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Selectica Resets the Trigger on the Poison Pill: Where Should the Delaware Courts Go Next?†

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INTRODUCTION

Since their invention in 1982, shareholder rights plans have been the subject of intense controversy.¹ Rights plans, or as they are known more pejoratively “poison pills,” enable a target board to “poison” a takeover attempt by making it prohibitively expensive for a bidder to acquire more than a certain percentage of

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1. The first poison pill was developed by Martin Lipton in 1982 in his defense of The El Paso Company from a hostile bid. Len Costa, *The Perfect Pill: A Small Innovation that Transformed Corporate Takeovers*, LEGAL AFF. (Mar./Apr. 2005), available at http://www.legalaffairs.org/issues/March-April-2005/toa_costa_marapr05.msp; see also Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 505–06 (1993).

the target company's stock (until recently 15–20%).² The poison pill can be put in place by the target's board without shareholder approval and can be revoked solely at the discretion of the board.³ Not surprisingly, some commentators view rights plans as choking off the market for corporate control and impermissibly shifting power from shareholders to directors.⁴ In some jurisdictions, such as the United Kingdom, shareholder rights plans are unlawful.⁵

As the epicenter of American corporate law, the tiny state of Delaware, however, has long viewed rights plans as a useful bargaining device for well-intentioned boards of directors. For the past twenty-five years, the Delaware courts have considered the legitimacy of the creation and deployment of shareholder rights plans. The foundational cases for this inquiry began with the Delaware Supreme Court's decisions in *Moran v. Household International, Inc.*,⁶ which upheld the creation of the rights plan, and *Unocal v. Mesa Petroleum Co.*,⁷ which decided that a board's use of the shareholder rights plan is subject to judicial review.⁸ The Delaware Supreme Court later added an additional gloss to these decisions in *Unitrin v. American General*,⁹ where it held that "preclusive"¹⁰ and "coercive"¹¹ defensive tactics were invalid, while other defensive tactics are reviewed to determine if they fall within the "range of reasonableness."¹² However, no one doubts that poison pills are fatal and no acquirer in more than thirty-five years has dared to swallow one.¹³

2. MEREDITH M. BROWN, RALPH C. FERRARA, PAUL S. BIRD, GARY W. KUBEK & WILLIAM D. REGNER, *TAKEOVERS: A STRATEGIC GUIDE TO MERGERS AND ACQUISITIONS* 16-41 (2d ed. 2009).

3. *Id.* at 16-40.3.

4. FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) (arguing against permitting target board management from using defensive tactics against proposed takeovers).

5. For a discussion of the international debate over the appropriate place of poison pills as takeover defenses, see Jennifer G. Hill, *Takeovers, Poison Pills and Protectionism in Comparative Corporate Governance* (European Corp. Governance Inst., Working Paper No. 168/2010, 2010).

6. 500 A.2d 1346 (Del. 1985).

7. 493 A.2d 946 (Del. 1985).

8. *Id.* at 954.

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

10. In *Versata Enterprises v. Selectica, Inc.*, the Delaware Supreme Court explained that "[a] defensive measure is preclusive where it 'makes a bidder's ability to wage a successful proxy contest and gain control' . . . 'realistically unattainable.'" 5 A.3d 586, 601 (Del. 2010). Rights plans are generally subjected to scrutiny as potentially preclusive defensive measures. *See id.*

11. "A coercive response is one that is 'aimed at "cramming down" on its shareholders a management-sponsored alternative.'" *Selectica*, 5 A.3d at 601 (quoting *Unitrin*, 651 A.2d at 1387). In this Article, we are not concerned with coercive defensive tactics. They constitute a very limited, specific set of defenses that are initiated by management, such as restructurings. In this Article, we focus on the more widely used tactics, such as rights plans and classified boards.

12. *Unitrin*, 651 A.2d at 1388.

13. Sir James Goldsmith was the last bidder to swallow the poison pill. *See* Mike Tharp, *Goldsmith Wins Fight for Crown Zellerbach Corp.—Agreement Gives Financier Control of*

Since 1985, the Delaware courts have had numerous opportunities to consider many facets of rights plans. In these cases, the Delaware judges have struck down some new variations of the poison pill as entrenchment mechanisms,¹⁴ but generally, they have approved traditional rights plans as useful bargaining devices for well-intentioned boards of directors.¹⁵ Most recently, in *Air Products and Chemicals, Inc. v. Airgas, Inc.*, Chancellor Chandler, in a thoughtful and lengthy analysis of Delaware precedent, found that that state's current jurisprudence permits rights plans to preclude tender offers.¹⁶ As a result, the only avenue for hostile bidders to succeed in their efforts to acquire target companies is by using a proxy contest for corporate control as the vehicle for removing resistant directors, and thereby obtaining the power to redeem the poison pill and close their tender offers.¹⁷ This makes it crucial to determine how far incumbents can go in tilting the voting playing field.

Rights plans' impact on proxy contests has been the subject of many judicial decisions. Initially, the courts carefully scrutinized the earliest versions of the rights plan.¹⁸ *Moran* blessed a rights plan with a 20% "flip-over" trigger on dissident stock ownership rights,¹⁹ which quickly led to the widespread proliferation of pills with similar trigger levels.²⁰ In the key passage of the decision, the *Moran* court

Firm's Board, Names Him Chairman, WALL ST. J., July 26, 1985, at 1.

14. See *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1182, 1198 (Del. Ch. 1998) (invalidating dead hand pill that can only be redeemed by directors in office when the rights become exercisable); *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 52 (Del. Ch. 1998), *aff'd on other grounds*, 721 A.2d 1281 (Del. 1998) (invalidating no hand pill that can only be redeemed six months after acquiring company's new directors take office).

15. See, e.g., *Stahl v. Apple Bancorp, Inc.*, No. 11510, 1990 Del. Ch. LEXIS 121, at *21-23 (Del. Ch. Aug. 9, 1990) (rejecting claim under *Moran*); see also *Black v. Hollinger Int'l, Inc.*, 872 A.2d 559, 567 (Del. 2005) (approving the use of a rights plan to stop controlling shareholder from selling company's largest asset); *Account v. Hilton Hotels Corp.*, 780 A.2d 245, 250-51 (Del. 2001) (approving adoption of rights plan by board and allowing the board to amend issued stock to include the rights plan).

16. 16 A.3d 48, 122 n.480 (Del. Ch. 2011). However, the Chancellor "does not endorse 'just say never.'" *Id.* at 129.

17. BROWN ET AL., *supra* note 2, at 16-68.

18. Some courts struck down rights plans on the grounds that they were unfairly discriminatory against acquirers. See, e.g., *Avon Products, Inc. v. Chartwell Assocs.*, 907 F.2d 322, 323 (2d Cir. 1990); *Amalgamated Sugar Co. v. NL Indus., Inc.*, 644 F. Supp. 1229, 1234 (S.D.N.Y. 1986). All of those decisions were subsequently overruled by state legislatures. See N.Y. BUS. CORP. LAW § 505(2)(i) (McKinney 2010); N.J. STAT. ANN. §14A:7-7(3) (West 2010).

19. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1355 (Del. 1985). Rights plans' 'flip-over' trigger is pulled when an acquirer that has gained a controlling position in a target firm seeks to implement a business combination between the target company and another entity. Thomas, *supra* note 1, at 511 n.27. Today, as a practical matter, the flip-over trigger rarely comes into play because unwanted acquirers are deterred from purchasing a controlling stake in the target by the flip-in trigger's existence. *Id.* at 512.

20. The overwhelming majority of American corporations have poison pills already in place, while the remaining firms could quickly put them in place. See, e.g., John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 267-87, 295 (2000).

held that it would not allow a rights plan whose trigger level was too low because such a plan would “fundamentally restrict” the stockholders’ ability to conduct a successful proxy contest, making it nearly impossible for a dissident shareholder to elect a board that would redeem the rights plan.²¹ Without that possibility, the management of a target firm could hide indefinitely behind a rights plan without fear of removal.²²

Recently, however, a novel form of rights plan has been developed—the NOL rights plan²³—which has a 5% trigger level that is particularly onerous for hostile bidders. The legitimacy of an NOL rights plan was first put to the test when Selectica, Inc. (“Selectica”), a Delaware corporation, enacted an NOL pill that restricted any shareholder from buying more than 4.99% of its voting shares.²⁴ Trilogy, Inc. (and its subsidiary Versata Enterprises, Inc., collectively, “Trilogy”), a competitor and potential acquirer, purchased more Selectica shares, thereby deliberately triggering the NOL rights plan.²⁵

In the ensuing Delaware litigation, Trilogy argued that the NOL pill unduly restricted its ability to win a proxy contest and therefore was a preclusive defensive tactic that violated *Moran* and *Unitrin*.²⁶ The Delaware Supreme Court rejected this claim in a decision that leaves open the question of how they would rule on other poison pills with a 5% (or lower) trigger level.

This raises important issues both for potential bidders and their targets. Presumably the Delaware courts would uphold other NOL rights plans with similar trigger levels, but is the court’s decision limited to companies, like Selectica, who have suffered significant economic losses? Or, does it apply more broadly? What about target companies that drop their pill trigger to 5% claiming that hedge fund activists pose a serious threat to their corporate well-being?²⁷

In this Article, we seek to provide the Delaware courts with an alternative approach that will add clarity in the law. We propose a new methodology for courts that must determine if a rights-plan trigger, or for that matter any defensive tactic, is preclusive and therefore invalid under Delaware law. We begin by analyzing the

21. *Moran*, 500 A.2d at 1356–57.

22. See Thomas, *supra* note 1, at 519.

23. See Mark D. Gerstein, Bradley C. Faris, Joseph M. Kronsoble & Christopher R. Drewry, Latham & Watkins, LLP, M&A Commentary, *Lessons from the First Triggering of a Modern Poison Pill: Selectica, Inc. v. Versata Enterprises, Inc.* (Mar. 2009), http://www.lw.com/upload/pubContent/_pdf/pub2563_1.pdf [hereinafter *Lessons from Selectica*]. NOLs are net operating loss tax benefits. Weak companies that suffer significant financial losses may carry them forward to offset taxable income earned subsequently. See *infra* Part II.A

24. *Selectica, Inc. v. Versata Enters., Inc.*, No. 4241-VCN, 2010 Del. Ch. LEXIS 39, at *22–25 (Del. Ch. Feb. 26, 2010).

25. *Id.* at *28.

26. *Id.* at *70–71.

27. Law firms are already claiming that *Selectica* validates “acting in concert” poison pills with 4.99% triggers, which are designed to stop shareholders from engaging in coordinated activities. See, e.g., Mark D. Gerstein, *Implications of Selectica for Next-Generation Poison Pills*, HARVARD L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Mar. 30, 2010, 9:21 AM), <http://blogs.law.harvard.edu/corpgov/2010/03/30/implications-of-selectica-for-next-generation-poison-pills/>.

Delaware case law to determine the appropriate legal standard for determining when defensive tactics are preclusive. We show that the Delaware courts have not provided clear guidance in their tests for preclusion, particularly in the crucial *Unitrin* case, where they give three different tests in the same opinion, and more recently in *Selectica*. In order to add clarity and certainty to the law, we argue that the Delaware courts should return to the original test set forth in *Moran*—a defensive tactic is preclusive if it “fundamentally restricts” a dissident shareholder’s ability to win a proxy contest.

We then argue that the courts should use a new approach to determine when a defensive tactic “fundamentally restricts” a shareholder’s ability to win a proxy contest. We develop a voting model that will allow them to transparently consider all of the key parameters that affect the outcome of corporate elections, including case-specific information about shareholder ownership patterns and voting recommendations of third-party voting advisors. Using this model, we illustrate the effects of lower trigger levels for all rights plans on dissidents’ chances of winning proxy contests, as well as the effect of the classified board, Employee Stock Option Plans (ESOPs), and white squire defenses. We find, for instance, that given certain assumptions about the share ownership patterns of the target firm, the Delaware Supreme Court was correct in *Selectica* when it found that the NOL poison pill is not preclusive.

Finally, we refine our analysis to consider several other significant, complicating factors, including the type of bidder, the type of contest, and the differences in third-party voting advisor recommendations that result from these variations. We argue that the courts should explicitly consider these factors in their determination with regard to the preclusive effects of defensive tactics. We further claim that courts should distinguish between the different types of bidders and voting contests when considering the validity of different defensive tactics. By doing so, a court will be able to take into account the various wealth effects that flow from different types of bids.

Our findings show that permitting an across-the-board lowering of rights-plan trigger levels would shift Delaware law to favor hedge funds and private equity firms over strategic acquirers, and greatly increase the power of third-party voting advisors, such as Institutional Shareholder Services (ISS) or Glass Lewis & Co. (“Glass Lewis”). We argue that there is little reason for corporate law to treat strategic acquirers worse than hedge funds or private equity funds, as the former frequently attach higher valuations to the target firm’s assets.²⁸ Nevertheless, an overly broad reading of *Selectica* will have this effect for three reasons. First, a lower poison pill trigger level will decrease the amount of stock that a potential strategic acquirer can accumulate, making it more difficult for it to prevail in a proxy contest for corporate control since the acquirer will have control over fewer votes. This effect will be stronger for strategic acquirers than hedge funds, or

28. Leonce L. Barger, Frederik P. Schlingemann, René M. Stulz & Chad J. Zutter, *Why Do Private Acquirers Pay So Little Compared to Public Acquirers?*, 89 J. FIN. ECON. 375, 376 (2008) (finding that average premium paid to target shareholders in acquisition by strategic buyers averaged 40 to 46.5%, whereas private equity firms paid only 28.5%).

private equity firms, because strategic acquirers use proxy contests for corporate control more frequently than other types of potential bidders.²⁹

Second, in the past, strategic acquirers have often bought large stakes in targeted firms, so-called “toeholds,” to offset the costs of an unsuccessful bid in the event that another bidder tops their offer.³⁰ Reducing the amount of target stock that strategic acquirers can accumulate lowers the expected value of a takeover attempt and will adversely affect their incentive to pursue value-enhancing acquisitions. Strategic bidders’ smaller toeholds in target firms will also reduce their incentives to launch proxy contests for corporate control as they will receive a smaller percentage of the benefits from improving target firm operations.

Third, strategic bidders with smaller stakes in target firms will find it harder to signal to the market that they are serious bidders. An accumulation of a substantial stake in a target company is a strong signal to the market, and to third-party voting advisors, both that the acquirer is serious about pursuing the target and that the acquirer believes that the target is undervalued.³¹ If the acquirer is prevented by a rights plan from acquiring a substantial stake in a target firm, then it will be much more difficult for it to convince other shareholders of its true intentions.

This Article proceeds as follows. In Part I, we briefly summarize Delaware’s jurisprudence on the use of takeover defenses against unsolicited buyers, beginning with *Moran* and *Unocal*, then continuing to *Unitrin*. We then turn in Part II to an analysis of the *Selectica* decision, focusing on the ramifications of that opinion for the future of poison pills. Part III develops our basic model, while Part IV refines our analysis to consider the effects of different types of bidders, different types of contests, and variations in third-party voting advisor recommendations. We conclude in Part V with a brief discussion of the policy implications of our results. We discuss the technical details of the model in an Appendix.

I. RIGHTS PLANS AS ROADBLOCKS TO UNWANTED PURCHASERS:

MORAN/UNOCAL/UNITRIN

Prior to the early 1980s, when an unwanted potential acquirer made an unsolicited tender offer to a target company’s shareholders, the target firm lacked a rock solid technique for stopping the offer in its tracks. True, the passage of the Williams Act in 1968³² had imposed some degree of order on the terms and conditions attached to tender offers, and extended, to a minimum of twenty business days, the time period before a bidder could close its tender offer.³³ Despite

29. Confidential email from proxy solicitor to Randall Thomas (Sept. 21, 2011) (on file with author).

30. Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1777 n.171 (1985) (bidder profits from ownership stakes in target firm usually offset the bidder’s search costs and bid commencement fees); James C. Freund & Richard L. Easton, *The Three-Piece Suit: An Alternative Approach to Negotiated Corporate Acquisitions*, 34 BUS. LAW. 1679 (1979) (discussing common practice of acquirers buying large stake in target firm before announcing bid).

31. See *Selectica*, 2010 Del. Ch. LEXIS 39, at *75.

32. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454.

33. 17 C.F.R. § 240.14e-1(2010).

these regulations, however, targets still needed to search high and low for individually tailored defenses that would enable them to escape the grips of hostile bidders.

The advent of the rights plan changed this dramatically. Without shareholder approval, a board of directors could within hours of a hostile tender offer install a poison pill that would make completing the tender exorbitantly expensive.³⁴ Although the bidder could, in theory, wage a proxy battle to take over the board and remove the pill, if the pill was combined with other defenses, such as a classified or staggered board, the resulting delay in completing the deal would be fatal to the entire acquisition.³⁵ Thus, not surprisingly, bidders frequently sought judicial relief from the implementation and deployment of poison pills. Because of Delaware's position as the epicenter of corporate law developments, the Delaware courts were quickly confronted with cases challenging all aspects of this new defense. As we show below, what emerged over time was a judicial standard that strikes down a poison pill only when a pill "both prevents a tender offer *and* unfairly tilts the electoral playing field against an insurgent."³⁶

A. Moran: Legitimizing the Creation of the Poison Pill

The Delaware Supreme Court first considered the validity of rights plans in *Moran v. Household International, Inc.*³⁷ Household International's directors implemented a rights plan because they were concerned about the company's vulnerability as a takeover target.³⁸ They decided to adopt a poison pill with a 20% trigger level, but which only included a flip-over trigger designed to stop any second step business combinations.³⁹ Moran, a director of the company, perhaps

34. The Delaware Supreme Court has ruled that "[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Paramount Commc'ns., Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (Del. 1990). In applying *Time*, a federal judge in *Moore Corp. v. Wallace Computer Services* did not require the Wallace board to redeem its poison pill because Wallace was in the process of implementing a long-term strategy and was only now starting to reap the benefits of that strategy. *See* 907 F. Supp. 1545, 1545–55, 1582 (D. Del. 1995). The Court concluded that the board was reasonable in not redeeming the pill so as to give Wallace's shareholders enough time to appreciate the value of the long-term strategy. *See id.*

35. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 923–24 (2002).

36. *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 337 n.182 (Del. Ch. 2010) (emphasis added).

37. *See* 500 A.2d 1346 (Del. 1985).

38. *Id.* at 1349. The directors were concerned about activity in the market that indicated Household might be a takeover target. *Id.* This concern was heightened when John Moran, one of Household's directors, stated that Household's stock was undervalued and argued in favor of a leveraged buyout of Household. *Id.*

39. *Id.* at 1348–49. "If the acquirer buys more than the specified percentage of stock, and then acquires the remaining target company stock in a merger, or other business combination transaction, the 'flip-over' provisions of the Rights Plan allow the holders of the

disgruntled over the rejection of his proposed leveraged buyout, filed suit seeking to enjoin the implementation of the poison pill.⁴⁰

As an initial step, the Delaware Supreme Court concluded that the directors of a Delaware corporation had the power to implement a poison pill.⁴¹ Undeterred, Moran,⁴² contended that the poison pill was invalid because it would deter “virtually all hostile tender offers.”⁴³ In rejecting this claim, the court emphasized that there were “numerous methods to successfully launch a hostile tender offer,” even with a poison pill in place.⁴⁴ Specifically, the court noted that although a poison pill may prevent a tender offer from closing, a determined bidder could acquire shares up to the amount of the poison pill trigger and conduct a proxy contest to remove the board and redeem the poison pill.⁴⁵ Critically, Household International did not have a classified board, and therefore the court did not need to examine the effect of the combination of a poison pill and a classified board.

Grasping the significance of the availability of the proxy contest as a legitimating feature of the rights plan, the appellants then claimed that the poison pill limited the stockholders’ ability to conduct a proxy contest. The court responded that, while a defensive measure that “fundamentally restrict[ed]” a hostile bidder from being able to win a proxy fight would not be a proportionate response, it concluded that the poison pill’s trigger of 20% had only a minimal effect upon proxy contests.⁴⁶ Finally, the court found that the use of the poison pill would be subject to judicial review under the *Unocal* test, discussed in the next section.⁴⁷

rights certificates, other than the acquirer, to buy the acquirer’s common stock at a fifty percent discount.” Thomas, *supra* note 1, at 511 (footnote omitted). The “flip-in” defense against creeping acquisitions had not yet been developed.

40. *Moran*, 500 A.2d at 1349.

41. *See id.* at 1351–53. The Delaware Supreme Court held that under title 8, section 157 of the Delaware Corporate Code, the board had the express authority to issue rights to purchase shares. *See* DEL. CODE ANN. tit. 8, § 157 (2010). Furthermore, the court determined that section 151 granted the board the broad authority to grant whatever rights and features it so chooses to the rights issued under section 157. *See id.* § 151; *Moran*, 500 A.2d at 1351–53. In addition, the Court decided that directors have additional authority to issue the poison pill under section 141(a), which confers upon the board broad power to manage the corporation’s “business and affairs.” *See* tit. 8, § 141(a); *Moran*, 500 A.2d at 1353.

42. *Moran*, 500 A.2d at 1354.

43. *Id.*

44. *Id.* at 1354–55.

45. *See id.* at 1354.

46. *Id.* at 1355 (citing *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1080 (Del. Ch. 1985)). Furthermore, the Chancery Court agreed with expert testimony that found that hostile bidders holding less than 10% of a target corporation’s stock were successful in gaining corporate control through a proxy contest or by threatening to hold one. *Id.* The Court of Chancery further found that the poison pill “d[id] not limit the voting power of individual shares,” *id.* (quoting *Household Int’l, Inc.*, 490 A.2d at 1080), and the “key variable in proxy contest success is the merit of an insurgent’s issues, not the size of his holdings.” *Id.*

47. *Id.* at 1355–56. In *Unocal*, the Delaware Supreme Court announced a new test for defensive tactics: (1) the board must show that it had reasonable grounds for believing that there was a threat to the corporation; and (2) the board’s defensive response was reasonable in relation to that threat. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–58

In sum, the *Moran* court emphasized that proxy contests, as well as other takeover strategies, were still available to any potential insurgent to gain control of target companies with rights plans. It points out that the key issue “is whether the restriction upon individuals or groups from first acquiring [the trigger level] of shares before waging a proxy contest fundamentally restricts stockholders’ right to conduct a proxy contest.”⁴⁸ However, that same year, the Delaware courts determined the parameters surrounding target companies’ use of the poison pill and other defensive measures.

B. Unocal: Reviewing the Use of Defensive Measures

The next major development in the analysis of takeover defenses occurred in *Unocal*.⁴⁹ T. Boone Pickens, president and chairman of the board of Mesa Petroleum and other related entities, then a corporate raider, but today better known as a hedge fund activist, made a front-loaded cash tender offer of \$54 per share to obtain 51% control of Unocal.⁵⁰ The remaining 49% of the shareholders would be squeezed out and receive junk bonds for their Unocal shares.⁵¹ Unocal responded to Pickens’s bid by conducting a self-tender at a premium price of \$72 per share for 50% of its stock.⁵² The Unocal board specifically excluded Mesa from their offer.⁵³ Faced with the defeat and potential losses on its investment in Unocal, Mesa filed suit to temporarily restrain the Unocal board from excluding Mesa from the self-tender.⁵⁴

The Delaware Supreme Court held that the Unocal board had the authority to “deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office,”⁵⁵ but they had the burden of proof to make such a showing.⁵⁶ The board could satisfy that burden “by showing good faith and reasonable investigation.”⁵⁷ The *Unocal* court found that the company’s board met this burden,⁵⁸ but recognized that satisfying it did little to

(Del. 1985).

48. *Moran*, 500 A.2d at 1355; see also *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 333 (Del. Ch. 2010) (quoting *Moran*’s language).

49. *Unocal*, 493 A.2d at 949.

50. *Id.* at 949 n.1, 956.

51. *Id.* While the junk bonds were purportedly worth the same as the first step cash bid, junk bonds were highly speculative and worth less than the cash value of the front end of the offer. *Id.*

52. *Id.* at 951.

53. *Id.*

54. See *id.*

55. *Id.* at 954–56.

56. See *id.* at 955–56. In determining whether a board is acting primarily to entrench itself, the court had previously required a board to fulfill an initial standard of proof test before the business judgment rule would apply. In *Cheff v. Mathes*, the Delaware Supreme Court held that the board must show that it had “reasonable grounds” to believe that a threat to the corporation’s and shareholders’ interests existed. 199 A.2d 548, 554–55 (Del. 1964).

57. This test was earlier developed in *Cheff*. *Cheff*, 199 A.2d at 555. A board’s proof of showing good faith and a reasonable investigation is “materially enhanced” if a majority of the board is comprised of outside independent directors. *Unocal*, 493 A.2d at 955.

58. The Unocal board consisted of a majority of outside directors, so the board’s actions

ensure that the board's actions were not primarily for entrenchment purposes.⁵⁹ Thus, it went on to determine that the board's defensive actions also "must be reasonable in relation to the threat posed."⁶⁰

In order to satisfy this "reasonableness" prong, the board must analyze the nature of the threat and its potential effect on the corporation in deciding what is a reasonable response to that threat.⁶¹ In *Unocal*, the board found that the threat posed by Mesa was a "two-tier coercive tender offer coupled with the threat of greenmail" designed to "stampede" shareholders to tender in the first step (in order to avoid the junk bonds) even if the price offered was wholly inadequate.⁶² The court held that Mesa's tender offer posed a significant threat to the shareholders and thus the board's self-tender excluding Mesa was reasonable in relation to that threat.⁶³

The *Unocal* standard of review applies to any defensive action taken by a board in response to an immediate or potential threat to the corporation, and in particular to a board's decision to use a poison pill to defeat an unwanted takeover bid for the company. The court endorsed a two-part test in assessing defensive tactics: (1) the board must show that it had reasonable grounds for believing that there was a threat to the corporation; and (2) the board's defensive response was reasonable in relation to that threat.⁶⁴ Combined with *Moran*, these two cases imply that target company boards must leave open some avenue for an unsolicited change of control transaction: if they close down the tender offer using the pill, they must leave open an avenue for a proxy contest. As we show in the next two sections though, the opportunity for such proxy fights seemed to shrink substantially.

C. Unitrin: *Judicial Gloss on the Unocal Test*

The Delaware Supreme Court revisited the *Moran* and *Unocal* decisions in *Unitrin Inc. v. American General Corp.*⁶⁵ In *Unitrin*, American General made an unsolicited merger proposal to Unitrin, which responded by installing a poison pill and implementing a stock repurchase program for roughly 20% of its stock.⁶⁶ American General filed suit seeking to enjoin Unitrin's use of the poison pill and its repurchase program under *Unocal*.

Applying *Unocal*, the court found that the Unitrin board had conducted a reasonable investigation in good faith of American General's offer and identified two threats that it posed to the corporate enterprise: (1) inadequate price; and (2) antitrust complications.⁶⁷ In reviewing the use of a repurchase plan in combination

were materially enhanced. *Unocal*, 493 A.2d at 957–58. Furthermore, the board, using the advice of its legal and financial advisors, had reasonably investigated and concluded that Mesa's front-loaded tender offer was coercive and was inadequate in price. *Id.* at 956.

59. *Id.* at 955–56.

60. *Id.* at 955.

61. *Id.*

62. *Id.* at 956.

63. *Id.* at 949.

64. *See id.*

65. 651 A.2d 1361 (Del. 1995).

66. *Id.* at 1370.

67. *Id.*

with a supermajority vote requirement (if a shareholder with 15% or more of the stock sought a merger), the court expounded upon the *Unocal* second step by explaining that first, there must be a “determination of whether a defensive response was draconian because it was either coercive or preclusive in character”; and second, if the response is not found to be draconian, it must be within a “range of reasonableness.”⁶⁸ The second step of *Unocal* was now comprised of two separate components.

On the facts of the case, the court needed to decide when a defensive measure is preclusive in the context of a proxy contest. Reexamining *Moran*, the court held that a defensive action (including a rights plan) will be considered to preclude a proxy contest only if the proxy contest is rendered either “mathematically impossible or realistically unattainable.”⁶⁹ In applying this preclusion test in *Unitrin*, the court conducted a detailed examination of the likelihood of American General being able to win a proxy contest.⁷⁰ The court found that if there were a 90% shareholder turnout in the proxy contest, then American General would need only 45.1% of Unitrin’s stock.⁷¹ Furthermore, 42% of Unitrin’s shares were owned by institutional investors (with 33% of Unitrin owned by only twenty institutions).⁷² Thus, the court held that winning a proxy contest was not “mathematically impossible or realistically unattainable” because American General could make its case to the voters by, among other things, offering a high enough price to sway these institutional investors to vote in favor of American General.⁷³ The court went on to remand the case to the Chancery Court to determine if the stock repurchase fell within the range of reasonableness.⁷⁴ It instructed that court to consider whether: the stock repurchase was statutorily authorized; it corresponded in degree to the size of the threat posed by American General’s offer; and it treated all shareholders equally.⁷⁵

68. *Id.* at 1387–88.

69. *Id.* at 1389. Thus, as Professor Gilson has observed, “under *Unitrin*, refusal to redeem the pill is not preclusive under *Unocal* unless a proxy fight is also precluded.” Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 501 (2001).

70. *Unitrin*, 651 A.2d at 1381. First, the court recognized that proxy contests never have 100% of shareholder participation. *Id.* at 1381. Second, the court ruled that not only would owning 15% of Unitrin (in order to avoid the supermajority vote provision) not be necessary for American General to win a proxy contest, but it would be illogical because it would trigger the poison pill as well as the constraints of title 8, section 203 of the Delaware Corporate Code. *Id.* at 1381–82 (noting that section 203 places restraints on the acquisition of a corporation by an “interested stockholder,” which is a stockholder that owns 15% or more of a corporation).

71. *Id.* at 1382. American General could acquire 14.9% of Unitrin stock without triggering the poison pill or supermajority vote provision and would only need an additional 30.2% of Unitrin stock to vote in favor of American General’s board slate to win a proxy contest (thereby obtaining 45.1% of the vote) and only 35.2% to obtain 50.1% of the vote in order to approve the merger. *Id.* at 1382–83.

72. *Id.* at 1382.

73. *Id.* at 1383.

74. *Id.* at 1389.

75. *Id.*

Unitrin's new definition of preclusion appears to modify *Moran*'s "fundamentally restricts the chances of winning a proxy contest" test for when a rights plan should be struck down under the *Unocal* doctrine. After *Unitrin*, courts will only deem a proxy contest to be precluded if proxy-contest success is deemed to be "mathematically impossible or realistically unattainable."⁷⁶ However, the court did not attempt to reconcile this language with its earlier holding in *Moran*, nor did it tell the lower courts which one of these two phrases—"mathematically impossible" or "realistically unattainable"—it meant for them to apply.

As time passed, the Delaware courts developed an ad hoc system of policing pills with different courts using different approaches.⁷⁷ The uncertainty over which standard should be applied became apparent in the Chancery Court's opinion in *Selectica* when the court was called upon to decide the legitimacy of the newly created NOL rights plan. In the next Part, we will examine that opinion.

II. SELECTICA AND ITS IMPLICATIONS

A. The NOL Pill: A Legal Innovation

In recent years, many unprofitable corporations have adopted so-called NOL poison pills.⁷⁸ This new form of rights plan is designed to protect these firms' NOLs against the possibility that share-ownership changes might cause the company to lose or limit its ability to use its NOLs to reduce its future tax liabilities.⁷⁹ NOLs are contingent assets whose value will be realized if the firm reports a future profit within the twenty-year lifetime of the NOL.⁸⁰ Because NOLs have potential value until their expiration, even a nearly insolvent firm can hope that at some point in the future it will return to profitability and be able to use its NOLs.⁸¹

For purposes of this Article, the most important feature of the NOL poison pill is that its trigger level is set at 4.99%,⁸² well below the level that has been historically used in rights plans and the level approved in *Moran*. The reasons for this low threshold are complex and deeply embedded in section 382 of the Internal Revenue

76. *Id.*

77. Thus, the Chancery Court struck down the dead hand pill in *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998) (finding it preclusive and coercive under *Unocal* standard), and the slow hand pill in *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25, 52 (Del. Ch. 1998) (violation of target board's *Unocal* duties), *aff'd*, 721 A.2d 1281 (Del. 1998), but on different grounds than those used by the Delaware Supreme Court in *Quickturn Design Systems, Inc. v. Mentor Graphics Corp.*, 721 A.2d 1281, 1291 (Del. 1998) (violation of § 141(a) of the Delaware General Corporation Law).

78. Merle Erickson & Shane Heitzman, *NOL Poison Pills: Selectica v. Versata*, 127 TAX NOTES 1303, 1369 (2010).

79. *Id.* at 1370.

80. *Id.*

81. See *Selectica, Inc. v. Versata Enters., Inc.*, No. 4241-VCN, 2010 Del. Ch. LEXIS 39, at *3 (Mar. 1, 2010), *aff'd*, 5 A.3d 586 (Del. 2010).

82. See *Lesson from Selectica*, *supra* note 23, at 1 and accompanying text.

Code, the current tax law concerning the transfer of NOLs between companies.⁸³ Without attempting to explain fully these tax code details, they essentially provide that if a corporation experiences an “ownership change” for tax purposes,⁸⁴ it may be limited in its ability to use its NOLs in the postchange period. The validity of the NOL poison pill was the central issue in *Selectica*.⁸⁵

B. Selectica, Inc. v. Versata Enterprises, Inc.

Selectica, a microcap company that had been losing money for several years, had amassed NOLs that greatly dwarfed its market capitalization.⁸⁶ Most of its value was therefore attributable to the NOLs. Consequently, the Selectica board began exploring the possibility of selling the company to utilize the NOLs, hiring an investment banker to solicit potential buyers.⁸⁷ Trilogy, a competitor of Selectica, made a bid to acquire it.⁸⁸ Although its bid was rejected, Trilogy purchased a substantial amount of Selectica stock, subsequently disclosing it held more than 5% of Selectica’s outstanding stock.⁸⁹ Selectica’s advisors warned that Selectica could lose most of its NOLs if Trilogy continued purchasing its stock, so to preserve the value of the NOLs for Selectica’s stockholders, the board adopted an NOL pill.⁹⁰

Trilogy continued acquiring Selectica stock, purposefully triggering the pill.⁹¹ The Selectica board concluded that its NOL pill had been triggered and implemented the exchange of rights called for therein,⁹² diluting Trilogy’s stock

83. For an overview of these issues, see *Selectica*, 2010 Del. Ch. LEXIS 39, at *4–5.

84. This is defined as an increase in the percentage of stock ownership by one or more 5% stockholders to more than 50% over the lowest percentage of stock held by those owners over a prior three-year period, or if more recent, since the date of the last ownership change. *Id.* at *4.

85. *Id.*

86. Selectica had accumulated roughly \$160 million worth of NOLs while its market capitalization was roughly only \$23 million. From 2006 to 2008, a few studies were conducted by either Selectica or large shareholders of Selectica to determine the exact value of the NOLs. *Id.*

87. *Id.* at *16.

88. *Id.* at *18–19.

89. *Id.* at *20.

90. *Id.* at *27. Furthermore, the Selectica board created a special committee to periodically review the poison pill and “‘determine whether the Rights Agreement [poison pill] continues to be in the best interest of the Corporation and its stockholders,’ as well as to review ‘the appropriate trigger percentage’ of the pill.” *Id.* at *26.

91. *Id.* at *28.

92. Selectica decided to employ a share exchange (the “Exchange”) rather than using the flip-in pill because of concern about the latter’s effect on the NOL analysis. *Id.* at *32–33. The actual process for implementing the pill caused turmoil. Selectica had to freeze all trading of its stock for roughly a month in order to issue the rights and the new stock. *Id.* at *38.

ownership percentage from 6.7% to 3.3%.⁹³ The board also put in place a new poison pill with a trigger of 4.99% (the “Reloaded NOL Pill”).⁹⁴ Litigation ensued.⁹⁵

1. The Chancery Court Decision

In reviewing Selectica’s NOL pill, the Exchange, and the Reloaded NOL Pill under the first prong of the *Unocal* standard, the Chancery Court concluded that Selectica had reasonable grounds to conclude there was a threat to the corporate enterprise.⁹⁶ A threat could exist even if an acquirer accumulated only 5% of the target’s stock because “a pill designed to protect NOLs *necessitates* precluding a lesser accumulation of shares than might be appropriate for a pill designed to prevent a hostile acquirer from establishing a control position in the company.”⁹⁷ The Chancery Court was satisfied that the NOLs had potential value and that Trilogy posed a serious threat to that value.⁹⁸

With the first prong of *Unocal* satisfied, the court turned to whether the NOL Pill, the Exchange, and the Reloaded NOL Pill were preclusive. First, Trilogy argued that the NOL Pill and the Reloaded NOL Pill were preclusive because the pills would prevent an insurgent “from signaling its financial commitment to the company sufficient to establish such credibility.”⁹⁹ Second, Trilogy claimed that because Selectica had a staggered board, an insurgent would have to win two proxy contests in order to gain control, exacerbating the insurgent’s difficulty of winning even one proxy contest with less than 5% ownership.¹⁰⁰ Finally, Trilogy explained that a 4.99% cap would increase the free-rider problem in proxy contests, denying an insurgent most of the potential benefits from a takeover.¹⁰¹

In response to Trilogy’s arguments, Selectica identified fifty public companies that have implemented similar NOL pills with a 5% trigger.¹⁰² It offered expert testimony that over a three-year period, out of fifteen proxy contests that occurred in microcap companies where the insurgent held less than 5.49% of the shares, the insurgent had been successful in obtaining at least one board seat in ten of those

93. Selectica did not actually implement the pill as written in the Rights Agreement. Instead of issuing ten times more stock to all shareholders except Trilogy, Selectica chose to only use a 2:1 ratio. *Id.*

94. *Id.* at *36–38.

95. *Id.* at *38–39.

96. *Id.* at *51–52. The court recognized the distinctiveness of this case stating, “[t]his case presents unique grounds for establishing this first part of the *Unocal* test as employing a poison pill for the ostensible purpose of protecting NOLs is a distinct departure from the poison pill’s originally intended use: the prevention of hostile takeovers.” *Id.* at *52.

97. *Id.* at *53 (emphasis added).

98. *Id.* at *55.

99. *Id.* at *75.

100. *Id.*

101. *Id.* at *76.

102. *Id.* at *78.

contests.¹⁰³ It also argued that with only twenty-two investors owning 62% of Selectica's stock, a proxy contest would be relatively inexpensive.¹⁰⁴

In evaluating the competing arguments, the Chancery Court needed to decide which one of the three tests for preclusion set forth in *Unitrin* and *Moran* to apply—"mathematically impossible," "realistically unattainable," or "fundamentally restricts." It decided to use the "mathematically impossible" test saying, "It is not enough that a defensive measure would make proxy contests more difficult—even considerably more difficult. [Rather] [t]o find a measure preclusive . . . the measure must render a successful proxy contest a near impossibility or else utterly moot, given the specific facts at hand."¹⁰⁵ In doing so, it rejected *Unitrin*'s "realistically unattainable" second standard and neglected to even mention the "fundamentally restricts" test taken from *Moran*. It did point out that "mathematically impossible" was almost never satisfied, stating, "Though Trilogy's expert testimony suggests that a poison pill with a less than 5% trigger 'has a substantial preclusive effect,' the Court cannot conclude that the NOL Pill, Exchange, and Reloaded NOL Pill were preclusive Such a high standard operates to exclude only the most egregious defensive responses."¹⁰⁶ Based on the "mathematically impossible" standard, however, the Chancery Court had no question that the NOL Pill, the Exchange, and the Reloaded NOL Pill were not preclusive, and ultimately not outside the range of reasonableness.¹⁰⁷

2. The Supreme Court Decision

A few months later, in a well-written, tightly drawn opinion, the Delaware Supreme Court affirmed the Chancery Court's decision.¹⁰⁸ The court had little trouble finding that the NOL pill should be permitted under the specific facts of the case under the familiar two-part *Unocal* test—step one requiring the board to show it had in good faith, and after reasonable investigation, concluded that Trilogy's stock purchases posed a threat to Selectica's corporate enterprise, and step two determining whether the defense adopted was reasonable in relation to the threat posed. Importantly for our purposes, the supreme court accepted the same expert testimony that had been introduced in the lower court and reached a similar conclusion that the NOL pill was not preclusive.¹⁰⁹

In its analysis of the reasonableness of the board's actions, the supreme court was careful to show how Trilogy had precipitated the triggering of the poison pill through its aggressive actions, while Selectica made serious efforts to avoid having

103. *Id.* at *79.

104. *Id.* at *79 & n.187.

105. *See id.* at *81 (footnote omitted). In support of this assertion, the court noted that in *Unitrin*, the Delaware Supreme Court had stated that "[t]he key variable in a proxy context would be the merit of [the challenger's] issues, not the size of its stockholdings." *Id.* at *82 n.189 (quoting *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1383 (Del. 1995)).

106. *See id.* at *80–81 (footnote omitted).

107. *Id.* at *93.

108. *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 608 (Del. 2010).

109. *Id.* at 599–603.

to use the defense.¹¹⁰ Moreover, the court noted that Trilogy was “a competitor, a creditor, and a stockholder of Selectica,” which gave it an incentive to inflict damage on Selectica by forcing it to deploy its poison pill.¹¹¹ Given the events that occurred, the court accepted without question the need for Selectica to put in a second, “reloaded” poison pill that would serve as a deterrent to further purchases by Trilogy.¹¹² Overall, the court had no trouble upholding these measures as reasonable in relation to the threat posed by Trilogy under the *Unocal* test.

While the supreme court affirmed the Chancery Court in its entirety, three important new points came out of its opinion. First, the court clarified the meaning of preclusion for defensive tactics under Delaware law by stating: “Because the ‘mathematically impossible’ formulation in *Unitrin* is subsumed within the category of preclusivity described as ‘realistically unattainable,’ there is, analytically speaking, only one test of preclusivity: ‘realistically unattainable.’”¹¹³ As discussed below,¹¹⁴ this will undoubtedly help the chancery court to better determine which defensive tactics are preclusive.

Second, and very surprisingly given the facts of the case, the supreme court went out of its way to “hold that the combination of a classified board and a Rights Plan do not constitute a preclusive defense.”¹¹⁵ Trilogy had argued that Selectica’s classified board and NOL poison pill required a challenger to launch and complete two proxy contests in order to change control, and this made success “realistically unattainable.”¹¹⁶ In rejecting this claim, the supreme court pointed out that nothing in Delaware jurisprudence requires that bidders be permitted to gain control of a target in one election,¹¹⁷ and that the delay imposed by a classified board did not prevent a determined acquirer from gaining control of a target via two proxy contests over a two-year period.¹¹⁸ However, the supreme court failed to acknowledge that recent scholarship exists that suggests the combination of the two

110. *Id.* at 605.

111. *Id.*

112. *Id.* at 606.

113. *Id.* at 601. This formulation was subsequently reaffirmed by the chancellor in his opinion in *Air Products & Chems, Inc. v. Airgas, Inc.*, 16 A.3d 48, 113 n.435 (Del. Ch. 2011).

114. *See infra* pages 17–19.

115. *Versata Enters., Inc.*, 5 A.3d at 604. Although the court plainly intended its language to be read as a holding, in the footnote attached to the end of the quoted statement, the court goes on to explain that Selectica “no longer” had a classified board because it amended its charter after the trial to eliminate it. *Id.* at 604 n.41. Thus, the presence of the classified board was not at issue in the case, and the court had no need to decide this point. *Id.* However, the chancellor’s subsequent opinion in the *Air Products* case, where the presence of a classified board was crucial to the outcome of the takeover battle, makes it clear that the Delaware courts have decided that the combination of a rights plan and a classified board is not preclusive. *See Air Products*, 16 A.3d at 115.

116. *Versata Enters., Inc.*, 5 A.3d at 604.

117. *Id.*

118. *Id.* at 604 (citing *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1186 n.17 (Del. Ch. 1998)).

defenses may be a showstopper,¹¹⁹ nor did it engage in any detailed analysis of the likely effects of the classified board and NOL pill in a proxy contest for Selectica.

Finally, the supreme court stated that its decision “should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs.”¹²⁰ The decision emphasized that “the specific nature of the threat [is what] ‘sets the parameters for the range of permissible defensive tactics’ at any given time.”¹²¹ The threat of a longtime competitor seeking to increase its stock ownership in order to intentionally impair NOL assets of the target was a very serious threat to the corporation,¹²² which permitted the Board to put in place a very serious defensive tactic: a 5% poison pill. Other threats of a less menacing nature might not warrant such a low trigger level on a poison pill, and even “non-preclusive, non-coercive defensive measure[s] can be] nonetheless unreasonable in light of the threat faced by the corporation.”¹²³ We turn next to the implications of the decision.

C. Some Implications of Selectica

1. The Meaning of Preclusion

Each of these three key aspects of the supreme court’s decision—the meaning of preclusion, how classified boards should be analyzed under the preclusion test, and how preclusion in a proxy contest is proved—has interesting implications. First, although the supreme court’s decision clarified that “there is, analytically speaking, only one test of preclusivity: ‘realistically unattainable,’” it did little to explain how to reconcile this holding with the court’s prior precedent in *Moran*.¹²⁴ In other words, by stating that the “realistically unattainable” test for preclusivity is *the* test to be applied, what signal is the supreme court sending to the Chancery Court about what it views as a preclusive defensive tactic?

On the one hand, the supreme court’s test in *Selectica* is less onerous than the one applied by the Chancery Court in the decision below, which asked whether such success was “a near impossibility or else utterly moot.”¹²⁵ On the other hand, the Delaware courts’ frequent and favorable citations to *Moran*’s “fundamentally restricts” test seemingly point to an even more dissident-friendly standard. For

119. See Bebhuk et al., *supra* note 35. In *Yucaipa*, the Chancery Court did consider such evidence, but still concluded that “the combination of a classified board and a rights plan are hardly show-stoppers in a vibrant American M&A market.” 1 A.3d 310, 347 (Del. Ch. 2010), *aff’d*, 15 A.3d 218 (Del. 2011).

120. *Selectica*, 5 A.3d at 607.

121. *Id.* (quoting *Unitrin*, 651 A.2d at 1384). This is consistent with Chancellor Chandler’s *Air Products* decision where he upheld the combination of the poison pill and classified board as used in that particular case but went on to state that a board cannot “‘just say never’” to a takeover bid. *Air Products*, 16 A.3d at 129.

122. *Selectica*, 5 A.3d at 607–08.

123. *Yucaipa*, 1 A.3d at 337.

124. *Selectica*, 5 A.3d at 601.

125. *Selectica, Inc. v. Versata Enters., Inc.*, No. 4241-VCN, 2010 Del. Ch. LEXIS 39, at *4 (Del. Ch. Mar. 1, 2010).

instance, in *Stahl v. Apple Bancorp, Inc.*,¹²⁶ then-Chancellor Allen interpreted *Moran*'s "fundamentally restricted" language as follows: "The thrust of the Supreme Court's reasoning in *Moran* was simply that the restrictions imposed by the stock rights plan on a proxy contest were immaterial to conducting a proxy fight effectively."¹²⁷ In other words, Allen's formulation is that *Moran* prohibits defensive tactics that have a "material effect" on the likelihood of dissident success. This is a far cry from *Selectica* on its face.

More recently, in *Omnicare, Inc. v. NCS Healthcare, Inc.*¹²⁸ (decided after the *Unitrin* decision), the Delaware Supreme Court stated that a defensive tactic is preclusive "if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by *fundamentally restricting* proxy contests or otherwise."¹²⁹ *Omnicare* is thus apparently endorsing a looser standard than *Unitrin*.

Is *Selectica* also endorsing the *Moran* test? This seems to be the case when the court approvingly included a lengthy quotation from *Moran*, in which the *Moran* court "rejected the contention 'that the Rights Plan strips stockholders of their rights to receive tender offers, and that the Rights Plan fundamentally restricts proxy contests.'"¹³⁰ In its earlier decision in *Unitrin*, the court also used both the "fundamentally restrict[s]" language of *Moran*,¹³¹ and two pages later the "mathematically impossible or realistically unattainable" test.¹³² Yet, the supreme court did not clarify whether they are equivalent tests.

Importantly, at least one very recent Chancery Court decision has interpreted *Unitrin* and *Moran* as creating the same standard for preclusion. In *Yucaipa American Alliance Fund II, L.P. v. Riggio*,¹³³ Vice Chancellor Strine measured the legitimacy of the rights plan at issue in the case under *Moran*'s "fundamentally restricts" test,¹³⁴ while also discussing how *Moran* informed *Unitrin*'s test for preclusion.¹³⁵ He opined that "[w]hen a pill both prevents a tender offer and unfairly tilts the electoral playing field against an insurgent, this court, to be true to

126. 1990 Del. Ch. LEXIS 121 (Del. Ch. Aug. 9, 1990).

127. *Id.* at *19–20.

128. 818 A.2d 914 (Del. 2003).

129. *Id.* at 935 (emphasis added).

130. *Selectica*, 5 A.3d at 604 (quoting *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985)).

131. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1387 (Del. 1995) (citing *Moran*, 500 A.2d at 1357).

132. *Unitrin*, 651 A.2d at 1389.

133. 1 A.3d 310 (Del. Ch. 2010).

134. *Id.* at 359. There he stated that the defendant company, Barnes & Noble, "has convinced me that [its] Rights Plan is not an unreasonable device that 'fundamentally restricts' Yucaipa [the dissident shareholder] from winning a proxy contest." *Id.* (quoting *Moran*, 500 A.2d at 1355).

135. *Yucaipa*, 1 A.3d at 336 ("Precisely because *Moran*'s approval of the pill was premised on the ability to get around the pill through a proxy contest, *Unitrin* recognized the importance of examining whether the company's defensive arsenal as a whole, including the pill, was preclusive in the precise sense of making it unrealistic for an insurgent to win a proxy contest." (citing *Unitrin*, 651 A.2d at 1387)).

Moran, should not hesitate to enjoin its operation.”¹³⁶ He further stated that “if a defensive measure does not leave a proxy insurgent with a fair chance for victory, the mere fact that the insurgent might have some slight possibility of victory does not render the measure immune from judicial proscription as preclusive.”¹³⁷ Where a pill has the effect of making an election victory unlikely for a dissident, “the proportionality prong of the *Unocal* test should require the board to make an extremely strong showing why the rights plan should be sustained.”¹³⁸ On the facts of *Yucaipa*, however, the Vice Chancellor upheld the rights plan because it left the dissident shareholder with “the ability to run a successful proxy contest to obtain board representation.”¹³⁹ Then-Chancellor Chandler seemed to pick up this theme in *Air Products* when he stated:

The fact that something might be a theoretical possibility does not make it “realistically attainable.” In other words, what the Supreme Court in *Unitrin* and *Selectica* meant by “realistically attainable” must be something more than a mere “mathematical possibility” or “hypothetically conceivable chance” of circumventing a poison pill. One would think a sensible understanding of the phrase would be that an insurgent has a reasonably meaningful or real world shot at securing the support of enough stockholders to change the target board's composition and remove the obstructing defenses.¹⁴⁰

The supreme court did not, however, mention *Yucaipa* in its decision in *Selectica*, and its silence casts doubt on its willingness to do so.

Thus, despite the fact that the supreme court appears to be attempting to clarify the test for preclusivity in its *Selectica* opinion, the meaning of the test and its interaction with prior precedent is still unclear.¹⁴¹

136. *Yucaipa*, 1 A.3d at 337.

137. *Id.* at 337 n.182.

138. *Id.* Later in the opinion, the vice-chancellor states that in determining proportionality under *Unocal*, “the key issue is whether the Rights Plan unreasonably inhibits the ability of *Yucaipa* to run an effective proxy contest.” *Id.* at 353.

139. *Id.* at 360; *see also id.* at 331 (poison pill cannot preclude dissident “from waging an effective proxy contest”); *id.* at 335 (trigger level must be at “such a reasonable threshold that the owner of a bloc up to the trigger level can effectively run a proxy contest”).

140. *Air Products & Chems, Inc., v. Airgas, Inc.*, 16 A.3d 48, 116 (Del. Ch. 2011) (citing *Yucaipa*, 1 A.3d at 337 n.182).

141. Chancellor Chandler in *Air Products* concluded that Delaware law would be more credible if the Supreme Court acknowledged that its later rulings have modified *Moran* and have allowed a board acting in good faith (and with a reasonable basis for believing that a tender offer is inadequate) to remit the bidder to the election process as its only recourse. The tender offer is in fact precluded and the only bypass of the pill is electing a new board.

16 A.3d at 122 n.480. While this is certainly a reasonable interpretation of existing Delaware precedent, we believe that the supreme court may wish to clarify its intentions on this issue to make clear that it does not intend to allow preclusive defenses to tender offers. For example, the supreme court may be willing to order redemption of the poison pill in the scenario posed in *Yucaipa* (and quoted in *Air Products*) where the target's classified board and poison pill force a determined hostile bidder to take all of the various economic risks

2. Classified Boards and Preclusion

In *Selectica*, the supreme court issued a blanket holding: a classified board and a poison pill are not preclusive as they merely delay, but do not prevent, a dissident from gaining control of the target company.¹⁴² In support of its conclusion the court stated: “The fact that a combination of defensive measures makes it more difficult for an acquirer to obtain control of a board does not make such measures realistically unattainable, i.e., preclusive.”¹⁴³ Yet, in order to determine whether a defensive measure is preclusive, *Selectica* and *Unitrin* direct judges to determine if the defensive tactic makes it more difficult for the dissident to “gain control” of the target.¹⁴⁴ Thus, the court seems to be making a judicial finding for all classified boards that the increased difficulty for bidders associated with the classified board (in combination with a rights plan) is not sufficient to make dissident success realistically unattainable.

If this is the case, one wonders what evidence the court considered in making this determination. Furthermore, why did it do so in a case where the issue had been mooted by factual developments in the case,¹⁴⁵ thus making it unnecessary to resolve the question? One possible justification is that the court perceived a direct threat to the classified board’s status as a valid takeover defense under Delaware law. To understand this point, recall that the invention of the poison pill, and the fact that a company without one can put one in place without shareholder approval and on a moment’s notice, means that any company with a classified board can immediately implement a poison pill.¹⁴⁶ In order to preserve the utility of the classified board, the court needed to find a way to affirm the use of the combination of a pill and classified board in a takeover setting. This required the court to consider the combination’s legitimacy under *Unocal* and, in particular, its preclusive effects on proxy contests.

The court had to choose between adopting a general rule of nonpreclusivity, or alternatively, conduct a case-by-case analysis of the preclusive effects of this combination of defenses. If it decided to pursue the latter, then the issue would be what a dissident shareholder would need to demonstrate in order to establish that the combination was preclusive. In *Moran* and *Unitrin*, and elsewhere in *Selectica*, the court actively weighed evidence about the likely effect of particular defensive measures by considering expert testimony on the likelihood of dissident success in the particular case. In fact, Vice Chancellor Strine in *Yucaipa* was careful to consider empirical evidence on both sides of the issue when discussing the effects of the combination of a poison pill and classified board, finding that it was not likely to be preclusive given that success in the first proxy contest gives a dissident great influence over the incumbent board, and that it is often unnecessary for the

associated with leaving a tender offer open for two years. *Air Products*, 16 A.3d at 128 n.510 (citing *Yucaipa*, 1 A.3d at 351 n.229).

142. See *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 604 (Del. 2010).

143. *Id.* (footnote omitted).

144. See *id.* at 601.

145. See *supra* note 88 and accompanying text.

146. See *Coates, supra* note 20, at 288. In fact, a stand-alone classified board without a poison pill is almost useless today as it does nothing to stop a hostile tender offer. See *id.*

dissident to win two elections to gain control or force a sale to a third party.¹⁴⁷ However, this analysis does not take into account the underlying share ownership patterns of the target company, the likely recommendations of the third-party voting advisors, or the costs of delay and uncertainty for a particular bidder that seemed to be required—we argue below¹⁴⁸—for a factual determination of the likelihood of success in a proxy contest.

The virtue of the general rule of nonpreclusivity adopted by the court is that it creates certainty.¹⁴⁹ Certainty is a virtue for corporate planners and is valued by the Delaware bench and bar.¹⁵⁰ Moreover, it is true that—barring exceptional circumstances, such as the presence of cumulative voting¹⁵¹—the classified board by itself has no direct impact on a dissident shareholder's chance of success in any one contest. After all, the classified board merely reduces the number of candidates that will be elected at the annual meeting and has no facial effect on how the votes themselves are cast.¹⁵²

However, if we are to examine the classified board's defensive effects on strategic bidders that wish to gain control of the firm, we must look at the effects of the temporal delay created by the classified board in combination with the poison pill.¹⁵³ This delay, which may add one or two additional years to the strategic

147. See *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 347 n.215 (Del. Ch. 2010) (citations omitted).

148. See *infra* Part III.A.

149. It presumably could be overcome if a dissident could find a way to show that the peculiar features of a particular combination of a poison pill and classified board made success in the initial proxy contest unrealistic, even without any consideration of the effects of the negative impact for the bidder of potentially needing to bring a second proxy fight if the first one was successful. In other words, the dissident would need to show that the combination of defenses did more than delay victory—that it stopped them from winning any proxy contest. This would not be the case with the current versions of those two defenses.

150. See, e.g., *Hariton v. Arco Elecs, Inc.*, 188 A.2d 123 (Del. 1963) (rejecting application of de facto merger doctrine in Delaware because of the inherent uncertainty it creates).

151. The combination of a classified board and cumulative voting can have an adverse impact on a dissident's ability to win all of the seats that are up for election in a proxy contest. RANDALL S. THOMAS & CATHERINE T. DIXON, *ARANOW AND EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL* §10.07 (3d ed. 2001). However, cumulative voting is an optional choice under state law, and is very rarely seen at public companies today. See Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 165–66 (1994).

152. Furthermore, as we discuss in Part IV below, the classified board will have relatively little effect on certain bidders, such as hedge funds, that only seek representation on the board and do not intend to run a second proxy contest to gain control of the target firm. This stems in part from Risk Metrics's greater willingness to give dissidents a positive voting recommendation in a representation contest rather than a control contest. See *infra* Part IV for further discussion.

153. We remind the reader that virtually any company can put in a poison pill overnight, so all firms have a shadow poison pill. This makes it vital to examine the effects of the combination of these two defenses. In terms of the temporal effects of a combination of these two defenses, they delay any hostile bidder's efforts to obtain control of a target firm. In this

bidders' quest for control, will greatly increase the transaction costs associated with a hostile bid and the risk of nonconsummation of the bid due to changes in market conditions.¹⁵⁴ Furthermore, if we ignore these costs for classified boards, does that mean the court intends for us to also ignore similar effects generated by new, innovative defenses that practitioners may design?¹⁵⁵

A better way of thinking about the effect of the classified board is to include an analysis of its impact on dissident success.¹⁵⁶ *Yucaipa* points to one way that a court could incorporate a general analysis of the combination of poison pill and classified board on a dissident's likelihood of success in a proxy contest, by factoring in the likelihood of the target firm board consenting to a transaction after an initial successful proxy fight, as well as its effect on a target board's decision to sell the firm to a white knight.¹⁵⁷ As Vice Chancellor Strine noted in *Yucaipa*, these values can be determined based on existing empirical research.¹⁵⁸ We return to this question in Parts III and IV where we discuss more fully how the effect of the classified board might be considered by courts in subsequent cases.

sense, the classified board has a similar effect to the slow hand poison pill that the Delaware courts have invalidated on other grounds. *See, e.g., Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1293 (Del. 1998).

154. The classified board has to increase the costs of making a bid and/or reduce its likelihood of completion if it is to be an effective defensive tactic. Gilson and Black make this point eloquently in their classic case book on mergers and acquisitions: "A [hostile] tender offer is made when the value to the acquiring company of the shares acquired exceeds the price paid plus transactions costs. . . . Unless the [defensive] tactic in question can change the value of one of the components of the formula in the appropriate direction . . . it should have no effect on the acquiring company's decision to proceed with the offer." RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 790 (2d ed. 1995).

155. For example, the no-hand poison pill that delayed a new board's ability to remove a poison pill and consummate an acquisition was invalidated by now-Justice Jacobs on the grounds that a six-month delay on any sale of the company was unreasonable under *Unocal*. *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 47–51 (Del. Ch. 1998), *aff'd on other grounds*, *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

156. A more textured analysis might also reduce the pressure that institutional investors have put on corporate directors to allow shareholders to vote on removing classified boards. Institutional Shareholder Services (ISS) reports that there have been record high levels of shareholder support for shareholder proposals to declassify corporate boards, which it attributes in part to "a trio of recent Delaware court decisions [that] upheld poison pills at companies with classified boards." ISS, *PRELIMINARY 2011 U.S. POSTSEASON REPORT* 6 (2011).

157. *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 347 n.215.

158. *Id.* In light of the supreme court's decision in *Selectica* and then-Chancellor Chandler's decision in *Air Products*, we would anticipate that these values will change in the future as boards of target firms with classified boards learn that they never need to accede to hostile bidders' (and their own shareholders') demands to sell the company prior to a second proxy contest. We further note that the effects of other combinations of defensive measures can also be calculated using historical data.

3. Evidence on Stock Ownership and Proxy Contest Success

Finally, *Selectica* seems to require Delaware courts to engage in a textured analysis of whether the dissident shareholder can realistically attain success in a proxy contest. As we explain below, the court has scrutinized two types of information in this regard: general information about dissident success in other proxy contests that have some of the characteristics of the contest at issue in the case,¹⁵⁹ and the actual share ownership patterns and relationships between shareholders in a particular case.¹⁶⁰ Most frequently, the Delaware courts' analysis seems to focus on general evidence from other proxy fights. Recall that in *Moran*, the court relied on expert testimony that insurgents owning less than 10% of the stock of the target corporation had frequently succeeded in proxy contests to uphold a 20% trigger in a flip-over pill.¹⁶¹ In *Selectica*, the Chancery Court pointed to expert testimony that insurgents with up to 5.49% of target stock had been successful in electing at least one director in more recent proxy contests.¹⁶² In that case, the court accepted *Selectica's* evidence that of fifteen proxy contests involving microcap target corporations, the challenger successfully seated nominees in ten contests.¹⁶³ As *Trilogy* pointed out, the challengers did not gain control in these contests where the target had a classified board.¹⁶⁴ In fact, only five of these cases involved targets with classified boards, and in these five cases, the challenger needed to conduct a second proxy contest in order to gain control.¹⁶⁵ Finally, the court pointed to the third-party voting advisor ISS'¹⁶⁶ favorable voting recommendations to its clients on some poison pills with less than 5% trigger levels.¹⁶⁷

In some cases, the court has gone further and explored the actual share-ownership distribution of the target firm. In *Unitrin*, for example, the supreme court

159. *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 602 (Del. 2010).

160. *Id.* at 603.

161. *Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1355 (Del. 1985).

162. *Selectica, Inc. v. Versata Enters., Inc.*, No. 4241-VCN, 2010 Del. Ch. LEXIS 39, at *79 (Del. Ch. March 1, 2010), *aff'd* 5 A.3d 586 (Del. 2010).

163. *Id.* at *79–81.

164. *Id.* at *79–80.

165. *Id.* at *79. More likely, these fifteen contests are being conducted by hedge fund shareholder activists. This type of activist investor typically acquires relatively small-percentage stakes in small or microcap firms, then runs short-slate contests in order to obtain board representation rather than directly seeking control. See Alon Bray, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1748 (2008). The goal in these proxy contests is to influence the board to adopt the activist investor's proposed strategies, such as a sale of the firm or a financial restructuring. There is good reason to believe that a 5% trigger will have little effect on their efforts. *Id.* at 1774. This suggests that hedge fund activists may indirectly benefit at the expense of strategic bidders from the *Selectica* decision, an inference that seems supported by the fact that the largest block of *Selectica's* stock was held by Steel Partners, a prominent activist hedge fund which succeeded in defeating the takeover efforts of a potential strategic bidder, *Trilogy*. We will return to this question in the next section.

166. ISS is the same organization as Risk Metrics.

167. *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 602–03 (Del. 2010).

discussed the percentage of stock ownership by the Unitrin directors both before (23%) and after (28%) the expected defensive stock repurchase took place.¹⁶⁸ It went on to state that a bidder with less than 15% of Unitrin's stock (the maximum permitted by its poison pill) "would need to amass only 45.1% of the votes assuming a 90% voter turnout" and that "[t]he record reflects that institutional investors own 42% of Unitrin's shares" and that "[t]wenty institutions own 33% of Unitrin's shares."¹⁶⁹ After this discussion, the court concluded that the defensive stock repurchase was not preclusive.¹⁷⁰

Similarly, in the supreme court's opinion in *Selectica*, the court noted that "Selectica's unique shareholder profile would considerably reduce the costs associated with a proxy fight, since seven shareholders controlled 55% of Selectica's shares, and twenty-two shareholders controlled 62%."¹⁷¹ The court noted that Steel Partners, Director Sems, and Lloyd Miller owned 23.5% of the company's stock, and went on to calculate that an acquirer would be able to win a proxy contest if it attracted the votes of nineteen shareholders that held 38.5% of the company's stock.¹⁷²

Finally, Vice Chancellor Strine's opinion in *Yucaipa* contains an extensive and detailed discussion of the target company's share distribution, the relationship between two large dissident shareholders, and the size and importance of the CEO's large block of shares. Strine mentioned that Riggio, Barnes and Noble's CEO, held nearly 30% of its stock, while other insiders held another 3.26% and corporate employees owned 6%,¹⁷³ in the course of rejecting Yucaipa's request to find that the Barnes and Noble board violated *Unocal* by "not lifting the pill to trigger at a level like 37%."¹⁷⁴ While the Vice Chancellor declined to do so for several reasons, at least one of them was that Yucaipa might well join forces with another large dissident shareholder, Aletheia, which held 17.44% of the stock, and seek to gain control without paying a control premium.¹⁷⁵ Strine then proceeded to find that if voter turnout in a proxy contest was 91%, management would go into the contest with 37% to 38% of the votes, but that Yucaipa could win the contest if it got a supermajority of the remaining votes.¹⁷⁶ Moreover, the court concluded that ISS was much more likely to support an insurgent slate than a management slate,¹⁷⁷

168. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1377-78 (Del. 1995). The court's suggestion that the target firm directors might vote their 28% blocking position in favor of the dissidents if the price was sufficiently high, *id.* at 1383, seems to conflict with those same directors' use of the poison pill to block the bidder from closing its tender offer. It seems logical that if the offering price was high enough to lead the directors to want to sell their shares, then there would be no need for the bidder to use the proxy contest to gain control, as the directors would just redeem the rights plan and allow the tender offer to move forward.

169. *Id.* at 1382.

170. *Id.* at 1389-90.

171. *Selectica*, 5 A.3d at 603.

172. *Id.* at 603 n.32.

173. *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 353 (Del. Ch. 2010).

174. *Id.* at 338.

175. *Id.* at 324.

176. *Id.* at 354.

177. *Id.* at 355.

and such a recommendation generally had a favorable impact for dissidents.¹⁷⁸ Finally, Strine pointed out that the poison pill's 20% trigger level permitted Yucaipa and Aletheia to each purchase up to 20% of the stock, thereby offsetting any advantage that the Riggio bloc might otherwise have.¹⁷⁹ As we show in Part III, this type of careful and textured analysis is crucial if courts are going to make realistic assessments of a dissident shareholder's chances of winning a proxy contest.

In sum, we have shown that, although the Delaware Supreme Court clarified the test for preclusivity in its *Selectica* opinion, there remains more work to be done. We further demonstrated that, in determining whether the combination of a staggered board and a poison pill is preclusive, the court should weigh case-specific evidence about its effect on the dissident's ability to successfully conduct a proxy contest for corporate control.

III. MODELING PRECLUSION UNDER *UNOCAL*

As mentioned previously, one of the key steps in judicial analysis of directors' defensive actions under *Unocal* and subsequent Delaware jurisprudence is to determine whether the defenses deployed by a target corporation are preclusive; that is, do they make success in a proxy contest "realistically unattainable?"¹⁸⁰ In making this determination, a judge must assess the likelihood of dissident success given the existence of the various defenses. Thus far, the courts have relied on ad hoc discussions of individual target companies' situations and piecemeal evidence of success in other contests in making their determinations.¹⁸¹ In this Part, we develop a model that can be applied to any company in order to assess the likelihood that a defense is preclusive. Based on the facts considered in earlier decisions, we isolate the salient aspects of corporate elections and incorporate them into a weighted voting model that estimates the probability that different corporate challengers will meet with success.¹⁸²

We begin in Part A by identifying those aspects of the voting process that the court has identified as relevant to the analysis of the takeover defense. We then describe our model in Part B, showing how the items identified are incorporated into it. Part C illustrates how the model can be employed in two typical situations—a proxy contest coupled with a tender offer and a proxy contest in a corporation with a staggered board. Finally, in Part D, we provide a short discussion of what information courts would need to use our model and how courts might decide what degree of likely success constitutes a "realistically unattainable" level.

A. Key Elements of the Basic Model

What are the salient characteristics of a corporation that are relevant to the efficacy of a takeover defense? We focus on four factors that have been identified

178. *See id.* at 357–58.

179. *Id.* at 356.

180. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1388–89 (Del. 1995).

181. *See supra* Part II.C.2–3.

182. The technical aspects of the model are discussed in the Appendix.

in the cases: the existence (and trigger level) of a poison pill, the existence of a staggered board, the distribution of shares among various constituencies,¹⁸³ and the opinion of third-party proxy voting advisors.¹⁸⁴ These four factors are relatively easy to measure and have been acknowledged as significant by the courts and others in assessing the efficacy of a takeover defense.¹⁸⁵

The poison pill is arguably the most important defensive measure available to most corporations.¹⁸⁶ In *Moran*, the Delaware Supreme Court recognized the influence that a poison pill trigger level can have on a bidder's prospects for a successful electoral challenge for corporate control.¹⁸⁷ In this regard, we must incorporate the trigger level for the pill into the analysis as it limits the size of a block that a dissident can accumulate. This may directly affect whether success in a proxy contest is realistically unattainable.

In a similar vein, the existence of a staggered board has long been acknowledged as a key takeover defense.¹⁸⁸ As the court noted in *Selectica*, “[a]ny classified board also operates as an antitakeover defense by preventing an insurgent from obtaining control of the board in one election.”¹⁸⁹ The existence of a classified board requires that a challenger win two consecutive proxy contests in order to take control of the board of directors. During this time period, much can happen as the market for both companies involved in the potential transaction can shift rapidly. The bidder will also incur substantial costs in keeping its bid open, which will affect its ex ante calculations of whether to launch a bid in the first place.¹⁹⁰ However, in our model, we focus solely on the fact that a classified board will, if kept in place, force a determined bidder to win two elections rather than just a single one.¹⁹¹

The distribution of shares among various constituencies is a third important factor in assessing the likelihood that a challenge to the board will be successful. Some of the reasons for this are obvious: if management has control of a large number of shares (either because of direct ownership or indirectly through an employee stock option plan (ESOP) or an arrangement with a white squire) they will be less vulnerable. Conversely, if a dissident is prevented from a substantial accumulation because of a poison pill, it will be less able to mount an attack. But

183. See, e.g., *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 603 (Del. 2010).

184. *Id.* at 602.

185. See *supra* Part II.C.2–3.

186. ROBERT F. BRUNER, *APPLIED MERGERS & ACQUISITIONS* 837 (2004) (“The poison pill is arguably one of the most significant financial innovations in recent decades and is probably the single most effective defense in the target’s arsenal.”).

187. Thomas, *supra* note 1, at 519.

188. Bebchuk et al., *supra* note 35, at 924.

189. *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 604 (Del. 2010).

190. *Selectica, Inc. v. Versata Enters., Inc.*, No. 4241–VCN, 2010 Del. Ch. LEXIS 39, at *75 (Del. Ch. Mar. 1, 2010).

191. We will consider the other effects in our discussion of the range of reasonableness in Part IV. Thus, for example, a target board of directors may stop trying to maintain the company’s independence after losing an initial proxy contest and sell the company, either to the bidder or a white knight. The court should take such a possibility into account in deciding if the classified board “fundamentally restricts” shareholders’ ability to win a proxy contest.

there are other ways in which the distribution of shares can affect the likely success of a dissident.

Shareholders' interests are not homogeneous. Some are interested in long-term returns, while others may be more concerned with short-run payoffs. These differing interests will materially affect how each group votes in takeover contests. Merger arbitrageurs, for example, are naturally more skeptical of takeover defenses than many other shareholders.¹⁹² Some shareholders will have a bias toward management if for no other reason than it lowers their transaction costs in deciding how to cast their proxy. Any method that tries to assess the likelihood of management winning a proxy battle must find a way to incorporate those biases into its analysis.

Finally, third-party proxy advisors, such as ISS or Glass Lewis,¹⁹³ can have an effect on institutional investors' voting patterns. Both the court and academic commentary have recognized that the recommendation of a proxy advisor can have a pivotal impact on the outcome of a vote.¹⁹⁴ Proxy advisory firms make recommendations to shareholders about how to vote their proxies in corporate elections and proxy contests.¹⁹⁵ The proxy advisory firms construct their recommendations using a variety of inputs and analyze the merits of voting proposals.¹⁹⁶ Proxy advisors make case-by-case recommendations for individual companies, based on the company's specific situation.¹⁹⁷ Institutional investors overwhelmingly use the services of ISS and the other third-party voting advisors, causing the recommendations to have an impact on the outcome in shareholder voting contests.¹⁹⁸ The size of this effect will vary across firms depending on the degree of institutional ownership of their stock, but it can be significant.

Of course, in deciding whether the corporate structure is either unreasonable or makes a successful proxy challenge realistically unattainable, we cannot *a priori* make assumptions as to what a proxy advisor's recommendation will be in any given situation. We can, however, consider the two cases of a pro-management

192. Merger arbitrageurs take a long position in the target company's stock and a short position in the acquirer, betting that the merger will close and they will make a profit. Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, in *NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES* 101, 125 (Yasuyuki Fuchita & Robert E. Litan eds., 2007). As a result, they are gambling that the merger will close and that any antitakeover defenses will be overcome.

193. For a concise history of ISS and Glass Lewis, see Alan Miller, *Conducting a Contested Stockholder Meeting*, in *MEETINGS OF STOCKHOLDERS 12-1, 12-20 to 12-21* (R. Franklin Balotti, Jesse A. Finkelstein & Gregory P. Williams eds., 3d ed. Supp. 2011).

194. *Selectica*, 5 A.3d at 602; *Yucaipa Am. Alliance Fund II v. Riggio*, 1 A.3d 310, 355 (Del. Ch. 2010); see also Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 696-97 (2009); James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1 (2010); Cindy R. Alexander, Mark A. Chen, Duane J. Seppi & Chester S. Spatt, *The Role of Advisory Services in Proxy Voting* (Nat'l Bureau of Econ. Research, Working Paper No. 15143, 2009), available at <http://ssrn.com/abstract=1434658>.

195. Cotter et al., *supra* note 194, at 6.

196. *Id.* at 7.

197. *Id.*

198. *Id.* at 24-26.

recommendation or an anti-management recommendation, and compute the likelihood of a successful challenge. If an anti-management recommendation still results in a miniscule chance for a successful challenge, then there may well be cause for concern that a challenge is realistically unattainable.

These four elements of corporate defenses and shareholder voting—pill trigger level, staggered board, share distribution, and third-party advisors—have to be assessed in order to decide if success in a proxy battle is realistically unattainable. We turn next to building a model that allows that level of analysis.

B. The Basic Model

Our model is based on the theory of weighted voting.¹⁹⁹ Unlike other formal models of corporate voting,²⁰⁰ our model incorporates the key fact that investors can control large blocks of stock and there is likely to be a correlation between how they cast their votes. We will characterize the various shareholders in terms of the size of their bias toward (or against) management and to the sensitivity of their vote to the opinion of a third-party proxy advisor. This will help capture two of the factors we have identified as significant to the analysis.

In our examples, we divide the corporation's shareholders into six constituencies: Management, Dissident, three different institutional groups (Institution I, Institution II, and Institution III), and the Public.²⁰¹ For each of these groups, we make some baseline assumptions about their bias toward management as well as how closely they follow a signal from a fixed third-party proxy advisor.²⁰² We assume that Management shares will always vote for management, while Dissident shares will always vote for the dissident, and that these two groups will each be insensitive to any signal from the advisor. We also assume that the Public is essentially a "noise" term corresponding to a random vote.²⁰³ We are assuming that the small percentage of shares held by individuals is as likely to be

199. See Part VI, the Technical Appendix, for details. Weighted voting attaches different weights to different shareholders' votes to reflect the fact that shareholders own different size blocks of stock.

200. See, e.g., Ronald J. Gilson & Alan Schwartz, *Sales and Elections as Methods of Transferring Corporate Control*, 2 THEORETICAL INQ. L. 783 (2001). For a critique, see Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 489 (2005).

201. In any given application of this model, one might choose to divide these groups in some different way. The model allows for more or fewer groups of shareholders.

202. The model can be adapted to allow for more than one third-party advisor if that is deemed advisable.

203. For ease of presentation we will assume that all shares are voted. While not strictly true it does not materially affect our analysis. Formally, one can view the share distributions we use as the distribution among the shares that are voted. This would require some small tweaking since, for example, a poison pill trigger of 20% would effectively be a somewhat higher percentage of the voted shares. Our method is not sensitive to small perturbations of this as we discuss in the Appendix. Furthermore, since we assume that the public shares are randomly voted and those shares are the ones least likely to be voted, the probabilities we compute are quite close to what one might get accounting for uncast shares.

voted on one way as the other. In that sense how those ballots are cast contains no information and hence act as “noise” in the final tally.

We classify the remaining share blocks (i.e., Institution I, II, and III) in terms of how sensitive they are to a voting signal from a third-party advisor and what their bias is toward supporting management. We assume that every share block is to some extent influenced by the third-party signal,²⁰⁴ which seems imminently reasonable since many of the proxy advisors publish their recommendations and institutional investors usually subscribe to such services.²⁰⁵ But some blocks will more closely follow the signal—say those that contract with the party for advice—and others, while following the signal generally, are more likely to behave independently (e.g., arbitrageurs and hedge funds). We will discuss these assumptions further in the next section.

The other two factors identified in Part A—pill trigger level and classified board—are also easily accommodated within our model. The size of the pill trigger is used as an upper bound on the size of the block of shares held by the dissident. The existence of a staggered board, and hence the requirement that a dissident win two consecutive elections in order to take control of the board of directors, is modeled by considering a two-stage election in which the dissident must win both stages in order to be successful.

The output from the model will be a pair of probabilities. One will be the probability that management wins, given a pro-management signal from the advisor. The second is the probability that management wins, given an anti-management signal from the advisor. In the context of analyzing takeover defenses, we are most interested in the latter because it is the most likely indication that management is attempting to entrench itself in power at shareholders’ expense.

C. Examples

In order to illustrate our argument while keeping the mathematics accessible to the nontechnical reader,²⁰⁶ we will give two illustrations of our model. The first example models a corporation in which management has control of a substantial amount of stock, perhaps because of an ESOP,²⁰⁷ or alternatively from the use of a white squire.²⁰⁸ In this illustration, we will also assume that the corporation has installed a poison pill with a 15% trigger. In our second illustration, we will consider a corporation with very small management holdings, but a staggered

204. Alternatively we might think that the blocks are positively correlated with the third-party signal.

205. Cotter et al., *supra* note 194, at 7.

206. The technically inclined reader should refer to the Appendix for further details.

207. An ESOP is an employee stock option plan. These are frequently used as defensive devices in takeover battles as a way of shifting a block of votes to management’s side of the table, and have been upheld by courts in most circumstances. *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 290–91 (Del. Ch. 1989).

208. A white squire takeover defense places a significant block of target company voting stock in the hands of a friendly third party to help management win in a takeover battle. *Id.* It is sometimes used in conjunction with an ESOP to maximize its impact. *Id.*

corporate board. In both of these illustrations, our goal is to estimate the a priori likelihood that management will win a proxy contest.

1. Proxy Contest in a Corporation with an ESOP/White Squire

In this scenario, Management, perhaps either through an ESOP or through a white squire, has control over a substantial percentage of the company's stock.²⁰⁹ The dissident shareholder has purchased as much stock as possible under the rights plan with a 15% trigger level.

As is common, we assume that individual shareholders own only a small percentage of the shares, leaving the vast majority of the shares in the hands of institutional shareholders.²¹⁰ We divide the institutional shareholders into three groups. We assume that the first group, Institution I, will follow the proxy advisor's recommendation. The second group, Institution II, will be biased toward Management, but will be influenced by the advisor's recommendation. The third group, Institution III, will be more opposed to Management in takeover situations, but still somewhat sensitive to the advisor's recommendation.²¹¹

Scenario A: Management with Small Shareholdings and ESOP/White Squire

Management	15%
Dissident	15%
Institution I	17%
Institution II	23%
Institution III	24%
Public	6%

In this illustration, we will model the likelihood of success in a proxy contest for control of the corporation. In a proxy contest for corporate control, both the Management and the Dissidents run competing slates for the target company's board of directors. We will assume that there is no accompanying tender offer by the Dissidents. Rather, the Dissidents are hoping to convince the shareholders that they could do a superior job of running the company if they were elected. Prior evidence indicates that shareholders are more likely to vote in favor of Dissidents in a proxy contest for control than in a routine uncontested director election, but they are less likely to do so than in a takeover contest with an accompanying tender offer.²¹²

209. As an example of this situation, consider Polaroid's battle for independence from Disney. *See id.* at 279–80.

210. This is typically the case in most large American public corporations, as courts have observed in particular cases. *See, e.g.,* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995). These institutions are also more likely to vote, to vote against management proposals, and to vote in favor of proposals put forward by other investors. *Id.* at 1382.

211. We discuss how these assumptions are incorporated into the model in the Appendix.

212. For a summary of evidence, see THOMAS & DIXON, *supra* note 151, at § 1.03. We

Under these conditions, our model indicates that a pro-management signal results in Management winning 71% of the time. A pro-dissident signal results in Management winning 34% of the time. We return to the question of whether these numbers are indicative of realistically unattainable success for the Dissident in Part III.D.2 below.

We can use the same model to examine the central issue in the *Selectica* case: does a 5% trigger on the poison pill make a dissident's likelihood of success in a proxy contest "realistically unattainable"? To model this, we assume that the Dissident's holdings are capped at 5% and the remainder of the shares is distributed proportionately among the various institutional shareholders. We assume the same set of biases as before.

Under these assumptions, our model shows that the likelihood of a Management win is exactly the same as when the pill trigger was set at 15%—so that the Delaware courts' conclusions in *Selectica* were correct, assuming that the target firm there had a similar stock ownership pattern to the one we are modeling here.²¹³ While counterintuitive at first glance, there is an intuitive explanation for this result. If Management controls a significant block, then the Dissident's success will be dependent on convincing the institutional investors to vote against Management. Since so much of the stock is held by institutions, and the vote of the institutions is highly correlated, the actual amount held by the Dissident is not likely to be dispositive of the outcome.²¹⁴ Thus, in this scenario, the actual ownership stake of the Dissident has no direct effect on the outcome of the election.²¹⁵

discuss how these assumptions are incorporated in the model in the Appendix.

213. That the dissident holds a smaller stake might well affect the outcome of the vote in other ways. Suppose that a proxy advisor is more likely to give a pro-dissident signal if the dissident holds a large stake than if it holds a small stake. This could be because the advisor is skeptical of the seriousness of the challenge, or worries about the financial strength in the former case. If we assume that the advisor gives a pro-management signal 50% of the time if the dissident holds a 15% stake in the company and will give a pro-management signal 70% if the dissident only holds a 5% stake, then under the assumptions in the model, management wins 60% of the time under a small pill trigger and only 52% of the time with a 15% trigger. For details, see Paul H. Edelman & Randall S. Thomas, *Resetting the Trigger on the Poison Pill: Selectica's Unanticipated Consequences* 47–48 (Vand. Univ. Law Sch. Law and Econ., Working Paper, No. 10-16, 2010), available at http://ssrn.com/abstract_id=1631941.

214. This illustrates the logic of the *Selectica* court's citation to its earlier decision in *Unitrin* that "[t]he key variable in a proxy contest would be the merit of the bidder's proposal and not the magnitude of its stockholdings." *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 603 (Del. 2010) (citing *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1383 (Del. 1995)). To put it slightly differently, institutions' votes track the value of the proposed transaction in proxy contest for corporate control, and in *Unitrin*, the institutional vote was decisive. However, in situations where the voters have an interest in preserving their control of the company, such as managers, or even outside directors, courts should be cautious in treating them as if they were otherwise disinterested shareholders. For instance, in *Unitrin*, the court seemed to ignore this point when it claimed that the directors holding 27% of the company's stock, and the ability to block a second step transaction in any acquisition effort, would respond to a high enough offer price by voting in favor of the bidder. *Unitrin*, 651 A.2d at 1383 (quoting testimony of one director that "everything has a price parameter").

215. We note that this result is dependent on the particular stock ownership pattern in the target firm. Even a 15% trigger level could be preclusive if we alter the stock ownership

2. Takeover Contest Using a Joint Tender Offer and Proxy Contest and Facing a Staggered Board

In this second example, the target company management controls only a small percentage of the shares. They have neither an ESOP in place nor a white squire.²¹⁶ We again assume that the Dissident has purchased the maximum number of shares permitted under the target company's rights plan.

As in the previous scenario, we assume that individual investors own a small stake and that most of the shares are in the hands of institutional investors. We use the same description of these institutions as before, namely Institution I follows the advisor's recommendations, Institution II generally favors Management but is sensitive to the advisor's recommendation, and Institution III is generally opposed to Management in takeover situations but is still influenced by the advisor's recommendations. For each of the scenarios mentioned above we will consider two different types of contests.

Scenario B: Management with Small Shareholdings

Management	3%
Dissident	15%
Institution I	16%
Institution II	30%
Institution III	30%
Public	6%

In the joint tender offer and proxy contest, we assume that there is a pending tender offer for the target company's shares, that the offer is at a premium over the market price,²¹⁷ and that the poison pill prevents the bidder from buying a controlling block of stock promptly with its offer. This forces the bidder to engage in a proxy contest to replace the current board with one that will deactivate the pill, allowing the bidder to buy a controlling interest. Because the Dissident has made a tender offer, the appeal of his election platform is that it will buy the company if it is successful. The prospect of a sale at a premium price is very attractive to most investors, much more so than in the prior example, so we assume that the shareholders will be more biased toward the Dissident than in the previous situation.

patterns in ways that adversely affect the dissident's chances of winning a proxy contest. However, we believe that for most large cap, publicly traded firms, it is reasonable to assume that a very high percentage of their stock is owned by institutional investors that are free to vote their shares in a manner designed to maximize share value (and likely are legally obligated to do so).

216. For a typical example of this scenario, see the situation in *Grand Metro. Pub. Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1051 (Del. Ch. 1988).

217. See Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1057-59 (2002) (discussing the joint tender offer and proxy contest for *Willamette Industries*).

To further complicate matters in this case, we assume that the company has a staggered board in place and thus the Dissident will have to win two consecutive proxy contests in order to place enough new members on the board to deactivate the pill.²¹⁸ In this circumstance, we assume that the shareholders will be more biased toward the Dissident in the second election than in the first because the Dissident has shown a strong commitment to gaining control of the company.²¹⁹

To model this situation, we compute the probability of Management winning in each of the elections separately. Then the overall likelihood of Management winning is the probability that it wins at least one of the elections, since for the Dissident to triumph he must win both. In this circumstance, our model has Management winning 21% of the elections in which there is an anti-management signal and 46% of the elections with a pro-management signal.

Contrast this with the outcome if there was no classified board and the Dissident need only win one election. In that case our model has Management winning only 13% of the elections for which there is an anti-management signal and 30% of the elections with a pro-management signal. So the effect of a staggered board is to almost double the likelihood that Management will retain control in the least favorable circumstances of an adverse recommendation from a proxy advisor. So even when the Dissident is at his most advantaged, fighting a proxy contest accompanied by a tender offer, the existence of a staggered board doubles the likelihood of Management retaining control. This, combined with the additional costs associated with sustaining a takeover bid over multiple years and the additional risk of a change in market conditions, certainly lends evidence to the claim that the combination of a staggered board with a poison pill is preclusive of a successful proxy challenge.

D. Final Considerations

We close this Part by commenting on two aspects of our proposed model. The first is the central role that information specific to the corporation and its defense plays in the analysis. The second is the question of how we should quantify the notion of “realistically unattainable.”

1. The Role of Information

In reading the Delaware cases on preclusion under *Unocal*, and in our model of corporate elections, information about the shareholders and their biases play a central role in assessing the preclusive effect of takeover defenses. To assess whether a dissident has a realistically attainable chance of success requires an understanding of who holds the shares, what their individual biases are, and what the likely effect of third-party advisors will be. What this means, of course, is that a

218. For a discussion of the effect of classified boards on hostile takeovers, see Bebchuk et al., *supra* note 35.

219. For the details of how we implement the model, see Part VI, the Technical Appendix.

set of defenses may be acceptable for one corporation but not for another, even if they face the same threat. The distribution of shares alone could make a difference.

Are the courts capable of gathering the information that they will need to make these kinds of assessments? We think so. There is already a large amount of literature on the behavior of institutional investors in proxy contests,²²⁰ and there recently has been a spate of work on third-party advisors as well.²²¹ If the courts indicate that they desire more detailed information on share-ownership patterns, no doubt it will be provided by the parties in any litigation.²²²

We are aware that in his opinion in *Airgas*, Chancellor Chandler addressed “[t]he real-world difficulty of a judge accurately assessing the ‘realistically attainable’ factor.”²²³ He rejected the testimony of two highly qualified proxy solicitors about the likelihood of Air Products, the dissident, being able to successfully win a proxy contest at a special meeting with a 67% majority vote requirement, calling them “unhelpful and unconvincing.”²²⁴ He did leave open the possibility that this type of testimony might be useful if it was based on actual discussions with shareholders about how they intended to vote at a meeting, and he did accept the uncontested testimony that “it is easier to obtain investor support for electing a minority insurgent slate than for a controlling slate of directors.”²²⁵

For our purposes, this suggests that a court might find the assumptions in our model to be too theoretical for a judge to accept as trial testimony. As an alternative, a judge could appoint an independent expert to assess the necessary parameters for estimating our model.²²⁶ This expert could estimate the various parameters necessary for estimating the likelihood of success in our model, or a simpler rough-and-ready version of it. As an example of a simplified version of the model, if there was only one type of institutional investor who holds 64% of the stock, then management will win when the institutional investor votes in his favor. In our model, we assume that a positive recommendation from the proxy advisor results in a positive vote about 85% of the time. So, on average, we would expect a pro-management vote 85% of the time. A better estimate would be to use a number somewhat smaller than 85% since, by aggregating all of the institutional voters, we have lowered the likely influence of the proxy advisor overall. In a similar way, a

220. See, e.g., Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

221. See Choi et al., *supra* note 194, at 696; Alexander et al., *supra* note 194, at 3; Cotter, et al., *supra* note 194, at 25.

222. “If you build it, he will come.” FIELD OF DREAMS (Universal Studios 1989).

223. *Air Products & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 116 (Del. Ch. 2011).

224. *Id.* at 117.

225. *Id.* at 120.

226. *In re Appraisal of Shell Oil Co.*, 607 A.2d 1213, 1222–23 (Del. 1992) (holding that the Delaware Court of Chancery has inherent power to appoint an expert witness); DEL. UNIF. R. EVID. 706 (court-appointed experts permitted).

negative recommendation from the advisor results in a pro-management management vote roughly 15% of the time.²²⁷

2. Threshold of Preclusion: How Unlikely Does Success Have To Be?

Given our ability to compute the probabilities with some level of confidence, what likelihood of dissident success should be considered “realistically unattainable”?²²⁸ At one extreme is the Chancery Court opinion in *Selectica*, affirmed by the Delaware Supreme Court, where the court seemed to say that even the slightest chance of success was sufficient using one part of *Unitrin*’s language, the “mathematically possible” portion of its standard. The supreme court did not reject that determination expressly, although by collapsing *Unitrin*’s two-part test into one “realistically unattainable” test it seems to have indicated that a higher likelihood of success was necessary. At the other end of the spectrum, Vice Chancellor Strine’s language in his *Yucaipa* opinion, drawing on *Moran*’s “fundamentally restricts” standard, suggests a greater level of potential success is needed, or a defensive measure may be found to be preclusive. Setting the proper threshold obviously has important policy implications for the market for corporate control: too high a threshold risks shutting the market down entirely, whereas too low a level encourages too many challenges, which would raise transaction costs with little benefit to the corporation.

Given the current ambiguity about this question, we think it important to try to offer some factors that may assist courts in their task of reviewing defensive tactics.²²⁹ First, at a theoretical level, we believe that in today’s highly competitive world economy, we must take into account the economic consequences of the market for corporate control on capital flows and the overall effects on economic efficiency for the American economy. Economic efficiency considerations point

227. A second alternative would be to use historical data about proxy contest success to estimate the effects of individual defenses or combinations of defensive measures. One of the authors conducted such a study on the effects of poison pills in proxy contests. Randall S. Thomas & Kenneth J. Martin, *The Impact of Rights Plans on Proxy Contests: Reevaluating Moran v. Household International*, 14 INT’L REV. OF L. & ECON. 327 (1994). While the presence of the shadow pill made it impossible to detect any direct effect of poison pills on the outcome of proxy contests, *see Coates, supra note 20*, Martin and Thomas found that any defensive measure that restricted dissident stockholdings below 10% had a statistically significant negative impact on the likelihood of dissident success in a proxy contest. Academic research of this type, preferably conducted without reference to an ongoing case, would give a judge grounds to find that a particular defense, or combination of defenses, were preclusive.

228. *See supra* Part I.C.

229. As noted above, our analysis rests on an underlying assumption that historical success rates are set at the “correct” or “efficient” level of success for the market for corporate control. However, while we believe that the status quo is generally acceptable to the Delaware judiciary, some scholars have disagreed. *See, e.g.,* EASTERBROOK & FISCHER, *supra* note 4 (advocating in favor of opening up the market for corporate control); Martin Lipton, *Twenty-Five Years After Takeover Bids in the Target’s Boardroom: Old Battles, New Attacks and the Continuing War*, 60 BUS. LAW. 1369 (2005) (advocating for a more limited market).

toward facilitating bids that transfer resources into the hands of higher-valued users. Typically, hostile offers by strategic bidders are priced at a substantial premium over the existing stock market price of the company, with 30%–50% premiums common.²³⁰ These buyers are going to own the entire company after an acquisition and will be responsible for any losses that are incurred. If strategic bidders are willing to pay such substantial premiums over existing market prices, then this is one indication that a shift in control of the target firm may lead to an improvement in overall economic efficiency. While we do not discount the possibility that the stock market is inefficient in some ways at some points in time,²³¹ and that some acquisitions may not benefit, particular acquiring companies,²³² there is very strong evidence that most mergers and acquisitions do result in direct benefits at least to the target company shareholders.²³³ Given that the dominant model of the corporation in the United States and in American corporate law claims that companies should be run by their directors for the benefit of their shareholders, we think it follows that there is a strong argument that the market for corporate control has an important place in our corporate governance system. We note that this is consistent with what we have observed in the United States for the past fifty years.

With that general background, we turn next to identifying factors that should influence the courts' view of what level of openness that should exist in proxy contests. Proxy contests are an important feature of the market for corporate control, especially since the invention of the poison pill and its dramatic effect on a bidder's ability to close a hostile tender offer. Historically, proxy contests have featured about a 28% dissident victory rate in gaining majority control of the board²³⁴ and roughly a 50% success rate in obtaining board seats overall.²³⁵ Potential bidders factor the likelihood of success into their calculations when deciding if they should make a bid. These statistics suggest that bidders would use a roughly 28%–50% average success rate in making their calculations. Yet, even if we use only the majority control victory percentage, this suggests that the Delaware courts should consider a 28% chance of success in a proxy contest as a reasonable

230. Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15 J. ECON. PERSP. 103, 106 (2001).

231. See generally Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in 1B HANDBOOK OF THE ECONOMICS OF FINANCE 1053 (George M. Constantinides, Milton Harris & René M. Stulz eds., 2003); ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 2* (2000); Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59, 60 (2003).

232. The classic article is Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372 (1990), where the authors document, among other things, that firms that overpay in acquisitions frequently become targets for other acquirers.

233. See generally Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15 J. ECON. PERSP. 103 (2001); Gregg A. Jarrell, James A. Brickley & Jeffrey M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988).

234. David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 413 (1993).

235. J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 289 (1998).

approximation of what “realistically attainable” success means under the preclusion determination in the second step of the *Unocal* test.²³⁶

Our analysis to this point has been concerned with the likelihood of success of a generic dissident. But different types of bidders may create different amounts of value. Thus, a strategic bidder that is bringing two companies in the same industry together to compete more effectively against other firms may be creating a very large amount of value, and be assuming all of the risks if things go badly, whereas a hedge fund that is trying to implement a financial restructuring of the target firm may lead to relatively less improvement in shareholder wealth. Private equity firms, while sometimes criticized as targeting companies with artificially depressed stock prices, and who rarely engage in hostile transactions, might fall somewhere in between these two extremes.²³⁷

This suggests some variations in the underlying proxy contest success rate under *Unocal* to take into account different types of bidders. If the court were to focus on a single threshold value of success as being realistically unattainable, the effect may be to advantage one kind of dissident over another. This could potentially lead to favoring dissidents interested in wealth transfers over those that are engaged in wealth creation. We would then be sacrificing some of the benefits of a robust market for corporate control.

How should these considerations be incorporated into the court’s analysis? We think that can be done by incorporating a detailed understanding of the institutional actors into the range of reasonableness analysis in the second step of the *Unocal* test, which we turn to now.

IV. ENHANCING THE ANALYSIS

Our basic voting model incorporates several key elements for a contextual assessment of the efficacy of certain defensive tactics. It focuses on the distribution of shares at a target company, on the trigger level of its poison pill, and on whether it had a classified board. In this Part, we try to more completely specify the model in order to permit a court to better see the effects of biases of various potential

236. Two caveats are in order here. First, a more refined analysis of historical data could consider success rates for each different type of proxy contest, including joint tender offer/proxy contests; proxy contests for corporate control; and proxy contests for representation on a board of directors (typically to gain one or two seats on a board). Each one of these has different historical average success rates and a more sophisticated analysis would use that data as a baseline for each individual contest of the appropriate type.

Second, implicit in our analysis is an underlying assumption that historical success rates are set at the “correct” or “efficient” level of success for the market for corporate control. While we believe that the status quo is generally acceptable to the Delaware judiciary, some scholars have advocated in favor of opening up the market for corporate control, *see generally* EASTERBROOK & FISCHER, *supra* note 4, while other authors have claimed it needs to be closed down. *See* Lipton, *supra* note 229. Obviously, if either of these views were adopted, the appropriate likelihood of success would need to be adjusted accordingly.

237. Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth?: The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219 (2009).

actors, either for or against management. Doing this requires us to consider the nature of the contest, the role of the proxy voting advisor, and the goals of the particular bidder/investor. As we will show, the preclusive effects of takeover defenses vary depending on the nature of the vote and the type of dissident. In order to truly assess defensive tactics, courts must consider all of these factors.

We begin by examining the principal actors in corporate battles, including the different types of dissident shareholders, and how the different corporate defenses will affect their respective behaviors. Then we discuss the roles of the proxy advisor and how they react to the various strategies employed by management and dissidents. Finally, we will consider how this information can be aggregated into our analysis of *Unocal's* second prong.

A. Strategic Acquirers, Private Equity Firms, and Hedge Funds

Who are the most common participants in corporate contests and what are their biases? To answer this question, we need to come up with a relatively simple, yet descriptive, typology for the broad categories of acquirers that participate in this market. We are aware that there are a wide variety of potential participants in the market for corporate control, using a broad array of types of techniques, including hostile and friendly transactions, tender offers, and proxy contests, and that any typology that we employ will undoubtedly oversimplify and misclassify certain groups of these purchasers. But, we think that there are three particularly important types of potential participants that we need to examine—strategic buyers, financial buyers, and hedge fund activists—and that doing so will markedly improve courts' analysis of takeover defenses and their effects.

1. Strategic Acquirers

Strategic acquirers want to gain control of the target company, typically to integrate the firm into their ongoing operations, so that they can gain operational efficiencies, cost reductions, or other benefits.²³⁸ They could be in the same industry as the target firm or, if in a different industry, can see the potential for incorporating the target firm into their operations so as to create value. The touchstone is that they are interested in the target firm because it fits into their long-range plans for their own business. Strategic bidders often have the highest potential valuation for target firms as they are best equipped to recognize synergistic value gains from combining target assets with their own assets to generate higher value for the combined firm,²³⁹ in addition to the other forms of efficiency gains that other types of bidders can realize from the acquisition.

238. GILSON & BLACK, *supra* note 154, at 258–311 (discussing various sources of operational synergistic value creation for strategic bidders); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 125–26 (1992). This concept is often referred to as “operational synergy.” “Operational synergy involves the prospect of improvements in the productive activities of the two companies.” GILSON & BLACK, *supra* note 154, at 258.

239. Barger et al., *supra* note 28, at 376 (operating companies can realize synergy gains from an acquisition, whereas private equity buyers do not recognize such gains).

Strategic bidders deploy a wide array of methods of making control acquisitions, including tender offers, mergers, asset purchases, or voting contests, sometimes coupled with a tender offer. These efforts can be supported by target management (“friendly” deals) or resisted by target management (“hostile” deals). As a practical matter, many initially hostile deals subsequently turn friendly as the target company board changes its mind about the acquisition proposal.²⁴⁰

For strategic bidders, the poison pill and its trigger level are of primary concern to hostile bidders, because for friendly deals the target board can choose to waive the protections of the rights plan to permit the friendly deal to move forward. However, the poison pill may also adversely affect the ability of a third-party bidder to upset an initially friendly deal between its target and a prior bidder if that transaction does not constitute a “sale” under the *Revlon* doctrine.²⁴¹ Under the *Revlon* line of cases, the Delaware courts have permitted target firms to protect pre-existing transactions that further the long-term business strategy of the company so long as control remains in the market place after the protected transaction is completed.²⁴² This protection will not extend to financial buyer-sponsored buyouts that are structured as all cash deals (because they trigger *Revlon*) so that the rights plan does not prevent strategic bidders from making topping bids in that situation.²⁴³

Voting rights come into play for strategic buyers in proxy contests for corporate control. These battles arise in two situations: first, when the strategic bidder needs to gain control of the target firm in order to remove its rights plan (and possibly other antitakeover defenses) so that it can close its tender offer; and second, if the acquisition is structured solely as a proxy contest to replace the target board without acquiring a controlling interest in the target firm’s stock.²⁴⁴

Voting rights may play a second important role when the strategic bidder’s transaction is a friendly merger, or becomes a friendly merger. In these cases, the target firm’s shareholders must approve the transaction before it can be

Private equity firms may also be able to realize certain synergistic gains, such as economies of scale, in “roll up” transactions, where they acquire multiple small companies that operate in the same industry and combine them. *Rollup*, WIKIPEDIA, <http://en.wikipedia.org/wiki/Rollup>. For examples, see *Roll Up, Roll Up: Banks and Private Equity*, *ECONOMIST*, Jan. 10, 2009, at 65; Ashley D. Torres, *Jacobs Private Equity Invests in XPO Logistics*, *S. FLA. BUS. J.* (Sept. 20, 2011), <http://www.bizjournals.com/southflorida/news/2011/09/20/jacobs-private-equity-invests-in-xpo.html>.

240. Weyerhaeuser’s acquisition of Williamette Industries, discussed in Lipton, *supra* note 217, at 1057–59, is a good example of a hostile deal that turned friendly once the target’s board determined that the price being offered was sufficiently high to merit a sale of the company.

241. Briefly, the *Revlon* doctrine applies under Delaware law whenever there is a “sale of control” or other form of sale of the corporation. *Paramount Commc’ns., Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1993). Once *Revlon* is triggered, enhanced judicial scrutiny is applied to any actions that a target board of directors takes that favor a particular bidder. *Id.*

242. See, e.g., *Paramount*, 637 A.2d at 47.

243. See, e.g., *In re Mony Grp. S’holder Litig.*, 852 A.2d 9, 21 (Del. Ch. 2004).

244. *GILSON & BLACK*, *supra* note 154, at 1401.

consummated. If a higher bid comes forward, or if the target firm shareholders believe that the initial bid was too low, they may vote down the merger proposal.²⁴⁵

Poison pills adversely affect strategic acquirers in a number of ways. If the acquirer makes a tender offer for the outstanding shares, then the more shares the acquirer holds, the more that he can himself benefit from the increase in the price. A large stake in the corporation also allows the acquirer to benefit should a rival suitor eventually outbid him because they can sell their holdings at a profit and offset their search costs.²⁴⁶ By effectively capping his holdings, a poison pill limits the benefits of a takeover. In addition, the fewer shares that an acquirer holds, the more difficult it will be to convince other shareholders (and proxy advisors) that the offer is a credible one. For both these reasons, the size of a poison pill trigger can be of great significance to a hostile strategic acquirer.

For the hostile strategic bidder, the existence of a staggered board is also a serious impediment to completing an acquisition. The staggered board may require that the bidder succeed in two consecutive proxy contests in order to take control of the corporation and dismantle any other defenses.²⁴⁷ This raises not only the cost of a contest but also the uncertainty of success. Moreover, the extended time frame for the contest opens up opportunities for competitors to enter the market for the target company.

2. Financial Buyers

Financial buyers are interested in the target company primarily because of its cash flows and future exit options.²⁴⁸ Private equity firms are frequent sponsors of leveraged buyouts (LBOs) of large public companies.²⁴⁹ While private equity

245. While once this was a rare event, in recent years, hedge fund activists engaged in merger-arbitrage activity have been quite successful in forcing companies to either raise the amount of the merger consideration or withdraw the proposed merger. *See infra* Part IV.A.3.

246. Bebchuk, *supra* note 30, at 1777 n.171 (bidder profits from ownership stakes in target firm usually offset the bidder's search costs and bid commencement fees); James C. Freund & Richard L. Easton, *The Three Piece Suit: An Alternative Approach to Negotiated Corporate Acquisitions*, 34 *BUS. LAW.* 1679, 1683 (1979) (discussing common practice of acquirers buying large stake in target firm before announcing bid).

247. Miller, *supra* note 193, at 12–27 (“In a takeover battle at targets with classified boards, a tender offer coupled with a successful proxy fight for a single class of directors is often the offensive maneuver that leads to a target's sale to the hostile acquirer . . .”).

248. JOSHUA ROSEBAUM & JOSHUA PEARL, *INVESTMENT BANKING: VALUATION, LEVERAGED BUYOUTS, AND MERGERS & ACQUISITIONS* 161 (2009); *see also Financial vs. Strategic Buyers*, MERCER CAPITAL (2011), <http://www.mercercapital.com/print/?id=310> (“Financial buyers can generally be classified as investors interested in the return they can achieve by buying a business. They are interested in the cash flow generated by a business and the future exit opportunities from the business.”).

249. Douglas Cumming, Donald S. Siegel & Mike Wright, *Private Equity, Leveraged Buyouts and Governance*, 13 *J. CORP. FIN.* 439, 439–40 (2007). “Leveraged buyouts involve institutional investors and financial sponsors (like a private equity firm) making large acquisitions without committing all the capital required for the acquisition.” *Leveraged Buyouts*, WIKIPEDIA, http://en.wikipedia.org/wiki/Leveraged_buyout. For a simple diagram of the structure of a leveraged buyout, *see id.*

embraces a broad category of investments, here we are concerned with private equity buyout funds that concentrate their efforts on LBOs via a going private transaction.²⁵⁰ We are interested in this type of private equity transaction because it results in a change of control of a publicly held corporation with the elimination of the public shareholders.

Most private equity transactions, that is, typical LBOs or going private transactions, are structured as a purchase of all of the publicly held stock of a public corporation by a privately held acquisition vehicle controlled by the buyer.²⁵¹ The private equity firm sponsoring the transaction will obtain its capital from equity contributions from one of its investment funds (as well as much smaller contributions from the managers of the portfolio firm) and combine them with the cash proceeds from loans secured by the assets of the target firm.²⁵² Each portfolio firm will then be operated on a stand-alone basis.²⁵³

Private equity firms almost always do friendly deals with target board approval, and frequently with the active participation of the target management as part of the buyout team.²⁵⁴ If the sale is structured as an auction of the target firm, the rights plan is generally not an issue in the initial rounds of bidding that take place but may be used to protect the winning bid from topping bids.

Private equity firms do confront voting issues in their transactions, but these are largely related to shareholder approval of mergers.²⁵⁵ The most significant set of recent voting issues for private equity buyers have arisen when hedge fund activist shareholders engaged in merger arbitrage have objected to the consideration offered in particular buyouts.²⁵⁶ In these circumstances, the rights-plan trigger level may

250. These include venture capital, midstage company finance, distressed firm investment, LBOs of divisions or subsidiaries of public companies, and going private deals. See generally Masulis & Thomas, *supra* note 237. Going private transactions are when a private equity firm, often in conjunction with a target company's major shareholders or management, buys out the public shareholders' stockholdings. ROBERT B. THOMPSON, *MERGERS AND ACQUISITIONS: LAW AND FINANCE* 443–47 (2010).

251. Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 124 (2009). For a general discussion of these transactions, see THOMPSON, *supra* note 250, at 443–47.

252. Kaplan & Strömberg, *supra* note 251, at 123–25.

253. Stephen D. Prowse, *The Economics of the Private Equity Market*, ECON. R., Third Quarter 1988, at 21, 28–29, available at <http://www.dallasfed.org/research/er/1998/er9803c.pdf>. For a simple pictorial explanation of the structure of private equity deals and portfolio companies, see *Private Equity Fund Structure*, CAPITAL GATE, http://www.capitalgate.com/private_equity_fund_structure.html.

254. The *Revlon* case is a good illustration of this process. Revlon management was included as part of the buyout group in the initial private equity deal proposed to the Revlon board of directors in response to Pantry Pride's hostile offer. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1986).

255. Since private equity transactions are friendly transactions, they involve either a single-step merger or a two-step tender offer followed by a merger. Because target management wants the deal to be completed, the private equity firm does not need to solicit votes in contested elections except in unusual situations.

256. Commonly, merger arbitrage is when

help private equity firms by stopping potential objectors from accumulating larger equity stakes and the associated voting rights in the target firm. This would hold true even if the hedge funds, or other objecting shareholders, are able to obtain target firm voting rights without the associated equity interest, so called “empty voting,”²⁵⁷ because the poison pill still limits their voting power (or the voting power of all the members of their “group”) to the maximum percentage specified in its trigger level.²⁵⁸

For similar reasons, a staggered board will be of little concern to a private equity purchaser. Since the transaction is likely to be friendly, there is no need to replace the board. In fact, a staggered board is a benefit to such a purchaser since it will impede any competing bids, thus making the completion of the purchase more likely.

3. Shareholder Activist Hedge Funds

Hedge funds can “generally have four characteristics: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements.”²⁵⁹ Hedge funds focus on particular private markets, the focus of which differentiates them from private equity or venture capital funds that also have these four characteristics.²⁶⁰ Hedge funds also avoid being regulated as mutual funds because they have a relatively small number of sophisticated or wealthy individual and institutional investors.²⁶¹

While hedge funds engage in a wide variety of investment strategies, we are interested in hedge funds that have acted as shareholder-activist investors on issues

a hedge fund takes a long position in a merger target and a short position in the acquirer and simply waits for the merger to close. The hedge fund makes a spread upfront between the higher value of the short target position and the lower value of the long acquirer position. At the merger closing, the two positions offset.

Partnoy & Thomas, *supra* note 192, at 125. For a more complete discussion, see THOMAS KIRCHNER, *MERGER ARBITRAGE: HOW TO PROFIT FROM EVENT-DRIVEN ARBITRAGE* (2009). For a simpler explanation, see *Risk Arbitrage*, WIKIPEDIA, http://en.wikipedia.org/wiki/Risk_arbitrage.

257. See generally *Crown Emak Partners v. Kurz*, 992 A.2d 377 (Del. 2010); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

258. Thomas, *supra* note 1, at 512–13.

259. Partnoy & Thomas, *supra* note 192, at 115 (citing 15 U.S.C. § 77d(2) (2006)) (providing the Securities Act of 1933 registration requirements); *id.* § 80a-2(a)(51)(A) (providing the Investment Company Act of 1940 registration requirements); *id.* § 80a-3(c)(7) (providing the Securities Exchange Act of 1934 reporting obligations); *id.* § 80b-3(b) (providing Investment Advisers Act of 1940 registration requirements)).

260. Partnoy & Thomas, *supra* note 192, at 115.

261. Most hedge funds are exempt from the Investment Company Act of 1940, either because (1) they have 100 or fewer beneficial owners and do not offer their securities to the public, or (2) all of their investors are “qualified” high net-worth individuals or institutions. See 15 U.S.C. § 80a-3c(1), (7).

related to governance and strategy. A common technique is for a fund to take a substantial long position in a firm's shares and then demand changes in that firm's governance and strategy.²⁶² As one of us has found in prior work, hedge funds influence corporate boards and managements by holding 5–10% positions²⁶³ in small numbers of companies, then working with other hedge funds and investors. They target undervalued companies that are profitable but with significantly higher institutional ownership and trading liquidity.²⁶⁴ These characteristics make it easier for the activists and their allies to acquire significant stakes quickly.

Hedge fund activists use a wide variety of tactics to pursue their objectives, and are largely successful even though they hold relatively small stakes.²⁶⁵ Hedge fund activists frequently take friendly positions toward target management, but other times they are openly confrontational with them. They generally are not interested in taking control of the company, but rather hope to act as minority investors with other shareholders' support to force value-enhancing changes in the target company.²⁶⁶ In earlier work, one of us found that activism aimed at the sale of the target generates the highest returns, with financial restructuring transactions also generating a significant abnormal return.²⁶⁷

Hedge funds are significantly different from strategic buyers and private equity firms because they are not generally actual purchasers of the firms that they target. Instead, they act as catalysts for change, sometimes pushing companies to put themselves up for sale (often to private equity firms), other times forcing a reluctant target firm to engage in financial restructuring or a host of other possible actions.²⁶⁸ When hedge funds use the ballot box, it is generally in support of a "short-slate" proxy contest where they seek to gain representation on a targeted firm's board of directors.²⁶⁹ The key to hedge funds' success is to generate investor pressure on a target firm to make changes.

The rights-plan trigger level is unlikely to directly affect the hedge fund activist. The activist fund itself will generally have a relatively small stake in the targeted firm, and will studiously avoid engaging in any type of conversation with other investors to avoid creating a "group" whose holdings would exceed the trigger level of the poison pill.

As with private equity, the existence of a staggered board is of little consequence to a hedge fund. A hedge fund will mostly be interested in gaining

262. Brav et al., *supra* note 165, at 1741–45 (summarizing hedge funds' stated objectives after acquiring substantial stock position in target firm).

263. The median initial (maximum) percentage stake that a hedge fund takes in the target is 6.3% (9.1%), and the median dollar stake, at cost, is \$11.9 (\$15.8) million in 2006-constant dollars. *Id.* at 1747.

264. *Id.* at 1749–55 (analyzing hedge fund targeting metrics).

265. *Id.* at 1747 (showing ownership positions), 1756 (showing stock price performance of targeted firms).

266. *Id.* at 1742.

267. *Id.* at 1759.

268. *Id.* at 1742.

269. Jared L. Landaw, Keith E. Gottfried & Barry H. Genkin, *The Ten Elements of a Proxy Contest Settlement*, 26 ACC DOCKET, Apr. 2008, at 74, 78.

representation on the board rather than taking control of it. A short-slate contest can be as effective in a staggered board as it is for a nonstaggered board.

B. Description of Third-Party Voting Advisors

As we discussed above, proxy-voting advisors give advice to institutional investors, and others, about how to vote their shares.²⁷⁰ ISS is the leading proxy-advisory firm in the world with clients such as forty-three of the largest fifty mutual fund groups.²⁷¹ Voting recommendations by ISS are viewed as influential, if not determinative, in proxy contests.²⁷² For example, companies involved in voting contests will often issue press releases pointing to favorable ISS voting recommendations. Given the dominance of the ISS and the concentration of the market in the proxy advisory services, some commentators have criticized ISS' "virtual monopoly."²⁷³

Institutional investors overwhelmingly use the services of ISS and the other third-party voting advisors, and empirical research has shown that a recommendation by ISS has an impact on the outcome in shareholder voting contests.²⁷⁴ Institutional Shareholder Services' (ISS') influence will vary across firms depending on the degree of institutional ownership of those firms' stock, but should be significant for many of them.²⁷⁵ Moreover, their recommendations will introduce a bias toward certain groups of dissidents and away from others.

To understand this point, consider first that these advisors, particularly ISS, issue recommendations on both control contests and contests that merely seek representation on a target firm's board of directors. ISS will often issue a favorable recommendation for dissident shareholders seeking to elect a minority of directors through short-slate proxy contests.²⁷⁶ Shareholder activist hedge funds run a disproportionate number of short-slate contests, so they are the primary beneficiaries of these recommendations.²⁷⁷

270. See *supra* notes 194–99 and accompanying text.

271. Cotter et al., *supra* note 194, at 7.

272. Alexander et al., *supra* note 194, at 34–35.

273. See Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 296–97 (2003) (citing problems of limited competition in proxy advisory services).

274. Alexander et al., *supra* note 194, at 270; Choi et al., *supra* note 194, at 657; Cotter et al., *supra* note 194, at 55.

275. Alexander et al., *supra* note 194, at 2 (discussing proxy fight over merger of Compaq Computer and Hewlett Packard Co. and stating “[o]bservers largely credited the favorable recommendation of Institutional Shareholder Services (ISS), a leading proxy advisory service, with turning the tide in favor of the controversial merger proposal”)

276. From 2006 to 2011, ISS supported hedge fund dissidents in fifty out of the seventy-eight contests where they sought board representation, but in the eleven contests where board control was at issue, ISS never supported the full dissident slate. INNISFREE M&A INC., VOTING ADVISORY SERVICES AND SHAREHOLDER ACTIVISM – SELECTED STATISTICS 1 (2011).

277. In the fifty proxy contests where ISS supported dissident shareholders' candidates, at least one of those candidates gained a board seat in 70% of the contests. *Id.*

By contrast, strategic buyers tend to launch proxy contests to replace either a controlling portion or the entire board of a target firm.²⁷⁸ ISS also issues voting recommendations in these contests, but the voting recommendations are less likely to favor the acquirer than ISS' short-slate recommendations favor dissidents,²⁷⁹ as valuation is a significant, if not overriding factor, in the decisions of ISS regarding strategic slates. This will reduce the bidder's likelihood of success and raise its costs for conducting the proxy contest since it will need to persuade all of the shareholders individually rather than focusing on ISS and having them send the necessary signal to their clients. The net effect of the differing impact of ISS is to favor hedge funds over strategic acquirers.

C. Incorporating These Factors into the Range of Reasonableness Analysis

Under *Unocal*'s second prong, takeover tactics cannot be preclusive, and even if they are not, they must still fall within the range of reasonableness.²⁸⁰ Given that we have just shown the importance of differentiating between the different types of bidders in judicial analysis, how should these differences be analyzed within the *Unocal* framework? We think that this type of more subtle differentiation would be best accomplished by courts in their consideration of the range of reasonableness part of the second prong of *Unocal* because a court's ability to incorporate different factors into the mathematical model we use for preclusion is already stretched to the limit. The second set of factors that we introduced in this section are more easily considered on an ad hoc basis by the court as a more nuanced way of determining if the overall response of the target to the dissident is reasonable.²⁸¹

How would a court do this? Consider the effects of a broad interpretation of *Selectica*, one that permits an across the board lowering of trigger levels for all rights plans. In a range of reasonableness determination considering both the type of bidder and the effects of third-party voting advisors, we believe that this would tilt Delaware law in favor of hedge funds and private equity firms over strategic acquirers, and would greatly increase the power of third-party voting advisors.²⁸²

278. Confidential email from proxy solicitor to Randall Thomas (Sept. 21, 2011) (on file with author).

279. Miller, *supra* note 193, at 12–26 (“[A]lthough some proxy advisory services (including ISS) have a clear track record of supporting the election of a minority of dissident directors, they have offered far less frequent support, and applied greater scrutiny, to slates seeking majority control.”).

280. *Unitrin Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1387 (Del. 1995).

281. The Delaware Supreme Court's analysis in *Selectica* is a good illustration of how courts are already taking into consideration additional factors about a bidder in their range of reasonableness analysis even after they complete their consideration of the preclusive effect of takeover defenses. *See* 5 A.3d 586, 605–06 (Del. 2010) (describing Trilogy as a competitor, creditor, and shareholder of *Selectica*).

282. Our analysis is largely consistent with what the Delaware Supreme Court did in its range of reasonableness analysis, where it considered not only Trilogy's interest as a bidder, but also its other interests as a competitor and a creditor of *Selectica*. *Id.* at 605. We think that in order to give the range of reasonableness part of the *Unocal* analysis any substance, courts need to not only consider these factors in the abstract but also attach some weight to them in determining whether or not to uphold defensive tactics as they did in *Selectica*. We

To demonstrate our point, we begin by noting that, as a matter of public policy, corporate law should not treat strategic acquirers worse than hedge funds or private equity funds, as the former may attach higher valuations to the target firm's assets. We believe that a broad reading of *Selectica* will have this effect for several reasons. First, a 5% poison pill trigger level may decrease the amount of stock that a potential strategic acquirer can accumulate, thereby making it more difficult for such a bidder to prevail in a proxy contest for corporate control as it will directly control fewer votes. The impact of this effect will be stronger for strategic acquirers than hedge funds, or private equity firms, because strategic acquirers use proxy contests for corporate control more frequently than other types of potential bidders.²⁸³

Second, strategic acquirers frequently buy large toehold stakes in targeted firms.²⁸⁴ This large target stock position helps offset the costs of an unsuccessful bid in the event that another bidder tops their offer and also allows them to buy some target stock at the pre-offer price. Reducing the amount of target stock that strategic acquirers can accumulate will decrease the expected value of a takeover attempt and adversely affect their incentive to pursue value-enhancing acquisitions. Forcing strategic bidders to take smaller toeholds in target firms also reduce their incentives to launch proxy contests for corporate control as they will receive a smaller percentage of the benefits from improving target-firm operations.

Third, strategic bidders with smaller stakes in target firms will find it harder to signal to the market that they are serious bidders. Large stakes send a strong signal to the market, and to third-party voting advisors, that the acquirer is seriously pursuing the target and believes it is undervalued. It will be harder to a strategic acquirer to convince other shareholders, and third-party voting advisors, about its true intentions if it cannot put its money where its mouth is.

Turning to hedge funds, the median size of their initial stock positions are only 6.3%,²⁸⁵ far below the usual 15 to 20% trigger level of current rights plans,²⁸⁶ although slightly higher than a 5% pill trigger level. Private equity firms almost always engage in friendly transactions and therefore target boards waive the provisions of the poison pill for them. We conclude that lower pill triggers will

assume that this is the reason that the Delaware courts have gone to such great lengths to include this additional piece in the *Unocal* test.

283. Confidential email from proxy solicitor to Randall Thomas (Sept. 21, 2011) (on file with author). “[A]ctivist hedge funds are generally not interested in taking control of the company.” Brav et al., *supra* note 165, at 1748.

284. Sandra Betton & B. Espen Eckbo, *Toeholds, Bid-Jumps, and Expected Payoffs in Takeovers*, 13 REV. FIN. STUD. 841, 858 tbl.4, 879 (2000) (finding an average toehold of 14.57% but that only 53% of bids in the sample had toeholds); Michael Bradley, Anand Desai & E. Han Kim, *Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3, 6 tbl.1 (1988) (reporting bidders have average toeholds of 10% at the time of takeover bid). For a more theoretical discussion, see Bebchuk, *supra* note 30 (bidder profits from ownership stakes in target firm usually offset the bidder's search costs and bid commencement fees); Freund & Easton, *supra* note 246, at 1777 n.171 (1979) (discussing common practice of acquirers buying large stake in target firm before announcing bid).

285. Brav et al., *supra* note 165, at 1747.

286. BROWN ET AL., *supra* note 2, at 16-41.

penalize strategic acquirers and, to a lesser extent, hedge funds relative to private equity firms.

Another effect of lower rights-plan triggers will be to increase the power of third-party voting advisors, such as ISS or Glass Lewis. To see this point, notice that the absence of strong signals by strategic bidders will expand these advisors' role in the voting process as the information that they provide to institutional investors and other block holders about potential acquisitions becomes relatively more important. Furthermore, if strategic buyers hold less stock, then the rest of the market will hold more, so that, all other things being equal, voting advisors' clients will hold a larger percentage of the voting shares in a proxy fight or sale situation, again increasing their influence. If the Delaware courts are concerned about the potential agency costs associated with extensive reliance on third-party voting advisors,²⁸⁷ they should consider whether their actions increase those costs.

Finally, hedge funds' incentives to start proxy contests should be relatively unaffected.²⁸⁸ In proxy fights, the dissident hedge fund often gets strong voting support from other hedge funds holding the target firm stock. Frequently these other hedge funds came into the stock because their opportunity analysis was similar to that of the dissident, so it is not surprising that they would be sympathetic to the dissident's agenda. Somewhat less frequently, a dissident hedge fund may attract "follower" hedge funds that buy in simply because of the dissident's ownership (the "wolf pack" phenomenon) and could be expected to vote similarly.²⁸⁹ To the extent that hedge funds rely on institutional investors for support in short-slate contests, third-party voting advisors should continue to support them as in the past. Typically, advisors give favorable recommendations to short-slate contests that seek to remove only a handful of directors, and these are the most popular type of contest for hedge funds.²⁹⁰ Institutional investors are likely to follow the voting advisors' recommendations in these noncontrol situations.

287. Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006).

288. Professor Jeffrey Gordon pointed out to us that the lower trigger level may reduce hedge fund returns by capping the number of shares over which those costs can be distributed. Email from Jeffrey Gordon, Richard Paul Richman Professor of Law, Columbia Law School, to Randall Thomas (Jan. 10, 2012) (on file with author). While we agree with this point, we note that what is key to our analysis is the relative impact of the drop in the trigger level on hedge funds versus hostile strategic bidders. Hostile bidders' costs are likely to be substantially higher than hedge funds' costs. This is because the hostile bidder needs to arrange financing for the acquisition of at least a controlling stake in the target firm plus run a full-fledged control contest, whereas hedge funds are buying a much smaller stake in the target and only conducting a short slate contest. The reduction of the pill trigger from 15 to 5%, will force hostile bidders to drop their initial stake to 5% and spread their higher costs over that smaller block. Hedge funds may need to drop their stake as well, but by significantly less, and then spread their relatively lower costs over their 5% block. As a result, the decline in the trigger level will disproportionately affect strategic bidders.

289. Confidential email from proxy solicitor to Randall Thomas (Sept. 23, 2011) (on file with author).

290. Miller, *supra* note 193, at 12–26.

By comparison, strategic bidders will launch fewer proxy contests for corporate control because of their reduced benefits from success. Third-party voting advisors' recommendations in control contests are generally less influential because institutional investors make their own minds up in these relatively rare, but economically significant, transactions. The overall result will be more short-slate contests and fewer control contests, which should increase the influence of third-party advisors on balance.

A second example further underscores why the type of bidder can make a big difference in understanding the preclusive effects of different defensive combinations. In this example, we note that the combination of a low (5%) pill trigger and a classified board is likely to be a formidable hurdle for a strategic buyer. The enforced delay of the classified board increases the likelihood of the dissident losing as well as creates delay in obtaining any potential financial payoff. The low trigger pill prevents the acquirer both from giving a strong signal to the market about its intentions as well as limiting its benefit from a run up in the stock price. The acquirer may have trouble convincing a proxy advisor to give a positive signal because of this limitation as well.

On the other hand, the same combination of defenses is much less likely to be an impediment for a hedge fund interested in getting representation on a board via a short slate. The fund will likely not desire a very large holding in the company and the staggered board is irrelevant to this objective. The hedge fund may very likely gain the support of a proxy advisor, which commonly supports such contests.

Thus, this particular set of the defenses is more onerous for the strategic acquirer than for the hedge fund. Our basic model of preclusion does not directly incorporate these important differences. However, in a range of reasonableness analysis a court could explicitly consider these factors in assessing the defensive response of the target firm. A court could also take into account whether the strategic acquirer is attempting a value-increasing transaction, or the hedge fund is engaged in a value-transferring transaction. Similarly, a court might consider it unreasonable to use certain defenses to prevent a takeover by a strategic bidder, even though on a different set of facts it could find they are perfectly fine to prevent a hedge fund to gain representation, or vice versa.

In sum, the second portion of the second prong of *Unocal*, the range of reasonableness analysis, can be used to fine-tune the first portion, the preclusion analysis, by incorporating these important differences. In this way, courts could finely calibrate their *Unocal* analysis so as to ensure that value-added transactions are not unduly penalized, while value-transferring ones move forward unimpeded.

V. CONCLUSIONS

The Delaware courts have expended enormous time and energy in their ongoing analysis of defensive tactics under the *Unocal/Unitrin* standard. While we agree with much of what they have done, we think that it is important for the court to provide a single standard of what constitutes a "preclusive" defensive tactic under Delaware law and to more transparently apply that standard. To begin with, we believe that they should explain the difference between *Unitrin's* "realistically unattainable" and *Moran's* "fundamentally restricts" standard. The latter phrase suggests that the dissident must have a more meaningful chance of success in a

proxy contest than the former. Moreover, it is not clear under either standard what chance of dissident success is sufficient.

Once these issues are clarified, we urge the court to adopt a simple, weighted voting model to calculate the impact of different defenses on the dissident's likelihood of success in a proxy contest. This model has the virtue of directly incorporating the share ownership patterns for any company directly into its analysis, while also considering the effect of proxy voting advisors on the outcome of such a vote. Finally, it provides a direct estimate of the likelihood of success of the dissident based on the particular defenses employed by the target company.

To avoid overly complicating the model, we urge the court to use the range of reasonableness analysis, when needed, as a way of considering several other important aspects of corporate elections. In particular, we argue that the court needs to consider the type of bidder that is involved in the proposed transaction, the type of contest that they are engaged in, and the effect of these two factors on the third-party voting advisors advice to its clients. We provide two examples of important defensive tactics to illustrate why these effects are so important.

The first example shows that an across the board approval of low trigger-level poison pills will tilt the acquisition playing field in favor of hedge funds at the expense of strategic bidders, while also greatly increasing the power of third-party voting advisors. Our second example demonstrates how a court's analysis of the effects of the combination of a classified board and a poison pill should take into account the type of voting contest being run as well as the type of bidder involved in the contest.

In the final analysis, we would hope that the court will clarify the legal standard it is applying in these cases, as it has far reaching effects. Delaware has carefully crafted its law to favor proxy contests over market transactions²⁹¹ and to subject acquisitions to close judicial scrutiny only when they involve a "change of control."²⁹² It must be careful lest it permit sudden changes that will throw its system into disequilibrium. We foresee that a broad endorsement of 5% rights plans' triggers will shift the legal landscape.²⁹³ An across the board reduction of poison pill trigger levels would discriminate against strategic bidders in favor of hedge funds and private equity firms. It would also greatly increase the power of third-party proxy voting advisors by giving them the deciding vote in most corporate elections. If the court does not wish to cause these types of changes to the

291. Gilson, *supra* note 69, at 502.

292. *Paramount Comm'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46–47 (Del. 1993).

293. We note that widespread use of such a trigger level would also reduce the amount of information available to the marketplace about potential takeover bids as it would interact with the 5% trigger for disclosure obligations contained in section 13(d) of the Securities Exchange Act of 1934. 15 U.S.C. § 78(m)(d) (2006). In other words, since the pill threshold would stop potential bidders from purchasing more than 5% of the target's stock, they would no longer have to disclose their holdings under section 13(d).

A second effect will be an overall decline in the number of large stockholders at public companies. These blockholders are generally thought to be the most effective type of monitors of potential management misconduct and add value for that reason. Clifford G. Holderness, *A Survey of Blockholders and Corporate Control*, *ECON. POL'Y REV.*, April 2003, at 51. Reducing the number of blockholders should have a negative overall effect on many corporations.

American corporate governance system, then it should take action to forestall a drop in poison pill trigger levels.

VI. TECHNICAL APPENDIX

In this Part, we formally describe the voting model used in this paper. An earlier version was introduced to study the effect of ownership structure on the likelihood of a successful corporate takeover.²⁹⁴ The model is designed to incorporate two important aspects of voting in corporate governance. The first is that there are blocs and not just single shares being voted, and the second is that there is an external signaler advising at least some of the participants on the vote. The model itself is a probabilistic version of a standard weighted voting model from the theory of cooperative games. For background the reader might consult Owen.²⁹⁵

The first part of our model describes weighted voting. Let $V = \{v_1, v_2, \dots, v_n\}$ be a set of voters and suppose that voter v_i votes a percentage s_i of the outstanding shares in favor of management with probability p_i . A subset $A \subseteq V$ of the voters can carry the election if

$$\sum_{i \in A} s_i > 50$$

and the probability that every voter in A votes in favor of management and every other voter is against is

$$\prod_{i \in A} p_i \prod_{j \notin A} (1 - p_j).$$

It follows, then, from elementary probability that the probability that the vote will be in favor of management is given by

$$\sum_{\substack{A \subseteq V \\ \sum_{i \in A} s_i > 50}} \prod_{i \in A} p_i \prod_{j \notin A} (1 - p_j)$$

The second part of our model is to include a signaling agent that affects the value p_i for some of the voters. We divide the voters into three groups. The first group of voters will cast their vote with a fixed probability although these probabilities need not be all the same. For example, the voter we designate Management will cast a vote in favor of management with probability 1.

A second class of voters will cast their vote in accordance with a signal they receive from an advisory agent I . Let I be an agent that issues one of two recommendations, either For, which is in support of management or Against. If a For recommendation is issued then this second class casts a vote in favor of

294. Edelman & Thomas, *supra* note 196, at 465.

295. GUILLERMO OWEN, GAME THEORY 212 (3d ed. 1995).

management with a probability p where p is distributed according to the probability density function

$$f(x) = \begin{cases} 0 & \text{if } x \leq .5, \\ 8x - 4 & \text{if } .5 \leq x \leq 1, \\ 0 & \text{if } 1 < x. \end{cases}$$

a graph of which is pictured in Figure 1.

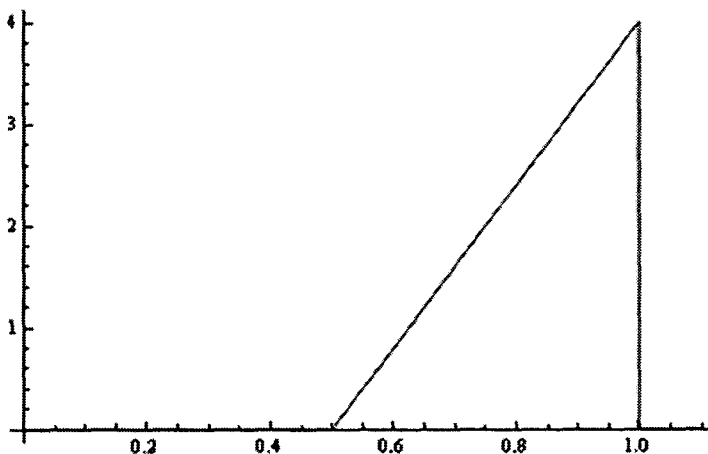


Figure 1

The intuition behind this choice of distribution function is that when presented with a For signal, the shareholders will most likely vote with management, but there may be some combination of noise in the signal that makes it less than a sure thing.²⁹⁶ In a similar way, a signal of Against results in the choice of a probability p taken from the distribution function

$$g(x) = \begin{cases} 0 & \text{if } x < 0, \\ 4 - 8x & \text{if } 0 \leq x \leq .5, \\ 0 & \text{if } .5 \leq x. \end{cases}$$

whose graph is shown in Figure 2.

296. This function is somewhat different than the one we employed in our earlier work. See Edelman & Thomas, *supra* note 200, at 466. The motivation for the change is that in the current application we will be assuming that the proxy advisor will be giving more in-depth analysis because more parties will be relying on it for information. With a more in-depth analysis comes increased opportunity for confusion. So we assume that the signal given by the advisor will be more open to interpretation and hence somewhat less strong.

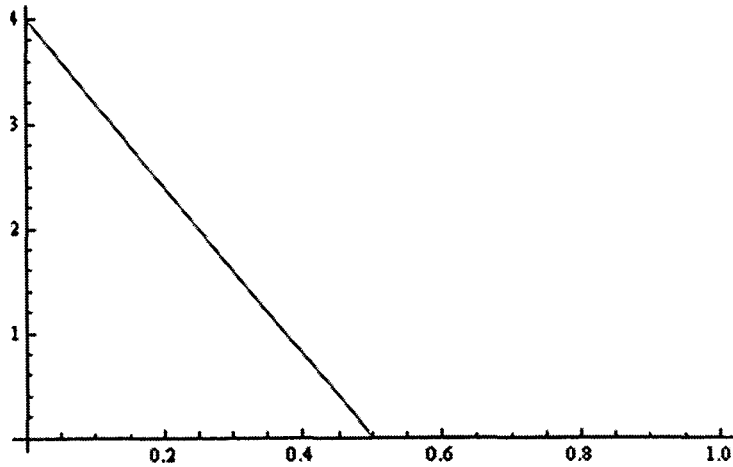
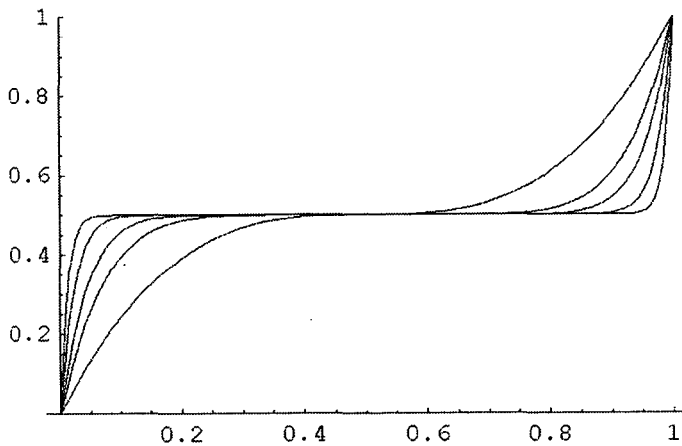


Figure 2

The vote of the last class of voters, while correlated with the signal given by I , is not as tightly controlled as the second class. For this last class of voters we use a two-parameter family of functions, $r(k, t, x)$, defined by

$$r(k, t, x) = \begin{cases} h(k, x)(1-t) + t & t \geq 0, \\ h(k, x)(1+t) & t \leq 0 \end{cases}$$

where $h(k, x) = 2^{2k}(x - \frac{1}{2})^{2k+1} + \frac{1}{2}$. The following graphs show how the parameters k and t affect the shape of this function.

Figure 3 $r(k, 0, x)$ for $k=1, 3, 5, 10$ and 20

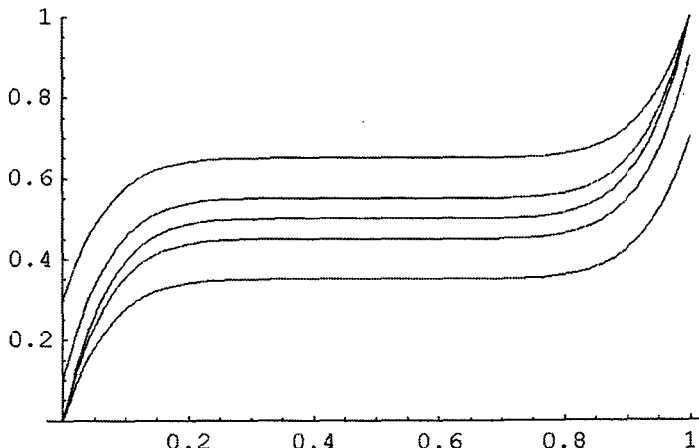


Figure 4 $r(3,t,x)$ for $t = -.3, -.1, 0, .1, \text{ and } .3$

The parameter k controls the flatness of the curve and the parameter t raises and lowers the curve. We will discuss the modeling significance of these parameters shortly.

The vote of this last class of shareholders is decided in the following way: If the signaler I gives a For signal, then a probability p is taken from the density function f , as with the previous class of shareholders, but this class votes in favor of management with probability $r(k,t,p)$. The value of k has the effect of making this class of shareholders more or less influenced by the signal, and the value of t introduces an underlying bias for or against management independent of the signal. The same method produces the probability for a vote in favor of management if the signaler gives an Against signal, only substituting the density function g for f .

The intuition that this model is trying to capture is that, for this last class of voters, the vote will be correlated with the signaler's recommendation, but that the extent of that correlation, and the underlying bias in favor of (or against) management might vary. Thus, the choice of the function $r(1,.3,x)$ would indicate a shareholder whose vote will strongly correlate with the signal, but has an underlying bias in favor of management. The function $r(20,-.3,x)$ results in a vote weakly correlated with the signal and with an antimanagement bias.

We give now an illustration as to how to put the two parts of this model together. Suppose the corporation consists of five voters, which we call Management, Dissident, Institution I, Institution II, and Public. Suppose further that Management holds 15% of the stock, Dissident holds 12%, Institution I has 30%, Institution II has 40%, and Public has 3%. We will assign Management the probability 1 of voting for itself, Dissident a probability of 0 and Public a probability of .5. Let Institution I listen to the signaler I (that is Institution I is of the second class of voters described above) and suppose Institution II is of the third class of voters, with vote governed by $r(5,-.2,x)$, so Institution II is somewhat biased against management and somewhat sensitive to the signaler.

From this data we can compute the expected probability that Management will win the election in the case that signaler I issues a For or Against. Suppose the signaler issues a For signal. Let us look at one scenario in which management wins, the one in which Management and Institution II vote for management (securing

15%+40%=55% of the stock in favor) and the other three voters vote against. The probability of Management, Dissident, and Public voting in this manner is 1, (1-0)=1, and (1-.5)=.5. The probability of Institution I voting this way is (1- p) where p is drawn from the distribution g , and the probability of Institution II voting in favor of management is $r(5, -.2, p)$. So the expected probability of Management winning the election with exactly this set of votes is

$$\int_{.5}^1 1 \times (1-0) \times (1-x) \times r(5, -.2, x) \times .5 \times (8x-4) dx = .0344$$

To compute the likelihood that management will win with some set of votes, we have to consider all of the different combinations of votes that result in management winning and integrate over the likelihood of such an outcome. The result in this instance is .462. That is, with this distribution of stock and the above assumptions about voting probabilities, if the signaler gives a For signal then we expect management to win slightly under half of the time.

One of the applications of our model will be to the analysis of defensive tactics such as a staggered board. In analyzing this situation we will need to compute the likelihood that management will lose two consecutive elections. If management wins the first election with probability p and the second election with probability q (which may be different from p as we describe subsequently) the likelihood of losing both elections is

$$(1-p) \times (1-q)$$

and hence the likelihood of winning at least one election is $1-(1-p) \times (1-q)$. Thus, if in order to succeed the dissident must win two consecutive elections, then management will win the contest with probability $1-(1-p) \times (1-q)$.

Rather than working in terms of the probability of a management win in the vote, we could also compute the expected number of votes for management. This is a much simpler computation. If p_i is the probability of voter i casting a bloc of s_i shares for management, then the expected vote for management is given by

$$\sum_{i=1}^n p_i s_i$$

While being simpler, it is somewhat less informative. Suppose that when management wins it is by a small margin, but when it loses it is by a large one. Then the probability of a management victory may well be quite large, but the expected vote total for management rather small. Nevertheless, it can be useful to see the model's predictions in terms of vote totals rather than probabilities.

Having defined the general form of the model, we want to describe the exact specifications that we made in doing the computations in Part III. To fully specify the model, we have to choose a distribution of shares among the voters and for each voter specify the likelihood that he will vote for management given a signal from the third party. In Part.III.C, we specified the share distribution for each of our

scenarios. What is left for us to describe is how the voters cast their votes in each of the two contests we describe.

In Example 1, the proxy contest for corporate control, we will make the following assumptions: Management always votes for itself ($p=1$), Dissident always votes for itself ($p=0$), Institution I votes according to the recommendation of the advisor ($p=x$, where x is taken from the probability density f or g depending on whether the advisor gives a For or an Against), Institution II is insensitive to the advisor with a slight bias against management ($p=r(20, -.1, x)$), and Institution III is insensitive to the advisor with a slight bias in favor of management ($p=r(20, .2, x)$).

To study the direct effect of a lower trigger on the success of management in a proxy contest, we looked at how the likelihood of a win changed as we redistributed the shares from the dissident to the three categories of institutional investors. We did the redistribution by dividing the shares taken from the dissident equally among the institutional investors. Thus, if we moved 9% of the shares from the dissident we assigned 3% to each of the three types of institutional investors.

In the case of a takeover contest with a tender offer, Example 2 in Part.III.C, we choose somewhat different probabilities. In this situation, the dissident's election platform is much stronger, since he has committed to buy the outstanding shares at a market premium, if the pill is redeemed. Thus, we assume that the other shareholders will be more disposed to voting for the dissident than they would be in Example 1. The specifications we use are: Management votes for itself ($p=1$), Dissident always votes for itself ($p=0$), Institution I votes according to the recommendation of the advisor ($p=x$), Institution II votes with a more pronounced bias against management ($p=r(20, -.5, x)$), and Institution III also has a bias against management ($p=r(20, -.2, x)$).

It is important to discuss how sensitive the model is to the choice of the exogenous parameters. We start with the behavior of the variable k which measures the sensitivity of the institutional investors to the proxy advisor's signal. In our applications this value is set to 20 for both sets of Institutional investors. Even if this value is lowered to 10 for both sets of investors, the computed probabilities vary on average by 10%. If both values of k are lowered to 5 the resulting probabilities can vary by as much as 30%.

Another exogenous variable is t which indicates the bias of the institutional investors to management. The values of t vary in our applications between $-.5$ and $.5$. Variations of one of these values by an amount of $.2$ results in a variation of the computed probabilities of around 25%.

Finally, the model is sensitive to the distribution of shares. For technical reasons, we have insured that the shareholders cannot be partitioned into two groups each holding exactly half of the shares. With that exception, it follows from the discrete nature of the model that small changes in the distribution will not affect the computed probabilities.

Lastly, we might consider how well this model fits the known empirical results. In one sense our model is not a very good fit. Recent studies show that a change in the recommendation of the proxy advisor results in a change of roughly 20–25% in

the vote for management.²⁹⁷ Using a more stringent definition of the influence of the advisor, Choi, Fish, and Kahan find that an ISS recommendation shifts 6–10% of the vote in director elections.²⁹⁸ By contrast, our model shows shifts more typically in the 13–16% range.

Should this difference be of concern for us? We think not. First, the current empirical work has focused on routine contests, whereas we are focusing more on the salient votes in proxy contests or takeover battles. There is little reason to think that one should expect to see similar numbers given the vastly different issues at stake.

There is another, and more interesting, reason why we should not expect our model to conform to the empirical studies. The empirical studies necessarily see only those elections that take place, not all possible elections. Proxy contests and takeover battles might be joined and then resolved before there is an actual vote. Management might agree to add members to the board to avoid short slate challenge, or they may agree to disarm a pill if they see that resistance is futile. Thus, the elections that are observed are but a small subset of those that might be conducted. This adds a systematic bias to the observations which our model would not exhibit.²⁹⁹

297. Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29, 46 (2002); Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, *Electing Directors*, 64 J. FIN. 2389, 2401 (2009). The former paper analyzes the vote on management proposals, the latter analyzes uncontested director elections.

298. Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 906 (2010).

299. This systematic bias is similar to what one observes about cases that actually go to trial rather than settling. This is the basis for the work of Priest and Klein. *See generally* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984).