I Told You So

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I. INTRODUCTION

I am informed by my betters, of whom there are many, that it is unseemly to say "I told you so."

But, I told you so.

Back in 1988, a mere quarter of a century ago, when Delaware's legislature was debating the merits of Section 203, and while I had the privilege of serving as a Commissioner of the United States Securities and Exchange Commission, I wrote a series of three letters to the Corporate Law Section of the Delaware State Bar Association.[1] All three letters sought to make a single, simple point: Section 203's exemption threshold that was originally proposed be set at 90%, and that was later reduced to 85%, was far too high. Based on the empirical data available as of 1988, it was highly improbable that bidders would, in any material number of cases, be able to

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[1]Letter from Joseph A. Grundfest, Commissioner, United States Securities and Exchange Commission, to David B. Brown, Esq., Secretary, Council of the Corporation Law Section of the Delaware State Bar Association (Dec. 10, 1987) (on file with author) [hereinafter "December 10 Letter"]; Letter from Joseph A. Grundfest, Commissioner, United States Securities and Exchange Commission, to David B. Brown, Esq., Secretary, Council of the Corporation Law Section of the Delaware State Bar Association (Dec. 18, 1987) (on file with author) [hereinafter "December 18 Letter"]; Letter from Joseph A. Grundfest, Commissioner, United States Securities and Exchange Commission, to David B. Brown, Esq., Secretary, Council of the Corporation Law Section of the Delaware State Bar Association (Dec. 22, 1987) (on file with author) [hereinafter "December 22 Letter"].

achieve those thresholds. A more realistic, though still ambitious threshold might, I suggested, be set at 75%.

Professor Subramanian's important article[2] picks up the story from 1988 and makes the point that Section 203's exemptive threshold has indeed been set at a level that has made it impossible for any transaction to qualify. He ably documents that "between 1990 and 2010, not a single bidder was able to achieve the 85% threshold required by Section 203."[3] He also documents that the empirical evidence on which courts have previously relied in judging the constitutionality of Section 203 is fatally flawed, and that when subject to careful examination actually underscores the historic impossibility of achieving Section 203's 85% exemption threshold. From these observations, Professor Subramanian argues that Section 203 could well be unconstitutional[4] and suggests that to avoid such a finding, Delaware consider amending Section 203 to lower the exemptive threshold to 70%.[5]

In commenting on Professor Subramanian's insightful analysis, I will initially take a historical perspective and then follow that up with a *realpolitik* analysis of the policy implications that follow from the data. As readers will observe, my conclusion is that even if Professor Subramanian's empirical analysis is precisely correct, as I believe it is, the probability that Delaware will *sua sponte* amend Section 203 is quite low, and the probability that courts will rule Section 203 to be unconstitutional is subject to a set of legal judgments that are difficult to predict on the current record.

II. THE LOGIC OF AN ENABLING PROVISION

In 1988, my primary objection to Section 203 was not based on the empirical debate over the percentage of votes cast that should trigger Section 203's exemption. It was instead over the statute's mandatory nature. I observed that many of the concerns over Section 203's effects "would be ameliorated if the statute is recast as an enabling provision that allows stockholders, acting by majority vote, the opportunity to elect to be governed by the provisions of proposed Section 203."[6]

As I explained, "If managements desire protections equivalent to Section 203, but have not sought to adopt them through the charter amendment process because they expect that stockholders would reject such

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[2]Guhan Subramanian, *Delaware's Choice*, 39 DEL. J. CORP. L. 1 (2014).
[3]*Id.* at 22.
[4]*Id.* at 21-31.
[5]*Id.* at 45.
[6]December 10 Letter, *supra* note 1, at 2.

proposals, then legislation would impose upon stockholders a restriction that they would not voluntarily adopt. Such an approach is inconsistent with Delaware's traditional reliance on an enabling approach that looks to stockholder ratification as an important safeguard in the decision to delegate authority to management."[7]

The salience of this observation regarding the value of an enabling approach is underscored by Delaware's recent, and very different, approach to the proxy access debate. Section 112 of the Delaware General Corporation Law, adopted in 2009, states that "[t]he bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required . . . to include in its proxy solicitation materials . . . in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder"[8] subject to conditions defining the eligibility of the nominee and of the nominating stockholders. Note that the legislature neither mandated nor prohibited proxy access. Instead, it simply made clear that bylaws could include provisions allowing for proxy access. Further, because Delaware law provides authority for stockholders to propose and vote on bylaw provisions on their own initiative, without the requirement of prior board approval,[9] a majority of a corporation's stockholders has the ability to act on its own to implement a proxy access regime even over the unanimous objection of the corporation's board.

Why such a difference in the approach that the Delaware legislature took to Section 203 and to Section 112? The answer lies neither in logic or principle. It lies in politics, and that fact should neither surprise nor disappoint anyone involved in the takeover debate.

Legislation is a political process, and each provision of the Delaware General Corporation Law can be viewed as the result of a decision that was politically optimal as of the time that it was made, and that remains politically optimal for as long as the provision is not repealed. If a large number of these political decisions happen to be consistent with an enabling philosophy of corporate law, we should not delude ourselves into believing that these provisions were adopted because they reflect an enabling philosophy of corporate law. That is not the direction of the causality. Instead, the *realpolitik* of the matter is that the enabling philosophy was the

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[7] *Id.* at 6.

[8] DEL. CODE ANN. tit. 8, § 112 (2011).

[9] *Id.* § 109(a) ("After a corporation other than a nonstock corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote.").

politically optimal approach for Delaware to adopt and maintain for a large portion of its corporation code, but not for all of the code.

Whenever it is politically optimal for Delaware to diverge from an enabling approach to corporate law, it will do so. Section 203 was an example of just such an instance. The political pressure of corporate managements at the time to respond to the threat of takeovers was sufficiently powerful that Section 203 could be proposed and adopted as a mandatory provision that could be imposed over the potential objection even of a large super-majority of the corporation's stockholder base. To be sure, Section 203 allows for corporations to amend their charters so as to opt out of its strictures,[10] but the charter amendment process requires an affirmative vote of the corporation's board followed by a stockholder vote.[11] A management that wants to abandon Section 203's protections is thus perfectly free to do so, but no amount of stockholder support for opting out of Section 203 can force a management to opt out. Instead, stockholders would have to mount a proxy contest to change the board, or assert other forms of pressure through "just vote no" campaigns in order to persuade the board to decide to make such a change.[12]

To the best of my knowledge, stockholders have yet to mount campaigns designed to persuade boards to opt out of Section 203. This state of affairs is in stark contrast to the large-scale efforts to persuade boards to de-stagger[13] and to abandon poison pills.[14] It is entirely possible that, as the governance debate evolves, and as stockholders come to recognize that Section 203 can act as a binding constraint once a pill is no longer in place, an increased amount of activism will revolve around proposal to opt out of

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[10] *Id.* § 203(b)(3).

[11] *Id.* § 242(b)(1).

[12] Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 903-08 (1993).

[13] "Among the S&P 500, staggered board incidence has gone from 60% in 2002 to 18% by 2012." Subramanian, *supra* note 2, at 2.

[14] *Id.* at 5 ("88% of S&P 1500 companies do not currently have pills, and in recent years 59% of companies without pills have not put them in when a bid is brought."); *see also id.* at 31-38 (discussing the decline of the pill); Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics* 2 (University of Penn., Institute for Law & Econ Research Paper No. 14-6, 2014) ("One of the most common shareholder proposals asks boards to redeem a poison pill or to submit it to a shareholder vote."); Mark D. Gerstein, Bradley C. Faris & Christopher R. Drewry, *The Resilient Rights Plan: Recent Poison Pill Developments and Trends*, at 3 (Apr. 2011), *available at* http://webcache.googleusercontent.com/search?q=cache:guxcFIJ2ZrUJ:www.lw.com/thoughtLeadership/recent-poison-pill-developments-trends-april2011+&cd=1&hl=en&ct=clnk&gl=us&client=firefox-a ("[A]n increase in the number, and success of, shareholder proposals to redeem rights plans . . . .").

Section 203, or to adopt provisions that provide for lower exemption thresholds.

III. THE EMPIRICAL DEBATE AS OF 1988

Once it is clear that Section 203 is, at its root, a political response to a political demand, it becomes equally clear that an exception based on a threshold that could be reasonably obtained in a material number of takeover battles would not constitute a politically attractive alternative for the legislature precisely because it would leave a material number of managements vulnerable to hostile takeover attacks. Indeed, all other factors equal, the stronger the opposition to any given management team, the more likely it is that a reasonable exemption target could be reached. Accordingly, the strongest support for a high, and effectively unobtainable exemption trigger would rationally emanate from the managements most threatened by the prospect of a takeover, and they would rationally lobby for a mandatory version of Section 203 with an exception trigger set so high that it could never be invoked. And that is precisely what happened.

As I explained at the time, a "comprehensive examination by the SEC's Office of the Chief Economist of all hostile offers between 1982 and 1987 (144 offers) has found not a single case in which a hostile bidder received over 90% of the outstanding shares."[15] This observation then stimulated a debate over the probability that hostile bids would, in the future, be able to reach the 90% threshold. In response to this debate I submitted further evidence documenting: (1) the distribution of blocking coalitions held by managements and boards at various threshold exemption levels; (2) the percentage of stockholders who tend to be non-responsive and who therefore effectively constitute a blocking coalition preventing a hostile bid from reaching the exemption's trigger level; and (3) management's ability to place shares in friendly hands so as to prevent a hostile bid from reaching the exemption's trigger level.[16]

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[15]December 10 Letter, *supra* note 1, at 7-8.

[16]December 18 Letter, *supra* note 1, at 2-9. I also observed that "[t]here are objective data that can help the Legislature determine the appropriate parameters of such an exemption, but to the best of my knowledge these data have not as yet been gathered and analyzed in a forum that is directly responsive to issues posed [in] the pending legislation." Testimony of Joseph Grundfest, SEC Commissioner, before Delaware General Assembly House and Senate Judiciary Committees (Jan. 20-21, 1988), *reprinted in* LAWRENCE A. HAMERMESH & R. FRANKLIN BALOTTI, THE NEW DELAWARE TAKEOVER STATUTE 144 (1988). I also offered to have the SEC collect additional relevant data within two months but in the rush to pass something this offer was never taken up by the Delaware legislature. *See* INVESTOR RESPONSIBILITY RESEARCH CENTER, STATE TAKEOVER LAWS (2003), at Delaware-6.

There was, in my view, substantial empirical evidence to support the prediction that Section 203's exemption triggers, initially proposed at 90% and enacted at 85%, would rarely if ever be reached. Professor Subramanian's article documents the accuracy of that prediction.

IV. THE EMPIRICAL DEBATE AS OF 2014

As Professor Subramanian ably demonstrates, "between 1990 and 2010, not a single bidder was able to achieve the 85% threshold required by Section 203."[17] Not to dwell on the point, but at the same time that I reserve the right to whisper, "I told you so," I might also whisper "and what did you expect?" The fact that not a single bidder was able to achieve the 85% threshold over a span of two decades demonstrates that the legislation worked perfectly as planned, given the political forces that animated its adoption. Indeed, it demonstrates the political skill of the drafters in initially proposing a 90% threshold that, in a display of apparent (but not necessarily real) reasonableness, could be dropped to 85% without adversely affecting the legislation's deterrent effect one whit.

Indeed, as Professor Subramanian points out, the evidence that federal courts have relied upon to conclude that the 85% exemption provides bidders with a "meaningful opportunity for success" and therefore does not make Section 203 vulnerable to Constitutional challenge as inconsistent with the Williams Act "was seriously flawed—so flawed, in fact, that even this original evidence supports the opposite conclusion: that Section 203 did not give bidders a meaningful opportunity for success."[18] The careful case-by-case examination conducted by Professor Subramanian demonstrates that, of the seventeen instances in which expert testimony asserted that bidders were able to achieve the 85% threshold, none actually fit the standard. In five cases the bidders held more than 15% of the outstanding equity at the time of the offer, which would have disqualified them from taking advantage of the 85% exemption; in two cases the bids were competing offers, again disqualifying them from the 85% exemption; four bids were friendly from initiation; three were approved by the target board before the bidder reached the 85% threshold; and in three instances the target boards were "formally neutral or passive on the offer, and so these bids were also not hostile in the traditional sense."[19] Thus, the data presented to the court showed not a single instance in which a hostile bidder overcame the 85% threshold test.

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[17] Subramanian, *supra* note 2, at 4.

[18] *Id.* at 29.

[19] *Id.* at 24 (quoting Guhan Subramanian, Steven Herscovici & Brian Barbetta, *Is*

V. WILL DELAWARE AMEND SECTION 203 AS A "SELF-HELP" REMEDY?

Professor Subramanian suggests that "instead of waiting for a constitutional challenge, Delaware could engage in self-help by amending Section 203 in ways that would put the statute on firmer constitutional footing."[20] To achieve this form of self-help, Professor Subramanian suggests that the 85% threshold be reduced to 70%, a level that, according to his data, would have allowed 12% of post 1989 bidders to avoid Section 203's strictures.[21] Professor Subramanian also suggests refinements to the calculation of the denominator in the calculation,[22] and clarifications as to the time period during which Section 203 might apply.[23]

While, as a matter of public policy, I might be eager to support each of these proposal, the probability that Delaware will act of its own initiative to amend Section 203 in light of an amorphous threat of an uncertain judgment that Section 203 is unconstitutional is, as a practical matter, vanishingly small. Viewed most generously from Professor Subramanian's perspective, even if legislators agreed that there is a material risk that the provision is unconstitutional, they might argue that it makes no sense to try to guess how to amend the provision in order to render it constitutional. The prudent measure from this perspective would be to await a final judgment that would give the legislature clarity as to remedial measures required to save the provision from constitutional doom. More aggressively, it is easy to see the majority of the legislature arguing that, even if the facts presented by Professor Subramanian are correct, it is far from clear that Section 203 is unconstitutional. The proper step would be litigating the provision's validity and respond when, as, and if necessary to any court's final judgment.

In any event, there is no observable political pressure to amend Section 203. Isaac Newton's First Law of Motion, suggesting that a body at rest will stay at rest until an external force acts on it[24] is just as accurate in the political world as it is in the world of physics. There is simply no force at work strong enough to dislodge the current equilibrium before the Delaware legislature, and the threat of such a force is unlikely to be effective in this context. In Newtonian mechanics, it takes an actual external force,

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Delaware's Antitakeover Statute Unconstitutional? Further Analysis and a Reply to Symposium Participants, 65 BUS. LAW. 799, 803-05 (2010)).

[20] *Id.* at 42.

[21] *Id.*

[22] *Id.* at 42-45.

[23] *Id.* at 44-45.

[24] SIR ISAAC NEWTON & JOHN MACHIN, THE MATHEMATICAL PRINCIPLES OF NATURAL PHILOSOPHY 19 (1729) ("Every body perseveres in its state of rest, or of uniform motion in a right line, unless it is compelled to change that state by forces impress'd thereon.").

like a judicial determination, to move the body from a state of rest, and a threat of an external force will not suffice. The same law holds true here, I would suggest. This then brings us to the ultimate question:

VI. IS SECTION 203 CONSTITUTIONAL?

As described by Professor Subramanian, Section 203 is constitutionally infirm because "under the Supremacy Clause, state laws cannot 'frustrate the purpose' of federal law; and the Williams Act passed by the U.S. Congress in 1968, provided disclosure and procedural requirements that were intended to 'place[ ] investors on an equal footing with the takeover bidder.'[25] A state antitakeover law that tilted the playing field too far toward target companies risked 'frustrating the purpose' of the Williams Act, thereby running afoul of the Supremacy Clause of the U.S. Constitution."[26] Section 203, with an exemption that has never been achieved in a quarter of a century, arguably tilts the balance too far and is thus vulnerable to Constitutional challenge.

The constitutionality of Section 203 was, however, last litigated in three cases decided in 1988.[27] Much water has flowed over the dam and under the bridge since those cases were decided. To be sure, Shapiro and Shapiro conclude that Section 203 "would be declared unconstitutional . . . if Professor Subramanian's factual findings were presented today."[28] But as they themselves recognize, this conclusion cannot rest on the firmest of foundations. To the extent that any such reasoning relies on the U.S. Supreme Court's decision in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), invalidating an Illinois takeover statute, Shapiro and Shapiro recognize that the court's decision there was "a plurality opinion based on federal preemption and a concurring opinion based on a medley of commerce clause rationales."[29] Moreover, to the extent that the Court's decision in *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987), upholding Indiana's "second generation" takeover statute, enters the analysis, Shapiro and Shapiro concede that CTS takes no position with regard to Edgar's preemption

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[25] Subramanian, *supra* note 2, at 21.

[26] *Id.*

[27] *See* BNS Inc. v. Koppers Co., 683 F. Supp. 458 (D. Del. 1988); RP Acquisition Corp. v. Staley Cont'l, Inc., 686 F. Supp. 476 (D. Del. 1988); City Capital Assocs. Ltd. P'ship v. Interco Inc., 696 F. Supp. 1551 (D. Del. 1988); *see also* Subramanian, *supra* note 2, at 22-23 (discussing cases).

[28] Stephen M. Shapiro & Dorothy H. Shapiro, Commentary, *Time to Amend the Delaware Takeover Law*, 39 DEL. J. CORP. L. 77, 78 (2014).

[29] *Id.*

analysis, and simply "distinguished *Edgar* and based the majority opinion on general commerce clause principles."[30]

It is far from clear that either of these two cases would be identically decided if presented to the Supreme Court today. The composition of the Supreme Court has changed dramatically,[31] as has its view of the relationship between the federal government and the states across a broad range of regulatory matters.[32] The Court's views regarding pre-emption have also evolved, [33] as has the court's views regarding the Commerce Clause.[34] Thus,

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[30] *Id.*

[31] Today, the Supreme Court is composed of the following nine justices: Elena Kagan, Sonia Sotomayor, Samuel Alito, John Roberts, Stephen Breyer, Ruth Bader Ginsburg, Clarence Thomas, Anthony Kennedy, and Antonin Scalia. Only two of the current Supreme Court justices, Anthony Kennedy and Antonin Scalia, were also serving in 1988. The 1988 Court was otherwise composed of the following seven justices: Sandra Day O'Connor, William Rehnquist, Harry Blackmun, Thurgood Marshall, John Paul Stevens, Byron White, and William Brennan, Jr. *See Members of the Supreme Court of the United States*, SUPREMECOURT.GOV, http://www.supremecourt.gov/about/members.aspx (last visited March 10, 2014).

[32] *See* Benjamin Beiter, *Beyond Medellín: Reconsidering Federalism Limits on the Treaty Power,* 85 NOTRE DAME L. REV. 1163, 1171 (2010) ("In the past two decades, the Supreme Court has shown a renewed interest in judicial enforcement of federalism limits, striking down laws for exceeding the enumerated powers of Congress for the first time since the New Deal. In *United States v. Lopez*, [514 U.S. 549 (1995)], the Court struck down the Gun-Free School Zones Act for not having sufficient relation to interstate commerce. Following the *Lopez* analysis, United States v. Morrison [529 U.S. 598 (2000)] invalidated provisions of the Violence Against Women Act, making clear that courts would defer less to legislative findings when the regulated activities were within the traditional police powers of the state."); Blake Hudson, *Climate Change, Forests, and Federalism: Seeing the Treaty for the Trees*, 82 U. COLO. L. REV. 363, 407-08 (2011) ("The new federalism that arose in the 1990s included a number of cases where the Supreme Court, for the first time since 1937, limited the scope of Congress's domestic powers and correlatively protected states' rights and the traditional subjects of state regulatory authority under the Tenth Amendment. The Supreme Court invoked federalism principles to strike down federal statutes in *New York v. United States*, [505 U.S. 144 (1992)], *United States v. Lopez*, [514 U.S. 549 (1995)], *City of Boerne v. Flores*, [521 U.S. 507 (1997)], *Printz v. United States*, [521 U.S. 898 (1997)] and United States v. Morrison[, 529 U.S. 598 (2000)].").

[33] *See* William W. Buzbee, *Does the Earth Belong to the Living? Property and Environmental Law Perspectives on the Rights of Future Generations*, 77 GEO. WASH. L. REV. 1521, 1572 (2009) (discussing "recent Supreme Court federalism precedents that erect presumptions against federal laws impinging on areas of traditional state regulation."); Christina Ma, *Hybridizing Federal and State Regulation of Clean Taxis Introduction*, 42 ENVTL. L. REP. NEWS & ANALYSIS 10840, 10840-41 (2012) ("[A] line of cases involved the Supreme Court's decisions in *Altria Group Inc. v. Good*[, 129 S. Ct. 538 (2008)] and *Wyeth v. Levine*, [129 S. Ct. 1187 (2009)] which, when taken together, evidenced a shift in the Court's preemption doctrine analysis. Under this shifted preemption framework, the Court emphasizes the importance of congressional intent rather than agency interpretation, and of the need to invoke a presumption against preemption, particularly in areas of traditional state police power.").

[34] *See* Oona A. Hathaway et. al, *The Treaty Power: Its History, Scope, And Limits*, 98 CORNELL L. REV. 239, 262 (2013) ("In the last twenty years, the Supreme Court has, for the first time since the New Deal, held that legislation exceeded the scope of the federal government's

even if one agrees whole-heartedly with Professor Subramanian's empirical analysis, it does not follow that courts sitting in judgment on the matter today would easily and inevitably conclude that Section 203 is unconstitutional because it does not allow bidders a "meaningful opportunity for success."

Indeed, Professor Subramanian recognizes that the question of Section 203's constitutionality is "not settled law."[35] There is a horse race to be run here, and as recent history suggests, it can be difficult to anticipate how the federal courts might decide these cases, if and when the question is presented.

VII. CONCLUSION

The facts are, in my view, quite clear, and Professor Subramanian's analysis marshals them with precision and vigor. Section 203 is a real impediment to takeover activity, and the binding force of that impediment can only become more apparent as the effectiveness of the poison pill declines. But this is, as I have suggested, precisely the outcome desired by the legislature. As to whether that impediment rises to the level of a constitutional infirmity, I express no view and recognize that learned counsel can, in good faith, express competing perspectives as to how that question might be resolved on the current record. As to whether Delaware will adopt a "self-help" strategy and amend Section 203 in order to address potential constitutional infirmities, I think the probability is low that any such action will be taken. The reality is that if Section 203 is to be amended, there will likely have to be litigation challenging the provision's constitutionality. Only if a court rules that the provision is in fact unconstitutional will Delaware's legislature have an incentive to amend Section 203 as best it can. The shape of any such amendment will, moreover, likely be contingent on the analysis

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authority under the Commerce Clause"); James R. May, *Healthcare, Environmental Law, and the Supreme Court: An Analysis Under the Commerce, Necessary and Proper, and Tax and Spending Clauses*, 43 ENVTL. L. 233, 248 (2013) ("[T]he Court's evolving heightened-scrutiny Commerce Clause jurisprudence"); Lainie Rutkow & Jon S. Vernick, *The U.S. Constitution's Commerce Clause, the Supreme Court, and Public Health*, 126 PUB. HEALTH REP. 750, 751-52 (Sept.-Oct. 2011) (recognizing general trend of Supreme Court decisions limiting federal authority to regulate under the auspices of the Commerce Clause); *see also* Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2587 (2012) ("Construing the Commerce Clause to permit Congress to regulate individuals precisely *because* they are doing nothing would open a new and potentially vast domain to congressional authority. . . . Allowing Congress to justify federal regulation by pointing to the effect of inaction on commerce would bring countless decisions an individual could *potentially* make within the scope of federal regulation, and—under the Government's theory—empower Congress to make those decisions for him." (emphasis in original)).

[35]Subramanian, *supra* note 2, at 47.

that leads to the finding of unconstitutionality. Further, because any such finding could well be far in the future, and because the political environment at that indeterminate future time is impossible to predict, any current legislature could easily conclude that the prudent step is simply to wait and see how this issue plays out in the courts.

So, now we wait to see how this issue plays out in the courts.