the meeting.[70]
Despite these tactical advantages, target directors subject to the City Code lack unilateral power to the degree held by their counterparts in a Delaware corporation because the Code essentially requires transaction-specific approval of defenses by the target's shareholders once a hostile bid has been made or reasonably appears imminent. The need for shareholder approval operates as a constraining force on the defensive proposals that the directors of any particular target are likely to advance. The restraints imposed by the Code parallel the basic structural feature of UK company law that allocates to shareholders control over the corporation's constitution, including control over the definition of directors' powers. Nonetheless, the Code does not grant shareholders the interim powers of initiative and direction that would typify a principal in an agency relationship. The Code, like cases treating directors' actions as voidable, casts shareholders in a reactive role, one in which decisions and actions are necessarily confined by the action that directors propose to take, as opposed to the active and initiatory role entailed in drafting by-laws and other mandates that directors must implement.[71]
[5.22] In Australia, unlike the United Kingdom, the constraints on target directors continue to be derived from general limits on the fiduciary position held by directors. The significance of these limits has not been developed in case-by-case litigation comparable in extent to the Delaware material canvassed above.

awarding more shares to executives than were authorised by the terms of a plan approved by shareholders. See *Sanders v Wang* (Del Ch, Nov 8, 1999) 1999 WL 1044880 (holding that complaint stated claims for gross negligence, waste of corporate assets, and breach of fiduciary duty; plaintiff sought remedies including rescission, imposition of constructive trust, and damages for any losses incurred by corporation).

[68]When a the company held a shareholder meeting, the shareholders approved the share issuance. This led the court to dismiss the objecting shareholder's action.

[69]For a comprehensive treatment of pre-bid defensive measures, see *Weinberg and Blank on Takeovers and Mergers* at § 4-7063 to 4-7093 (Lawrence Rabinowitz, ed) (5th ed 2000).

[70]*Id* at § 4-7096.

[71]To similar but not identical effect, the Toronto Stock Exchange has a requirement for listing that compels the withdrawal of a poison pill unless shareholders approve within six months after the board adopts the pill. See Hamermesh, *supra* note 17, at 442 n 141; Toronto Stock Exchange Company Manual, Appendix G, in Victor P Alboini, *Securities Law and Practice* Vol 10 (1984 & 2000 Supp). This specific requirement is based on a broader stock exchange rule that gives the exchange discretion to require shareholder approval when a transaction "is of such a nature as to make shareholder approval desirable, having regard to the interests of the company's shareholders and the investing public." *Id* § 606(c).

To some degree, this may be the consequence of differences in the underlying corporations legislation imposing categorical limits on directors' authority; for example, a selective buy-back of shares requires shareholder approval, which it would not under the Delaware statute.[72] The fundamental principle is that directors may not use their discretionary powers for other than proper purposes. Whether directors acted for one purpose as opposed to another is a question of fact that turns on the directors' subjective beliefs about why they took a particular action.[73] However, a purpose that is proper does not become improper if it carries the incidental consequence of frustrating an imminent take-over bid. Thus, Australian cases uphold defensive transactions when directors can justify then by reference to the corporation's commercial interests.[74] Additionally, a corporation, acting though its directors, may have a legitimate interest in the identity of its shareholders and in the circumstances under which it may be able to raise capital in the future.[75] If, as would often be the case, directors act for multiple purposes, one of them improper, the question is whether the improper purpose dominated in that, had it not been present, the directors would not have acted as they did.[76]

Ratification and exoneration of directors

[5.23] The basic distinction developed in this paper is also relevant to understanding why corporate law, at least in the United States, imposes limits on extent to which shareholders may, by a majority vote, exonerate directors from claims of breach of duty. Although it is helpful to distinguish among types of claims that shareholders may assert, the lines of analytic demarcation tend to merge when directors take action that that affects control of a corporation. Consider first a claim that a transaction constituted a waste of the corporation's assets. This is a doctrine developed most fully in recent cases contesting the terms of executive compensation. As recently defined by the Delaware Supreme Court, "waste" occurs when directors "irrationally squander or give away corporate assets." A transaction does not constitute waste when the corporation receives any substantial consideration in exchange and "if there is a good faith judgment that in the circumstances the transaction is worthwhile...."[77] The dis-

[72] See Corporations Law Pt 2J.1; Ford, Austin & Ramsay, *supra* note 10, at 1173-82. Section 160(a) in the Delaware statute empowers a corporation to purchase or otherwise acquire its own securities. A corporation may not purchase or redeem its own shares when its capital is impaired or when the result of the transaction would be an impairment of capital. See Del Code Ann, tit 8, § 160(a)(1). The Delaware statute does not require a corporation to cancel or retire shares that it has repurchased, in contrast to the Australian requirement, see Ford, Austin & Ramsay, *supra* note 10, at 1177, but repurchased shares that the corporation holds are not entitled to vote and may not be counted for quorum purposes, see Del Code Ann, tit 8, § 160(c).

[73] See *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

[74] See, eg, *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 8 ACLR 199, 1 ACLC 1294.

[75] See *Darvall v North Sydney Brick & Tile Co* (1989) 16 NSWLR 260 (Ct App).

[76] See *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 at 294. As a consequence, "[t]here seems to be no escape for the tribunal of fact from the difficult task of deciding whether one of a number of purposes can be taken to have been more important than others in the minds of the directors." Ford, Austin & Ramsay, *supra* note 10, at 336.

[77] *Brehm v Eisner* (Del 2000) 746 A2d 244 at 263.

positive question is whether “no business person of ordinary, sound judgment could conclude that the corporation received adequate consideration.”[78] The vote of a majority of a corporation’s shareholders is not effective to ratify waste or to exonerate directors from claims arising from a wasteful transaction.[79] Only through a unanimous vote may shareholders ratify waste.[80] The rationale given for this position in *Lewis v Vogelstein* is that waste “constitutes a gift of corporate property and no one should be forced against their will to make a gift of their property.”[81]

What’s puzzling about this rationale is that the Delaware statute explicitly empowers corporations to make gifts of their property for stated purposes, a power that directors may exercise without shareholder assent unless the certificate of incorporation requires shareholder assent.[82] This puzzle can be resolved if scenarios that constitute waste are viewed as ones in which directors are no longer exercising authority on behalf of the corporation. Instead, directors who commit the corporation to a transaction that constitutes waste act as co-agents on behalf of a group of co-principals – the corporations’ shareholders– thus making the consent of each co-principal necessary. Thus, in *Lewis v Vogelstein*, quoted above, the court referred to “their” property, that belonging to shareholders. Similarly, shareholders are deemed to be co-principals (albeit not explicitly so) by the court’s resolution in *Sanders v Wang*, in which a corporation’s directors issued shares in excess of the number previously authorised by the shareholders in voting to approve the specifics of an executive compensation plan. The court held the that the unauthorised issuance constituted waste because the corporation received no consideration in exchange when it issued the additional shares.[83] By treating shareholders as co-principals, at least in this limited respect, the waste doctrine necessarily carves out an exception to the majoritarian rule otherwise applicable to shareholders’ decisions, an exception that is not satisfied even if the majority vote follows ample disclosure of information.[84]

[5.24] In contrast, Delaware cases recognise that the vote of a majority of a corporation’s shareholders may be effective to exonerate directors from claims of

[78] *Id.*

[79] See *Lewis v Vogelstein* (Del Ch 1997) 699 A2d 327 at 335.

[80] See *Saxe v Brady* (Del Ch 1962) 184 A2d 602 at 605.

[81] See *Lewis v Vogelstein* 699 A2d at 335-36.

[82] See Del Code Ann, tit 8, § 122(9)(providing that every corporation incorporated under statute shall have power to “[m]ake donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof”). See also Sarah Worthington, ‘Corporate Governance: Remedying and Ratifying Directors’ Breaches’, *LQR,* Vol 116, 2000, pp 638, 672 (noting that “[a] company can give away its assets, provided that the decision is taken for proper purposes and does not contradict any express restrictions in the company’s constitution. The company will be doing exactly this *whenever* it decides to exonerate its defaulting directors. . . . In principle a company ought to be able to exonerate its directors for *any* breach of fiduciary duties.”).

[83] (Del Ch, Nov 8, 1999) 1999 WL 1044880.

[84] But see *Harbor Fin Partners v Huizenga* (Del Ch 1999) 751 A2d 879 at 897-98 (arguing that waste doctrine is unnecessary to protect shareholders because “where disinterested shareholders are given the information necessary to decide whether a transaction is beneficial to the corporation or wasteful to it, I see little reason to leave the door open for a judicial reconsideration of the matter”).

negligence or gross negligence that result from a failure to use due care.[85] The shareholder vote will not have this effect unless it is informed.[86] Directors who act incompetently or carelessly still act on behalf of the corporation, making relevant the shareholders' power to act collectively by a majority vote.

The question of exoneration arises in the context of contested take-over transactions if a majority of a target's shareholders vote to approve a defensive transaction proposed by directors who arguably breached the duties outlined above.[87] Delaware cases decline to find that a shareholder vote exonerates the directors. The rationale is that permitting majority shareholder approval in this context would legitimate action by the board that coerces a minority of the shareholders into assenting to an unwelcome transaction, one perhaps "draconian" under the standards explored above.[88] It is relevant that the board itself is the author of the transaction in question and in a strategic position to shape how the transaction is presented to the shareholders for approval.[89] Analogously, a principal in a relationship of common-law agency is not bound by a ratification induced by an agent's misrepresentation or other conduct that would make a contract voidable, such as duress.[90] A minority of shareholders, likewise, should not be deprived of claims on the basis of the assent of a majority of shareholders when what is assented to is itself coercive of shareholder decision-making or preclusive of the effective exercise of the voting franchise to elect new directors.

Other considerations

[5.25] Thus far the analysis in this paper has not ventured beyond the analytic precincts defined by statutory language and structures, common-law doctrines, and settled precedent. One reason for caution in venturing beyond these formal confines is that several key empirical questions remain unanswered, making it difficult to assess what consequences might follow were shareholders to be empowered to adopt by-laws regulating the adoption of poison pills or instructing directors to redeem them. For example, it is open to active dispute whether on balance shareholders are injured by the adoption of poison pills. With the exception of one early event study that identified a relatively small negative effect on shareholder wealth when directors adopted a poison pill, most studies have

[85]See, eg, *Smith v VanGorkom* (Del 1985) 488 A2d 858 at 889.

[86]See *id.*

[87]See *In re Santa Fe Pac Corp Shareholder Litig* (Del 1995) 669 A2d 59 at 68; cf *In re Wheelabrator Techs Shareholder Litig* (Del Ch 1995) 663 A2d 1194 at 1202-03 (explaining that operative effect of shareholder approval is either to shift the burden to the plaintiff of establishing that a transaction was not entirely fair or to shift the standard of review to whether directors exercised business judgment; under Delaware cases shareholder approval exonerated directors only against claims of failure to exercise due care prior to committing corporation to a transaction, or claims that directors took action that exceeded their authority when the action taken is not ultra vires, wasteful, or fraudulent).

[88]See 669 A2d at 68.

[89]Cf. *Sanders v Wang* 1999 WL 1044880, at *9 (relevant that board occupied a fiduciary role as "arbiter of the processes" by which executive compensation plans originated and were presented to shareholders for approval; court holds shareholders should not be understood to have read into plan an adjustment mechanism to increase the number of shares that could be awarded as a consequence of subsequent share splits when prior plans contained such mechanisms, as did another feature of the contested plan).

[90]See Restatement Third, Agency § 4.02(a).

not found any significant effect.[91] Moreover, the methodology of these event studies has been challenged because their focus on the moment when directors adopt a poison pill does not adequately reflect the reality that directors may adopt a pill at any time, even after a hostile bid emerges.[92] Perhaps reflecting this unsettled state of knowledge, it is rare for corporations' certificates of incorporation to contain provisions restricting directors' ability to adopt a poison pill unilaterally.[93]

It is also difficult to assess what the practical impact might be were shareholders to be more generously empowered to adopt by-laws. Topics other than poison pills — such as executive compensation and the selection and retention of a corporation's CEO — might prove attractive subjects for by-law action, necessitating definitional battles over the proper province for a by-law. Nor are a corporation's shareholders identical in their preferences. Some may have extramural interests more important than their interests as investors that could motivate proposals for corporate action via by-law.[94] More generally, it is troubling that a generous reading of the by-law power could position shareholders to exercise power without responsibility for the consequences. Indeed, when the composition of the shareholding body is in flux, responsibility would be elusive. Troublesome consequences may also follow for the accountability of directors within such a regime. It is also noteworthy that commentators who identify flaws in shareholder voting when its purpose is the election of directors appear sanguine that comparable flaws would not afflict the process through which a by-law would be formulated and voted upon by shareholders.[95] Finally, it is open to question whether and how frequently the shareholders of a corporation that has a poison pill in place are better served by retaining discretion in the board as opposed to mandating that the pill be redeemed at a particular time. Mandating redemption could foreclose the possibility of a subsequent deal on better terms than the bid that prompted the mandate to redeem the pill.[96] On the other hand, directors' ability to adopt a pill free of the prospect of any countermand from shareholders may deter initial bids that would otherwise be made.

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[91] See Coates, *supra* note 37, at 280-86.

[92] *Id* at 286-91.

[93] *Id* at 289.

[94] Some commentators note that shareholders themselves may present "agency problems" in relationship to other shareholders. See, eg, Coffee, *supra* note 51, at 619 (characterising as "destabilizing" the appearance of labor unions as activist shareholders, and noting that some unions with token investments have used shareholder activism as a tactic in a collective bargaining process); Coates, *supra* note 37, at 334, n 253 (noting relatively poor investment performance of large public pension fund known to oppose defensive tactics against hostile take-overs).

[95] See Gordon, *supra* note 17, at 528 (noting that "cognitive assumptions are contradictory" and commenting that "[i]f shareholders are prone to mistakes in evaluating a hostile bid, why are they suddenly wiser in deciding how to vote in the related proxy battle presenting the same issue?") and 551 ("in giving shareholders the right to choose the residual governance regime, we should not assume that shareholders will respond in economically irrational ways.").

[96] In *Blasius*, the court hypothesises a comparable scenario as a circumstance that could even justify an issuance of shares that would dilute a majority block already acquired by an initial bidder. See 564 A2d at 662 n 5.

Conclusion

[5.26] In many respects, the formal structure of corporate law and the mechanisms it creates are incompatible with arguments that rely heavily on an analogy to simple relationships of common- law agency. Agency explained more about the relationship between shareholders and directors in an earlier era but that relationship proved incompatible with conducting large-scale enterprises through the corporate form. The solution, achieved in the United States through statutes that define the powers of shareholders and directors, in turn makes it plausible to attempt to resolve boundary disputes among powers by reference to the statute, which leaves little room for arguments grounded in simple agency concepts. Corporate-law systems in the United Kingdom and Australia systematically strengthen the hand dealt to shareholders but do not confer on shareholders the powers of principals in a relationship of common-law agency. The shareholder-friendlier structure of takeover regulation in the United Kingdom limits directors' authority to take defensive measures against unwelcome bids by requiring a shareholder vote to approve measures that directors propose to take but does not empower shareholders to give advance instructions to directors.