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Daniel R. Fischel

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Recommended Citation
THE "RACE TO THE BOTTOM" REVISITED: REFLECTIONS ON RECENT DEVELOPMENTS IN DELAWARE'S CORPORATION LAW

Daniel R. Fischel*

The extent to which state corporation law provides adequate protection for shareholders' interests has been a subject of considerable controversy in recent years.¹ The debate has been particularly heated with respect to the Delaware corporation law, due to the high percentage of firms that have chosen to incorporate, or reincorporate, in Delaware.² In a highly publicized article, Professor William Cary, former Chairman of the Securities and Exchange Commission, has argued that Delaware has achieved this dominance by virtue of its liberal or "enabling" corporation statute (as interpreted by judicial decisions) which allows management to further its own interests at the expense of those of the shareholders.³ In Cary's view, Delaware's prominent role in corporation law has been achieved as a result of its success in the "race for the bottom."⁴

Cary's attack on the laxity of state corporation laws, and of Delaware law in particular, has been echoed by numerous leading law professors and social reformers, who have advocated various forms of

* Associate Professor of Law, Northwestern University. B.A., Cornell University, 1972; M.A., Brown University, 1974; J.D., University of Chicago, 1977. The author would like to thank Frank H. Easterbrook and Stephen Presser for their assistance.


² For a statistical demonstration of Delaware's dominance in the market for incorporations, and particularly, in the market for reincorporations, see Dodd & Leftwich, The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation, 53 J. BUS. 259 (1980).

³ Cary, note 1 supra.

⁴ Id. The phrase, "race for the bottom," is Cary's. See id. at 666.
federal regulation of corporations.\textsuperscript{5} Federal regulation is necessary, proponents argue, to ensure that shareholders receive the necessary protection which has not been provided under state corporation law.\textsuperscript{6} To implement this objective, bills have been introduced which would have greatly increased federal regulation of corporations.\textsuperscript{7}

Despite strong academic and popular support, federal regulation of corporations does not appear likely in the near future. It would be a mistake to conclude, however, that Professor Cary and other critics of the current state of corporation law have had no effect. One obvious effect generated by the voluminous literature on corporate governance is the widespread perception that there is something “wrong” with the way corporations are governed. Although not one shred of empirical evidence has been adduced to support this view, the avalanche of proposals for change of the corporate structure continues unabated. Another apparent effect, more important for my purposes, is the change in Delaware law itself. In a series of recent decisions, the Delaware Supreme Court has strengthened considerably the power of minority shareholders vis-a-vis management.\textsuperscript{8} These decisions have largely


\textsuperscript{6} See generally Senate Hearings on Corporate Rights, note 5 supra. Entered into the record as a part of these hearings was the following statement, signed by 80 law professors at 62 different law schools:

As law teachers who have had a special opportunity to study the law of corporations from an independent perspective and to reflect on the proper function of corporation law and the extent to which the law in its current state fulfills that function, we have a particular interest in the current hearings on the possibility of an expanded federal role in corporation law.

While we believe that it would be difficult if not impossible at this time to achieve a consensus among us as to the precise role the federal government should play in shaping the organic law of corporations, we are in general agreement that state corporation statutes and case law have suffered over the years from what Professor William Cary of Columbia University has called a “race to the bottom,” and that as a consequence they no longer adequately serve to guide and regulate the activity of large corporations and their managers, as is the proper role of organic law. We also believe that, with the Supreme Court apparently in the process of drawing limits against the further expansion of federal regulation of corporations through the medium of the securities laws, and with public concern about various kinds of corporate impropriety running at a high level, there is a particular urgency at this time for the Congress to consider some form of federal intervention in this area, whether through the means of a federal chartering statute, through federal “minimum standards” for state corporation laws, or some other mechanism.

\textit{Id.} at 344.


\textsuperscript{8} See Part II, infra, at 923-41.
been applauded by commentators who view them as a reversal of the perceived promanagement bias that has characterized Delaware corporation law.9

The purpose of this article is to evaluate these recent developments in Delaware law. In Part I, I critically analyze the “race to the bottom” thesis and demonstrate that it is based on a fundamental misunderstanding of the corporate form of firm organization. Several recent Delaware Supreme Court decisions, which illustrate the emerging trend in Delaware law, are discussed in Part II. I conclude that these decisions, although containing much rhetoric about protection of shareholders, will actually operate to reduce shareholders’ welfare. In Part III, I offer some tentative observations on the effect of these recent developments on the future of Delaware corporation law.

I. AN ANALYSIS OF THE ATTACK ON DELAWARE’S CORPORATION LAW

A. The “Race to the Bottom” Thesis

Professor Cary and the other proponents of the “race to the bottom” thesis have focused on the revenue that is produced for a state which attracts corporate incorporations.10 The search for revenue, the argument runs, has led states, particularly Delaware, to attempt to create a favorable climate for management in order to attract new business. The result has been the enactment of enabling statutes which allow management to run the corporation’s affairs with little interference from shareholders or the courts.11 These enabling statutes “have watered the rights of shareholders vis-a-vis management down to a thin gruel.”12 This effect has been exacerbated by the Delaware courts which, as a result of an incestuous relationship with legislators and the practicing bar,13 have adopted a “laissez-faire attitude”14 and thus have

11 The student author is the most emphatic in his characterization of Delaware law:

The sovereign state of Delaware is in the business of selling its corporation law. This is profitable business, for corporation law is a good commodity to sell. The market is large, and relatively few producers compete on a national scale. The consumers of this commodity are corporations, and as we shall see, Delaware, like any other good businessman, tries to give the customer what he wants. In fact, those who will buy the product are not only consulted about their preferences, but are also allowed to design the product and run the factory.

Id.

12 Id.
13 Id. at 690-92.
14 Id. at 690.
“contributed to shrinking the concept of fiduciary responsibility and fairness.”15

Widespread reform is thought necessary to remedy this “race to the bottom.” There is no reason, Professor Cary argues, why “the policy of a single state occupying a critical position should be permitted to grant management unilateral control untrammeled by other interests.”16 Rather, “[t]here is a need for uniformity in standards to prevent the application of Gresham’s law.”17 To provide this uniformity, Cary advocates increased federal regulation of corporations. He proposes a “Federal Corporate Uniformity Act” that would “remove much of the incentive to organize in Delaware or in rival states.”18 This proposed statute would include, inter alia, federal minimum fiduciary standards, a requirement that certain uniform provisions be included in the certificate of incorporation to ensure more shareholder control, and a requirement of more frequent shareholder approval of corporate transactions.19

Other proposals for federal regulation to fill the gap left by the absence of meaningful state regulation go even further. The recently proposed Corporate Democracy Act of 198020 and Protection of Shareholders’ Rights Act of 1980,21 would, for example, require that a majority of a corporation’s board be composed of independent directors; that some committees be composed entirely of such directors; that extensive disclosure be made in regard to such matters as planned plant closings and compliance with environmental controls; that a shareholder vote be conducted on major corporate transactions; and that cumulative voting be used in all directors’ elections. Thus far, none of the proposals for federal regulation have been adopted.

B. The “Race to the Bottom Thesis” and the Theory of the Firm

Professor Cary’s critique of Delaware’s permissive corporation statute is an application of the classic Berle and Means thesis that the separation of ownership from control in the large publicly held corporation eliminates the incentives of managers to act in the best interests of shareholders.22 It is only because of this lack of incentive to maximize shareholders’ wealth that an enabling statute, which provides

15 Id. at 696.
16 Id. at 698.
17 Id.
18 Id. at 701-02.
19 Id.

Berle and Means conclude that, under the corporate system, the “function” of having power
management with broad discretion in handling the corporation's affairs, can be viewed as objectionable.

The difficulty with this interpretation of the structure of the corporation, as well with as the "race to the bottom" thesis itself is that these theories are based on a model of shareholder irrationality. Why, given the infinite number of alternative investment opportunities, do shareholders voluntarily entrust their money to managers who have no incentive to maximize their welfare? And why would shareholders ever voluntarily invest in firms located in Delaware, given its alleged pro-management bias which supposedly exacerbates the detriment to shareholders caused by the separation of ownership and control? The extreme unlikelihood that investors would behave in this irrational manner suggests that the Berle-Means-Cary thesis is based on an erroneous premise regarding the structure of the modern publicly held corporation. Recent contributions to the literature on the theory of the firm suggest that the premise is indeed flawed.

In contrast to the traditional approach, which views shareholders as the "owners" of the firm, modern theory emphasizes that the private corporation, like other forms of organization, is simply a legal fiction which serves as a nexus for a set of contractual relationships among individuals. These individuals include the "owners" of labor, material, and capital inputs and also the consumers of the firm's output. It is thus meaningless to think of shareholders as the "owners" of over an enterprise has become separated from that of having interests in an enterprise. See id. at 112-13. As a result of such separation, [i]fwe are to assume that the desire for personal profit is the prime factor motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profitseeking controlling group.

Id. at 114. As for other possible motivations of the control group,

[s]uffice it here to realize that where the bulk of the profits of enterprise are scheduled to go to owners who are individuals other than those in control, the interests of the latter are as likely as not to be at variance with those of ownership and that the controlling group is in a position to serve its own interests.

Id. at 116.

23 For a persuasive refutation of the "race to the bottom" thesis, see R. WINTER, note 1 supra.

24 Shareholders would not be acting irrationally if shares of corporations incorporated in Delaware traded at a lower price. This question has been analyzed empirically. See Part IC, infra, at 920-21. Cary, however, makes no such assumption and therefore his analysis is based on a model of shareholder irrationality.

25 E.g., A. BERLE & G. MEANS, supra note 22, at 113: "In the present study we have treated the stockholders of a corporation as its owners . . . . Of the whole complex of individuals having interests in an enterprise, only those are called owners who have major interests and, before the law, only those who hold legal title."

Rather, shareholders and bondholders provide the firm with its capital in anticipation of receiving a certain rate of return from the firm’s activities. Because there is no assurance that this rate of return will ever be realized, shareholders and bondholders share the risk that total revenues will be less than total costs at the end of any given production period.

When the firm is viewed in this “nexus of contracts” perspective, it becomes clear that the separation of ownership of capital from control of management decisions is actually laudable as an efficient form of economic organization. There is no reason why the risk bearers, who supply the firm with some or all of its capital, should have any control over the firm’s decisionmaking. Indeed, since investors are generally risk averse, the rational investor may choose to hold a diversified portfolio containing securities of a great many firms. Since the whole point of diversification is to avoid concentration of one’s wealth in a particular firm, it necessarily follows that an individual security holder will have neither the interest nor the expertise to manage the affairs of a firm. Such a security holder would much prefer to remain passive and entrust decisionmaking responsibility to a set of professional managers. Thus efficient allocation of risk bearing implies a large degree of separation of security ownership from control of a firm.

This is not to suggest that the separation of ownership and control is costless. In any agency relationship—such as the relationship between shareholders and managers—the interests of the agent will diverge from those of the principal. The agent will have incentives to consume excess leisure or otherwise act in ways inconsistent with maximizing the wealth of the principal. But while these agency costs are an inevitable consequence of the separation of ownership and control, it in no way follows that shareholders are “prejudiced” as a result. Since these agency costs are anticipated, the price which shareholders will pay for shares will reflect the effect of the divergence between their interests and those of the managers. Furthermore, these agency costs

27 Fama, supra note 26, at 290.
28 The terminology is Fama’s. Id.
29 This point is lost on proponents of a system of shareholder democracy under which shareholders are given more power in running the corporation's affairs.
30 A person is risk averse if he would pay less than $5 for a 50% chance of receiving $10; risk neutral if he would pay exactly $5; and risk preferring if he would pay more than $5. The risk aversion of investors can be inferred from the higher rate of return paid to holders of equity securities as opposed to debt. Holders of equity securities bear more risk because debt obligations represent a prior claim on the firm's income stream. Therefore, holders of equity demand—and receive—a higher (average or expected) return on their capital investment.
31 For a general discussion of agency costs in the context of the corporation, and the market forces—particularly the tender offer—that minimize these costs, see Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1169-74 (1981).
would not be incurred unless such costs were outweighed by the gains from the efficient division of labor resulting from the separation of ownership and control.\(^{32}\)

Moreover, various market forces exist to minimize the amount of agency costs. Managers, like other individuals, have strong incentives to maximize the market value of their services. Since the managerial labor market must use performance of the firm to evaluate a manager's ability, each manager has a stake not only in his own performance, but also in the performance of the other managers, both above and below him. Managers therefore monitor each other's performance to determine relative contributions to the success of the firm.\(^{33}\)

Other market mechanisms exist to minimize the divergence of managers' interests from those of the shareholders. Various compensation packages such as stock option plans, which cause managers to share the risk bearing function with shareholders, provide managers with an incentive to maximize shareholders' wealth and keep stock prices high. Additionally, in the event that the performance of a team of managers is inferior, the market for corporate control, particularly the merger and the tender offer, provide a mechanism for displacing inefficient managers and moving assets to higher valued uses.\(^{34}\) The existence of this mechanism provides managers with another incentive to minimize agency costs to avoid being the target of a takeover bid. Collectively, these market mechanisms greatly reduce the divergence of interests between managers and shareholders by penalizing managers who are responsible for excessive agency costs.

The foregoing view of the theory of the firm has obvious implications for the "race to the bottom" thesis. The decision of where to incorporate is one of countless decisions that managers must make as agents for the firm. For the reasons discussed above, managers have compelling incentives to make this decision in the shareholders' best interests. If incorporation in Delaware were really harmful to shareholders, shares of firms located there would trade for less, managers would reduce the value of their services, and the firm might be an attractive takeover candidate with the probable result that existing managers would be displaced. Since managers have no incentive to injure themselves in this fashion, a far more likely explanation is that Delaware has achieved its prominent position because its permissive corpo-

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\(^{32}\) Jensen & Meckling, supra note 26, at 328.

\(^{33}\) See generally Fama, note 26 supra. The limitations on managers' ability to monitor each other are discussed in Easterbrook & Fischel, supra note 31, at 1172-73.

\(^{34}\) The concept of a market for corporate control was introduced by Henry Manne. See Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965). See also Easterbrook & Fischel, note 31 supra; Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Tex. L. Rev. 1 (1978).
ration law maximizes, rather than minimizes, shareholders' welfare.\textsuperscript{35} Delaware's preeminence, in short, is in all probability attributable to success in a "climb to the top" rather than to victory in a "race to the bottom."

\textbf{C. The "Race to the Bottom" Thesis: The Empirical Evidence}

The "race to the bottom" thesis can be tested empirically. If the popularity of Delaware as a state of incorporation and reincorporation is attributable to the ease with which managers can exploit shareholders, then the negative effect which such exploitation would have upon the firm's income stream would be reflected in lower stock prices.\textsuperscript{36} To take the extreme case, stock prices of firms incorporated in Delaware would be zero if Delaware law allowed managers to divert all corporate funds to themselves. If, on the other hand, the primacy of Delaware is attributable to a permissive corporation statute, as interpreted by judicial decisions, that allows private parties to maximize their joint welfare by contract, then stock prices should reflect this fact as well.

In the one empirical study that has tested this proposition, economists Peter Dodd and Richard Leftwich measured the effect on stock prices when a firm reincorporates in Delaware.\textsuperscript{37} Dodd and Leftwich found that stockholders of firms reincorporating in Delaware earn positive abnormal returns of 30.25\% over the twenty-five month period preceding and including the month of the change.\textsuperscript{38} They found no evidence of any negative market reaction either before or after reincorporation.\textsuperscript{39}

The Dodd-Leftwich study is a powerful empirical refutation of the "race to the bottom" thesis and, more generally, of the attack on the separation of ownership and control in the large publicly held corporation. It suggests that managers make the decision where to incorporate with the objective of maximizing shareholders' welfare.\textsuperscript{40}

\textsuperscript{35} See generally R. WINTER, note 1 supra. For a similar analysis with respect to dividend policy, see Fischel, \textit{The Law and Economics of Dividend Policy}, 67 VA. L. REV. 699, 713 (1981).


\textsuperscript{37} Dodd & Leftwich, note 2 supra.

\textsuperscript{38} \textit{Id.} at 275. Returns are abnormal if they cannot be explained by general market movements or by chance.

\textsuperscript{39} \textit{Id.} at 281-82.

\textsuperscript{40} The authors conclude: Our study reveals that the case for federal chartering is not supported by the evidence. The
point differently, it refutes the underlying assumption of the Cary thesis that shareholders will be exploited in the absence of federal regulation of the corporation.

D. The Bankrupt Case for Federal Regulation of the Corporation

The case for federal regulation of the corporation is based on the premise that, in the absence of regulation, management will exploit shareholders. Since states, as personified by Delaware, have abdicated their responsibility to protect shareholders, the argument runs, federal regulation is necessary to fill this regulatory void. This view is, as I have emphasized, contradicted by all available theoretical and empirical evidence.\(^4\) The far more plausible hypothesis, one that is supported by theoretical and empirical evidence, is that states such as Delaware have adopted enabling corporation statutes to allow private parties to enter into contractual arrangements that they find mutually advantageous.\(^4\)

This is not to suggest that the most efficient solution would be to have no corporation law. By providing a set of standardized terms that the parties would contract for in any event, corporation law increases welfare by minimizing transaction costs.\(^4\) Corporation law can also ensure that the market forces which provide managers with incentives to act in the best interests of shareholders operate without interference.\(^4\) Since founders of corporations have the option of incorporating in any of the fifty states, each state has strong incentives to enact a statute that will attract new incorporators. This competition in corporate charters ensures that, as in any other competitive market, only the efficient will survive. In the context of the market for corporate charters, this means that only states (such as Delaware) which have corporation laws that enable private parties to maximize their joint

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\(^4\) Evidence is consistent with our hypothesis that managers of a firm take advantage of the competition among states to locate in a state which offers an efficient set of restrictions on the firm, given the firm’s anticipated production-investment and financing decisions.

\(\text{Id. at } 282.\)

See Parts IB & IC, infra, at 916-21.

See Parts IB & IC, infra, at 916-21.

If it were not a breach of the duty of loyalty for managers to loot the corporation, for example, contractual restrictions would be drafted to prevent this result. See R. Posner, Economic Analysis of Law 292-96 (2d ed. 1977); Easterbrook & Fischel, supra note 31, at 1180-82. For an argument that the function of fiduciary duties in corporation law is to provide a set of wealth maximization principles that shareholders would contract for in the absence of transactions costs, see Easterbrook & Fischel, Corporate Control Transactions, ___ YALE L.J. ___ (1982).

Corporation law, for example, can facilitate the operation of the market for corporate control. Easterbrook & Fischel, note 31 supra (arguing that corporate managers should be precluded from resisting tender offers).

The concept of a competition in corporate charters was introduced in R. Winter, note 1 supra.
welfare without undue regulatory interference will attract a high percentage of incorporations.

Federal regulation of corporations would destroy the salutary effect of the market for corporate charters. A scheme of regulation by fiat would replace a system of fifty states striving to create an attractive climate for private parties to maximize their joint welfare. There is no reason to believe, and every reason to doubt, that the elimination of the market for corporate charters will increase shareholders' welfare.\footnote{Cf. Rose-Ackerman, Does Federalism Matter? Political Choice in a Federal Republic, 89 J. Pol. Econ. 152 (1981) (discussing the importance of diversity created by different state rules).}

Moreover, specific aspects of proposed federal regulation would almost certainly decrease shareholders' welfare. Professor Cary, other proponents of federal regulation, as well as the Securities and Exchange Commission itself, for example, all argue that more disclosure should be made to shareholders and that more decisions entrusted to management should come within their control. Modern developments in the theory of the firm as well as everyday experience demonstrate, however, that shareholders have no interest in such an expanded role, but rather prefer to remain passive.\footnote{For an explanation of why the rational shareholder would prefer to remain passive, see Easterbrook & Fischel, supra note 31, at 1170-71. See also Fama, note 26 supra. Essentially, the reason for shareholder passivity is that the benefits to the nonpassive shareholder expected from a detection and remedy of excessive agency costs—which accrue to all shareholders according to their holdings—are substantially less than the costs which would be incurred in so doing. These costs would include that of persuading fellow shareholders—e.g., by a proxy fight—to take effective action against management. If suboptimal management is detected by an individual shareholder, the economic course of action for such a shareholder is to sell his stock—not to initiate an expensive and protracted proxy fight. Easterbrook & Fischel, supra note 31, at 1171.}

It is no answer to respond, as the SEC recently has, that this lack of interest is attributable to the inadequacy of existing disclosures and that shareholders would take an active role if disclosure were made more extensive.\footnote{See Division of Corporation Finance, Securities and Exchange Commission, Staff Report on Corporate Accountability (1980).} The SEC has only reached this conclusion by steadfastly adhering in its assumption concerning the virtues of shareholder democracy despite the lack of any theoretical or empirical evidence supporting it.\footnote{By contrast, the available evidence suggests that there are powerful incentives for shareholders to refrain from becoming informed of even existing disclosure. The rational strategy for a shareholder-investor is generally passivity. See note 47 and accompanying text supra.}

Other aspects of proposed federal regulation are similarly objectionable. A strict minimum standard of fiduciary duty imposed on directors, officers, and controlling shareholders advocated by Cary and others would operate to the detriment of shareholders by subjecting a wide range of managerial decisions to judicial review. In light of the incentives that managers have to make business decisions in the best interest of shareholders, there is no reason to believe that courts, or shareholders, would be able to improve on managerial decisionmaking.
Indeed, precisely the reverse is true. The common proposal for increased regulation of interested director transactions suffers from a similar defect. While increased regulation may reduce self-dealing somewhat, this benefit likely would be outweighed by the costs imposed by the nullification of numerous efficient transactions. Finally, the costs of the ever present proposal for decisionmaking by a majority of independent directors also would likely outweigh any benefits. These directors may engage in fewer self-dealing transactions, but they also may lack the incentive and competence to run the corporation’s affairs. There is no reason to believe that shareholders would be better off if corporations were run by more “independent,” but also less effective managers.

The examples could be multiplied but by now the point should be clear. The corporate form of firm organization, as well as the primacy of Delaware corporation law, have thrived because of advantages provided to private parties in maximizing such parties’ joint welfare. So long as investment in corporations incorporated in particular states is a voluntary exercise, it is impossible to argue with this proposition. If a particular form of firm organization were more efficient, or if the law of one state were more conducive to maximizing shareholders’ welfare than the law of Delaware, founders of corporations would have every incentive to make the structural change or move the state of incorporation voluntarily. That these changes have not been made voluntarily is perhaps the most persuasive argument against federal regulation of corporations.

II. RECENT DEVELOPMENTS IN DELAWARE’S CORPORATION LAW

The attack on Delaware corporation law and the plea for federal regulation of corporations, while unsupported by a shred of theoretical or empirical evidence, have attracted tremendous popular support. Indeed, as has been widely perceived, the Delaware courts themselves appear to have reacted to the critics. In a series of important recent decisions, the Delaware Supreme Court has gone a long way toward limiting the discretion of managers and controlling shareholders while increasing the power of minority shareholders. In this Part I discuss several of these recent decisions.

A. Singer v. Magnavox Co.

*Singer v. Magnavox Co.* involved a tender offer by Development Corporation for the common shares of Magnavox Company, followed by a merger of Magnavox into a wholly owned subsidiary of Develop-

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50 See notes 1 & 5 supra.
51 E.g., Ferrara & Steinberg, supra note 9, at 277-80, 299-301.
52 380 A.2d 969 (Del. 1977).
ment. The initial tender offer by Development, at a price of nine dollars per share, resulted in the acquisition of 84.1% of Magnavox's outstanding stock.\textsuperscript{53} Having acquired control of Magnavox, Development then attempted to acquire all equity interest in Magnavox through a merger.\textsuperscript{54} Shareholders of Magnavox were then given notice of the merger, informed that they would be offered nine dollars for their shares, the same as the tender offer price; that success of the merger was assured because of Development's control of Magnavox; and finally that shareholders who decided not to accept the nine dollars could seek the appraisal remedy provided under Delaware law.\textsuperscript{55}

Plaintiffs, minority shareholders of Magnavox, brought suit to enjoin the merger, alleging that defendants violated their fiduciary duty as controlling shareholders by attempting to consummate a merger which did not serve any valid corporate purpose other than the elimination of Magnavox's minority shareholders at an inadequate price.\textsuperscript{56} The price was alleged to give defendants "a disproportionate amount of the gain said defendants anticipated would be recognized from consummation of the merger."\textsuperscript{57} The defendants conceded the existence of a fiduciary duty, but argued that this obligation was met by offering fair value for the Magnavox shares and, in any event, the plaintiffs' exclusive remedy was to seek an appraisal in conformity with Delaware law.\textsuperscript{58}

The defendants' claim was well grounded in previous decisions. In \textit{Stauffer v. Standard Brands, Inc.},\textsuperscript{59} for example, the Delaware Supreme Court held, in essence, that appraisal was the exclusive remedy under the Delaware short form merger statute,\textsuperscript{60} which establishes a procedure for the merger of a parent corporation and its 90 percent-or-more owned subsidiary. And in \textit{David J. Greene & Co. v. Schenley Industries},\textsuperscript{61} the Delaware Chancery Court extended \textit{Stauffer} to other types of freezeout mergers.

Relying on \textit{Stauffer}, \textit{Schenley}, and the 1967 revision of the Delaware corporation statutes that reflected "continuing legislative approval of mergers and the avoidance of their disruption by protesting shareholders," the Delaware Chancery Court granted a motion to dismiss, relegating the plaintiffs to an appraisal remedy.\textsuperscript{62} The Delaware

\textsuperscript{53} Id. at 971.
\textsuperscript{54} Id.
\textsuperscript{55} Id. at 972.
\textsuperscript{56} Id. at 972, 978.
\textsuperscript{57} Id. at 978.
\textsuperscript{58} Id. at 977.
\textsuperscript{59} 187 A.2d 78 (Del. 1962) (\textit{Stauffer} was overruled by Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979)). \textit{See} note 67 and accompanying text \textit{infra}.
\textsuperscript{60} DEL. CODE ANN. tit. 8, § 253 (1975).
\textsuperscript{61} 281 A.2d 30 (Del. Ch. 1971).
Supreme Court reversed, however, and rejected the contention that appraisal is the exclusive remedy.\textsuperscript{63}

The court emphasized that the defendants' arguments were premised upon the erroneous proposition "that a shareholder's right is exclusively in the value of his investment, not its form,"\textsuperscript{64} and that "a dissenting shareholder has no legally protected right in his shares . . . beyond a right to be paid fair value."\textsuperscript{65} The court thus rejected the contention that appraisal was the exclusive remedy. Because investors have legally protected rights in the form, as well as the value of their investment, the court held that a "merger, made for the sole purpose of freezing out minority shareholders, is an abuse of the corporate process"\textsuperscript{66} and therefore a breach of fiduciary duty. The court held further that the fiduciary duty of the majority to the minority requires that the merger meet the requirement of "entire fairness."\textsuperscript{67}

The court's reasoning is far from convincing. Particularly curious is the court's emphasis on the legal protection afforded the "form" as well as the value of a shareholder's investment which justifies the "business purpose" requirement. The court apparently believed that the typical shareholder views shares of stock as equivalent to antique paintings or unique parcels of land. Why else would a shareholder have a compensable legal injury even though he received more than the market value of his shares?\textsuperscript{68} In reality, however, the rational shareholder is more likely to own shares of several corporations and be concerned solely with the value of his investment. Moreover, it is extremely unlikely that shareholders value their shares at more than the market price.\textsuperscript{69} Thus, there was no need for the court to impose a "business purpose" requirement to protect the investor's right to the form of his investment because, simply stated, the form of an invest-

\textsuperscript{63} Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).
\textsuperscript{64} Id. at 977 (emphasis in original).
\textsuperscript{65} Id. (footnote omitted).
\textsuperscript{66} Id. at 980.
\textsuperscript{67} Id. The "business purpose" and "entire fairness" requirements were extended to short-form mergers in Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979).
\textsuperscript{68} The court's discussion is particularly unpersuasive because every fundamental corporate change involves an alteration of the form of a shareholder's investment. Traditionally, however, the law has presumed that minority shareholders can be bound by the majority provided that they receive the economic equivalent of their investment. For a justification of why minority shareholders must be provided with the economic equivalent of their investment, see Easterbrook & Fischel, supra note 43, at .
\textsuperscript{69} If one shareholder valued shares at a higher price than the market price, this shareholder would long ago have purchased the shares held by other shareholders. By this process of arbitrage, different values for the same asset—the shares—would have been eliminated and an equilibrium price would be reached. See, e.g., Modigliani & Miller, The Cost of Capital, Corporation Finance, and the Theory of Investment, 48 AM. ECON. REV. 261 (1958). See also Easterbrook & Fischel, supra note 43, at .
ment in stock does not merit protection.\textsuperscript{70}

Even more puzzling is the court's additional requirement that a merger satisfy the test of "entire fairness."\textsuperscript{71} This term has no readily apparent meaning, and the court made no attempt to define it. One interpretation of the term is that shareholders are entitled to the market value of their shares. But in \textit{Singer}, the minority shareholders were paid a premium over the market price, and could seek appraisal if they were nevertheless dissatisfied. Something more than compensation for market value must have been intended by the requirement of "entire fairness." But what? Another possibility is that minority shareholders are entitled not only to market value, but also a share of the gains resulting from the merger. Indeed, such an entitlement is precisely what the plaintiff in \textit{Singer} claimed.\textsuperscript{72} This interpretation of the term "entire fairness," however, would make a nullity out of the provision of the appraisal statute that specifically excludes any such post-transaction gains.\textsuperscript{73} Whatever the court in \textit{Singer} meant by its "entire fairness" requirement, it probably did not intend to repeal the statutory appraisal remedy by implication. The meaning of the term remains a mystery.

In the final analysis, the weaknesses in the court's opinion are attributable to its lack of understanding of the economic realities of the transaction at issue. The transaction challenged in \textit{Singer} was a second step freezeout merger following a tender offer at a premium over market value. The purchaser in a tender offer is willing to pay a premium because it believes that it can manage the assets of the firm more profitably than the incumbent management.\textsuperscript{74} The premium the purchaser is willing to pay is some percentage of the increase in value expected by the purchaser once the transfer of control has been effectuated. Indeed, unless the bidder believes that an increase in value will result from the transfer of control, it would be acting irrationally in paying the premium over the market price.

\textsuperscript{70} The court's fallacy may well have stemmed from the vacuous notion that stockholders "own" the corporation. The fallacy behind this notion is described at notes 25-28 and accompanying text \textit{supra}.

\textsuperscript{71} \textit{Singer} v. Magnavox Co., 380 A.2d at 980.

\textsuperscript{72} \textit{Id.} at 978. For a critical discussion of gain sharing proposals, as well as an argument that \textit{Singer} should not be interpreted as requiring sharing of gains, see Easterbrook & Fischel, \textit{supra} note 43, at ___.

\textsuperscript{73} \textsc{Del. Code Ann. tit. 8, § 262 (1975).} \textit{See Tanzer v. Int'l Gen. Indus.,} 379 A.2d 1121 (Del. 1977) (holding that majority shareholders may vote their own corporate concerns and determine to consummate proposed merger even though majority shareholders will derive personal profit from transaction, provided that merger motivated by \textit{bona fide} "business purpose" and that majority shareholders discharge duty to minority shareholders by satisfying "entire fairness" test of \textit{Singer}). \textit{But see} Lynch v. Vickers Energy Corp., 429 A.2d 497, 503 & n.5 (Del. 1981) (suggesting that \textit{Singer} requires that all gains be disgorged).

\textsuperscript{74} See authorities cited in note 34 \textit{supra}, which discuss the operation of the market for corporate control.
Transfers of control, therefore, facilitate the movement of assets to more highly valued uses and thereby benefit shareholders and society as a whole. Shareholders who tender at a premium over the market price receive an unambiguous benefit in the form of the premium. More importantly, an active takeover market benefits shareholders even if their firm is never the subject of a tender offer. The tender offer is an effective device for displacing incumbent managers if their performance lags. To avoid such displacement managers have strong incentives to operate efficiently and keep share prices high. The tender offer, therefore, gives managers strong incentives to act in the best interests of shareholders, while simultaneously providing a mechanism for displacement of inefficient managers.

From the perspective of the potential purchaser, however, transfers of control are expensive. Apart from the obvious cost of the premium over the market price necessary to induce the sale of control, the purchaser must risk considerable sums in research costs to determine which firms can be operated profitably after a shift in control. Unless the purchaser somehow can recoup these costs, no transfers of control ever will take place. To be sure, the purchaser benefits if the share prices of the target firm appreciate after the transfer in control. But this gain accrues pro rata to any remaining shareholders who did not sell to the purchaser. The freezeout—a mechanism for eliminating these free-riding shareholders—is one method whereby the purchaser can recoup the costs of the acquisition by appropriating to itself the gains resulting from the transfer of control. By awarding the gains available from transfers of control to those who uncover the potential value increasing transaction rather than to passive shareholders, the availability of a freezeout procedure to those who purchase control contributes to efficiency in the market for corporate control. The increase in efficiency results from ensuring that those who effectuate the combination, and who therefore create the gain, are allowed to recover the gain. And because an efficient market for corporate control is a powerful device for monitoring management performance, the freezeout mechanism ultimately increases shareholders' welfare.

The defects of the "business purpose" and "entire fairness" re-

75 The benefits that tender offers create for shareholders and society as a whole are discussed in detail in Easterbrook & Fischel, note 31 supra.
76 See text accompanying note 34 supra.  
77 Easterbrook & Fischel, supra note 31, at 1178-79. 
78 The purchaser may also benefit from appreciation in the value of its own shares after obtaining control. There is some evidence that this is the case. See Bradley, Interfirm Tender Offers and the Market for Corporate Control, 53 J. Bus. 345 (1980).
79 The freezeout itself may create gains by eliminating conflicts of interest and otherwise reducing agency costs. The economics of freezeout transactions are discussed in Easterbrook & Fischel, supra note 43, at __.
80 See text accompanying notes 33-34 supra.
quirements established by Singer should now be apparent. The "business purpose" of the transaction at issue in Singer was an attempt by Development to recoup the costs of the acquisition by reducing agency costs and by preventing the nontendering, free-riding shareholders of Magnavox from participating in the expected appreciation in the value of Magnavox's shares. The transaction was "entirely fair" to minority shareholders because they received well over the market value for their shares. If the court had understood the economics of the transaction, it would have realized that there was no need for judicial intervention.

On balance, the effect of Singer is to increase somewhat the bargaining power of minority shareholders in freezeout transactions. By having the power to enjoin, or even to attempt to enjoin, a merger for lack of a valid "business purpose" or "entire fairness", minority shareholders are effectively blackmailing the majority. To avoid costly litigation, and possibly an injunction against the transaction, the majority will have to buy out the minority. The defect of such a system is that it operates in a manner very similar to the long discarded vested rights approach which required unanimity among shareholders before major corporate transactions could be effectuated. In both cases, holdout problems preclude many value increasing transactions from going forward. While some minority shareholders may benefit ex post from their increased bargaining position, the effect of Singer is to reduce shareholder wealth ex ante, because it decreases the number of value increasing transactions by increasing the costs of consummating such a transaction.

The effect of Singer has been lessened by subsequent decisions. Because freezeout transactions will virtually always have a valid "business purpose" and be "entirely fair," one would predict that courts would typically find that both of these requirements were satisfied. This is precisely what has occurred. See, e.g., Dower v. Mosser Indus., 648 F.2d 183 (3d Cir. 1981); Tanzer v. Int'l Gen. Indus., 379 A.2d 1121 (Del. 1977); Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. Ch. 1981), aff'd, No. 58, 1981 (Del. Feb. 9, 1982). But see Harman v. Masoniilan Int'l, Inc., No. 207, 1980 (Del. Feb. 9, 1982) (reaffirming the "business purpose" and "entire fairness" requirements). For a discussion of Singer and the cases interpreting it, see Easterbrook & Fischel, supra note 43, at __.

At common law, a single shareholder could veto mergers and other fundamental corporate changes. 13 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 5906.1 (rev. perm. ed. 1980). The obvious problem with such a rule is that it frustrates many value increasing transactions.

Shareholders' wealth is maximized by a legal rule which allows the greatest number of value-increasing transactions. Share prices ex ante will be highest where the probability of a value-increasing transaction that will increase the firm's future earnings is the greatest. It is irrelevant how these gains are allocated ex post. Minority shareholders who are excluded from any gains ex post are fully compensated ex ante by the higher share price. Even when viewed ex post, shareholders who hold diversified portfolios will be winners most of the time. For a fuller discussion of this point, see Easterbrook & Fischel, supra note 43, at __.

The *Lynch v. Vickers Energy Corp.* litigation[^84] grew out of an offer by Vickers Energy Corporation to purchase any and all of the outstanding shares of the common stock of its subsidiary, TransOcean Oil, Inc. At the time of the offer, Vickers was the holder of 53.5% of the outstanding shares of common stock of TransOcean.[^85] During the months immediately prior to the offer, TransOcean common stock traded at around seven dollars per share in the over-the-counter market.[^86] The price offered by Vickers to minority shareholders of TransOcean was twelve dollars per share.[^87]

The circular accompanying the offer informed TransOcean’s shareholders of management’s belief that TransOcean’s net asset value was “*not less than* $200,000,000 (approximately $16.00 per share) and could be substantially greater.”[^88] The circular also stated that, because of the highly speculative conditions affecting oil and gas values, any asset valuation was “necessarily arbitrary.”[^89] The purpose of the transaction was stated to be to “acquire as many of the shares . . . as possible . . . [because Vickers believes that TransOcean’s] stock has a value higher than the recent market prices for such shares and represents an attractive long-term investment at the present time.”[^90] Finally, TransOcean’s shareholders were informed that the offer could result in an inactive market for remaining shareholders and deregistration of TransOcean’s securities if a substantial number of shareholders tendered in response to the offer.[^91]

The offer succeeded in obtaining approximately eighty percent of the outstanding shares of TransOcean.[^92] The plaintiff, holding one hundred shares, was one of the shareholders to tender.[^93] Several days later, however, the plaintiff brought an action against Vickers to recover damages allegedly suffered as a result of the offer.[^94] The plaintiff claimed that the twelve dollar price, even though representing more than a fifty percent premium over the market price, was “grossly inade-
In particular, the plaintiff alleged that Vickers had failed to disclose that it was in possession of a geologist's report that fixed the value of the assets, based on a series of assumptions, at $250,800,000, and that Vickers also had failed to disclose that it had authorized open market purchases of TransOcean stock during a period preceding the offer at up to fifteen dollars per share. The plaintiff alleged that Vickers' failure to disclose these items constituted an actionable breach of fiduciary duty entitling the plaintiff to recover damages.

Plaintiff's right to any remedy under Delaware law was far from clear. Indeed, a strong argument could be made that under Delaware law Vickers owed plaintiff no duty of disclosure whatsoever. In *Lank v. Steiner*, for example, the Delaware Supreme Court had reaffirmed the "special circumstances rule" under which a director could purchase shares from a stockholder without disclosure unless the director "is possessed of special knowledge of future plans or secret resources and deliberately misleads a stockholder who is ignorant of them." No information of this type was alleged to have been withheld in *Lynch*. Even assuming that Vickers, as a controlling shareholder, stood in the same position as a director, it would have been under no duty to disclose.

In any event, relevant stock price data strongly suggests that no material information was withheld. If Vickers had concealed material, favorable information about TransOcean, such as the value of its assets, the value of TransOcean's stock should have risen when the information was released. Instead, the stock price fell continually for a period after the tender offer.

Thus it is difficult to see how any shareholder of TransOcean was injured by the tender offer. How can it be seriously argued that a shareholder who voluntarily sold his shares at twelve dollars a share, a

96 Lynch v. Vickers Energy Corp., 351 A.2d at 574. Open market purchases were never made at this price. *Id.* at 575. The average price paid for shares in the open market prior to the tender offer was $11.49, and this fact was disclosed. *Id.*
98 *Id.* at 265-66, 224 A.2d at 244.
99 Vickers did have to make disclosure, however, under the federal proxy rules. Lynch v. Vickers Energy Corp., 351 A.2d at 572.
100 The relevant theoretical and empirical evidence indicates that stock prices incorporate new information quickly and without bias. See note 36 supra.
101 TransOcean's common stock was trading during all relevant periods on the over-the-counter market, and was quoted by the National Association of Securities Dealers, Inc. The pretender offer price of TransOcean in the months preceding the offer was between $7 and $8, rising to $9 7/8 in anticipation of the tender offer. Upon the public announcement of the tender offer at $12 per share, the market price immediately rose to $11 7/8 during October 1974. After the tender offer expired on October 31, 1974, the price of TransOcean stock was $9 7/8. Lynch v. Vickers Energy Corp., 351 A.2d at 570.
fifty percent premium over the market price, was injured when the defendants and shareholders who did not tender were left with shares worth far less than this amount? Under prior Delaware law, this absence of injury should have been fatal to plaintiff's claim. For example, in Poole v. N.V. Deli Maatschappij, the Delaware Supreme Court held that shareholders who sold their stock to a majority shareholder in reliance upon a tender offer circular which contained fraudulent misrepresentations were not entitled to any recovery if the tender price exceeded the "actual" value of the stock. In light of Poole, the plaintiff's claim in Lynch appeared to be totally without merit.

Recognizing the insubstantial nature of the plaintiff's allegations, the chancery court held, in separate opinions, that there were no material nondisclosures and that plaintiff suffered no injury as a result of the transaction. The court held that the defendant's failure to disclose the $250,000,000 asset appraisal by the geologist was not misleading given the unrealistic assumptions underlying the appraisal and management's statements that it believed the assets to be worth "not less than" $200,000,000 and their value "could be substantially greater." The court further held that management had no duty to disclose the fifteen dollars maximum that Vickers had established for open market purchases of TransOcean stock. Since the open market purchases were made at an average price of $11.49 per share and this fact was disclosed, the court indicated that disclosure of the $15.00 figure would have been misleading. With respect to the question of actual injury in a subsequent proceeding the court relied on market, earnings, and asset value data to find that the $12.00 figure received by plaintiff exceeded the actual value of TransOcean stock, as valued on a going concern basis at the time of the tender offer.

103 See also Mills v. Elec. Auto-Lite Co., 552 F.2d 1239 (7th Cir.), cert. denied, 434 U.S. 922 (1977) (holding that despite majority shareholder's refusal to disclose material facts, the minority shareholders were not injured and therefore were not entitled to damages).
107 Id. at 575.
108 The court stated that disclosure of the $15 ceiling might have lulled a TransOcean stockholder into believing that such price would be paid at a later time if he declined the $12 offer. Id.
109 The court assigned a 40% weight to asset value of $17.50, a 40% weight to market value of $9.48, and a 20% weight to earnings value of $5.25, yielding a total value of $11.85. Lynch v. Vickers Energy Corp., 402 A.2d at 12. While this weighting procedure of asset value, market price, and earnings value is commonly employed, it may be seriously questioned whether any factor other than the market price of an actively traded security should be relevant in determining value. The market price is the most accurate indicator of a firm's future prospects, and incorporates other factors that may affect value. See note 36 supra. Assigning separate weights to asset value and earnings value, therefore, is really a form of double counting. See Mills v. Elec. Auto-Lite Co., 552 F.2d 1239, 1247 (7th Cir.), cert. denied, 434 U.S. 922 (1977) ("when market value is available and reliable, other factors should not be utilized in determining whether the terms of a
The Delaware Supreme Court reversed on both the liability and damages issues. The supreme court held that Vickers breached its duty of "complete candor" by failing to disclose the asset appraisal and the fifteen dollars maximum price that it was willing to pay in open market purchases. On the damages issue, the court held that the chancery court erred by focusing on the actual value of the stock at the time of the tender offer rather than providing the plaintiff with rescission of the entire transaction or damages equivalent thereto. Since rescission was deemed impractical, the court ordered that the plaintiffs were entitled to damages of an amount equal to "the increment in value that Vickers enjoyed as a result of acquiring and holding the TransOcean stock in issue." This increment in value was to be measured at the time of the conclusion of the trial on damages, July 15, 1978, nearly four years after the tender offer. The Poole case was distinguished on the grounds that the complaint in that case alleged fraudulent misrepresentation, but not breach of fiduciary duty and that the plaintiffs in Poole only asked for an appraisal remedy. As guidance for the lower court, the supreme court stated that damages on remand should be between a minimum of $15.00 a share, the maximum amount

merger were fair."). See also Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355, 361-62 (2d Cir. 1979) and In re LTV Securities Litigation, 88 F.R.D. 134, 144 (N.D. Tex. 1980), in which both courts explicitly adopted the efficient capital market theory.


113 The court stated that "[t]he question, then, is whether the Poole approach should be applied here. We think not, for at least one significant reason: a breach of fiduciary duty was alleged in this litigation and it was found by this court, but such a claim was neither charged nor found in Poole." Id. at 500-01 (citation omitted). This distinction is nonsensical. As the chancery court stated, a fraudulent misrepresentation, the challenged conduct in Poole, is obviously a more serious form of misconduct than a nonfraudulent omission. Lynch v. Vickers Energy Corp., 402 A.2d at 10. A fraudulent misrepresentation is always actionable. Failure to disclose information, however, is frequently not actionable because of the importance of recognizing and protecting a property right in information. See Fischel, supra note 34, at 13-15.

The Delaware Supreme Court in Lynch justified the measure of damages by reference to the rule that a beneficiary is entitled to any gains made by a trustee as a result of a breach of trust. Lynch v. Vickers Energy Corp., 429 A.2d at 503 n.5. This analogy, however, is seriously flawed. Unlike corporate managers, trustees do not attempt to engage in entrepreneurial activity to maximize profits, but rather strive to preserve capital and minimize risk. Because of this difference in economic function, a wide variety of practices are permissible for corporate managers but not for trustees. For example, contracts between an interested director and a corporation will generally withstand judicial scrutiny. See Del. Code Ann. tit. 8, § 144 (1974). The rationale for this legal rule is that such contracts, despite the existence of a conflict of interest, will frequently be advantageous to the firm. A trustee, on the other hand, is forbidden from ever profiting personally from the trust relationship. The fiduciary duties in the two situations are different because the interests of the principals are different. See R. Winter, supra note 1, at 33; Easterbrook & Fischel, supra note 43, at ___
authorized in open market transactions, and a maximum of $41.40, the amount sought by the plaintiff.

The court’s reasoning is indefensible. The fact that TransOcean’s stock price did not increase, but rather decreased, when the alleged wrongful nondisclosures became known indicates that no material information was withheld. This is hardly surprising because it is almost inconceivable that the value of the assets of TransOcean—whose stock was traded in a public market dominated by sophisticated institutional investors—was unknown in the market. Because no material information was withheld, it necessarily follows that selling shareholders who received a large premium over the market price were benefitted, not injured.

The Delaware Supreme Court ignored this windfall benefit received by the plaintiffs and focused instead on the difference between the value of TransOcean’s stock at the time of the tender offer in October 1974 and the time of the trial on damages in July 1978. The rationale of this procedure was to deprive defendant of any gains obtained by its wrongful acquisition of the additional TransOcean stock. But this measure of damages was incorrect. The relevant time for determining these “wrongful” gains was the point when the withheld information was disclosed. At this point in time, all relevant information was known and it was then possible to assess the gains and losses of the parties.

The obvious problem with attempting to measure the gains obtained by comparing a price in 1974 with one in 1978 is that any changes that occur may be attributable to events having nothing to do with the challenged conduct. Inflation or falling interest rates may be responsible; the industry as a whole may have experienced an increase in demand for its products. There is simply no way to determine from comparing two stock prices four years apart what percentage, if any, of the gains experienced over such period are attributable to the event four years previous.

In any event, even under the test established by the court, the defendant did not obtain any gains. The market price of TransOcean’s stock in July 1978 was approximately fifteen dollars per share. If Vickers had invested the twelve dollars they paid per share in 1974 in an alternative investment, such as a mutual fund, the firm would have

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114 Of course, the relevance of the price at the time the omission is cured becomes less and less reliable as the time it takes to discover the omission increases because of the risk that any change may be attributable to other factors. See Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 STAN. L. REV. 371, 384-85 (1974) [hereinafter cited as STANFORD Note].

115 Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholders’ Welfare, 36 BUS. LAW. 1733, 1742 (1981); STANFORD Note, supra note 114, at 373.

realized greater profits than made from the tender offer.\textsuperscript{117} Similarly, any plaintiff who received the twelve dollars in 1974 could have invested this sum and done better than if the tender offer never occurred. At the very least, the selling shareholder could have received the twelve dollars and reinvested in TransOcean at a market price lower than twelve dollars at any time for eighteen months following the tender offer.\textsuperscript{118} In short, it is difficult to see how defendant Vickers, as opposed to the plaintiffs, obtained any gain from the tender offer.

The most significant drawback of the case, however, is not the poorly reasoned opinions but its impact on value-increasing transactions. The transaction in \textit{Lynch} was the first step in a parent corporation's attempt to eliminate the minority shareholders in a subsidiary.\textsuperscript{119} Such transactions perform valuable economic functions.\textsuperscript{120} In many merger situations, the value of the combined entity will be greater than the sum of the parent and the subsidiary considered separately. This increase in value may be attributable to economies of scale as a result of vertical integration, centralized management, and corporate planning, and economies of information. In addition, the avoidance of legal problems inherent in allocating corporate opportunities between a parent and subsidiary with minority shareholders could also contribute to an increased value for the combined entity.

Large cost savings may also result from the elimination of costs attributable to public ownership of the subsidiary.\textsuperscript{121} Being public requires that the firm incur substantial expenditures for legal and auditing fees, stockholder relations, and compliance with myriad disclosure obligations mandated by the SEC and organized stock exchanges. By going private, the firm not only avoids costs of compliance, but also minimizes the risk of liability resulting from failure to comply with uncertain disclosure obligations. Moreover, the avoidance of disclosure obligations can be value-increasing in situations where the firm would sacrifice prospective business opportunities if disclosure were required.

The effect of \textit{Lynch}, like the effect of \textit{Singer}, will be to decrease the incidence of value-increasing transactions. By requiring better than perfect disclosure, and by providing minority shareholders who received a windfall with the right to collect large damages, \textit{Lynch} will inhibit tender offers by making them more expensive. This inhibiting effect will be particularly acute because the amount of damages under \textit{Lynch} is not known until many years after the tender offer. Thus, there

\textsuperscript{117} Vickers would have had a far more successful investment, for example, if it had invested the $12 in a portfolio of oil stocks which experienced substantial growth in the period following 1974.

\textsuperscript{118} This was emphasized by the chancery court in holding that the plaintiffs had failed to mitigate damages. \textit{Lynch v. Vickers Energy Corp.}, 402 A.2d at 12.

\textsuperscript{119} \textit{Id.} at 9.

\textsuperscript{120} See Easterbrook & Fischel, \textit{supra} note 43, at ___.

\textsuperscript{121} \textit{Id.}
is no way for the bidder, at the time the offer is made, to compare expected benefits against expected costs. Shareholders will hardly be happy with such a legal rule that makes it less likely that they—like the shareholders in *Lynch*—will be offered an opportunity in the future to sell their shares at a substantial premium over the market price.

**C. Zapata Corp. v. Maldonado**

The issue in *Zapata Corp. v. Maldonado*\(^{122}\) was whether the board of directors of Zapata Corporation could dismiss a derivative suit brought by dissident shareholders alleging breaches of fiduciary duty.\(^{123}\) In 1979, four years after the derivative suit was initially commenced in the Delaware Court of Chancery, Zapata's directors formed and appointed a committee composed of two newly appointed outside directors who were independent of management.\(^{124}\) The committee was authorized to investigate the claims asserted by the various plaintiffs and to take any course of action it deemed appropriate.\(^{125}\) After an investigation, the committee filed a written report concluding that the shareholder suits were without merit and contrary to Zapata's best interests.\(^{126}\) Based on the committee's report, counsel for Zapata moved to dismiss the Delaware suit\(^{127}\) and also two similar suits filed in federal courts in New York and Texas.\(^{128}\)

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\(^{122}\) 430 A.2d 779 (Del. 1981).

\(^{123}\) The facts underlying the *Zapata* case are as follows. In 1970, directors of Zapata adopted a stock option plan under which certain of Zapata's officers and directors were granted options to purchase Zapata common stock at $12.15 per share. The plan provided for the exercise of the options in separate installments, the last of which was to occur on July 14, 1974.

Exercise of the final options, however, was complicated by Zapata's plan to tender for a substantial number of its shares just prior to the exercise date. Announcement of the tender offer was expected to increase the then market price of Zapata stock from $18 or $19 per share to near the tender offer price of $25 per share. The complication introduced by this anticipated effect was that the increase in price in Zapata stock would cause its directors to incur substantial additional tax liability if the options were exercised after the announcement of the tender offer.

To avoid this increased tax liability, Zapata's directors voted to accelerate the date on which the options could be exercised to July 2, 1974. On July 8, 1974, Zapata announced the tender offer.

Derivative suits were then filed by dissident shareholders. The Delaware suit alleged that accelerating the time of exercise of the stock options constituted a breach of fiduciary duty. The theory of the complaint was that by exercising their options at a lower price to reduce their tax liability, Zapata's directors also reduced the corporation's tax deduction by the same amount that they saved for themselves. These facts appear in *Maldonado v. Flynn*, 413 A.2d 1251, 1254-55 (Del. Ch. 1980), rev'd and remanded sub nom. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

\(^{124}\) *Zapata Corp. v. Maldonado*, 430 A.2d at 781.

\(^{125}\) *Id.*

\(^{126}\) *Id.*

\(^{127}\) *Id.*

Since Delaware had no decisions spelling out whether directors could terminate a derivative action, the various courts had considerable flexibility in resolving the issue. Not surprisingly, the courts reached dramatically different results. In the federal court action in New York (Maldonado I), Judge Weinfeld emphasized the long accepted principles recognized in Delaware that the power to conduct a corporation’s litigation is within the power of the board of directors and that business decisions are shielded from judicial review under the business judgment rule. Thus the court held that under Delaware law a committee of disinterested directors could, in its business judgment, require the termination of a derivative suit brought on the corporation’s behalf.

The Delaware Chancery Court, however, reached precisely the opposite conclusion in Maldonado II. The chancery court held that a shareholder had an individual right to bring a derivative suit that could not be frustrated by a corporation’s directors. Moreover, the court emphasized that the business judgment rule was inapplicable to the termination question. The business judgment rule, in the court’s view, is properly understood as a “defensive” procedural device that protects directors from personal liability except in the most extraordinary circumstances. The rule is inapplicable when no conduct is being challenged, as when directors attempt to use the rule “offensively” to dismiss a derivative suit. The chancery court, therefore, held that the suit could not be dismissed.

The Delaware Supreme Court chose yet a different approach. The court began by correctly rejecting the chancery court’s conclusion in Maldonado II that a shareholder possesses an absolute right under Delaware law to initiate and maintain a derivative suit over the corporation’s objection. The court then rejected the conclusion by the federal district court in Maldonado I that the business judgment rule prevents a court from reviewing a disinterested committee decision to terminate a derivative suit. Because of the “realities of a situation” whereby “directors are passing judgment on fellow directors . . . who

130 Id. at 279-80.
133 Id. at 1256-57.
134 Id.
136 Zapata Corp. v. Maldonado, 430 A.2d at 787.
designed them to serve both as directors and committee members,”137 dismissal based on the business judgment rule, in the court’s view, would provide insufficient “safeguard against abuse.”138

The court thus concluded that “a middle course”139 between the approaches in Maldonado I and II was required. For a derivative suit to be dismissed pursuant to a report by an independent committee, the corporation must file a pretrial motion that includes “a thorough written record of the investigation and its findings and recommendations.”140 Each side must have an opportunity to file a record on the motion.141

Once the motion has been made, lower courts must apply a two-part test to determine whether dismissal is appropriate. Under the first step, the court must inquire into the independence and good faith of the committee and the reasonableness of the bases supporting its conclusions.142 The corporation’s motion to dismiss should be denied, “[i]f the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee.”143 The corporation has the burden of proof on all of these issues.

If the corporation satisfies the initial burden of proof, the court then applies the second step of the test.144 Under this second step, the court must determine, “applying its own independent business judgment, whether the motion should be granted.”145 In exercising its own business judgment, the court “should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation’s best interests.”146 Having established this two-step test for determining whether a derivative suit can be dismissed, the court remanded the case for further proceedings.

The most significant, and most unsettling, aspect of Zapata is the court’s explicit rejection of the business judgment rule as the proper standard for determining whether a derivative suit can be dismissed. The fundamental premise of the business judgment rule is that shareholders’ welfare is maximized if business decisions are made by manag-

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137 Id.
138 Id.
139 Id. at 788.
140 Id.
141 Id.
142 Id. at 789.
143 Id. at 788.
144 It is unclear whether the second step is mandatory or discretionary with the trial judge. Compare id. at 788 (the court “should apply a two-step test”) with id. at 789 (after the first step, the court “may proceed, in its discretion, to the next step”).
145 Id. at 789.
146 Id.
Courts and shareholders lack the experience and the information necessary to challenge managerial decisions intelligently. By preventing second-guessing of management's business decisions, the rule serves the salutary purpose of ensuring that these decisions will be made by those most competent to do so at the lowest cost.\textsuperscript{148}

The decision whether or not to sue is conceptually identical to other business decisions that management must make.\textsuperscript{149} A wide variety of factors must be considered before the decision is made. Management must determine whether the corporation has a valid claim against the alleged wrongdoer, and if so, what the likelihood and magnitude of recovery are expected to be. Management also must decide whether it can take any steps other than litigation against the alleged wrongdoer. If the alleged wrongdoer is an insider, for example, a reduction in salary or bonus may be a preferable alternative to litigation. Finally, a suit's potential impact on public, employee, and commercial relations also must be analyzed.

Examining these factors to determine whether to bring suit is particularly within the competence of management. If a decision is made not to sue, the business judgment rule should shield this decision from being second-guessed by shareholders or courts in the same way that it shields other business decisions.\textsuperscript{150} Thus the business judgment rule—

\textsuperscript{147} Easterbrook & Fischel, supra note 31, at 1195-97. \textit{See also} Fischel, supra note 35, at 716-17.

\textsuperscript{148} Even if courts did have the experience and expertise necessary to make business decisions intelligently, there would still be reason to prefer that these decisions be made by managers. Unlike managers, courts are not subject to the market for managerial services, the market for corporate control, or the constraints of the product market. For this reason, bad decisions by managers are self-penalizing; bad decisions by courts are not. \textit{See} notes 152-54 and accompanying text infra.


\textsuperscript{150} In a recent article, Professors Coffee and Schwartz have argued that the decision not to sue is quite different from the normal decisions protected by the business judgment rule because the decision not to sue: is not usually made under time pressure; does not expose the directors to a significant risk of liability; inherently involves the creation of a reviewable record facilitating judicial review; and is likely not to be objective because of the problem of "structural bias in board determination." Coffee & Schwartz, \textit{The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform}, 81 COLUM. L. REV. 261, 280-83 (1981).

The argument is unpersuasive. The fact that the decision not to sue is generally not rushed does not distinguish it from a wide variety of other business decisions, such as the introduction of a new product or the payment of a dividend. That directors do not face a significant risk of liability from making a decision not to sue is irrelevant, because the fundamental premise of the business judgment rule is that courts and shareholders are unable to make business decisions. The question, therefore, is whether courts and shareholders are competent in deciding whether to sue, not whether the directors will face liability for their decision. The "creation of a reviewable record" argument is similarly irrelevant because, even if true, this argument does not suggest why courts should be able to second-guess managerial decisionmaking. Finally, the "structural bias" argument ignores the incentives that all managers have to monitor each other. \textit{See} note 33 and accompanying text supra.
as has been held by the New York Court of Appeals in *Auerbach v. Bennett*\(^\text{151}\)—should provide the basis for dismissals of derivative suits brought by shareholders after an independent committee has decided not to sue.

To be sure, there is some risk that independent committees will not exercise unbiased business judgment because their members are appointed by, and receive information from, directors named as defendants.\(^{152}\) But this risk is inherent in any agency relationship, including the corporate form of firm organization, and is in no way unique to derivative suits. There is a risk, for example, that directors will not exercise unbiased business judgment in setting their salaries or in deciding the size of their offices and support staff. But these decisions are not therefore entrusted to shareholders. Except in the most extreme situations, managers have free rein to make these types of decisions without interference from shareholders or courts. The rationale for this policy of noninterference is that market forces such as the market for managerial services and the market for corporate control\(^{153}\) are more effective in minimizing agency costs than shareholder suits and judicial review. Thus shareholders would lose more than they would gain if all decisions regarding salary, office size, and similar issues were subject to challenge in the courts. Shareholders and courts are simply not competent to analyze intelligently these decisions.

The same is true with respect to the decision to terminate a derivative suit: shareholders and courts lack the familiarity with a corporation's affairs required to make such a decision intelligently. While there is a risk that self-interest will affect this decision, various market forces are more effective in minimizing this risk than is intervention by shareholders and courts. All managers, including independent directors, have strong incentives to monitor each other.\(^{154}\) Failure to moni-

\(^{151}\) 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *Accord* Lewis v. Anderson, 615 F.2d 778 (9th Cir. 1979) (California law); Abbey v. Control Data Corp., 603 F.2d 724 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980) (Delaware law). Both federal courts concluded that such a state law doctrine was, under the circumstances of the cases at bar, not in conflict with the underlying policies of the federal securities laws.

\(^{152}\) The risk is somewhat less than it may first appear, however, because naming directors as defendants will frequently be a pleading device rather than a true indication that they will not act objectively.

Even if the directors are, in fact, not truly independent, it is unclear why a shareholder should therefore be automatically entitled to bring a derivative suit. Directors are not prohibited from acting on behalf of the corporation merely because they are interested. Such directors may act on behalf of the corporation if they establish that the transaction in question is “fair” (beneficial) to the firm. *E.g.* Lewis v. S.L.&E., Inc., 629 F.2d 764 (2d Cir. 1980); DEL. CODE ANN. tit. 8, § 144(a)(3) (1974). Under the first tier of the *Zapata* test, however, directors, if they are found not to be independent, are deprived of the ability to demonstrate that dismissal is beneficial to the firm.

\(^{153}\) See text accompanying notes 33-34 supra.

\(^{154}\) See text accompanying note 33 supra.
tor adequately is a self-penalizing form of behavior. Inadequate monitoring is a form of suboptimal decisionmaking. Such suboptimal decisionmaking by managers will cause the price of the firm’s stock to trade at a lower price than other firms with superior internal monitoring. At a certain point, a firm that did not police internal misconduct would become an attractive takeover candidate. At the very least, managers of a firm that performed poorly because of their failure to monitor each other would reduce the value of their own services in the process. In light of these monitoring mechanisms, and the inability of shareholders and courts to decide intelligently whether a derivative suit should be brought, the risk that a disinterested committee of directors will not act objectively should not be a basis for the wholesale rejection of the business judgment rule.

When viewed in this light, the difficulties of the Zapata opinion are apparent. In the first step of the court’s two-part test, a corporation making a motion to dismiss a derivative suit must file a “thorough written record of the investigation and its findings and recommendations.”155 The corporation then has the burden of proof on the issues of independence, good faith, and reasonable bases. It is doubtful whether these requirements are in the best interests of shareholders. Many business decisions, including a decision whether or not to sue, are made on the basis of less than complete information. Rational shareholders prefer management to make decisions in this manner because their welfare is maximized by decisions that yield the highest profits net of the costs of gathering information.156 Shareholders would not favor a legal rule that required managers to spend large sums on information gathering if these costs exceed the expected gain from better informed business decisions.

The rule in Zapata, however, requires managers to expend these sums for information gathering. In the typical shareholder suit challenging a business decision, management is under no obligation to compile a record justifying its actions. Rather, a showing that the challenged decision falls within the sphere of the management’s lawful business judgment will be sufficient to defeat the plaintiff’s action. But under Zapata, if the challenged action is a decision not to sue, management must compile a “thorough” written report containing sufficient detail and documentation to satisfy the burden of proof on a number of issues. Zapata, in short, requires managers to incur large costs for the production of information, even where such expenditures are not cost justified.

Moreover, assuming that the first step of the court’s test can be met, the corporation still will be unsuccessful in dismissing the deriva-

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155 Zapata Corp. v. Maldonado, 430 A.2d at 788.
156 Easterbrook & Fischel, supra note 31, at 1196.
tive suit if the court, exercising its "own independent business judgment" decides that the suit should go forward.\textsuperscript{157} Where appropriate, the court's exercise of business judgment should focus on "matters of law and public policy in addition to the corporation's best interests."\textsuperscript{158} It is difficult to see how this second step of the Zapata test can be reconciled with the goal of maximizing shareholders' welfare. Indeed, the whole notion of a court exercising business judgment flies in the face of one of the most basic premises of corporation law—that courts are unable to make business decisions.\textsuperscript{159} Moreover, so long as the purpose of corporation law remains to establish organizing principles under which shareholders may conduct the enterprise for their own benefit, no court should allow a derivative suit to proceed because of considerations of "law and public policy" even though it is contrary to the shareholders' best interests. Nobody would seriously argue that an individual has an obligation to sue in order to vindicate some "public policy" when such a suit is contrary to his best interests. Yet this is precisely what Zapata allows a court to require for corporations.\textsuperscript{160} For all of the above reasons, the effect of Maldonado, like the effect of Singer and Lynch, will be to reduce shareholders' welfare.

III. THE FUTURE OF DELAWARE'S CORPORATION LAW

The impact of the Delaware Supreme Court's decisions in Singer, Lynch, and Zapata on the future of Delaware corporation law should not be exaggerated. Delaware's corporation law was not perfect before these decisions,\textsuperscript{161} and it has not been uniformly bad after.\textsuperscript{162} More-

\textsuperscript{157} Zapata Corp. v. Maldonado, 430 A.2d at 789.
\textsuperscript{158} Id.
\textsuperscript{159} The notion of a court exercising business judgment was justified by reference to cases involving approval of settlement of derivative suits where courts have traditionally exercised business judgment. Id. at 787-88. The analogy, however, is flawed. The rationale for judicial review of settlement actions is the need to police collusive settlements because of the conflict of interest of the attorney. An attorney who will receive 10% of the proceeds of a judgment will not expend $15 worth of effort even if the gain to the corporation would be $100. The attorney, therefore, has an incentive to settle for far less than the value of the claim. This problem is absent in the dismissal of derivative suit context.
\textsuperscript{160} It could be argued that a derivative suit should not be dismissed even where the expected costs exceed the expected benefits. Because shareholders have the option of diversifying, the argument runs, a derivative action should not be dismissed where the expected gains to shareholders as a class exceed the costs of litigation. See Coffee & Schwartz, supra note 150, at 308-09, which raises but does not resolve the issue. The problem with the argument is that the expected costs and benefits from litigation are indeterminate. There is simply no way for a court to ascertain with any reasonable degree of accuracy whether the loss to the shareholders of a particular firm from enforcing a cause of action is outweighed by the gains, if any, to other shareholders. It is more plausible that shareholders of other firms will suffer losses by the creation of legal rules that require firms to pursue causes of action where to do so is not cost-justified.
\textsuperscript{161} Perhaps the worst major decision of the Delaware Supreme Court prior to Singer, Lynch, and Zapata was in Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964). There the court held that a target's management can resist an attempt to acquire control if management has a "policy
over, the basic Delaware corporation statute has, for the most part, been left intact during the past few years and major changes do not appear to be imminent. Nevertheless, there are several reasons why the recent trend in the Delaware Supreme Court poses a threat to the continued primacy of Delaware.

A. Decreased Stability of Precedents

One of the well known attractions of Delaware as a place to incorporate is its rich and stable body of precedents. This body of precedent is advantageous as a guide to decision in future cases, and more importantly, as a backdrop for structuring commercial transactions to avoid litigation altogether. In this respect, a stable body of precedent makes the conduct of corporate affairs less costly by reducing uncertainty.

Singer, Lynch, and Zapata are all radical departures from prior law. Each will dramatically increase uncertainty. Prior to Singer, a corporation planning a merger could safely assume that the transaction would go forward without interference, with dissident minority shareholders limited to an appraisal remedy. After Singer, the same corporation must be prepared for a suit attempting to enjoin the transaction on the amorphous grounds that it lacks a valid “business purpose” or is not “entirely fair.” Prior to Lynch, a corporation planning a tender offer could safely assume that the transaction would go forward if the selling shareholders who voluntarily tendered received more than the current value of their shares. After Lynch, the same corporation must be prepared to pay shareholders damages in excess of the value of their shares at the time they tendered. Prior to Zapata, a corporation could assume that it could dismiss a derivative suit if the suit was contrary to the shareholders’ best interests. After Zapata, the same corporation must face the prospect that a court exercising “independent business judgment” and considering questions of “public policy” will allow the suit to go forward.

The uncertainty created by these decisions is not limited to the subject matter of the cases themselves. Corporate planners in all areas can now expect far more litigation challenging business decisions and be far less certain about the ultimate outcome. This uncertainty is a real economic cost that will make incorporation in Delaware less attractive.

dispute” with the prospective bidder. The problem with the decision is that it allows an inefficient group of managers to frustrate the transfer of control to more capable managers on the ground that the new managers would change the direction of the firm to make it more profitable.

162 See cases cited in note 81 supra.

B. Decreased Receptivity to Mergers and Acquisitions

Another commonly understood explanation for the popularity of Delaware corporation law has been its longstanding receptivity to mergers and acquisitions.\textsuperscript{164} In this respect, the Delaware corporation law has performed a valuable economic function.

There is now an extensive theoretical and empirical body of literature on the importance of mergers and acquisitions for maximizing shareholders' welfare.\textsuperscript{165} If a firm is poorly managed, its stock price falls relative to other comparable firms. This decline in the price of the firm's shares in turn attracts potential bidders, who perceive an opportunity to profit by purchasing the firm and managing it more efficiently. As a result, the poorly managed firm will likely find itself faced with a merger proposal or a tender offer.\textsuperscript{166}

Shareholders benefit from this movement of assets to higher valued users in several respects. Shareholders who sell to the bidder obviously benefit because they receive a premium over the current market price of their shares. Indeed, shareholders generally benefit, even if their firm never is the subject of a takeover attempt. Because managers realize that they may be displaced by a successful bidder if performance lags, they have strong incentives to operate efficiently and keep share prices high. Shareholders' welfare is maximized, therefore, by legal rules that facilitate the transfer of control at the lowest possible cost.\textsuperscript{167}

Mergers that do not involve transfers of control also tend to increase shareholders' welfare. A merger of a parent and a subsidiary corporation will likely result in economies of scale, management, and information, and will eliminate problems of allocating corporate opportunities between the two firms. A purely private transaction may increase the value of the firm by eliminating a dissident minority shareholder, saving the costs attributable to public ownership, and preserving corporate secrecy. Again, legal rules that allow these value-increasing transactions to occur at the lowest possible cost are in the best interests of shareholders.\textsuperscript{168}

Until Singer, there was a general presumption in Delaware that mergers and acquisitions are value-increasing. Dissident shareholders typically were unable to increase the cost of an acquisition by pursuing an obstructionist holdout strategy. Dissidents were limited to an appraisal remedy under which they were entitled only to the value of

\textsuperscript{164} Indeed, this is the expressed policy of the Delaware legislature. \textit{See} text accompanying note 62 \textit{supra}. \textit{See also} Dodd & Leftwich, \textit{supra} note 2, at 267-68 (suggesting that firms may reincorporate in Delaware when anticipating expanding by merger).

\textsuperscript{165} The empirical evidence is collected in Easterbrook & Fischel, \textit{supra} note 31, at 1187 n.69.

\textsuperscript{166} \textit{See} text accompanying note 34 \textit{supra}.

\textsuperscript{167} Easterbrook & Fischel, note 31 \textit{supra}.

\textsuperscript{168} Easterbrook & Fischel, \textit{supra} note 43, at __.
their shares at the time of the transaction but none of the resulting synergy gains. In situations where one corporation owned ninety percent of the stock of a second corporation, the two could be merged under the short-form merger statute without any need for a shareholder vote.

This presumption in favor of mergers and acquisitions changed with Singer and Lynch. These cases dramatically expand the ability of dissident shareholders to challenge mergers. The "business purpose" and "entire fairness" requirements of Singer, coupled with the damages rule of Lynch—whereby tendering shareholders are entitled to some uncertain measure of damages well in excess of the market value of their shares—give minority shareholders powerful weapons for disrupting value-increasing transactions. These transactions will now be more costly and, as a result, will occur less frequently. Because shareholders will be worse off by this development, incorporation in Delaware will be less attractive.

C. Increased Regulatory Constraints on Corporate Activities

The purpose of corporation law is to provide a set of organizing principles under which private parties can enter into contractual arrangements that maximize their joint welfare. The function of corporation law, therefore, is rather limited. Apart from minimizing transaction costs and possibly facilitating the operation of market forces that discipline management, corporation law has little role to play. As a general rule, it should not preclude private parties from structuring their affairs in whatever manner they choose any more than the government should interfere with other types of contractual arrangements. Enabling statutes such as Delaware's corporation law, as interpreted by judicial decisions, that give management maximum flexibility in running the corporation's affairs are based on precisely this principle of freedom to contract. Recent developments in the theory of the firm emphasize the fundamental compatibility between manager and shareholder interests and suggest that shareholders' welfare is maximized under a regime such as Delaware's. The available empirical evidence confirms this hypothesis.

Singer, Lynch, and Zapata, however, suggest that Delaware courts will take a far more activist role in regulating corporate internal affairs. In each of these cases, the Delaware Supreme Court held, in effect, that courts could regulate the particular business decisions at issue. This trend of increased judicial scrutiny of business decisions is inconsistent

169 See notes 58-62 and accompanying text supra.
172 See Parts IB & IC, supra, at 916-21.
with the nonregulatory approach of the Delaware corporation law, which is based on the premise that shareholders' welfare is maximized with minimum judicial and legislative interference.

It is possible only to speculate on what effect this trend will have on future decisions. A well-established but controversial line of Delaware cases, for example, holds that dividend policy is solely within management's discretion.\textsuperscript{173} Similarly, it is well settled that, if certain formalities are observed, a corporation can structure an acquisition in Delaware without providing minority shareholders with appraisal rights.\textsuperscript{174} Finally, directors of Delaware corporations do not have to familiarize themselves with every detail of the corporation's affairs, nor develop extensive internal control systems, but rather can rely on summaries and reports of corporate officials.\textsuperscript{175} While each of these pro-management legal rules has been criticized, they all are consistent with the principle that management is in the best position to make business decisions, has strong incentives to make these decisions in the best interest of shareholders, and will suffer various market penalties if they perform inadequately.\textsuperscript{176} If Delaware courts, following the lead of Singer, Lynch, and Zapata, depart from these principles, much that is attractive about incorporating in Delaware will be lost.

\textbf{CONCLUSION}

Delaware's enabling corporation statute, as interpreted by judicial decisions, has been sharply attacked because of its alleged failure to provide adequate protection to shareholders. Despite the widespread acceptance of this belief, it is not supported by any theoretical or empirical evidence. Several recent decisions of the Delaware Supreme Court, however, appear to lean in the direction of the critics. If the trend of these decisions continues, Delaware corporation law will begin, if not a "race to the bottom," at least a "descent from the top."

\begin{footnotes}
\item[173] See, \textit{e.g.}, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Berwald v. Mission Dev. Co., 40 Del. Ch. 509, 185 A.2d 480 (1962).
\item[174] See, \textit{e.g.}, Hariton v. Arco Elec., Inc., 182 A.2d 22 (Del. Ch. 1962), aff'd, 188 A.2d 123 (Del. 1963).
\item[176] See generally Fischel, note 35 \textit{supra}.
\end{footnotes}