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## COMMENTS

# AN OVERVIEW AND ECONOMIC ANALYSIS OF TENDER OFFERS AND MANAGEMENT'S RESPONSE TO TAKEOVER THREATS

### I. INTRODUCTION

The recent increase in corporate takeovers<sup>1</sup> has produced many concerns: in individuals about the impact on the economic health of the nation; in courts and legislatures about aggressive tactics used by potential acquirors and resisting management alike; in shareholders about who is tending to their interests.<sup>2</sup> Much concern arises out of management's<sup>3</sup> response to a

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1. The frequency of corporate takeovers is "virtually without precedent." Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44, 44 n.1 (1983); see also Barker, *The Federal Reserve and Junk Bond Financing: Anomaly or Inconvenience?*, 19 PAC. L.J. 769, 770 (1988) ("The last two decades have seen a dramatic increase in the unsolicited tender offer as an important weapon in the acquisition of corporate control."). For a discussion of the cyclical nature of corporate takeover activity, see Comment, *Antitakeover Legislation: Not Necessary, Not Wise*, 35 CLEV. ST. L. REV. 303, 303-04 (1987).

2. Perhaps not the board of directors when a takeover is at issue: An abundance of empirical evidence in the area of social psychology demonstrates that pressures on corporate boards of directors toward conformity and cohesiveness and informational dependence combine to make it virtually impossible for corporate boards to exercise impartial judgment with respect to management proposals as measured against the best interests of the corporation and its shareholders. Harrington, *If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids*, 34 SYRACUSE L. REV. 977, 1026 (1983).

3. The terms "management" and "board of directors" will be used interchangeably for the purposes of this Comment. Both groups typically share a common objective when confronted with a takeover threat, *i.e.*, the desire to keep their positions, and therefore management and the board of directors cooperate to achieve this. One commentator explains the dilemma faced by management and the board of directors: "Takeovers of course can be abused, and often are perpetrated by not very attractive people. But they do have the virtue of providing a discipline on established managements; under free-enterprise capitalism, takeovers are to chief executives what layoffs are to labor." *Review & Outlook: The Milken Indictment*, Wall St. J., Mar. 31, 1989, at A10, col. 1.

takeover threat, which may be sparked by self-interest rather than fiduciary obligations to shareholders.<sup>4</sup> There are diverse opinions about the proper role of management in responding to threats of takeovers.<sup>5</sup> This Comment will discuss the leading economic theories that analyze the proper role of management in the takeover context. A basic understanding of tender offers,<sup>6</sup> the most common takeover threat, is necessary to comprehend fully these theories.

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4. This conflict of interest is widely acknowledged. "A tender offer creates an obvious and inherent conflict of interest between managers and shareholders. The offer presents shareholders with the opportunity to receive a substantial premium over market price, while managers face the very real prospect of losing their jobs if the offer succeeds." Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257, 1263 (1985). Another commentator observes:

The directors have an inherent conflict of loyalty because in most hostile takeover situations the inside directors will lose their jobs and benefits and the other directors will lose their board membership. This conflict is so great in most situations that judicial review of the transaction is going to be necessary . . . .

Comment, *Anti-Takeover Measures - What Standard Should be Used to Evaluate Them?*, 25 HOUS. L. REV. 419, 437 (1988); see, e.g., *Crane Co. v. Harsco Corp.*, 511 F. Supp. 294, 305 (D. Del. 1981) (inherent conflict of interest in tender offer); *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969) ("whenever a tender offer is extended and the management of the threatened company resists, the officers and directors may be accused of trying to preserve their jobs at the expense of the corporation").

5. Concerning the proper role of management of a target corporation, one commentator said:

The debate arose out of the perception of many observers that defensive tactics employed by incumbent managements of larger companies are often more directed to the preservation of their own power, position, prestige, and prerequisites than to the maximization of the wealth of the shareholders whom they presumably serve.

Harrington, *supra* note 2, at 977-78.

Judge Posner frames the controversy in these terms:

The whole issue of permissible defensive tactics in the face of a tender offer is immensely contentious . . . . There are two polar positions in the debate. One views hostile takeovers as a bad thing, on a variety of grounds such as that they make managers of companies that are potential targets of takeover bids worry too much about short-term financial results and that they promote absentee ownership and control. . . .

The other pole is that all resistance to takeover attempts is bad. The market price of publicly traded stock impounds all available information about the value of the stock, and anyone who offers a higher price . . . thereby offers an unequivocal benefit to the shareholders of the target firm, which management if it is really a fiduciary of the shareholders should embrace rather than oppose.

*Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986) (Posner, J.), *rev'd*, 481 U.S. 69 (1987) (citations omitted). For a discussion of three theories on the proper role of management in the takeover context, see *infra* notes 206-386 and accompanying text.

6. A "tender offer" is "essentially an invitation by the bidder to stockholders

## II. OVERVIEW OF THE TENDER OFFER PROCESS

A. *Threshold Issues in the Acquisition Process*

Target corporations ripe for a takeover tend to share common characteristics.<sup>7</sup> While the presence of such characteristics does not guarantee that tender offerors are eyeing the corporation with interest, it does indicate a degree of vulnerability.<sup>8</sup> Tender offerors prefer to pursue corporations with financial characteristics such as low earnings compared to their competition's, low price/earnings ratios, high liquidity, and declining dividends.<sup>9</sup>

Nonfinancial characteristics can also make a corporation attractive to potential acquirors. Tender offerors prefer to present their offer to a broad, dispersed base of shareholders who lack strong ties to the target corporation because loyalty to the corporation is less likely to weigh heavily in their decision whether to tender their shares.<sup>10</sup> Management performance is also a significant factor in the search for a target corporation.<sup>11</sup> In fact, the existence of ineffectual management may be the characteristic which sends the strongest message to potential acquirors that the corporation is ripe for takeover. While weak management is classified more properly as a nonfinancial characteristic, as opposed to a financial characteristic, its presence in a corporation will inevitably affect the financial characteristics

individually to directly enter into a transaction—a tender of the shares they own in exchange for cash or securities—with the bidder.” Harrington, *supra* note 2, at 983. For a discussion of the definition of “tender offer,” see Andre, *Unconventional Offers Under the Williams Act: The Case for Judicial Restraint*, 11 J. CORP. L. 499 (1986); *see also infra* note 45.

7. E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 1 (1973); Comment, *Antitakeover Maneuvers: Developments in Defense Tactics and Target Actions for Injunctive Relief*, 35 Sw. L.J. 617, 619-20 (1981).

8. E. ARANOW & H. EINHORN, *supra* note 7, at 1.

9. E. ARANOW & H. EINHORN, *supra* note 7, at 2-9. Other attractive financial characteristics include substantial cash flow from depreciation, undervalued fixed assets, and nominal debt and contingent liability. *Id.* at 9.

10. Comment, *supra* note 7, at 619-20. In addition, the concentration of ownership is a factor to consider. “Where the majority of a corporation’s shares are concentrated in the hands of a relatively limited number of independent investors, the risks of a takeover are increased simply because the offeror has fewer people to persuade to make its offer successful.” E. ARANOW & H. EINHORN, *supra* note 7, at 6. Also, the smaller the amount of stock held by management relative to total outstanding shares, the more attractive the corporation is to a potential acquiror. *Id.* at 9.

11. E. ARANOW & H. EINHORN, *supra* note 7, at 9. A raider may also be attracted to a corporation for reasons other than those listed here. The raider may be looking for a dependable source of raw materials or goods or it may be seeking to develop a full horizontal or vertical product distribution system. Comment, *supra* note 7, at 618; *see also* 1 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS 9-10 (1978).

of the corporation. The presence of all or any one of these factors is certainly not a litmus test of vulnerability but rather should serve to provide management with awareness of the possibility that acquirors will view the corporation as ripe for a takeover.

Once a corporation has been identified as a target for investment activities, there are several methods a potential acquiror can use to secure control of the corporation.<sup>12</sup> These control methods vary in the degree to which target management can intervene in the bid for control. Therefore, these control methods typically face varying degrees of opposition from shareholders opposed to the management intervention. Little controversy about the propriety of management's role in the bid for control arises in two of the transactional methods—mergers and sales of assets—because shareholder approval of the transaction is required. Shareholders are given the opportunity to voice their approval or disapproval of the proposed change in control.<sup>13</sup>

A third method of securing control of a corporation is a proxy fight. In a proxy fight, the potential acquiror solicits shareholder votes for merging the target and the acquiror's corporation.<sup>14</sup> Like a merger or sale of assets, a proxy fight is unlikely to result in shareholder dissension since the opportunity exists for shareholder approval.<sup>15</sup>

Stock accumulation is another method for exerting control over a target corporation.<sup>16</sup> There are several ways for an interested party to accumulate

12. For a discussion of various takeover techniques, see Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities—An Update*, 40 BUS. LAW. 1403, 1411-14 (1985).

13. REVISED MODEL BUSINESS CORP. ACT § 11.03 (1984) (majority of shareholders must approve a merger); REVISED MODEL BUSINESS CORP. ACT § 12.02 (1984) (majority of shareholders must approve a sale of assets); see also Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 842-43 (1981); Comment, *Anti-Takeover Measures - What Standard Should be Used to Evaluate Them?*, 25 HOUS. L. REV. 419, 419 (1988).

14. The potential acquiror may:

solicit[] the help of shareholders in the target corporation through the use of notices and advertisements. The objective of the raider is to use the shareholders' votes at the annual meeting to force the target to merge with the raider. If the raider can obtain sufficient shareholder support for his position, by securing enough votes for his propositions, the raider may not have to spend vast amounts of money actually acquiring stock.

Empirical Research Project, *Defensive Tactics to Hostile Tender Offers - An Examination of Their Legitimacy and Effectiveness*, 11 J. CORP. L. 651, 658-59 (1986).

15. REVISED MODEL BUSINESS CORP. ACT §§ 7.22, 7.24 (1984). See also Lipton & Brownstein, *supra* note 12, at 1413 ("a proxy fight can on occasion be a rather expeditious method of acquiring control or forcing an extraordinary transaction on a target").

16. Empirical Research Project, *supra* note 14, at 659.

enough stock to gain effective control of a corporation. The potential acquiror may privately negotiate with individuals who hold large amounts of stock<sup>17</sup> or he can purchase stock on the open market.<sup>18</sup> The accumulation of enough stock will permit the acquiror to exercise voting power at shareholders' meetings and thus secure control over the target.<sup>19</sup>

The most effective and widely-used stock accumulation method is the tender offer.<sup>20</sup> The chief controversy surrounding the tender offer process focuses upon the propriety of target management employing takeover defenses to defeat the tender offer before shareholders can assess the merits of the tender offer for themselves.<sup>21</sup> Depriving shareholders of the opportunity to participate in the tender offer usually means depriving them of the opportunity to sell their shares at a premium over the market price. Disgruntled shareholders and the potential acquiror may then bring suit to challenge management's role in defeating the offer.<sup>22</sup>

Tender offers may be classified as friendly or hostile.<sup>23</sup> If the offer is friendly, the directors of both corporations cooperate to reach a mutually acceptable offering price and then merge the two corporations.<sup>24</sup> The tender offer is perceived as hostile if the target's management or board of directors fear an adverse impact on the corporation or their own positions.<sup>25</sup> In a

17. This is known as a "self-tender." For a discussion of self-tenders, see Lipton & Brownstein, *supra* note 12, at 1416-18.

18. For a discussion and example of a large-scale open market repurchase, see Lipton & Brownstein, *supra* note 12, at 1418.

19. REVISED MODEL BUSINESS CORP. ACT §§ 7.21-28 (1984) governs the voting rights of shareholders.

20. "Tender offers have become the weapon of choice because they are considered faster, less messy . . ." Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, 89 CASE & COM., Nov.-Dec. 1984, at 35. For a discussion of the practical and legal considerations in making tender offers, see E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 10-45 (1977); see generally Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

21. For a discussion of various theories on the propriety of target management employing takeover defenses, see *infra* notes 206-386 and accompanying text.

22. "The reaction of shareholders to managerial resistance depends on the outcome. Few protest when resistance leads to a takeover at a higher price. When resistance thwarts the takeover attempt altogether, however, litigation usually follows." Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1163 (1981).

23. Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 693-94 (1984); Empirical Research Project, *supra* note 14, at 659.

24. Greene & Junewicz, *supra* note 23, at 694-95; see also Comment, *Anti-Takeover Measures - What Standard Should be Used to Evaluate Them?*, 25 HOUS. L. REV. 419, 419-20 (1988); see generally E. ARANOW, H. EINHORN & G. BERLSTEIN, *supra* note 20.

25. See Empirical Research Project, *supra* note 14, at 659.

hostile takeover, management or the board usually seeks to make the acquisition as unattractive as possible for the potential acquiror to discourage a bid for control. Such a response is known as a takeover defense.<sup>26</sup>

Certain types of tender offers have been especially criticized, such as the front-end loaded, two-tiered takeover, the junk bond takeover, and the greenmail tender offer. The front-end loaded, two-tiered tender offer is an offer which pressures target shareholders to sell quickly at the price offered by the offeror.<sup>27</sup> In the first phase of the offer, the offeror solicits sales of the target stock at a premium over the current market price.<sup>28</sup> In the second stage, the shareholders who did not tender their shares in the first phase are offered the chance to sell at a price lower than that offered in the first phase.<sup>29</sup> Therefore, the offeror motivates the target shareholders to sell as quickly as possible to maximize their gain upon sale.<sup>30</sup> Unfortunately, the need for quick action leaves little time for the shareholders to assess rationally the merits of the offer. Many commentators have criticized the coercive nature of the front-end loaded, two-tiered tender offer.<sup>31</sup>

26. For a discussion of takeover defenses, see *infra* notes 105-64 and accompanying text.

27. Empirical Research Project, *supra* note 14, at 660; see also Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257, 1260 (1985).

28. Baysinger & Butler, *supra* note 27, at 1260; Empirical Research Project, *supra* note 14, at 660.

29. Baysinger & Butler, *supra* note 27, at 1260; Empirical Research Project, *supra* note 14, at 660.

30. As one commentator describes it:

Acquiring companies use this two-step, two-price technique to pressure target shareholders to tender their shares quickly. Faced with the possibility of having to accept a lower price in the subsequent merger, target shareholders rush to sell their shares at the higher price, thereby hastening the offeror's acquisition of control.

Comment, *The Front-End Loaded, Two-Tiered Tender Offer*, 78 NW. U. L. REV. 811, 812 (1983).

31. Greene & Junewicz, *supra* note 23, at 679-81; Lipton & Brownstein, *supra* note 12, at 1412-13; Note, *Applying the Federal Reserve Board's Margin Lending Rules to Restrict the Use of Junk Bonds in Hostile Corporate Takeovers*, 43 WASH. & LEE L. REV. 1087, 1093 & n.38 (1986). One commentator notes:

Such "freeze-out" or "takeout" mergers are a private form of eminent domain; they are involuntary unless the target's holders want to sell at the first stage offer price. Moreover, the price difference between the two stages presents shareholders with a prisoner's dilemma that raises questions as to whether even the tendering of shares during the first stage of the takeover is involuntary.

Baysinger & Butler, *supra* note 27, at 1260-61.

The junk bond<sup>32</sup> tender offer also has been heavily criticized.<sup>33</sup> In this type of tender offer, the offeror forms an asset-free "shell corporation" which sells junk bonds to finance the acquisition.<sup>34</sup> The criticism focuses on the riskiness of the arrangement because the offeror may secure the bonds with the assets of the target corporation and, then, he often sells parts of the corporation to pay off the junk bond debt.<sup>35</sup>

The greenmail tender offer,<sup>36</sup> however, probably has been the subject of the most controversy.<sup>37</sup> The greenmailer offeror acquires a controlling

32. "A junk bond is a bond that is backed by the assets of the target company." Empirical Research Project, *supra* note 14, at 660 n.81; *see also* Lipton & Brownstein, *supra* note 12, at 1411-12. Because of their riskiness, junk bonds typically have a return of approximately 325 basis points higher than on other corporate bonds. *The Financing of Mergers & Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs*, 99th Cong., 1st Sess. 385 (1985). For further discussion of junk bonds, *see* Comment, *Junk Bonds: Do They Have a Value?*, 35 EMORY L.J. 921 (1986).

33. Empirical Research Project, *supra* note 14, at 660-61. *But see* Comment, *supra* note 32, at 968 ("There is no consensus that junk bonds represent a problem which must be remedied.").

34. Empirical Research Project, *supra* note 14, at 660; Note, *supra* note 31, at 1088-90.

35. Empirical Research Project, *supra* note 14, at 660. It has been observed that:

[O]nce the corporate raider accomplishes the takeover, the target company becomes responsible for payment of the high rate of interest to the investors who purchased the junk bonds to help finance the takeover. If the earnings of the target company are inadequate to meet the high interest rates demanded by the high yield bonds, the new management must sell the target company's assets to pay interest to purchasers of the bonds. The liquidation of the target company's assets to service the debt created through the issuance of junk bonds raises serious economic concerns about the use of junk bonds to finance hostile corporate acquisitions.

Note, *supra* note 31, at 1093.

36. "The term 'greenmail' refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 n.13 (Del. 1985). *See also* Comment, *Greenmail: From Backrooms to Boardrooms to Courtrooms*, 23 CAL. W.L. REV. 273, 274 (1987).

37. Empirical Research Project, *supra* note 14, at 661; *see also* Comment, *supra* note 36, at 280-84 ("Inevitably, greenmail has a detrimental effect on the capital structure of a target company since the company is forced to incur unnecessary debt in order to fight the alleged takeover."); Note, *supra* note 31, at 1093 n.38 (greenmail may "weaken the competitiveness of the United States economy"). Gilson observes that "[o]ut of this political maelstrom, one element of virtual consensus has emerged: greenmail—target management paying a potential acquiror to go away by repurchasing his shares at a premium—is bad." Gilson, *Drafting an Effective Greenmail Prohibition*, 88 COLUM. L. REV. 329, 329-30 (1988). *But see* Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 341 (1985) ("Both two-tiered tender offers and greenmail benefit the



block of the target's stock and, then, offers to sell the stock back to the target at a premium price. The board may be willing to buy back the stock at a premium price, desiring to protect the corporation or themselves, and the consequence is an immediate, usually large, profit for the green-mailer.<sup>38</sup>

## B. Legislative Issues in the Acquisition Process

### 1. Federal Regulation

There are many federal statutes which potentially restrict the tender offeror in making her bid for control of the corporation. These statutes include the anti-fraud provisions of the Securities Act of 1933,<sup>39</sup> as amended, the Securities and Exchange Act of 1934,<sup>40</sup> as amended, and federal law regulating civil Racketeer Influenced and Corrupt Organizations (RICO), as amended.<sup>41</sup> The backbone of the federal regulatory scheme governing tender offers, however, is the Williams Act,<sup>42</sup> enacted by Congress in 1968 in response to heightened takeover activity.<sup>43</sup> Congress intended the Williams Act to place investors on equal footing with the takeover bidder.<sup>44</sup> The Williams Act addresses two types of securities transactions: substantial stock

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market for corporate control, particularly where corporate control contests are fraught with substantial risk."); Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 61 (1985) ("Greenmail may not only be desirable from shareholders' perspective, but it can facilitate the efficient functioning of the market for corporate control.").

38. Empirical Research Project, *supra* note 14, at 661. "The greenmailer's goal is not to acquire but to be bought out at a good price." Lipton & Brownstein, *supra* note 12, at 1413.

39. 15 U.S.C. § 77q (1982).

40. *Id.* §§ 78a-kk.

41. 18 U.S.C. §§ 1961-68 (1982 & Supp. 1989).

42. The Williams Act was enacted under the Securities Exchange Act of 1934, which is found at 15 U.S.C. §§ 78a-kk (1982). The Williams Act is found at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982). For a discussion of federal securities regulation of tender offers, see E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 64-152 (1973). For a discussion of the merits of antitakeover legislation, see Note, *Antitakeover Legislation: Not Necessary, Not Wise*, 35 CLEV. ST. L. REV. 303 (1987). This author takes the view "[t]he adequacy of the business judgment rule forestalls the need for antitakeover legislation." *Id.* at 327.

43. CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 79 (1987); see Note, *Missouri Takeover Regulation: Solving the Shareholder Coordination Problem*, 63 WASH. U.L.Q. 491, 492 (1985).

44. Fischel, *supra* note 20, at 10 (citing Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149, 150 (1966)).

acquisitions and tender offers.<sup>45</sup> Its effects are designed to be neutral as between management and potential acquirors.<sup>46</sup> In reality, however, the effect is to benefit management because it creates delays which increase the cost of interest expense on the debt used in the acquisition and eliminates the essential element of surprise.

The intended beneficiaries of the Williams Act are the shareholders of target corporations.<sup>47</sup> Disclosure requirements and time constraints are the primary means to that end.<sup>48</sup> Congress adopted this "informed choice"<sup>49</sup> position to "balance the sometimes conflicting goals of maintaining adequate market discipline over managers through the market for corporate control and of providing shareholders with a fair opportunity to evaluate the merits of offers."<sup>50</sup>

The Williams Act requires a bidder to disclose information about the offer such as the bidder's background, the extent of the bidder's holdings in the target corporation, the source of the funds used to finance the offer, and the objective of the offer, including plans to liquidate or significantly restructure the corporate structure.<sup>51</sup> The Williams Act assumes that the individual shareholder is at a disadvantage relative to management

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45. 15 U.S.C. §§ 78m(d), 78(n)(d) (1982 & Supp. 1989). The Williams Act does not define "tender offer" but other sources have provided some guidance. See E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 1-34 (1977); see generally Note, *The Tender Offer: In Search of a Definition*, 43 WASH. & LEE L. REV. 901 (1986).

46. H.R. REP. No. 1711, 90th Cong., 2d Sess., reprinted in 1968 U.S. CODE CONG. & ADMIN. NEWS 2811, states that:

The bill avoids tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. It is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case.

*Id.* at 2813; see also *Edgar v. MITE Corp.*, 457 U.S. 624, 633 (1982) (congressional intent to treat management and bidder equally); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 29 (1977) (Congress committed to neutrality).

47. Empirical Research Project, *supra* note 14, at 672.

48. Empirical Research Project, *supra* note 14, at 672; Note, *supra* note 43, at 492-93. For a discussion of the timing and disclosure requirements, see *infra* notes 51-62 and accompanying text. For a discussion of litigation based upon violations of these requirements, see E. ARANOW, H. EINHORN & G. BERLSTEIN, *supra* note 45, at 104-92.

49. *CTS Corp.*, 481 U.S. at 97 (White, J., dissenting) ("The Williams Act expressed Congress' concern that individual investors be given sufficient information so that they could make an informed choice on whether to tender their stock in response to a tender offer."); see Baysinger & Butler, *supra* note 27, at 1262.

50. Baysinger & Butler, *supra* note 27, at 1262.

51. 15 U.S.C. § 78m(d)(1) (1982 & Supp. 1989). For a discussion of the disclosure requirements, see E. ARANOW, H. EINHORN & G. BERLSTEIN, *supra* note 45, at 35-103.

and the bidder in regard to having access to the information necessary to maximize his investment options.<sup>52</sup>

Congress intended the time constraints<sup>53</sup> of the Williams Act to allow shareholders more time to analyze carefully the information disclosed by the bidder.<sup>54</sup> Otherwise, shareholders may feel compelled to act hastily due to fear of missing the opportunity to tender their shares. Seven days after the bidder makes the offer, the Williams Act permits tendering shareholders to change their minds and withdraw their shares.<sup>55</sup> If the shares have not been purchased by the offeror within sixty days of the offer, then the shareholder who has second thoughts may withdraw his shares at any time.<sup>56</sup> In addition, all tender offers must remain open for at least twenty days.<sup>57</sup> If the bidder desires to purchase fewer shares than shareholders have tendered in response to the offer, then the bidder is required to purchase the tendered shares on a pro rata basis.<sup>58</sup>

Other regulations promulgated by the Securities and Exchange Commission (SEC) also impose substantive requirements on tender offerors. Of particular importance are the All-Holders and Best-Price rules.<sup>59</sup> The All-Holders rule requires the tender offeror to extend his offer to all shareholders, rather than select shareholders.<sup>60</sup> The Best-Price rule requires the tender offeror to pay the highest consideration paid during the tender offer to all shareholders who choose to tender.<sup>61</sup> Thus, all shareholders who choose to tender will receive equal compensation for their shares. This may alleviate some of the coerciveness of the front-end loaded, two-tiered tender offer,<sup>62</sup> but not prohibit such offers entirely since they involve two separate tender offers.

## 2. State Regulation

State tender offer legislation has been subject to more litigation and controversy than the Williams Act.<sup>63</sup> States responded almost immediately to

52. It is implicit in the Williams Act "that independent shareholders faced with tender offers often are at a disadvantage." *CTS Corp.*, 481 U.S. at 82.

53. See *infra* notes 55-57 and accompanying text.

54. Empirical Research Project, *supra* note 14, at 672.

55. 15 U.S.C. § 78n(d)(5) (1982 & Supp. 1989).

56. *Id.*

57. 17 C.F.R. § 240.14e-1(a) (1988).

58. 15 U.S.C. § 78n(d)(6) (1982).

59. 17 C.F.R. §§ 240.14d-10(a)(1),(2) (1988).

60. *Id.* § 240.14d-10(a)(1).

61. *Id.* § 240.14d-10(a)(2).

62. Empirical Research Project, *supra* note 14, at 674.

63. For a discussion of state regulation of tender offers, see E. ARANOW, H. EINHORN & G. BERLSTEIN, *supra* note 45, at 207-57. For a discussion of the deficiencies of state legislation, see Siegel, *Tender Offer Defensive Tactics: A*

the wave of takeover activity in the 1970s by passing legislation directed at tender offers.<sup>64</sup> The purpose of these state statutes, known as first generation statutes, was to protect domestic corporations, primarily by delaying the tender offer process.<sup>65</sup> Like the Williams Act, these statutes employed compulsory waiting periods before the offeror could extend the offer.<sup>66</sup> The legislation went a step beyond the regulatory effect of the Williams Act<sup>67</sup> by requiring hearings on the sufficiency of the disclosure and the overall "fairness" of the tender offer.<sup>68</sup> These first generation statutes abandoned the neutrality of the federal legislation in an effort to protect target management by giving them notice and time to act in defense.<sup>69</sup> These statutes were attacked frequently on constitutional grounds,<sup>70</sup> although it was not until the landmark case of *Edgar v. MITE Corp.*<sup>71</sup> that the

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*Proposal for Reform*, 36 HASTINGS L.J. 377, 392-94 (1985). Siegel proposes an amendment to the Model Business Corporation Act to deal with the issues toward which state legislation is aimed. *Id.* at 409. See also Boehm, *State Interests and Interstate Commerce: A Look at the Theoretical Underpinnings of Takeover Legislation*, 36 WASH. & LEE L. REV. 733 (1979).

64. "During the first fifteen-year period following the enactment of the Williams Act, thirty-seven states passed legislation regulating tender offers." Note, *supra* note 43, at 493. For a discussion of these first generation state takeover statutes, see Wilner & Landy, *The Tender Trap: State Takeover Statutes and their Constitutionality*, 45 FORDHAM L. REV. 1, 5-9 (1976).

Since corporations are creatures of state statutes, states' interest in regulating them is quite natural:

It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A state has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs.

*CTS Corp.*, 481 U.S. at 91.

65. Empirical Research Project, *supra* note 14, at 676.

66. *Id.*; see also Note, *supra* note 43, at 493.

67. "An inherent problem with state takeover legislation is that states naturally favor local target corporations over bidders. State legislators are more concerned with the preservation and stability of local business concerns than with management entrenchment." Note, *supra* note 43, at 491 n.4.

68. Empirical Research Project, *supra* note 14, at 676; see also Note, *supra* note 43, at 493.

69. Siegel, *supra* note 63, at 412 n.160. "[S]everal states gave management the advantage by requiring time delays or time consuming hearings." *Id.* "Although Congress desired to favor neither the bidder nor target management, the states historically have struck a balance in favor of target management and its efforts to resist takeovers." *Id.* at 412.

70. See, e.g., *MITE Corp. v. Dixon*, 633 F.2d 486, 500-02 (7th Cir. 1980), *aff'd*, 457 U.S. 624 (1982). But see *City Investing Co. v. Simcox*, 476 F. Supp. 112 (S.D. Ind. 1979), *aff'd*, 633 F.2d 56 (7th Cir. 1980) (upheld Indiana takeover statute as constitutional).

71. 457 U.S. 624 (1982); see also Leacock, *American Business Law: Restricting Hostile Take-overs in American Law*, 1987 J. Bus. L. 514; Empirical Research Project, *supra* note 14, at 676-80.

issue of constitutionality was resolved. In *MITE*, the Supreme Court relied on the commerce clause in holding that the Illinois Business Takeover Act was unconstitutional. The Court held that the Illinois Act was an impermissible burden on interstate commerce<sup>72</sup> since the interests advanced by the Illinois Act, protecting local investors and regulating the internal affairs of domestic corporations, were not promoted sufficiently to permit its burden on interstate commerce.<sup>73</sup>

A minority of the *MITE* Court also held that the Williams Act preempted the Illinois Act based on the supremacy clause.<sup>74</sup> The Illinois Act was viewed as giving target management an unfair advantage over potential acquirors by allowing target management more time to implement defensive strategies and permitting the Secretary of State to review the substantive fairness of the offer. The Court found this contrary to the neutrality underlying the Williams Act.<sup>75</sup>

Following *MITE*, many courts struck down as unconstitutional first generation state takeover statutes.<sup>76</sup> In response, state legislatures modified

72. *MITE*, 457 U.S. at 646. The commerce clause is found at U.S. CONST. art. I, § 8, cl. 3. It gives Congress the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." *Id.* The Court found that the statute affected more than just Illinois residents because nonresident shareholders were precluded from tendering stock. *MITE*, 457 U.S. at 643. "[T]he Illinois statute is a direct restraint on interstate commerce and . . . has a sweeping extraterritorial effect." *Id.* at 642.

73. The Court found these to be legitimate state interests but the Illinois Act covered nonresident shareholders as well as resident shareholders. The Illinois Act "directly regulates transactions which take place across state lines, even if wholly outside the State of Illinois." *MITE*, 457 U.S. at 641. This was an impermissible burden on interstate commerce. The Court also found that the Williams Act would provide those legitimate protections sought by the Illinois Act. *Id.* at 644-45.

74. *Id.* at 630-40. The case was resolved under the Court's commerce clause analysis so that the preemption question need not be reached. The supremacy clause provides that "the Laws of the United States . . . shall be the supreme Law of the Land." U.S. CONST. art VI, cl. 2. The central inquiry in a preemption analysis is "whether the proposal presents an obstacle to the accomplishment of the federal statute's full purpose and objective." Siegel, *supra* note 63, at 414.

75. *MITE*, 457 U.S. at 637-40; see also Leacock, *American Business Law: Restricting Hostile Takeovers in American Law*, 1987 J. Bus. L. 514, 516.

The Court appeared to advocate an economic viewpoint in describing the effects of the Illinois Act. "The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced." *MITE*, 457 U.S. at 643 (citing Easterbrook & Fischel, *supra* note 22, at 1173-74).

76. Note, *supra* note 43, at 491; see, e.g., *Mesa Petroleum Co. v. Cities Serv. Co.*, 715 F.2d 1425, 1431 (10th Cir. 1983); *Telvest, Inc. v. Bradshaw*, 697 F.2d 576, 582 (4th Cir. 1982); *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558, 565 (6th Cir. 1982).

their statutes to deal with the constitutional deficiencies identified in *MITE*.<sup>77</sup> *CTS Corp. v. Dynamics Corp. of America*<sup>78</sup> tested the constitutionality of these second generation state statutes. In this case, the Supreme Court analyzed the Indiana Control Share Acquisition Act<sup>79</sup> and upheld its constitutionality.<sup>80</sup> The Indiana Act provided, in part, that domestic corporations could deny voting rights in special circumstances to shareholders who purchase shares above a minimum threshold.<sup>81</sup> In its preemption analysis, the Court found the Indiana statute cured the constitutional defects of the Illinois statute in *MITE*.<sup>82</sup> First, the statute favored neither management nor the bidder by allowing communications with the target shareholders about the upcoming offer.<sup>83</sup> Second, the Indiana Act did not allow for infinite delays in the tender offer process,<sup>84</sup> and third, it did not allow state agencies to assess the "fairness" of the tender offer.<sup>85</sup>

In its commerce clause analysis, the Supreme Court balanced the burden on interstate commerce against the benefits to the state and upheld the Indiana takeover statute.<sup>86</sup> The primary benefit of the statute was protection of shareholders of Indiana corporations.<sup>87</sup> Shareholder protection was furthered by "allowing shareholders collectively to determine whether the takeover is advantageous to their interests . . . where a hostile tender offer may coerce shareholders into tendering their shares."<sup>88</sup> The Court found

77. For a discussion of how various states have modified their takeover statutes, see Empirical Research Project, *supra* note 14, at 680-84; see also Note, *supra* note 43, at 496-97.

78. 481 U.S. 69 (1987); see also Comment, *supra* note 1, at 343-46.

79. Indiana Bus. Corp. Law, IND. CODE §§ 23-1-42-1 to -11 (Supp. 1988).

80. 481 U.S. at 94.

81. Indiana Bus. Corp. Law, IND. CODE §§ 23-1-42-5, -7, -9 (Supp. 1988). The Indiana statute was upheld despite the fact that "[v]ery few tender offers could run the gauntlet that Indiana has set up." *CTS Corp.*, 481 U.S. at 77 (quoting the lower court opinion, *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 263 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987)).

82. "[T]he overriding concern of the *MITE* plurality was that the Illinois statute considered in that case operated to favor management against offerors, to the detriment of shareholders. By contrast, the statute now before the Court protects the independent shareholder against both of the contending parties." *CTS Corp.*, 481 U.S. at 81-82; see also *id.* at 83-84.

83. *Id.* at 83.

84. *Id.*

85. *Id.* at 83-84 (doesn't "allow the state government to interpose its views of fairness between willing buyers and sellers of shares of the target company").

86. *Id.* at 87-89. "Because nothing in the Indiana Act imposes a greater burden on out-of-state offerors than it does on similarly situated Indiana offerors, we reject the contention that the Act discriminates against interstate commerce." *Id.* at 88.

87. *Id.* at 91.

88. *Id.* at 91-92. "In our view, the possibility of coercion in some takeover bids offers additional justification for Indiana's decision to promote the autonomy of independent shareholders." *Id.* at 92.

these interests outweighed the statute's minimal impact on interstate commerce.<sup>89</sup>

As expected, the Supreme Court's approval of the Indiana takeover act resulted in other states modifying their own statutes.<sup>90</sup> Missouri is one such state. The Missouri second generation takeover statute is section 351.407 of the Revised Statutes of Missouri.<sup>91</sup> The Missouri Act is identical to the Indiana Act in many important respects and, therefore, as with the Indiana Act, likely to survive a constitutional challenge.<sup>92</sup> The Missouri Control Share Acquisition Act requires an acquiror to deliver a disclosure statement to the target corporation.<sup>93</sup> The Act compels the bidder to disclose his identity, the number of shares he holds before the proposed acquisition, and a "description in reasonable detail of the terms of the proposed control share acquisition."<sup>94</sup> The focus of the Missouri Act is its requirement that a majority of the target's shareholders approve the proposed control share acquisition.<sup>95</sup> The target corporation must hold a special shareholders' meeting for this purpose within fifty days after receipt of the disclosure statement.<sup>96</sup>

The Missouri Act also provides for the rights of shareholders who are opposed to the proposed control share acquisition.<sup>97</sup> Dissenting shareholders may receive the fair value of their shares as of the date the vote was taken on voting rights accorded the control shares.<sup>98</sup> The statute also provides that if the dissenting shareholder and the corporation are unable to agree on the fair value of the shares, then a court may make such a determination.<sup>99</sup>

89. *Id.* at 87-88. The Court held that the Indiana statute did not discriminate against interstate commerce. Rather, it "visits its effects equally upon both interstate and local business." *Id.* at 87 (quoting *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 36 (1980)).

90. Comment, *CTS: Returning Limited Regulation of Tender Offers to the State*, 19 TEX. TECH L. REV. 1453, 1471-84 (1988); Note, *Expanding the Horizon of the Williams Act: State Antitakeover Laws in the Aftermath of CTS Corp. v. Dynamics Corp. of America*, 34 WAYNE L. REV. 1419, 1437-43 (1988).

91. MO. REV. STAT. § 351.407 (Supp. 1988).

92. Note, *supra* note 43, at 508. This note provides a constitutional analysis of the Missouri statute. *Id.* at 499-508.

93. MO. REV. STAT. § 351.407(2) (Supp. 1988).

94. *Id.* § 351.407(2)(5)(a).

95. *Id.* § 351.407(5).

96. *Id.* § 351.407(3). The Act also has a notice requirement. "If a special meeting is requested, notice of the special meeting of shareholders shall be given as promptly as reasonably practicable by the issuing public corporation to all shareholders of record as of the record date set for the meeting, whether or not entitled to vote at the meeting." *Id.* § 351.407(4)(1).

97. *Id.* § 351.407(6)-(9).

98. *Id.* § 351.407(6). This is similar to the rights of shareholders who oppose a proposed merger. See REVISED MODEL BUSINESS CORP. ACT § 13.02-.28 (1984).

99. MO. REV. STAT. § 351.407(8) (1986).

C. *Managerial Responses to Proposed Acquisitions*

## 1. Focus of the Controversy

Management's response to the proposed tender offer engenders controversy since it is so difficult to determine whether they are protecting the corporation or themselves. Target management may fear that the proposed takeover will adversely affect the long run economic viability of the corporation<sup>100</sup> or they may fear that they will be replaced or terminated if the corporation is reorganized.<sup>101</sup> Often these fears overlap. Management employs anti-takeover devices to defeat tender offers.<sup>102</sup> Problems arise when the target shareholders question the motivation behind management's fighting off the offer: Whose interest are they protecting? Their own or the shareholders?<sup>103</sup> Later, this Comment discusses in detail the propriety of management's use of takeover defenses.<sup>104</sup>

The arsenal used by target corporations to fend off tender offerors can be classified broadly as preventive or remedial.<sup>105</sup> The corporation implements preventive tactics, also known as "shark repellants,"<sup>106</sup> prior

100. "If management believes that the takeover would be injurious to the corporation, its fiduciary duties require it to take steps to ward off the unfriendly takeover attempt." Empirical Research Project, *supra* note 14, at 667 (citation omitted). However, "[w]here an attractive offer is made by a well-managed, financially sound company whose operations are not incompatible with the target, management may recommend that its shareholders accept the bid or, at a minimum, not take any action opposing the bid." E. ARANOW & H. EINHORN, *supra* note 7, at 219.

101. The dilemma faced by target management has been described as "the conflict between maximization of shareholder wealth and perpetuation of management's control over the corporation and, coincidentally, over the jobs, salaries, prerequisites, power, and prestige of the individual managers." Harrington, *supra* note 2, at 989-90.

102. Anti-takeover defenses are discussed in E. ARANSON, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 193-206 (1977); M. LIPTON & E. STEINBERGER, 1 TAKEOVERS AND FREEZEOUTS § 6.05 (1986).

103. See *supra* note 2.

104. See *infra* notes 206-386 and accompanying text.

105. Empirical Research Project, *supra* note 14, at 653, 661. For an exhaustive list of both types of tactics, see Harrington, *supra* note 2, at 984-86. For a discussion of how to prepare to meet a takeover threat by establishing a defense team, "black book" (a battle plan), and other strategies, see Comment, *supra* note 7, at 620-32. The defensive tactics may also be classified as financial or structural. Comment, *Anti-Takeover Measures—What Standard Should be Used to Evaluate Them?*, 25 Hous. L. REV. 419, 420 (1988).

106. Comment, *supra* note 7, at 624 n.43. "Shark repellent' clauses are aimed at discouraging unwanted suitors, the 'sharks,' from initiating takeover attempts and preventing them from wresting complete control from the management." *Id.*



to being approached by potential raiders. Remedial tactics are implemented after the raider has invited shareholders to tender their shares.<sup>107</sup> All of these weapons seek to prevent shareholders from tendering their shares to the bidder.<sup>108</sup> The means to this end is the creation of obstacles and disincentives which make the target less attractive and less vulnerable to the offeror:

The common denominator of all these maneuvers is, of course, to deter and, failing this, defeat direct offers to shareholders by bidders. This is accomplished by creating economic and legal barriers or disincentives to the initiation, continuation, or consummation of the offer, generally by making the transaction costs so high that, when added to the direct costs of purchasing the stock at the associated premium, the costs of the transaction outweigh the anticipated benefits.<sup>109</sup>

## 2. Preventive Tactics

Preventive tactics usually are implemented through the corporation's charter or bylaws<sup>110</sup> and such tactics are widely used.<sup>111</sup> Over 40% of the

107. Empirical Research Project, *supra* note 14, at 661-62.

108. Easterbrook & Fischel, *supra* note 22, at 1161-62; see also Gilson, *The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 777 (1982) (citations omitted). (the idea is to "encourage the 'shark' to seek a more appetizing or more easily digested alternative"); Harrington, *supra* note 2, at 986 (such obstacles and disincentives are designed to make "transaction costs so high that, when added to the direct costs of purchasing the stock at the associated premium, the costs of the transaction outweigh the anticipated benefits").

109. Harrington, *supra* note 2, at 986. This commentator also notes that "despite the heated—perhaps overheated—debate that the use of these techniques has fostered, they usually do not work, at least once a hostile tender offer has been commenced." *Id.* at 986-87 (citation omitted).

110. Empirical Research Project, *supra* note 14, at 662. The purpose of such amendments is to "increase the bargaining power of management when confronted with a hostile outside contest for control of the corporation." Pound, *The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence*, 30 J. L. & ECON. 353, 353 (1987). For further discussion of charter and bylaw provisions, see E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 193-99 (1977). The authors conclude that "[m]ost of these types of amendments are contrary to the basic principles of corporate democracy, for they permit incumbent management to control a corporation long after it has lost the support of its shareholders." *Id.* at 195.

111. For a discussion of the effects of these "shark repellants" on shareholders' expected gains from takeover activity, see Pound, *supra* note 110, at 357-66. The author concludes that "these amendments increase the bargaining power of management in the event of a control bid, to the detriment of shareholder wealth. The amendments appear to reduce the frequency of takeover bids significantly while not improving the expected value of shareholder gains in those takeover contests that do occur." *Id.* at 367.

Fortune 500 corporations have adopted some form of "shark repellent."<sup>112</sup> The most common type is the fair price amendment which requires the acquiror to pay the same price for each share in a bid for control.<sup>113</sup> A second type of shark repellent is the requirement that a supermajority vote of shareholders, usually 66-80%, must approve a proposed merger.<sup>114</sup> Another common preventive tool is the classified board provision which requires the election of the board of directors for staggered terms.<sup>115</sup> With this the shareholders can remove only a small number of directors at any one time, thus, eliminating the opportunity for the raider to stack the board in his favor.<sup>116</sup>

A provision in the target's charter or bylaws that directors may be removed only for valid cause also makes the target less vulnerable to takeovers.<sup>117</sup> No matter how many voting shares the offeror has accumulated, until the next scheduled annual election, she still can not vote the present directors out of office and replace them with directors of her choice unless valid cause exists for replacing the present directors.<sup>118</sup>

The most widely discussed preventive tactic is the poison pill plan.<sup>119</sup> A poison pill plan is typically in the form of an option distributed to all

112. Pound, *supra* note 110, at 353 (citing INVESTOR RESPONSIBILITY RESEARCH CENTERS ANTITAKEOVER CHARTER AMENDMENTS: A DIRECTORY OF MAJOR AMERICAN CORPORATIONS (1985)).

113. Pound, *supra* note 110, at 353. These amendments prevent "freezeouts," whereby the majority shareholder forces a minority shareholder out at an unreasonable price. Comment, *supra* note 7, at 625 n.51.

114. Pound, *supra* note 110, at 353-54; *see also* Mullaney, *Guarding Against Takeovers—Defensive Charter Provisions*, 25 BUS. LAW. 1441 (1970); Empirical Research Project, *supra* note 14, at 663. For criticism and support of supermajority voting provisions *see id.* at 663-64.

115. Empirical Research Project, *supra* note 14, at 662; *see also* Comment, *supra* note 7, at 624 & n.44. This is also a delaying tactic which discourages the raider from pursuit. *Id.* One commentator observes:

The strategy of this tactic is to prevent a body of shareholders from gaining complete control of the board of directors by voting at one shareholders' meeting. By using the staggered board method the target corporation can increase dramatically the amount of time and resources an offeror must spend to take control of the board of directors and the target itself.

Empirical Research Project, *supra* note 14, at 662 (citations omitted).

116. Empirical Research Project, *supra* note 14, at 662.

117. Comment, *supra* note 7, at 624; *see also* Hochman & Folger, *Deflecting Takeovers: Charter and By-Law Techniques*, 34 BUS. LAW. 537, 538 (1979); Empirical Research Project, *supra* note 14, at 662.

118. Empirical Research Project, *supra* note 14, at 662.

119. After the Delaware Supreme Court upheld the poison pill plan in *Moran v. Household Int'l*, 500 A.2d 1346 (Del. 1985), more than "300 companies rushed to adopt plans that in many cases are more extreme than the plan upheld in *Household*." Helman & Junewicz, *A Fresh Look at Poison Pills*, 42 BUS. LAW.

common shareholders allowing them to purchase stock upon the happening of a "triggering event."<sup>120</sup> The triggering event is usually a proposed transaction involving a change in control such as a tender offer for a certain percentage of the corporation's stock. Upon the happening of this event, the shareholders may exercise their rights to buy shares of the target corporation or of the raider corporation at a specified low price.<sup>121</sup> This has the effect of diluting the control held by the raider and her ability to secure control through a tender offer.<sup>122</sup> Many large publicly-held corporations employ poison pill plans.<sup>123</sup>

771, 771 (1987).

Closely related to the poison pill is poison debt. Poison debt is a fairly recent phenomena which operates like this:

When a target company and its advisers realize that a hostile acquiror will rely heavily on borrowed funds and the target company's own assets in order to consummate and pay for a takeover, they often devise defensive strategies designed to disrupt the potential acquiror's financing and its means of repayment. High interest rates and generous commitment fees will not overcome a lender's normal and usual practice of requiring a borrower to repay loans and debt securities in accordance with their terms. Thus, even buyers of junk bonds will think twice before making loans in situations where the risk of repayment is overwhelming. Even if loans can be obtained, the additional compensation required by lenders for dramatically increased risks may render the transaction economically unattractive to the acquiror.

Clemens, *Poison Debt: The New Takeover Defense*, 42 BUS. LAW. 747, 748 (1987). (This article also contains a thorough discussion of poison debt as a defensive tactic).

120. Dawson, Pence & Stone, *Poison Pill Defensive Measures*, 42 BUS. LAW. 423, 423 (1987); Helman & Junewicz, *supra* note 119, at 772; Note, *Dynamics Corp. of America v. CTS Corp.: Posner's Plan for Poison Pills*, 1987 Wis. L. REV. 711, 711-12 [hereinafter Note, *Posner's Plan*]; Note, *Share and Share Unalike: Judicial Response to Poison Pill Discrimination Among Shareholders of the Same Class*, 33 WAYNE L. REV. 1067, 1067-68 (1987) [hereinafter Note, *Share and Share Unalike*].

121. Dawson, Pence & Stone, *supra* note 120, at 423, Helman & Junewicz, *supra* note 119, at 772; Note, *Share and Share Unalike*, *supra* note 120, at 1067-68.

122. Dawson, Pence & Stone, *supra* note 120, at 428; Helman & Junewicz, *supra* note 119, at 773; Note, *Share and Share Unalike*, *supra* note 120, at 1069. Poison pills can also have other effects: deterring substantial accumulation of stock, creating uncertainty in the pricing of a tender offer, creating delays. See Dawson, Pence & Stone, *supra* note 120, at 431-32. For a discussion of the risks of poison pills, see *id.* at 432; Helman & Junewicz, *supra* note 119, at 771-72. Poison pills also make it "prohibitively expensive to acquire [a corporation] in an unfriendly tender offer." Herzel & Shepro, *The Changing Fortunes of Takeover Defenses*, 15 SEC. REG. L.J. 116, 122 (1987). "A key factor in the popularity of pills is that they can be adopted quickly by boards of directors without stockholder approval." *Id.*

123. Herzel & Shepro, *supra* note 122, at 121. "Corporations have been adopting 'poison pill' defensive measures at a rapid pace following the decision

Bidders and shareholders have frequently challenged the adoption of poison pill plans as a promotion of management's best interests rather than the shareholders' best interest.<sup>124</sup> In analyzing the validity of such plans, courts have distinguished between flip-in and flip-over plans.<sup>125</sup> Flip-over plans allow the target shareholder to buy stock in the offeror corporation at a reduced price.<sup>126</sup> Flip-in plans allow target shareholders to buy stock in the target corporation at a discount after the triggering event.<sup>127</sup> Flip-in plans have additional bite because the bidder may be discriminated against and not permitted to exercise the same rights to purchase shares in the target as are exercised by other shareholders of the corporation.<sup>128</sup> Because of their discriminatory aspects, courts have viewed the flip-in plans with more suspicion than the flip-over plans<sup>129</sup> although resolution of the discrimination issue has not been uniform.<sup>130</sup> The Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*<sup>131</sup> upheld a defensive strategy under Delaware law which discriminated between shareholders by not allowing the tender offeror to participate in the selective exchange plan.<sup>132</sup>

of the Delaware Supreme Court in *Moran v. Household International, Inc.*, in November, 1985." Dawson, Pence & Stone, *supra* note 120, at 423 (footnote omitted).

124. For a discussion of some of the primary objectives of poison pills, see Dawson, Pence & Stone, *supra* note 120, at 425-26. For a discussion of factors which the board should consider, see Helman & Junewicz, *supra* note 119, at 777-88.

125. See Note, *Posner's Plan*, *supra* note 120, at 719. For a discussion of other types of poison pills, see Dawson, Pence & Stone, *supra* note 120, at 428-31; Note *Share and Share Unalike*, *supra* note 120, at 1070-73.

126. Dawson, Pence & Stone, *supra* note 120, at 424; see also *id.* at 426-28.

127. *Id.* at 424, 428.

128. "Flip-in rights are void in the hands of the large stockholder whose actions result in the flip-in." Herzl & Shepro, *supra* note 122, at 123. "It is worth repeating that the economic heart of the flip-in idea is discrimination against the acquiring stockholder whose actions trigger the flip-in. The acquiring stockholder is not allowed to exercise the flip-in rights." *Id.* at 124.

129. See *id.* at 121-29. Also, it should be noted that "the idea that a board of directors cannot favor one bidder during a control contest but, instead, must act as an impartial auctioneer has begun to appear." *Id.* at 129. This bodes ill for discriminatory strategies.

130. Note, *Share and Share Unalike*, *supra* note 120, at 1074; see also Helman & Junewicz, *supra* note 119, at 776.

131. 493 A.2d 946 (Del. 1985).

132. The court phrased the issue as "the validity of a corporation's self-tender for its own shares which excludes from participation a stockholder making a hostile tender offer for the company's stock." *Unocal*, 493 A.2d at 949. The court concluded that the discriminatory plan was a valid exercise of business judgment:

[T]here was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate

The court held that the discrimination was not unlawful.<sup>133</sup> In contrast, more recent cases have taken a grim view of the discriminatory effects of flip-in provisions.<sup>134</sup>

Legal scholars do not agree on whether managerial responses to takeover threats should be permitted.<sup>135</sup> Supporters of the tactics insist that such tactics benefit shareholders by allowing them more time to decide whether it is in their best interest to tender their shares.<sup>136</sup> Critics argue, however, that "[t]he case against antitakeover amendments is based on the fact that the amendments serve to increase managerial bargaining power—and hence managerial discretion for self-interested behavior—in the single situation in which such self-interested behavior is most likely to occur."<sup>137</sup>

### 3. Remedial Tactics

If preventive tactics in the target corporation's charter or bylaws fail to thwart the threatened attack, then management may resort to remedial

enterprise. Further, the selective stock repurchase plan chosen by Unocal is reasonable in relation to the threat that the board rationally and reasonably believed was posed by Mesa's inadequate and coercive two-tier tender offer. Under those circumstances the board's action is entitled to be measured by the standards of the business judgment rule.

*Id.* at 958. However, "[a] corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available." *Id.* at 955. "The restriction placed upon a selective stock repurchase is that the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office." *Id.* The Delaware Supreme Court upheld a flip-over poison pill plan in *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985). The *Moran* court noted that the application of the business judgment rule may differ in preventive or remedial tactics. "[P]re-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment. Therefore, in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule." *Id.* at 1350. The SEC has attempted to alleviate some of the perceived unfairness of discriminatory tender offers with the All-Holders and Best-Price rules. See *supra* notes 59-62 and accompanying text. This has the effect of prohibiting discriminatory self-tenders as a defensive strategy. *Herzel & Shepro*, *supra* note 122, at 118. While the effect on poison pills is unclear, the rules could "undermine the confidence of Delaware and other courts in the *Unocal* decision as a justification for the flip-in pill." *Id.* at 124.

133. *Unocal*, 493 A.2d at 956 ("[W]e are satisfied that the selective exchange offer is reasonably related to the threats posed."). *But cf. infra* note 132.

134. *R.D. Smith & Co. v. Preway, Inc.*, 644 F. Supp. 868, 875 (W.D. Wis. 1986) (flip-in plan probably violates Wisconsin law but injunction denied because irreparable harm not shown); *Amalgamated Sugar Co. v. NL Indus.*, 644 F. Supp. 1229, 1234 (S.D.N.Y. 1986) (court invalidated flip-in plan under New Jersey law because it discriminated among shareholders), *aff'd*, 825 F.2d 634 (2d. Cir. 1987); see *Helman & Junewicz*, *supra* note 119, at 774.

135. For a discussion of three theories, see *infra* notes 206-386 and accompanying text.

136. See *infra* notes 208-63 and accompanying text.

137. *Found. Supp.* note 110, at 354.

tactics after the takeover has been proposed.<sup>138</sup> Such tactics are many and diverse, and inevitably have colorful names.<sup>139</sup>

Management may seek to foil a tender offeror by inviting a "white knight" to rescue them.<sup>140</sup> The "white knight" is another acquirer who is "friendly" to incumbent management and more likely to leave the organizational structure intact than is the feared raider.<sup>141</sup> This may also promote an "auction" for the target corporation and maximize the offering price.<sup>142</sup> On the other hand, the white knight may turn out to be a "dragon," with more harmful intentions than management feared from the raider.<sup>143</sup>

The "sale of the crown jewel" is another remedial tactic which may make the target corporation so unattractive to the offeror that it retreats.<sup>144</sup> This involves selling a key asset or piece of the target's property to a third party<sup>145</sup> or an option to buy if the raider is successful in his bid for control. This is particularly painful for the raider whose primary interest is acquiring that particular asset.<sup>146</sup> An extreme application of this defensive measure is "corporate suicide," where the target sells off all of its assets of any value so the offeror has nothing to gain from acquiring the target.<sup>147</sup> Commentators have criticized these tactics because depletion of corporate

138. For a discussion of remedial tactics, see E. ARANOW, H. EINHORN & G. BERLSTEIN, *supra* note 20, at 199-202.

139. For a glossary of colorful takeover terms, see L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 569-70 (1983); Reiser, *supra* note 20, at 35.

140. See Comment, *Antitakeover Maneuvers: Developments in Defense Tactics and Target Actions for Injunctive Relief*, 35 Sw. L.J. 617, 629-30 (1981).

141. Comment, *Anti-Takeover Measures — What Standard Should be Used to Evaluate Them?*, 25 Hous. L. Rev. 419, 420 n.18 (1988) ("A 'white knight' is a purchaser favored by management. The 'white knight' will usually continue to let the corporation operate itself, thus entrenching management."); see also Comment, *supra* note 7, which discusses the advantages of this tactic:

First, the white knight generally will offer more favorable terms in order to secure shareholder approval. Secondly, the shareholder, rather than target management, will make the ultimate decision regarding both the raider's tender offer and the proposed white knight merger. Consequently, the shareholder is not excluded from the decision-making process and likely will reap an economic benefit from the transaction.

*Id.* at 629-30 (footnotes omitted).

142. Harrington, *supra* note 2, at 986.

143. Empirical Research Project, *supra* note 14, at 664.

144. Siegel, *Tender Offer Defensive Tactics: A Proposal for Reform*, 36 HASTINGS L.J. 377, 377 n.3 (1985).

145. Comment, *supra* note 4, at 420 n.15; Empirical Research Project, *supra* note 14, at 664; see, e.g., *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 367 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982).

146. Siegel, *supra* note 144, at 377 n.3.

147. Empirical Research Project, *supra* note 14, at 664; see also *Joseph E. Seagram & Sons, Inc. v. Abrams*, 510 F. Supp. 860, 861 (S.D.N.Y. 1981). This is also known as the "Jonestown" defense. Reiser, *supra* note 20, at 44.

assets in this manner can have serious consequences for the long run economic health of the corporation.<sup>148</sup>

Several remedial tactics also require potentially enormous financial outlays. The target corporation may attempt to fend off takeover attempts by going private. The target can purchase its own shares on the open market or from its shareholders to lessen the probability that an outsider could acquire enough of an interest in the corporation to have control.<sup>149</sup> In addition, this discourages takeovers because the price of the target stock rises due to the increased trading activity and, thus, increases the total cost of the target corporation.<sup>150</sup>

The "Pac Man" defense is a fairly new phenomenon in the area of remedial takeover devices. It involves a "tender offer by the subject company for the securities of the original bidder."<sup>151</sup> Essentially, the target makes a counter offer to acquire the pursuing corporation.<sup>152</sup> "By making a counter offer, the target company implicitly acknowledges the desirability of a combination between itself and the bidder. The counter offer changes the terms of that combination, particularly determining which corporation will be dominant."<sup>153</sup>

A financially healthy target corporation may also defend itself by acquiring a competitor of the pursuing corporation.<sup>154</sup> The target can then raise an antitrust claim based on the proposed acquisition by the bidder because the purchase would result in the bidder also acquiring its competitor.<sup>155</sup> "[H]owever, courts tend to be skeptical of antitrust claims raised by the target, particularly when it has consummated a hasty acquisition for the sole purpose of fending off a takeover attempt."<sup>156</sup>

148. Empirical Research Project, *supra* note 14, at 664-65; see Herzell, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107, 114-15 (1980).

149. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) (self tender offer); see Empirical Research Project, *supra* note 14, at 665. For a discussion of the problems faced by a target corporation employing a self tender offer to fight a takeover, see Siegel, *supra* note 144, at 384 n.31.

150. Siegel, *supra* note 144, at 384 n.31.

151. Harrington, *supra* note 2, at 977 n.2 (quoting SEC Advisory Comm. on Tender Offers, Report of Recommendations, FED. SEC. L. REP. (CCH) (Special Report) at 140 (July 15, 1983)); see also Siegel, *supra* note 144, at 377 n.2.

The "Pac Man" defense was first developed in Bendix's bid for Martin Marietta in 1982. Harrington, *supra* note 2, at 977. For further discussion of the Pac Man defense, see Lipton & Brownstein, *supra* note 12, at 1419-20.

152. Siegel, *supra* note 144, at 377 n.2.

153. *Id.*

154. Empirical Research Project, *supra* note 14, at 665-66.

155. See Comment, *supra* note 7, at 622-23 for a discussion of the delays that also flow from taking over a competitor of the raider; see also Empirical Research Project, *supra* note 14, at 665-66.

156. Comment, *supra* note 7, at 630 (footnotes omitted).

A target corporation may also implement a "scorched earth" defense.<sup>157</sup> These are

[l]ast-ditch efforts to discourage the hostile acquirer and make the target company less attractive—en masse departure of top management in the event of a raid, paying out a big cash dividend to the shareholders, selling off the crown jewels, buyback of the company's own stock at a higher price than what is being offered by the acquirer, or bloating the company with debt.<sup>158</sup>

The target may also drive off a potential suitor, or at least slow down the acquisition process, by instituting litigation against the raider.<sup>159</sup> This may increase the tender price or force the bidder to withdraw.<sup>160</sup> The basis of the suit is an alleged illegality in the acquisition process such as a violation of antitrust law, federal or state securities laws, or the Williams Act or state takeover statutes.<sup>161</sup> The remedy sought is usually an injunction barring the bidder from acquiring any more stock in the target corporation.<sup>162</sup> Federal decisions holding that the target corporation lacked standing to sue for injunctive relief, however, may threaten the availability of this weapon.<sup>163</sup>

Target management may attempt to defeat the tender offer by direct communications with their shareholders about the merits of the tender offer to dissuade them from tendering their shares.<sup>164</sup> The subject of such communications may include criticism of the offering price, emphasis on the long run growth potential of the corporation, and information on

157. See Reiser, *supra* note 20, at 48-49.

158. *Id.* at 49-50; see, e.g., *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 628 (D. Md. 1982); *Joseph E. Seagram & Sons, Inc. v. Abrams*, 510 F. Supp. 860, 861 (S.D.N.Y. 1981).

159. Comment, *supra* note 4, at 420-21 n.20.

160. See Easterbrook & Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155 (1982) for a discussion of such suits and their implications.

161. See generally Harrington, *supra* note 2, at 985; Rosenzweig, *Target Litigation*, 85 MICH. L. REV. 110, 127-29 (1986); see also Comment, *supra* note 7, at 632.

162. One commentator observes that "[a]lmost without exception, any announcement of a takeover bid is now instantly followed by an injunction action filed by the corporate management charging the 'raider' with most of the crimes in the Decalogue, but usually stopping short of statutory rape." Rosenzweig, *supra* note 161, at 113-14 (quoting R. JENNINGS & H. MARCH, *SECURITIES REGULATION* 671 (5th ed. 1982)).

163. Comment, *supra* note 7, at 632, 636-37, 641-43.

164. *Id.* at 628. The corporation may foster close ties with shareholders by using newsletters and personal contact. The corporation should also maintain a detailed analysis of the composition of its shareholders, e.g., geographics, cost basis, potential reactions to takeover threats. *Id.* at 621. "This tactic plays to the feelings of the shareholder. It appeals to the shareholder as part of the corporate 'family' not to let the raider, who is an 'outsider' disrupt the corporate 'family.'" Empirical Research Project, *supra* note 14, at 666.



adverse tax consequences resulting from accepting the tender offer.

#### D. *Judicial Examination of Management Response to Proposed Acquisitions*

##### 1. The Business Judgment Rule

The business judgment rule<sup>165</sup> governs judicial review of the propriety of the actions taken by a corporation's board of directors.<sup>166</sup> This common law standard presumes that the directors, in good faith, exercised sound business judgment.<sup>167</sup> "A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose."<sup>168</sup> When the business judgment rule shields the action of the directors, the directors will not be personally liable nor will a court enjoin their actions.

The protective presumption of the business judgment rule can be rebutted by showing abuse of the directors' fiduciary duties.<sup>169</sup> The presumption applies to challenges to the propriety of director action whether such action is a routine business decision or a defensive response to a

165. As described by the court in *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971), the rule means that

a court will not interfere with the judgment of a board of directors unless there is a showing of gross and palpable overreaching. A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.

*Id.* at 720 (citation omitted).

166. See, e.g., *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985). See generally Arshnt, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979). For a discussion of whether the business judgment rule should be used to evaluate the legality of defensive tactics, see Comment, *supra* note 4.

167. It is a presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). See Note, *Antitakeover Legislation: Not Necessary, Not Wise*, 35 CLEV. ST. L. REV. 303, 320 (1987).

168. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

169. See Siegel, *supra* note 144, at 381; Note, *supra* note 167, at 320. For a discussion of the fiduciary responsibilities of directors, see H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* §§ 231-42 (3d ed. 1983).

takeover threat.<sup>170</sup> Management self-interest, which inheres in any takeover contest, causes many courts and commentators to question the propriety of applying the business judgment rule in the takeover context.<sup>171</sup> As this Comment will discuss later, several courts, including the Supreme Court of Delaware, have accepted a modified version of the common law standard.<sup>172</sup>

Proponents of the business judgment rule advance several reasons in its support. The rule allows directors the discretion to develop effective corporate policy without fear of second-guessing by the courts. Directors may take bold, aggressive action when the situation demands it.<sup>173</sup> The rule encourages qualified individuals to serve as directors by alleviating their fear that courts will hold them personally liable for poor judgment

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170. “[A]n informed decision to reject a takeover proposal, hostile or friendly, will not excuse demand absent particularized allegations of a breach of fiduciary duty, such as self-dealing, fraud, overreaching or lack of good faith.” Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984); *see also* Siegel, *supra* note 144, at 384 (“In essence, the courts have treated management decisions made during a hostile tender offer like other difficult issues that a board of directors often faces.”). The court in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) stated:

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board’s duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.

*Id.* at 954.

171. One commentator declares:

[T]he business judgment rule analysis of target defensive measures is both overly simplistic and wholly inappropriate, and has only exacerbated what may reasonably be interpreted to be serious abuses of the board’s managerial prerogatives when faced with a potential, if not inherent and clear, conflict of interest with the board’s responsibilities to shareholders.

Harrington, *supra* note 2, at 980.

Another observes that “applying the business judgment rule to directors’ actions regarding tender offers raises questions of loyalty which would not necessarily arise in actions concerning the ordinary course of business.” Comment, *supra* note 4, at 425. “Because directors are subject to an inherent conflict of interest in a takeover situation, they should bear the burden of showing that they have acted in the best interest of the corporation.” *Id.* at 428; *see also* Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders’ Welfare*, 36 BUS. LAW. 1733, 1745-47 (1981); Easterbrook & Fischel, *supra* note 22, at 1197; *see generally* Comment, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control*, 76 NW. U.L. REV. 980 (1982); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621 (1983).

172. *See infra* notes 188-205 and accompanying text; *see generally*, Comment, *The Presumptions and Burdens of the Duty of Loyalty Regarding Target Company Defensive Tactics*, 48 OHIO ST. L.J. 273 (1987).

173. *See* Comment, *supra* note 4, at 424; Siegel, *supra* note 144, at 380; Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 650-51 (1983); Comment, *supra* note 1, at 321.

calls made in the exercise of their discretion.<sup>174</sup> The rule also allows courts to side-step the need to judge complex business decisions which they lack the expertise or resources to analyze.<sup>175</sup> Finally, it is widely believed that market forces, e.g., takeover threats, monitor director conduct and motivate directors to act in accordance with the best interests of the corporation.<sup>176</sup> While the rationale for the rule is firmly established in the context of many business decisions, there is skepticism about whether takeover defenses further these purposes.<sup>177</sup>

The fiduciary responsibilities of directors to shareholders traditionally have been described in terms of two obligations: the duty of care and the duty of loyalty.<sup>178</sup> The duty of care "requires the fiduciary to exercise the care that a reasonably prudent person in a similar position would use under similar circumstances."<sup>179</sup> The directors' duty of loyalty proscribes conduct arising out of self-interest.<sup>180</sup>

The rule does not shield the directors or their actions if the challenger can show a breach of the duty of care or the duty of loyalty.<sup>181</sup> Upon

174. The rule "encourages competent people to become directors without fear of personal liability for honest errors in judgment." Note, *supra* note 173, at 651; see also Siegel, *supra* note 144, at 380; Comment, *supra* note 1, at 320-21; Comment, *supra* note 4, at 424.

175. See Siegel, *supra* note 144, at 380; Comment, *supra* note 1, at 321; Comment, *supra* note 4, at 424; Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1969 (1984); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 651 (1983); see also Easterbrook & Fischel, *The Proper Role of Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1195-96 (1981).

176. See Easterbrook & Fischel, *supra* note 175, at 1196.

177. See Comment, *supra* note 4, at 437-38. This author posits that the standard instead should be based upon Fischel and Easterbrook's theory. *Id.* at 438-39. For a discussion of the Fischel and Easterbrook theory, see *infra* notes 264-324 and accompanying text.

178. Harrington, *supra* note 2, at 987; see also Empirical Research Project, *supra* note 14, at 668.

179. Comment, *The Presumptions and Burdens of the Duty of Loyalty Regarding Target Company Defensive Tactics*, 48 OHIO ST. L.J. 273, 274 (1987); see, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); *Enterra Corp. v. SGS Assocs.*, 600 F. Supp. 678, 684 (E.D. Pa. 1985). As phrased by the Model Business Corporation Act, this standard requires the manager to "perform his duties . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." MODEL BUSINESS CORP. ACT § 35 (1984). As phrased by one commentator, the standard of care requires "conscious exercise of judgment; an informed decision; good faith and disinterested decision-making; and a rational basis for the decision." Comment, *supra* note 1, at 321.

180. See *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939); *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939).

181. Siegel, *supra* note 144, at 381.

such a showing, the burden shifts to the directors to establish by a preponderance of evidence that the challenged decision was "intrinsically fair."<sup>182</sup>

The possibility of a director's decision that is tainted by self-interest seems especially apparent when the decision stems from a takeover threat.<sup>183</sup> Directors are called upon to determine whether the tender offer is in the best interests of the shareholders. At the same time, the directors are painfully aware that they are deciding the fate of their own future employment. A decision to recommend that shareholders accept such an offer almost certainly means the loss of the directors' positions with the target corporation. Therein lies the conflict of interest. Some commentators view "the directors' action regarding a takeover attempt as no different from other business decisions: their duty is to act in the best interests of the corporation and its shareholders and, as such, their decisions should be accorded the same presumptions as any other business decision."<sup>184</sup> Others view the role of the business judgment rule in the takeover context dubiously:

A decision concerning the control of a corporation is a business decision; therefore, the business judgment of directors should be entitled to some weight. A less deferential version of the business judgment rule should be applied, however, because of the inevitable self-interest of directors who stand to lose control of the corporation.<sup>185</sup>

## 2. Modification of the Business Judgment Rule in the Takeover Context

Most challenges to the applicability of the business judgment rule in the takeover context have met with defeat.<sup>186</sup>

182. Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 714-15 (1984).

183. "[A]pplying the business judgment rule to directors' actions regarding tender offers raises questions of loyalty which would not necessarily arise in actions concerning the ordinary course of business." Comment, *supra* note 4, at 425.

184. Comment, *supra* note 172, at 275; see also Comment, *supra* note 4, at 422-23.

185. Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 660 (1983); see also Siegel, *supra* note 144, at 378 (most courts have found that management can "fight the offer and simultaneously satisfy its fiduciary duty of loyalty"). For a discussion of the deficiencies of the business judgment rule in the takeover context, see *id.* at 390-92.

186. Easterbrook & Fischel, *supra* note 175, at 1198. "While the cases are disorderly and sometimes inconsistent, one dominant theme emerges: the willingness of the courts to apply the business judgment rule whenever the target's board is sagacious enough—or well enough advised—to create a colorable record sufficient to give the courts some ostensibly reasonable pretext on which to do so." Harrington, *supra* note 4, at 1001.

Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454

Despite target management's inherent conflict of interest in deciding whether to employ defensive tactics, recent state and federal decisions consistently have applied the business judgment rule to these management decisions. Although directors have devised and implemented far reaching defensive tactics, the courts have steadfastly adhered to the business judgment rule without regard to the effectiveness or novelty of these tactics. Courts applying this flexible standard have overwhelmingly held that plaintiffs did not establish the requisite level of proof of management self-interest to overcome the presumption of the business judgment rule.<sup>187</sup>

Those who distinguish between decisions made in the takeover context and other business decisions have persuaded some courts to modify the business judgment rule when applying it to takeover decisions.<sup>188</sup> One issue facing such courts is who should bear the initial burden of proof: should the challenger be required to show a breach of the directors' duty before the court will review the decision or should the burden shift to the directors initially to justify their actions when the challenged decision is in response to a takeover threat?<sup>189</sup> A few courts automatically have shifted the burden to the directors to justify their actions.<sup>190</sup> Others have placed the burden on the challenger to establish that the directors' sole or primary motive was to insulate their positions from a challenge to their control.<sup>191</sup> Still

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U.S. 1092 (1981), has been called the "highwater mark of the unchecked application of the business judgment rule." Comment, *supra* note 4, at 427. The court there held that "any rational business purpose" entitled the directors to protection. *Panter*, 646 F.2d at 293. *But see* Comment, *supra* note 1, at 323 ("Critics argue that less deference should be given to decisions concerning the control of a company because of inherent tendencies toward self-interest by directors who stand to lose control. To some extent the criticism has been heeded as judicial decisions involving corporate control have begun to erode the deference given to directors under the business judgment rule.").

187. Siegel, *supra* note 144, at 382-83. One commentator declares that: [T]he courts and proponents of the business judgment rule have left the area in a shambles of confusing and contradictory statements which seem to yield only one consistent result: the target's board can take, with impunity, virtually any action it wishes to frustrate the ability of the stockholders to tender their shares to a bidder.

Harrington, *supra* note 2, at 1005.

188. *See infra* notes 189-205 and accompanying text; *see generally* Comment, *supra* note 172.

189. *See* Comment, *supra* note 172, at 276.

190. *See, e.g.*, *Cheff v. Mathes*, 41 Del. Ch. 494, 494-95, 199 A.2d 548, 554 (1964); *Bennett v. Propp*, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962); *see generally* Comment, *supra* note 172, at 276-78.

191. *See, e.g.*, *Panter v. Marshall Field & Co.*, 646 F.2d 271, 297 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 950 (N.D. Ill. 1982); *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969); *see also* Harrington, *supra* note 2, at 991-1001; *see generally* Comment, *supra* note 172, at 278-80.

others have required the plaintiff to show that *one* of the directors' motives was to retain control.<sup>192</sup>

Once the presumption of the business judgment rule has been rebutted, the directors lose the protective umbrella of the rule<sup>193</sup> and bear the burden of justifying their actions.<sup>194</sup> In the usual business judgment rule analysis, this burden is quite heavy and requires the directors to show that the "transaction at issue was intrinsically fair to the corporation and its shareholders."<sup>195</sup> When the management action in question involves a proposed takeover, however, the courts have eased the burden on the directors.<sup>196</sup>

Some courts require a showing that the directors made the decision primarily in the corporate interest,<sup>197</sup> while others have required the directors to show that the decision was fair and reasonable to the shareholders.<sup>198</sup> A few courts have used a standard of "valid corporate business purpose,"<sup>199</sup> an extremely easy standard to meet. The Supreme Court of Delaware, in *Unocal Corp. v. Mesa Petroleum Co.*,<sup>200</sup> placed the initial burden on the directors to justify their actions.<sup>201</sup> The court also adopted an intermediate two-pronged standard by which to judge the directors' conduct after the burden shifts.<sup>202</sup> First, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness

192. See, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 265 (2d Cir. 1984); *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980); see generally Comment, *supra* note 172, at 280-82.

193. See *supra* note 181 and accompanying text.

194. Comment, *supra* note 172, at 282-83.

195. *Id.* at 283.

196. *Id.*; see also Siegel, *supra* note 144, at 385 ("Although courts have phrased the standard of proof in different ways, a series of decisions has established a high threshold for plaintiffs to prove that the directors' defensive tactics constituted a breach of their loyalty.").

197. See, e.g., *Cheff v. Mathes*, 41 Del. Ch. 414, 506, 199 A.2d 548, 555 (1964); see generally Comment, *supra* note 172, at 283-84.

198. See, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 265-66 (2d Cir. 1984). See generally Comment, *supra* note 172, at 284-85.

199. *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980).

200. 493 A.2d 946 (Del. 1985).

201. *Id.* at 954-55. "Because of the omnipresent specter that a board may be acting primarily in its own interests, . . . there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Id.* at 954; see also Comment, *supra* note 172, at 290-93.

202. See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) ("[I]n *Unocal* we held that when the business judgment rule applies to adoption of a defensive mechanism, the initial burden will lie with the directors."); Dawson, Pence & Stone, *supra* note 120, at 424 ("directors bear the initial burden of establishing that defensive measures are adopted in good faith after reasonable investigation and are reasonable in relation to the threat posed").

existed because of another person's stock ownership."<sup>203</sup> Second, they must show that the defensive tactic in issue was "reasonable in relation to the threat posed."<sup>204</sup> It remains to be seen whether the lack of unanimity among the courts on the application of the business judgment rule to takeover situations will follow the lead of *Unocal*. *Unocal* developed a standard described as allowing enough directorial discretion to function effectively and yet permit review of "arbitrary decisions or contrived motivations."<sup>205</sup>

### III. ECONOMIC ANALYSES OF TARGET MANAGEMENT'S ROLE IN RESPONDING TO ECONOMIC THEORIES

#### A. Introduction to Economic Theories

Economic analyses are popular methods for judging the area of corporate takeover offers.<sup>206</sup> These economic theories differ in their view of the role served by tender offers and the role of target management in responding to tender offers. This Comment will discuss three leading theories: the Lipton Theory; the Efficient Capital Market Theory, advocated by Easterbrook and Fischel; and the Structural Theory, advocated by Gilson. These theories<sup>207</sup> will be compared on critical issues such as:

203. *Unocal*, 493 A.2d at 955. "However, they satisfy that burden "by showing good faith and reasonable investigation." *Id.* (quoting *Cheff v. Mathes*, 41 Del. Ch. 414, 506, 199 A.2d 548, 555 (1964)); see also *Moran*, 500 A.2d at 1356. See generally Comment, *supra* note 172, at 293. This burden may be eased by showing that a majority of the directors approving the defensive tactics are outside independent directors. *Unocal*, 493 A.2d at 955. The burden is only eased, however, by establishing that the outside independent directors have acted in accordance with their belief that corporate policy and effectiveness were threatened by the potential acquiror. *Id.* This qualification lessens the possibility that the outside directors, who have been selected by incumbent management, will be overly deferential to the recommendations of the inside directors.

204. *Unocal*, 493 A.2d at 955.

205. Comment, *supra* note 172, at 293.

206. Three economic theories are discussed in this Comment. See *infra* notes 208-386 and accompanying text.

207. A discussion of all economic theories on this subject is beyond the scope of this Comment. Another leading theory on this subject is presented by Lucien Bebchuk in *Bebchuk, The Case for Facilitating Tender Offers*, 95 HARV. L. REV. 1028 (1982). *Bebchuk* disagrees with Easterbrook and Fischel about the effects on the corporation of soliciting competing tender offers in a "bidding war." He "supports a rule of auctioneering that: (1) provides, by regulating offerors, time for making competing bids; and (2) allows incumbent management to solicit such bids by providing information about the target to potential buyers." *Id.* at 1030. This viewpoint is similar to that of Gilson, discussed *infra* at notes 381-86 and accompanying text.

- (1) the characterization of who is effected by management's use of defensive strategies;
- (2) the function of tender offers;
- (3) the effect on shareholders of management's use of defensive strategies;
- (4) the business judgment rule as a standard in the takeover context; and
- (5) the appropriate response by management to takeover bids.

### B. The Lipton Theory

The Lipton theory is pro-management.<sup>208</sup> Based on his assertion that the defeat of tender offers by management benefits both society and target shareholders,<sup>209</sup> Lipton posits that the target board of directors should be allowed to resolve a takeover decision just like any other major business decision.<sup>210</sup>

The premises for Lipton's theory are two-fold: (1) corporations bestow benefits on more than their shareholders;<sup>211</sup> and (2) shareholders may benefit more from rejecting a takeover offer than from accepting one.<sup>212</sup> These benefits, however, will be realized only if management's discretion to accept or reject a takeover bid is constrained only by their fiduciary obligations to the corporation and its shareholders.<sup>213</sup>

208. Lipton would forbid constraining management's use of defensive tactics. Lipton's view has much support from the judiciary. *See, e.g.*, Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). Lipton discusses these cases in Lipton, *Takeover Bids in the Target's Boardroom; An Update After One Year*, 36 BUS. LAW. 1017, 1017-22 (1981).

209. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 105-09 (1979). *See also infra* notes 217-19 and accompanying text. Easterbrook and Fischel disagree with Lipton's assertion that the defeat of tender offers benefits society and shareholders. They assert "the premise that tender offers increase social welfare by moving productive assets to higher valued uses and to the hands of better managers." Easterbrook & Fischel, *supra* note 175, at 1182.

Easterbrook and Fischel also challenge Lipton's assertion that many corporations which are the subject of takeover bids are well-run and therefore a takeover does not distribute the assets to more productive use. If the target is well-run, Easterbrook and Fischel assert, then this is reflected in the stock price. "Unless the acquiror is giving away its money, the premium price paid for the shares indicates a real gain in the productivity of the assets." *Id.*

Easterbrook and Fischel also challenge Lipton's assertion that since many acquired firms are cash-rich, takeovers do not provide benefits. Takeovers are beneficial to cash-rich firms, according to Easterbrook and Fischel, because the new management will put these idle cash resources to productive use. *Id.* at 1183.

210. "A takeover bid is no different than any other fundamental business decision." Lipton, *supra* note 209, at 120. Lipton presents a detailed guideline on the steps management should take when evaluating an offer. *Id.* at 121-24.

211. *Id.* at 105-06; *see infra* notes 217-19 and accompanying text.

212. *Id.* at 106-09; *see infra* notes 220-23 and accompanying text.

213. *Id.* at 105 ("proscribing the ability of companies to defend against takeovers would adversely affect long-term planning and thereby jeopardize the economy").



Lipton's analysis of the proper role of target management in responding to takeover offers is unique. Rather than focusing solely on the question "are the complaints of those dissatisfied with the management response justified?," Lipton says that those complaining about management are primarily "certain arbitrageurs and professional investors"<sup>214</sup> whose short-run interests are inconsistent with the long-run interests of the corporation and its shareholders.<sup>215</sup> Having identified the source of the dissatisfaction, Lipton frames the central issue in these terms:

Whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares?<sup>216</sup>

According to Lipton, society receives more than economic benefits from the operation of the corporate system. This is the first premise of his theory. These benefits derive from the expanded role of the board of directors in the current corporate system to include societal concerns.<sup>217</sup> This broadened role of director responsibility now includes the consideration of the environment, employee health and safety, employee pensions, product safety, charitable contributions, and community involvement in political action when making business decisions.<sup>218</sup> Society will realize these benefits, however, only if the law permits the board of directors to focus on the long-run interests of the corporation and not force the board to sacrifice these interests to satisfy the short-run interests of arbitrageurs and professional investors.<sup>219</sup>

214. *Id.* at 104.

215. Lipton asserts that this group of disgruntled investors "do not share the concern of corporate management with the need for long-term planning in a high technology economy." *Id.* Lipton also notes that "[t]he overall health of the economy should not in the slightest degree be made subservient to the interests of certain shareholders in realizing a profit on a takeover." *Id.*

216. *Id.*

217. *Id.* at 105 ("Efforts to broaden the concerns of directors to include employees, consumers, the community, the environment and the national welfare have reached full fruition only during the last 20 years.").

218. *Id.* at 105-06. The court in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) stated that directors may consider the impact of the takeover on "'constituencies' other than shareholders (*i.e.*, creditors, customers, employees, and perhaps even the community generally)." *Id.* at 955. See also Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156 (1932) ("those who manage our business corporations should concern themselves with the interests of employees, consumers, and the general public, as well as of the stockholders").

219. Lipton, *supra* note 209, at 104. "[T]he policy considerations are overwhelmingly in favor of specific recognition that the directors not only have the right to make takeover decisions based on their reasonable business judgment, but that macrosocioeconomic issues must be considered along with the long-term interests

Lipton's premise is that target shareholders can benefit economically from rejecting a takeover bid.<sup>220</sup> "Contrary to popular belief on Wall Street, the decision to accept or reject a takeover is not so heavily weighted in favor of acceptance that as a matter of experience it can be said that the shareholders are always disadvantaged by rejection."<sup>221</sup> To support this, Lipton presents evidence that, between 1974 and 1979, the shares of corporations that rejected or defeated a tender offer later reached a higher market price or were acquired in another tender offer at a higher price.<sup>222</sup>

of the shareholders and the company as a business enterprise." *Id.* at 115-16.

Easterbrook and Fischel reject Lipton's assertion that directors have a duty to protect interests of constituencies like charities and other non-investor groups and therefore, should reject tender offers. They identify the flaws in this proposition as:

(1) It doesn't explain why a successful tender offer should be injurious to the corporation's employees, suppliers, or creditors. "Takeovers improve economic efficiency, and that improvement usually enhances the position of those who deal with the firm." Easterbrook & Fischel, *supra* note 175, at 1190.

(2) Even if the new management implements new policies which affect these constituencies, why should it be assumed that they will necessarily work to the detriment of these shareholders? *Id.* at 1190-91.

(3) This idea rejects the principle that the primary responsibility of agents (managers) is to their principals (shareholders). *Id.* at 1191. "A manager responsible to two conflicting interests is in fact answerable to neither." *Id.* at 1192.

Gilson also discusses the role of corporate social responsibility in managerial decisions. See Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 862-65 (1981).

220. Lipton, *supra* note 209, at 109 ("shareholders have profited in the overwhelming majority of defeated takeovers").

221. *Id.* at 106.

222. *Id.* Easterbrook and Fischel offer an explanation for this later increase in stock prices which is contrary to Lipton's theory:

The most plausible reason for a price increase following a tender offer's defeat is that the market sees the defeat as only one round in an extended auction. The market anticipates that in the future another offeror—one not saddled with the first offeror's higher costs of information—will acquire the target. Many management-induced withdrawals are followed by higher offers, and share prices increase as the eventual acquisition becomes more likely.

Another possible explanation for the price increase following a defeated tender offer is that the offer itself served to rouse the target's management to action. The offer warned management to improve its performance, and either the offer or the accompanying public disclosure may have provided the target's management with the information to do so.

Regardless of the cause of the price increase, shareholders in general have little cause for rejoicing. The price rise comes about because someone is taking a free ride on information generated by the first offeror. Free riding of this sort reduces the incentive to make the first offer, and, for the reasons we have developed earlier, decreases the amount of monitoring, decreases the number of offers, and harms shareholders in the long run.

Easterbrook & Fischel, *supra* note 175, at 1189-90.

Lipton concludes that "the shareholders of more than 50 percent of the targets are better off today than if the defeated tender offer had succeeded."<sup>223</sup>

In addition, shareholders who bring suit against the board of directors for rejecting a tender offer have suffered no economic damage, according to Lipton.<sup>224</sup> This is because the true measure of damages should be the difference between the tender offer price and the true value of the corporation at that time, a figure which he asserts is probably not reflected in the market price of the stock.<sup>225</sup> Since a rational offeror would not act contrary to his self-interest by making a tender offer at a price greater than the true value of the corporation at that time, the disgruntled shareholders have suffered no economic damage by management's rejection of the offer.<sup>226</sup> Lipton also points out another economic benefit to the shareholders resulting from management rejecting the tender offer: If the corporation rejects an unsolicited takeover bid but later is acquired by another offeror, then the shareholders receive a higher price for their shares than offered in the original offer in 95% of the cases.<sup>227</sup>

223. Lipton, *supra* note 209, at 107. Lipton later updated his study and found that an even higher percentage of shareholders benefited from the defeated tender offer. Lipton, *Takeover Bids in the Target's Boardroom; An Update After One Year*, 36 BUS. LAW. 1017, 1025 (1981). Easterbrook and Fischel are unpersuaded by Lipton's study:

Lipton does not attempt to determine whether the price change resulted from general market movements or from the defeat of the tender offer. Nor does he consider the possibility that the price of the firm's stock would have been still higher if the tender offer had succeeded. Finally, by focusing on share price after an offer is defeated, Lipton ignores the *ex ante* interest of shareholders in keeping prices high.

Easterbrook & Fischel, *supra* note 175, at 1189 n.75.

224. Lipton, *supra* note 209, at 108 ("Only if it were assumed that the raider was acting contrary to its self-interest and proposing to pay more than true value, would there have been any damage to the shareholders of the target that could be recoverable in such a lawsuit.").

225. *Id.* "[T]he experience of the past five years shows that the stock market has been valuing most companies at between 50 percent and 66 2/3 percent of what they are worth to someone acquiring control . . ." *Id.* Easterbrook and Fischel disagree:

[T]he notion that stock is priced in the market at less than its true value is implausible. If there were significant divergences between price and value, investors could reap substantial gains by purchasing the undervalued shares and selling the overvalued shares. This process of arbitrage would continue until it became harder and harder to discover bargains; at some point the cost of discovering the bargain would exceed the trading gains that could be realized in the process.

Easterbrook & Fischel, *supra* note 171, at 1734; *see also id.* at 1742 ("The number of possible causes of price changes is almost infinite.").

226. Lipton, *supra* note 209, at 108.

227. *Id.* At least one court agrees:

Having concluded that the board of directors' decision to reject a takeover bid can promote the interests of both society as a whole and target shareholders, Lipton examines the role of the directors in such situations.<sup>228</sup> He uses an analogy to make the point that requiring the directors to accept automatically any takeover bid that offers a substantial premium over the market is not in the best interests of the shareholders.<sup>229</sup> Assume that directors were required, as part of their fiduciary duties, on an annual basis, to determine whether it was possible to sell or liquidate the corporation at a substantial premium over the market. If the directors found it was possible to do so when they made their annual assessment, then it would be required.<sup>230</sup> Lipton posits that this annual assessment is the functional equivalent of requiring the directors to accept automatically any takeover bid that represents a premium for the shareholders.<sup>231</sup>

He identifies three basic problems with this requirement of automatic acceptance (and, for that matter, the requirement of an annual assessment): (1) It does not make good business sense to accept automatically the offer just because it includes a premium without regard to the possibility that a greater premium may be achieved in the future;<sup>232</sup> (2) A requirement for an "annual life or death assessment"<sup>233</sup> would prove extremely disruptive;<sup>234</sup>

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An intriguing recent finding is that targets that resist tender offers yet are later acquired do better, at least in the short run, in maximizing shareholder wealth than targets that do not resist. The qualification is vital; if, as seems likely, defensive tactics reduce the number of tender offers, then shareholders may lose in the long run.

*Dynamics Corp. of Am. v. CTS Corp.* 794 F.2d 250, 255 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987).

228. Lipton, *supra* note 209, at 109-24.

229. *Id.* at 109-10.

230. *Id.* at 109.

231. *Id.* at 109-10.

232. *Id.* at 109.

233. *Id.* at 109-10.

234. Employees, customers, and suppliers would have no assurance of the corporation's continued existence and would extract a price from the corporation for these insecurities. Long-term planning would be sacrificed in anticipation of short-run disruption. *Id.* at 110. Easterbrook and Fischel respond to Lipton's assertion that tender offers adversely affect long-term planning by stating:

The threat of takeovers does not prevent managers from engaging in long-range planning. If the market perceives that management has developed a successful long-term strategy, this will be reflected in higher share prices that discourage takeovers. To be sure, the risk of a tender offer ensures that corporate managers will be unable to assume that they can continue in office indefinitely. But this risk of displacement does not reduce welfare. Precisely the opposite is true; some insecurity of tenure is necessary to spur managers to their best performance. Society benefits from an active takeover market, therefore, because it simultaneously provides an incentive to all corporate managers to operate efficiently and a mechanism for

and (3) "[T]here is no reason to believe that the experience with mandated annual life or death assessments would be any different than the experience with rejection of unsolicited tender offers,"<sup>235</sup> *i.e.*, as discussed previously,<sup>236</sup> the shareholders are not harmed necessarily by rejecting short-run gains for larger gains that are anticipated in the long-run.

Lipton expands upon his assertion that the disruptive effect of requiring management to accept automatically any takeover bid at a premium will have negative repercussions for executives, employees, customers and suppliers. It is simply a matter of good business policy to send the message that the corporation intends to remain an "independent entity and not be taken over"<sup>237</sup> and management should be permitted, in fact, encouraged, to implement it. Management can achieve this through adopting anti-takeover amendments to the charter and bylaws and other protective devices.<sup>238</sup>

Lipton states that it would not be in the best interests of the shareholders, and, therefore, not a fiduciary obligation of the directors, to let the shareholders decide for themselves<sup>239</sup> when presented with a takeover bid at a substantial premium.<sup>240</sup> This assumes that, given the opportunity to do so, the shareholders will always accept the offer. The proposed takeover is a "foregone conclusion."<sup>241</sup> Why are shareholders so receptive to offers which may ultimately prove to be adverse to their best interests? First, according to Lipton, there really is no such thing as free choice if the issue is resolved only at the shareholder level because individual shareholders will reason as follows: Inevitably, the raider will acquire control. So if I don't tender now, as a member of the minority, the raider will force me to tender later, *i.e.*, I will be "squeezed out."<sup>242</sup> If I tender later

displacing inefficient managers.

Easterbrook & Fischel, *supra* note 175, at 1183-84; *see also* Easterbrook & Fischel, *supra* note 171, at 1743 ("It is far from clear how, either in theory or in practice, tender offers could endanger long-term planning.").

235. Lipton, *supra* note 209, at 110.

236. *See supra* notes 220-23 and accompanying text.

237. Lipton, *supra* note 209, at 110.

238. *Id.* at 110-11 ("a charter amendment requiring the directors to consider the interests of employees, customers, suppliers and others when considering a merger or takeover bid; charter amendments designed to deter unsolicited takeover bids; and migration to a state with laws that inhibit unsolicited takeovers").

239. *Id.* at 113-20.

240. *Id.* at 120 ("As long as matters such as capital expenditures, discontinuances of businesses and bankruptcy are for the reasonable business judgment of the directors, there is no reason to put acceptance or rejection of a takeover bid on any different basis.").

241. *Id.* at 113 ("This has been the experience in almost every tender offer during the past five years.").

242. *Id.* at 113-14. "Such 'freeze-out' or 'takeout' mergers are a private form of eminent domain; they are involuntary unless the target's holders want to sell at the first stage offer price." Baysinger & Butler, *supra* note 4, at 1260-61.

rather than now, I will never have the opportunity to sell at a price as high as the tender offer.<sup>243</sup> The rational shareholder always accepts the tender offer. Given this inevitable result, Lipton concludes that “any uncoerced decision *against* acceptance of a tender offer can *only* be made at the board of directors level.”<sup>244</sup>

The second reason that it is not in the shareholder’s best interests to leave the decision to a “shareholder referendum”<sup>245</sup> focuses on the change in composition of shareholders over the last thirty years. Individual investors do not hold a majority of a company’s stock. Rather, 20-50% of the stock of many large public corporations is in the hands of professional investors<sup>246</sup> and when a corporation is identified as the probable recipient of a tender offer, arbitrageurs frequently purchase 10-50% of the stock.<sup>247</sup> Thus, the individual investor could find himself in a minority while many of the shareholder “votes” at this shareholder referendum are cast by a large and vocal constituency of professional investors and arbitrageurs whose interests are inconsistent with the interests of individual investors.<sup>248</sup> The arbitrageur’s only interest is in “a quick sale at a profit.”<sup>249</sup> Professional

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243. “The alternative of not accepting the tender offer is virtual assurance that, if the offer is successful, the shares will have to be sold in the lower priced, second step.” *CTS Corp.*, 481 U.S. at 83 (quoting Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs, SEC Exchange Act Rel. No. 21079, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,637, at 86,916 (June 21, 1984) (footnote omitted)).

244. Lipton, *supra* note 209, at 114 (emphasis in original). Gilson rejects this notion. “The arguments which suggest that shareholders will choose, or be forced into, conduct which is not optimal even from their own perspective, are thus not convincing. Management discretion to prevent a tender offer simply cannot be justified on paternalistic grounds.” Gilson, *supra* note 219, at 862. In response to the assertion that shareholders need management input because management is superior at market analysis, Gilson states that this is only possible if management is basing its investment analysis on inside information. *Id.* at 858-59. Shareholders will still have access to this information when management makes public its belief that the market undervalues the corporation in an attempt to educate the shareholders and thus defeat the offer. *Id.*

245. Lipton, *supra* note 209, at 113.

246. *Id.* at 114.

247. *Id.*

248. *Id.* at 114-15. Gilson also addresses the role of arbitrageurs in the tender offer process and concludes that the interests of arbitrageurs and long-term investors are indeed consistent: they both desire to sell their shares. He reaches this conclusion by analogizing the arbitrageur to “less risk-averse surrogates” for the long-term investors. The long-term investors have already expressed their desire to sell by selling shares to the arbitrageur because they believe the premium offered by the arbitrageur to outweigh their long-term investment interests. Thus, when the arbitrageur turns around and immediately sells those shares to the tender bidder, this “merely reflects, by proxy, the desires of the selling shareholders.” Gilson, *supra* note 219, at 856.

249. Lipton, *supra* note 209, at 114. For a discussion of the role of professional

investors are interested in polishing their image and retaining liquidity.<sup>250</sup> Rational individual investors who, according to Lipton, seek longterm growth are unlikely to value these interests as highly.

As further support for his view, Lipton points out that the corporate system does not leave disgruntled shareholders weaponless. If the shareholders are dissatisfied with the decision reached by the directors in response to the takeover bid, they always retain the right to replace the directors through the exercise of their voting rights.<sup>251</sup>

Lipton also challenges the idea that a takeover bid is like a merger and since shareholders vote on mergers, they should be permitted to vote on takeover bids.<sup>252</sup> The fundamental difference between the two transactions

risk arbitrageurs in tender offers, see E. ARANOW & H. EINHORN, *supra* note 7, at 173-91. *But see* Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, 89 CASE & COM., Nov.-Dec. 1984, at 35 (“[p]articipation by the ‘arbs,’ as they are often called, is crucial to the success of most big takeovers”). Easterbrook and Fischel assert that Lipton’s attack on arbitrageurs is unwarranted:

Arbitrageurs perform a constructive role by purchasing and selling shares. They offer shareholders who wish to sell their shares at a profit in advance of a tender offer (and thereby avoid the risk that the offer will be defeated, oversubscribed, or never made) the opportunity to do so. By constantly searching for firms that are likely to be the subject of a tender offer, arbitrageurs also make the market more efficient. Finally, arbitrageurs, by selling their shares to an offeror, contribute to the transfer of assets to those who can manage them more efficiently. . . . Arbitrageurs, like other shareholders, buy and sell shares in order to make a profit. By doing so, they contribute to market efficiency, provide a necessary check on suboptimal management, and facilitate the transfer of control to more capable managers.

Easterbrook & Fischel, *supra* note 175, at 1183 n.60.

250. Lipton, *supra* note 209, at 114.

251. *Id.* at 116. Easterbrook and Fischel disagree with the ability of shareholders to fend for themselves:

[I]t is futile to expect shareholders to perform this task of monitoring. Proxy campaigns are notoriously difficult to wage, and they are unlikely to succeed unless someone first assembles a substantial bloc of shares. Even then the incumbents win most contested elections. It is easy to see why. Shareholders choose to be passive, to ignore contested elections, because when shareholdings are dispersed no one shareholder’s vote will affect the outcome of the contest. Why should the shareholder spend time and effort learning about the contest if the result does not depend on his effort? Why, indeed, would anyone take the time to wage a proxy campaign? The protagonist invests substantial resources in learning about the firm’s affairs and formulating proposals for change, only to have other shareholders disregard the contest. Even if the contest succeeds, and the expenses of those who organized the fight are reimbursed, the leaders receive benefits only in proportion to their shareholdings. Most of the benefits are captured by the shareholders who watched the contest from the sidelines and took no risk. In sum, it pays to be a passive shareholder.

Easterbrook & Fischel, *supra* note 171, at 1736.

252. Lipton, *supra* note 209, at 116.

is that directors consider and approve a merger proposition before it ever gets to the point of a shareholder vote.<sup>253</sup> That is not the case with a tender offer which, if not blocked by the directors, goes directly to the shareholders who "vote" by deciding whether to tender their shares.<sup>254</sup> The important consideration and approval by directors is lacking entirely.<sup>255</sup>

Lipton has developed a plan of managerial action that he suggests will fulfill management's fiduciary responsibilities. Management should make a full presentation to the board on all factors relevant to the issue, including historical and present financial figures, projections, business plans and an analysis of the bidder.<sup>256</sup> The directors should seek expert opinion on the insufficiency of the offering price from an independent investment banker. The directors should seek legal opinions on antitrust and other legal issues, including whether the directors "have received adequate information on which to base a reasonable decision."<sup>257</sup> The directors should appoint a committee of independent directors if the presence of directors who are also officers creates the appearance of self-interest.<sup>258</sup> The next step in Lipton's plan involves the directors considering all of these factors and deciding whether to reject or accept a takeover bid. Lipton posits that the final step for directors to take upon deciding to reject a bid is to implement defensive strategies. He would permit directors to choose from a wide range of defensive weapons. "Once the directors have properly determined that a takeover should be rejected they may take any reasonable action to accomplish this purpose."<sup>259</sup>

In summary, Lipton's theory asserts that directors should not be required to accept automatically any tender offer representing a substantial premium over the market by not employing defensive tactics.<sup>260</sup> Rather, the directors must consider the impact of the takeover on various constituencies like employees and the community.<sup>261</sup> If the directors reach the conclusion that acceptance of the tender offer is not in the best interests of these constituencies or the shareholders, then the board should not be required to submit the matter to a shareholder referendum.<sup>262</sup> Rather, the board should

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253. *Id.* ("In the case of a merger, however, nonapproval by the directors means that it is not submitted to the shareholders.")

254. *Id.*

255. *Id.*

256. *Id.* at 121-22.

257. *Id.* at 122.

258. *Id.*

259. *Id.* at 123.

260. *Id.* at 103.

261. *Id.* at 130. "The directors should consider the impact of the takeover on employees, customers, suppliers, and the community. National policy is a proper consideration." *Id.*

262. *Id.*



be empowered to adopt the means necessary to remain an independent business entity.<sup>263</sup>

### C. *Easterbrook and Fischel: The Efficient Capital Market Theory*

Efficient capital markets are the basis of Easterbrook and Fischel's view of target management's role in response to a takeover bid.<sup>264</sup> The essential premise of this theory is that the capital market is efficient; "efficiency" in this context meaning that the prices of all securities in the capital market "accurately and promptly reflect the securities' intrinsic value relative to all publicly available information."<sup>265</sup> This means that "the market responds immediately to relevant information that any one may have and never attaches the wrong evidentiary weight to the information."<sup>266</sup>

263. *Id.* "[O]nce the board of directors has in good faith and on a reasonable basis determined to reject a takeover bid, the target may take any reasonable action to accomplish this purpose . . ." Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017, 1017 (1981).

264. The Efficient Capital Market Theory has implications for other areas of securities regulation beyond the role of management in responding to a tender offer. See, e.g., Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

Lipton disagrees with Easterbrook and Fischel's perception of the interaction between the efficient capital market theory and takeover activity. He states:

The experience of the post-Williams Act period is that the profit enhancement accounting for takeovers, readily available long-term credit, the advantages of borrowing in an inflationary period, the lack of return on investment in new facilities in many industries equivalent to the return from a takeover, and the "social acceptability" of takeovers starting with the 1973-4 decisions of major companies and leading investment bankers to engage in takeovers, have had much more to do with takeover activity than the efficient market theory or any effort by raiders to replace "sub-optimal" management.

Lipton, *supra* note 263, at 1024 n.30.

265. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 1 (1978). This makes "the prices of securities the best available indicators of their value." *Id.* at 5. "It means that the price of shares reflects the collective wisdom of all traders about the value of the stock, and it also means that there is no reliable way to determine the direction, amount, or even existence of any difference between today's and tomorrow's price." Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1166 (1981).

266. Fischel, *supra* note 265, at 1. Easterbrook and Fischel assert that "[a] great deal of evidence shows that securities markets in the United States are indeed efficient in the sense that no rule for stock picking enables the analyst to do better than he could have done by choosing stocks at random." Easterbrook & Fischel, *supra* note 171, at 1735.

At least one commentator strongly disagrees that the market is efficient. "[T]he

In efficient capital markets, a speculator cannot systematically make extraordinary profits by identifying stocks which are mispriced and then trading in such stocks.<sup>267</sup> A trader who gathers and analyzes public information about publicly-held companies in an attempt to determine which stocks are underpriced and, therefore, profit from buying low and selling high will fail.<sup>268</sup> There is no way to "beat the market"<sup>269</sup> systematically because traders compete against each other in identifying mispriced securities and act on this information. This process injects information into the marketplace and, correspondingly, into the price of securities.<sup>270</sup> The result is that the market price of securities' reflect all available information.<sup>271</sup> Thus, "the price of shares reflects the collective wisdom of all traders about the value of the stock, and it also means that there is no reliable way to determine the direction, amount, or even existence of any difference between today's and tomorrow's price."<sup>272</sup>

If management runs a company efficiently, then, that factor is relevant to the value of that firm's stock. Likewise, if management runs a company inefficiently, then, that factor is also relevant to the value of that firm's stock.<sup>273</sup> Since the price of that stock reflects all relevant information, a poorly-managed company's stock price will reflect that poor management.<sup>274</sup>

empirical studies are anything but conclusive and . . . the efficient market hypothesis remains just that—a hypothesis that remains unproven and which may well, for that matter, be inherently unsusceptible of proof." Harrington, *If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids*, 34 SYRACUSE L. REV. 977, 1010 (1983).

Harrington also rejects the idea that desire to replace inefficient management triggers takeovers. He points to other motivating factors, such as:

the prospect for synergistic gains *via* economies of scale, a reduced cost of capital, tax savings, or an increased market share. The belief that the target's shares are undervalued by the market is another potential motivation. The sheer desire to expand the size of the company is a third. These motivations are either ignored or denied by the efficient market model proponents.

*Id.* at 1011.

267. Fischel, *supra* note 265, at 2-5. Looking at the "big picture," there are no profits to be made because "[i]t is very unlikely that price and 'value' will diverge in large markets for shares." Easterbrook & Fischel, *supra* note 265, at 1165; *see also id.* at 1165-68.

268. Fischel, *supra* note 265, at 4 ("investors should not be able to 'beat the market' systematically by identifying undervalued or overvalued securities").

269. *Id.*

270. *Id.*

271. Even insider trading contributes to market efficiency. *Id.*

272. Easterbrook & Fischel, *supra* note 265, at 1166.

273. Fischel, *supra* note 265, at 1.

274. *Id.* at 1-2, 5.

Poor performance of a company's securities in the capital market is a common indication of poor management. The lower the market price of the securities compared to what it would be with better management, the

The corporation with inefficient management and its corresponding low stock price attracts the tender offeror because she hopes to replace the inefficient management and, thus, improve the corporation's financial health.<sup>275</sup> Improved financial health bestows benefits on the acquiror and the shareholders alike.<sup>276</sup> Since stock prices reflect all relevant information, they will reflect the change in management effectiveness and, therefore, increase.<sup>277</sup>

The "Market for Corporate Control" is the name given to the market function of creating signals in stock prices which invite changes in control that maximize shareholder welfare.<sup>278</sup> The mere presence of signals alone in the marketplace is not sufficient to maximize shareholder wealth.<sup>279</sup> That is the function of tender offers. Tender offers operate in the market for corporate control as a "mechanism whereby control shifts from less capable managers to others who can manage corporate assets more profitably."<sup>280</sup>

Allowing corporations to erect barriers against tender offers by employing defensive strategies defeats this whole process of allowing the market to monitor managerial effectiveness and replace management when necessary. The directors' duty to protect shareholders does not motivate these

more attractive the firm is to outsiders with the ability to take the firm over.

*Id.* at 5.

275. *Id.* For a discussion of characteristics of target companies which make them vulnerable to takeover, see *id.* at 7 n.19.

276. Easterbrook & Fischel, *supra* note 265, at 1173-74; see also Easterbrook & Fischel, *supra* note 171, at 1737 ("Both parties to the transaction gain: the shareholders of the target obtain a profit because of the premium bid, and the bidder makes an ordinary profit on its investment in search, acquisition, and making improvements."). Easterbrook and Fischel assert that the benefits are present even if a tender offer never succeeds:

[S]hareholders benefit even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags. Managers will attempt to reduce agency costs in order to reduce the chance of takeover, and the process of reducing agency costs leads to higher prices for shares.

Easterbrook & Fischel, *supra* note 265, at 1174.

277. Fischel, *supra* note 265, at 1; Easterbrook & Fischel, *supra* note 265, at 1174.

278. The seminal article on this is Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). The market for corporate control is the "correlative benefit of the efficient market theory." Harrington, *supra* note 2, at 982.

279. Fischel, *supra* note 265, at 2 ("The informational efficiency of a security market does not, however, imply the existence of a corresponding market for corporate control, a mechanism permitting control to shift from one group of managers to another group that can employ the assets of the corporation more profitably.").

280. *Id.* at 5. There are other methods to effect a change in control but the cash tender offer is the means most favored by aggressors. *Id.* at 2.

strategies, rather motivation occurs “because a change in control is likely to herald a forced change in management.”<sup>281</sup>

Easterbrook and Fischel identify other factors besides the threat of tender offers that create incentives for incumbent management to promote the best interests of shareholders. Managers who are the sole owners of a company will naturally maximize their own welfare since they are the shareholders.<sup>282</sup> This is not the case, however, in publicly-held corporations because ownership and control are separate—the shareholders own and the managers control.<sup>283</sup> Their interests are not consistent, therefore, management cannot be expected to maximize the welfare of shareholders at their own expense.<sup>284</sup> The losses borne by shareholders due to less than optimal management are known as agency costs,<sup>285</sup> which are equal to the difference between shareholder wealth under optimal management and shareholder wealth under incumbent management.<sup>286</sup> According to Easterbrook and Fischel, agency costs are an inevitable result of the separation of ownership and control.<sup>287</sup>

Market forces alleviate the burden of agency costs by “minimiz[ing] this divergence of interests between managers and shareholders.”<sup>288</sup> These mechanisms include incentive programs such as profit-sharing and stock options which allow the manager to share in the corporation’s profitability, thus encouraging profit maximization.<sup>289</sup> In addition, managers who perform well create a demand for their services so they also benefit.<sup>290</sup>

The role of shareholders in monitoring managerial effectiveness is another important aspect of the efficient capital market theory.<sup>291</sup> It is theoretically possible for shareholders to “oust poor management on their own initiative,”<sup>292</sup> after all, they are the owners of the corporation. In

281. *Id.*

282. *Id.* at 8.

283. *Id.*

284. Easterbrook & Fischel, *supra* note 265, at 1170; *see also* Easterbrook & Fischel, *supra* note 171, at 1735 (“Anyone who hires an agent—and the corporation’s officers are agents—must find some way to control the agent’s conduct. In the absence of control devices, the agent will have an incentive to siphon off profits, fritter away time, or otherwise further his own interest at the shareholders’ expense.”).

285. Easterbrook & Fischel, *supra* note 171, at 1735; Easterbrook & Fischel, *supra* note 265, at 1169-74.

286. Easterbrook and Fischel, *supra* note 265, at 1170.

287. Easterbrook & Fischel, *supra* note 171, at 1735-36.

288. Fischel, *supra* note 265, at 8.

289. *Id.* at 8-9.

290. *Id.* at 8.

291. *Id.* at 9.

292. *Id.* Harrington agrees that shareholder autonomy is really a myth. “The liquidity provided for by the corporate structure makes it more economical for most shareholders, including institutions, to sell rather than wage a proxy fight or

reality this is unlikely to happen because the costs of individual shareholders monitoring managerial performance and ousting ineffectual management are prohibitive.<sup>293</sup> Because of the practical impossibility of shareholders monitoring managerial performance,<sup>294</sup> shareholders need the threat of tender offers and other motivating market mechanisms to monitor for them.<sup>295</sup>

Under the efficient market theory, there is little or no justification for federal or state tender offer regulation.<sup>296</sup> Fischel analyzes the justifications for the disclosure requirements and disposes of them in turn. The market will monitor management performance through tender offers only if offerors are rewarded for their efforts in identifying weak management and asserting control.<sup>297</sup> Disclosure requirements work against this by forcing an offeror

tender offer when they are unhappy with corporate performance." Harrington, *supra* note 2, at 1014-15. "There is no economic reason for either the small individual or the large institutional shareholder to do more than sell when dissatisfied." *Id.* at 1015.

293. Fischel, *supra* note 265, at 9. Easterbrook and Fischel describe the dilemma of individual shareholders as follows:

Shareholders might be able to reap substantial gains from improving the performance of managers as their agents. But this improvement is difficult to achieve, and the difficulty is the reason why outsiders (tender bidders) play an important role. The agency costs typically will go undetected by individual shareholders. Most shareholders are passive investors seeking liquid holdings. They have little interest in managing the firm and less incentive to learn the details of management. No one shareholder can collect all or even a little of the gains available from monitoring the firm's managers. The benefits would be dispersed among all stockholders according to their investments, not according to their monitoring efforts. Because other shareholders take a free ride on any shareholder's monitoring, each shareholder finds it in his self-interest to be passive.

Easterbrook & Fischel, *supra* note 265, at 1170-71.

294. Another commentator states:

Shareholders are said to be rationally ignorant because of the large costs relative to very small expected individual benefits of staying informed about the internal affairs of the corporation. Expected benefits are negligible because of the unlikelihood that they will have a positive effect on managerial behavior and because informed shareholders will have to share the benefits of their inventions with others. Thus, shareholders are rational in taking a 'free ride' on the possible intervention of other shareholders.

Baysinger & Butler, *supra* note 4, at 1258 n.6.

295. Fischel, *supra* note 265, at 9. Easterbrook and Fischel state:

Tender offers are a method of monitoring the work of management teams. Prospective bidders monitor the performance of managerial teams by comparing a corporation's potential value with its value (as reflected by share prices) under current management. When the difference between the market price of a firm's shares and the price those shares might have under different circumstances becomes too great, an outsider can profit by buying the firm and improving its management.

Easterbrook & Fischel, *supra* note 265, at 1173.

296. Fischel, *supra* note 265, at 9-29.

297. *Id.* at 13 ("For the market for corporate control to function effectively, outsiders must have adequate incentives to produce information.").

to make public this privately produced information even though the offeror incurred costs in obtaining it.<sup>298</sup> The offeror is forced to share this information with the public and this "failure to recognize a property right in privately produced information, will decrease the incentives to produce this information."<sup>299</sup> Decreasing incentives lead to decreased information which leads to entrenching inefficient management.<sup>300</sup>

Fischel also attacks the idea that regulation is needed to fight off "white-collar pirates"<sup>301</sup> who allegedly will seize "proud old companies,"<sup>302</sup> liquidate them, and "split up most of the loot among themselves."<sup>303</sup> This reasoning is flawed in two respects. If the "proud old company's" management is truly performing well, then the corporation is safe from a bid for control. The "white-collar pirates" will see no opportunity to gain from a takeover.<sup>304</sup> The second flaw in this thinking is the assumption that liquidation is necessarily evil.<sup>305</sup> "If the liquidation value of an enterprise is greater than its going concern value, the tender offeror renders an economic benefit by liquidating its assets."<sup>306</sup>

The other requirements of the Williams Act<sup>307</sup> also are unjustified according to Fischel because they merely serve to increase the costs of making tender offers and thereby decrease the incentive for potential acquirors to use them to monitor management.<sup>308</sup> This undermines their use as "a check against entrenched inefficient management to the detriment of current shareholders."<sup>309</sup>

State tender offer regulation is viewed as an even worse evil than the Williams Act.<sup>310</sup> As discussed earlier, state statutes tend to go even further

298. *Id.*

299. *Id.*

300. Fischel also notes that "[i]n other securities transactions, inequalities of bargaining power attributable to superior intelligence, research, or diligence are not only permitted but are considered to be integral to a free market economy." *Id.* at 14.

301. *Id.* at 17 (quoting Senator Harrison Williams in 111 CONG. REC. 8257-58 (daily ed. Oct. 22, 1965)).

302. *Id.* (quoting Senator Harrison Williams, 111 CONG. REC. 8257-58 (daily ed. Oct. 22, 1965)).

303. *Id.* (quoting Senator Harrison Williams, 111 CONG. REC. 8257-58 (daily ed. Oct. 22, 1965)). And even if there was a danger of "looting," state laws regulate the acquiror's fiduciary duties. *Id.*

304. *Id.* at 17 (no empirical support for assumption that "'proud old companies' that have been operating profitably for years may somehow be turned into 'corporate shells' by unscrupulous 'white collar pirates'").

305. *Id.* at 17-18.

306. *Id.* at 18. In reality, few tender offers have the sole objective of liquidating the assets of the corporation. *Id.*

307. For a discussion of the Williams Act, see *supra* notes 42-62 and accompanying text.

308. Fischel, *supra* note 265, at 18-19.

309. *Id.* at 26.

310. *Id.* at 27.

than the federal statute in intruding into the market.<sup>311</sup> They create delay and eliminate the element of surprise.<sup>312</sup> Thus, management has more time to throw up barriers against the offer. These statutes “pose a powerful threat to the operation of the market for corporate control.”<sup>313</sup>

According to Easterbrook and Fischel’s theory, “any strategy designed to prevent tender offers reduces welfare.”<sup>314</sup> A successful takeover defense causes the target shareholders to miss the opportunity to sell their shares at a premium over market value.<sup>315</sup> This lost premium represents the shareholders’ entitlement if the corporate management operated at maximum efficiency.<sup>316</sup>

Management’s resistance is “socially wasteful”<sup>317</sup> even when it later results in another tender offeror making an offer at a higher premium.<sup>318</sup> The higher premium paid to each shareholder is offset exactly by the total price paid by the bidder which is borne by the bidders’ shareholders.<sup>319</sup> The increase in price paid to the target shareholders is simply a transfer payment from the bidders’ shareholders to the target shareholders.<sup>320</sup>

A “bidding war” has a negative impact on the target shareholders because of the basic law of economics that price and demand are in an inverse relationship—when price increases, demand decreases.<sup>321</sup> This means there will be fewer tender offers when the offering price increases, which means there will be less monitoring of managerial performance.<sup>322</sup>

Easterbrook and Fischel conclude that target management can serve the shareholders’ best interests by adopting a position of passivity when confronted with a tender offer.<sup>323</sup> “Management should be able to take

311. See *supra* notes 63-69 and accompanying text.

312. Fischel, *supra* note 265, at 27-28.

313. *Id.* at 28.

314. Easterbrook & Fischel, *supra* note 265, at 1174. “In most cases resistance reflects either mismanagement (to the extent it pointlessly denies shareholders the opportunity to obtain a premium) or manager’s self-protection (to the extent its point is to preserve managers’ jobs or ‘sell’ their acquiescence in exchange for bonuses or promises of future employment.” Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 1 (1982).

315. Easterbrook & Fischel, *supra* note 265, at 1174-75.

316. *Id.* at 1175.

317. *Id.*

318. *Id.*; see also Easterbrook & Fischel, *supra* note 314.

319. Easterbrook & Fischel, *supra* note 265, at 1175.

320. *Id.* Easterbrook and Fischel provide a thorough discussion of their “no-auction” rule in Easterbrook & Fischel, *supra* note 314.

321. Easterbrook & Fischel, *supra* note 265, at 1176-77; Easterbrook & Fischel, *supra* note 314, at 2 (“managers’ ability to engage in any defensive tactics reduces the number of offers by making targets more expensive to acquire. This is a simple application of the economic law of demand.”).

322. Easterbrook & Fischel, *supra* note 314, at 2 (“By raising the price, auctions reduce the number of acquisitions and thus the amount of monitoring.”).

323. Easterbrook & Fischel, *supra* note 265, at 1201-04.

action that has the effect of preserving its control only if there is an overriding or compelling corporate purpose to justify the conduct at that time.”<sup>324</sup>

#### D. Gilson: The Structural Approach

Gilson’s view of target management’s role in response to a tender offer is based upon an analysis of the structure within which the modern, public corporation operates.<sup>325</sup> While the state’s enabling statute provides the initial framework for the public corporation,<sup>326</sup> Gilson emphasizes the role of nonlegal factors inherent in the markets in which the corporation operates.<sup>327</sup>

Gilson developed his theory, known as the “structural approach,”<sup>328</sup> in answer to the flaws in the traditional approach to management response to takeover threats.<sup>329</sup> The traditional approach frames the issue in terms of management’s fiduciary duties—the duty of care and the duty of loyalty.<sup>330</sup> Gilson declares that using the business judgment rule as a standard to measure whether directors have fulfilled their duty of care is meaningless because the business judgment rule rarely permits probing of management’s decisions.<sup>331</sup> “[T]he business judgment rule does not express the measure by which a court determines whether management has discharged its duty

324. Fischel, *supra* note 265, at 43. Easterbrook and Fischel recognize that it will sometimes be difficult to determine when management is acting in the course of ordinary business and when the motive is to thwart the takeover. “It is . . . possible . . . that many business decisions ostensibly taken for the purpose of seizing valuable business opportunities, are actually undertaken for the purpose of defeating the tender offer.” Easterbrook & Fischel, *supra* note 265, at 1202. They suggest this dilemma be resolved by focussing on the timing of the management action. If the action is taken before target management had reason to believe there would be a tender offer, then the action will be presumed to be in the ordinary course of business. If the action is taken immediately after management became aware of an impending offer, then it is presumed that the actions were intended to defeat the offer. *Id.* at 1203-04.

325. “[R]esolution of the conflict of interest inherent in the tender offer process[] can be achieved only by carefully examining the entire structure of the modern corporation.” Gilson, *supra* note 219, at 820.

326. *Id.* at 831-33.

327. *Id.* at 821, 831.

328. *Id.* at 821.

329. *Id.* “The difficulty with the traditional approach . . . goes beyond the uncertainties of motivational analysis. It is not the *reason* for management’s action which creates the conflict, but the fact that management *acts at all.*” *Id.* at 820.

330. *Id.* at 821.

331. *Id.* at 822-23. “The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.” *Id.* at 822 n.10 (quoting Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 *YALE L.J.* 1078, 1099 (1968)).



of care; rather, its application reflects a conclusion that the management action in question will not be reviewed at all."<sup>332</sup>

Gilson also criticizes the traditional duty of loyalty analysis in monitoring managerial conduct.<sup>333</sup> The standard by which the duty of loyalty is measured is said to be one of "fairness,"<sup>334</sup> which is a "thoroughly respectable rule of law as applied to the area of its original application,"<sup>335</sup> but Gilson states that the courts have succeeded in avoiding judicial examination by eliminating the conflict of interest inquiry when applied to the takeover context.<sup>336</sup> This leaves the business judgment rule as the applicable standard of review, meaning that the duty of loyalty is merely redundant.<sup>337</sup>

Gilson states that the "courts' abdication of regulatory authority through the business judgment rule,"<sup>338</sup> however, is not undesirable.<sup>339</sup> Courts are not equipped to handle complex business decisions.<sup>340</sup> In addition, he asserts, a court's review of managerial conduct occurs too late to yield any significant benefits and does not protect shareholders.<sup>341</sup> The best protection for shareholders against weak management and other risks of business failure is to diversify their investment portfolios.<sup>342</sup> Finally, there are other forces which motivate managerial effectiveness: the markets for products, employment, and capital. The operation of these forces to protect shareholder interests does not incur the transaction costs incurred by litigation.<sup>343</sup>

332. Gilson, *supra* note 219, at 822.

333. *Id.* at 824-31.

334. *Id.* at 824-25.

335. *Id.* at 825.

336. *Id.* at 828-29. Gilson has some support from other commentators. "The courts have treated the central issue posed as concerning the duty of care rather than the duty of loyalty, and thus invoke the business judgment rule to effectively insulate managerial defensive tactics from judicial scrutiny." Harrington, *supra* note 2, at 990.

337. Gilson, *supra* note 219, at 828-29.

338. *Id.* at 823.

339. *Id.* ("even if such a review were possible, it seems virtually certain that the game would not be worth playing").

340. *Id.* ("it is, for example, almost impossible to distinguish between acts of corporate social responsibility and acts of long-term profit maximization").

341. *Id.* Gilson states:

The impact of the court's decision on future management does not justify judicial review. A general directive to be wise rather than foolish is of little help. More specific remarks concerning the wisdom of the competing alternatives and the manner in which they might better have been evaluated, even if correct, are unlikely to prove a source of guidance for future managers.

*Id.*

342. *Id.* at 824.

343. *Id.* at 823-24.

Having identified the failings of the traditional approach, Gilson suggests a structural approach to analysis of tender offer defenses.<sup>344</sup> State statutes that regulate corporations provide the skeleton of the corporate structure.<sup>345</sup> These statutes define the corporate skeleton in virtually identical terms: Owners of shares elect a board of directors. The board of directors selects executive officers. The executive officers and other corporate employees manage the corporation's business.<sup>346</sup>

To flesh out this basic corporate skeleton, Gilson analyzes "the relationships and interactions—some statutory, others not—which determine corporate behavior."<sup>347</sup> He begins by examining principles derived from the separation of ownership and control.<sup>348</sup> Separating ownership and control has made more efficient allocation of resources possible but not without extracting a cost from shareholders.<sup>349</sup> This cost results from the divergence of interests between management and shareholders and the expectation that management will maximize its own welfare over shareholders.<sup>350</sup>

344. *Id.* at 831-48.

345. *Id.* at 820, 831. At least one commentator rejects the idea that the corporate structure dictates that tender offers are necessary to regulate management. "To infer from the silence of corporate law statutes some structural intent to create a 'safeguard,' a counterweight to constrain management self-dealing, is to build a sandcastle." Harrington, *supra* note 2, at 1013.

346. Gilson, *supra* note 219, at 833.

347. *Id.*

348. *Id.* Harrington rejects the notion that the separation of ownership and control necessarily lead to the results Gilson claims:

The assumption, if any, underlying the structure of the corporation is that of a long-term commitment of equity capital to the enterprise. It arose *faut de mieux*, that is, simply because large corporations could not operate on any other assumption. The "safety valve" is that of liquidity *via* the Wall Street Rule—the ability to sell on the market in exchange for renunciation of the right to sell the assets of the firm, by merger or asset sale, without the affirmative agreement of management. To read into a *casus omissus* the specific structural intention that Gilson, Manne, and others have done under the guise of structural analysis, when the case itself is one which never arose, is more than this structure will bear.

Harrington, *supra* note 2, at 1014.

349. Gilson, *supra* note 219, at 834-35. Gilson identifies the following reasons as responsible for shareholder inability to manage the corporation themselves:

- (1) It is costly to acquire the information necessary to participate in management;
- (2) It is costly to create and coordinate mechanisms to determine what decisions the shareholders have made;
- (3) Management may require specialized skills which shareholders lack.

*Id.* at 834.

350. *Id.* at 834-36. Gilson states:

Management acts as agents of the shareholders. They can be expected, if otherwise unconstrained, to maximize their own welfare rather than the shareholders'. As a result, it is in the owners' interests to incur "monitoring" costs: expenditures like third-party audits, designed to make it

Market forces working in the corporation's operating environment alleviates somewhat the burden imposed upon shareholders by the separation of ownership and control.<sup>351</sup> These forces operate to decrease the divergence between management and shareholder interests.<sup>352</sup> One such force is the product market.<sup>353</sup> The market for a company's product will "penalize a company with inefficient management"<sup>354</sup> because of the failure to meet changing consumer needs. A corporation can fail due to management failings in product development, marketing, and distribution.<sup>355</sup> Since this would result in a loss of management jobs, managers have an incentive to maximize corporate performance in the product market.

A second market constraint is the market for managerial talent.<sup>356</sup> This is the market driven by demand for the services provided by managers. "The corporation's performance is commonly treated as a measure of a manager's skills, and hence is a central determinant of the future value of the manager's services."<sup>357</sup> Thus, the manager is motivated in his performance because his future opportunities and rewards depend upon his contribution to corporate performance.

The capital market is a third market constraint. It constrains managerial misconduct because the stock price reflects poor corporate performance.<sup>358</sup> Managerial inefficiency will reflect in a lowered stock price which creates opportunities for third parties to step in and replace the inefficient management.<sup>359</sup> Obviously, this is a motivating factor for incumbent managers who value their jobs.

These market forces fail to constrain management self-dealing, however, in the context of takeover threats.<sup>360</sup> The product, employment and capital markets, when combined with the judicially-enforced fiduciary duty of

more difficult for management to prefer itself at the expense of the shareholders."

*Id.* at 836.

Gilson divides management misconduct into two broad categories:

- (1) inefficiency, *i.e.*, managers could work harder or more efficiently and increase shareholder wealth;
- (2) misappropriation, *i.e.*, management may misdirect a portion of the corporation's income stream.

*Id.* at 837. It is the second type for which the market for corporate control is essential.

351. *Id.* at 836.

352. *Id.*

353. *Id.* at 837.

354. *Id.*

355. *Id.*

356. *Id.* at 837-38.

357. *Id.* at 838.

358. *Id.*

359. *Id.*

360. *Id.* at 839-40.

directors,<sup>361</sup> work effectively to monitor and minimize managerial inefficiency but are not as effective in monitoring and minimizing managerial self-dealing.<sup>362</sup> To fill this gap in the corporate structure, Gilson looks to another market force, the market for corporate control.<sup>363</sup> The theory behind the market for corporate control

posits that a decrease in corporate profits, whether because of inefficient management or because efficient but self-dealing management has diverted too much income to itself, causes the price of the corporation's stock to decline to a level consistent with the corporation's reduced profitability. This creates an opportunity for entrepreneurial profit. If shares representing control can be purchased at a price which, together with the associated transaction costs, is less than the shares' value following displacement of existing management, then everyone—other than the management to be displaced—benefits from the transaction. Selling shareholders receive more for their stock than its value under previous management; new management receives an entrepreneurial reward through the increased value of acquired shares and society benefits from more efficiently used resources.<sup>364</sup>

The market for corporate control is essential in monitoring managerial effectiveness<sup>365</sup> and may well be the only potentially serious force for limiting managerial discretionary self-dealing.<sup>366</sup> There are two conditions precedent for the market for corporate control to operate in a way which provides these benefits to shareholders, new management, and society.<sup>367</sup> These are: (1) The market price of the corporation's stock accurately reflects management inefficiency (*i.e.*, the market is efficient),<sup>368</sup> and (2) There must be mechanisms available for displacing inefficient or weak management.<sup>369</sup>

The existence of the first condition, an efficient market, is widely acknowledged.<sup>370</sup> The problem lies with the availability of mechanisms to displace incumbent management.<sup>371</sup> Gilson examines the mechanisms available under state corporation statutes and focuses on the tender offer as

361. For a discussion of the fiduciary duties of directors, see H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* §§ 231-42 (3d ed. 1983).

362. Gilson, *supra* note 219, at 839-40.

363. *Id.* at 841-45. Easterbrook and Fischel also discuss the market for corporate control. See *supra* notes 278-80 and accompanying text.

364. *Id.* at 841-42.

365. *Id.* at 841. "The market for corporate control is crucial to the corporate structure because neither other markets nor a fiduciary 'fairness' standard effectively constrains some forms of management self-dealing." *Id.* at 845.

366. *Id.* at 841.

367. *Id.* at 842.

368. *Id.*

369. *Id.*

370. *Id.* Gilson quotes Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 96 (1978): "[T]here is no other proposition in economics which has more solid empirical evidence supporting it than the efficient market hypothesis." Gilson, *supra* note 219, at 824 n.14.

371. Gilson, *supra* note 219, at 842.

the most effective way to displace inefficient management.<sup>372</sup> "The market for corporate control is the principal constraint on management self-dealing in important situations, and the tender offer is the only displacement mechanism which has the potential to effectuate that constraint."<sup>373</sup> Permitting target management to block tender offers will decrease or eliminate the effectiveness of the market for corporate control in controlling management self-dealing.<sup>374</sup> It is no surprise that Gilson posits, "if management can use defensive tactics to obtain a degree of control over tender offers similar to that given it over mergers and sales of assets, then the corporate structure is fundamentally altered in a fashion which allows management effective monopoly power over corporate control."<sup>375</sup> Gilson concludes that "defensive tactics, if successful, circumvent the mechanism by which the corporate structure constrains managerial discretion and, therefore, are improper."<sup>376</sup>

372. *Id.* at 842-45.

373. *Id.* at 844.

374. *Id.* at 844-45.

375. *Id.* at 846. Other commentators have identified other benefits from takeover activity:

Evidence indicates that takeovers produce substantial wealth to shareholders and result in an aggregate net benefit to the economy. Economic benefits result from takeover activity through efficiency gains created by volume production and distribution systems. Takeovers can produce economies of scale which create opportunities which would otherwise be unavailable. Further opportunities may become available through technology transfers not possible between unrelated corporations. An increased market share that occurs after an acquisition produces per unit cost reductions capable of offsetting higher consumer prices usually associated with oligopolous industries.

Takeovers can produce substantial economic gains by causing assets to be shifted to higher valued uses. Optimization of asset-use potential will result from the combined corporations' ability to capitalize on alternate opportunities previously unavailable on a stand-alone basis. Economic gains may stem from actual utilization or increased market valuation based on greater use potential.

Comment, *supra* note 1, at 331.

Another commentator has investigated the effect of ownership change on various business costs and concludes that takeovers can decrease organizational overhead costs. "Takeovers constitute a mechanism for halting and even reversing the growth in the corporate bureaucracy, and this is an important part of their contribution to productivity growth." Lichtenberg, *Takeovers Slash Corporate Overhead*, Wall St. J., Feb. 7, 1989, at A20, col. 6.

376. Gilson, *supra* note 219, at 846.

If management can adopt defensive strategies which prevent shareholder decisions to accept a tender offer, the results are predictable. An offer will be made only if the perceived value of the corporation following displacement of incumbent management exceeds the share price offered plus the transaction costs associated with acquiring the shares. If incumbent management can increase the transaction costs associated with a tender

The market for corporate control provides a system of checks and balances on management self-dealing in another fashion. If a potential acquiror approaches management with a proposal for a merger or sale of assets and management which is acting out of self-interest rejects him, then the "spurned suitor" can bypass management and directly approach the shareholders through a tender offer.<sup>377</sup>

Gilson does not go to the extreme of advocating managerial passivity when faced with a tender offer.<sup>378</sup> Rather, he identifies the appropriate role for target management in this situation. Target management should be encouraged to communicate with their shareholders to provide the information necessary to decide whether to tender their shares.<sup>379</sup> For example, management should provide information on the accuracy of the pre-offer market price or on the value of the acquiror's stock if an exchange is proposed.<sup>380</sup>

Gilson also advocates that target management assume a "bargaining role" when confronted with a tender offer.<sup>381</sup> This involves management actively soliciting offers from other potential acquirors to get the highest price for its shareholders who choose to tender.<sup>382</sup> This "auctioneer" role of management does not provide the same opportunities for management

offer, the incentive to make that offer and the constraint imposed by the potential that an offer will be made are decreased, and incumbent management's discretion correspondingly increased.

*Id.* at 844-45.

377. *Id.* at 846-47 ("should management become too recalcitrant, an alternative is available").

378. At least one court agrees with Gilson's view:

[I]t does not follow that loyalty requires passivity. If someone stops you on the street and says, "Say, that's a beautiful watch you're wearing—I'll give you \$250 for it," you won't necessarily agree to the sale even if the watch is worth only \$100 to you . . . You may want to see whether you can sell it for even more than \$250, now that you have an inkling of what its market value may be. Likewise the first tender offer may not be the best.

*Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 254 (7th Cir. 1986) (Posner, J.) (citation omitted), *rev'd*, 481 U.S. 69 (1987).

379. Gilson, *supra* note 219, at 865-67. Gilson states that shareholder communications may be labelled as a defensive tactic since they protect management, but he nevertheless advocates its use because "it works through the market for corporate control, rather than by preventing the market from operating by foreclosing shareholder access to an offer." *Id.* at 867.

380. *Id.* at 866-67.

381. *Id.* at 868-75. Gilson provides a thorough discussion of this "bargaining role" in Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

382. Gilson, *supra* note 219, at 869-75. For a discussion of how Easterbrook and Fischel challenge the role of management as "auctioneers," see Easterbrook & Fischel, *supra* note 314, at 2 ("all defensive tactics, whether or not for the purpose of triggering an auction, reduce shareholders' wealth").

self-dealing that other defensive strategies allow.<sup>383</sup> Shareholder and management interests are in harmony when the corporation is auctioned because both groups seek to obtain the maximum offering price.<sup>384</sup> Therefore, "there is little potential for management misusing the bargaining process for self-serving ends."<sup>385</sup>

Gilson has formulated a rule of guidance which summarizes the role of management in response to a tender offer. The Rule incorporates the communication and bargaining functions he advocates:

During the period commencing with the date on which target management has reason to believe that a tender offer may be made for part or all of a target company's equity securities, and ending at such time thereafter that the offeror shall have had a reasonable period in which to present the offer to target shareholders, no action shall be taken by the target company which could interfere with the success of the offer or result in the shareholders of the target company being denied the opportunity to tender their shares, *except* that the target company (1) may disclose to the public or its shareholders information bearing on the value or the attractiveness of the offer, and (2) may seek out alternative transactions which it believes may be more favorable to target shareholders.<sup>386</sup>

#### IV. A SUGGESTED ALTERNATIVE

There does not appear to be a clear winner among the leading economic theories. The flaws in the assumptions and analyses of these theories, as identified by the opposing theorists, and the divergence in the resolutions reached by each theory lead to the conclusion there is no theory which is far superior to the opposing theories. Perhaps the ideal resolution of this problem lies in following principled eclecticism—choosing the best of each. A sampling of the best of each theory, in this author's opinion, is presented below:

##### A. *To Whom do Directors Owe a Duty?*

Lipton asserts that society only derives more than economic benefits from the corporate system if directors are permitted to implement defensive strategies at their unfettered discretion. The fallacy here is two-fold: (1) Directors owe their fiduciary duties to shareholders, not the public at large. To the extent that the interests of these constituencies are in conflict, the

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383. Gilson, *supra* note 219, at 869-70 ("bargaining limited to securing a higher offer is a defensive tactic consistent with shareholder interests because it operates by effectuating rather than interfering with the market for corporate control").

384. *Id.* at 870.

385. *Id.* at 869.

386. *Id.* at 878-79 (emphasis in original).

duty to shareholders must prevail. (2) In most cases, however, the interests of both society and shareholders are indeed consistent because corporate concerns, such as the environment, employee health, and product safety, will simultaneously advance the resolution of societal concerns. Therefore, directors must base their decisions solely on the best interests of the shareholders, but in the process, such decisions will also advance societal concerns.

*B. It is Meaningless to Categorize the Interests of Shareholders who Oppose Management's Implementation Defensive Strategies*

Lipton characterizes the "complainers" as arbitrageurs and speculators who have interests in opposition to the other investors. This characterization fails in two respects: (1) Quick profit and polishing their images may indeed be the sole interests of arbitrageurs and speculators. Regardless of where their interests lie, they are still shareholders and thus entitled to participate in corporate decision-making to the same extent as other shareholders. (2) Lipton's assumption that the interests of these constituencies are diametrically opposed to each other may have no foundation in reality. Other investors may have no more interest in the long-run economic viability of the corporation than have arbitrageurs and speculators.

*C. Individual Shareholders are Unable to Decide for Themselves Whether it is in their Best Interests to Accept or Reject a Tender Offer*

Capital markets may indeed be efficient and, thus, reflect the existence of inefficient management in the prices of securities. It is a mistake, however, to assume that this means individual shareholders are capable of deciding for themselves whether to tender their shares, as suggested by Easterbrook and Fischel. This ignores reality. Easterbrook and Fischel seem to recognize this when they assert that while it is theoretically possible for shareholders to oust inefficient management on their own by use of their shareholder rights, in reality this is highly unlikely to happen because of the costs incurred. Likewise, while it may be theoretically possible for shareholders to react in response to the signals of the market for corporate control and assess for themselves the merits of a tender offer, this is highly unlikely to happen because individual shareholders typically lack the time, experience, or desire to do so. Therefore, shareholders need advice when presented with a tender offer. Management is in the best position to provide this advice. First, management has access to the relevant information. Second, management has the experience and skill to analyze that information in the context of a tender offer. Third, management owes its shareholders a fiduciary duty to share their assessment of the merits of the tender offer.



*D. Management's Response to Takeover Threats Should be Closely Scrutinized*

Having concluded that management does indeed fulfill a vital role in the tender offer process, contrary to the view of Easterbrook and Fischel, it does not inevitably follow that this role should be unrestrained by all forces except fiduciary obligations, as suggested by Lipton. Rather, a compromise is called for in light of the inherent potential for management self-dealing in the context of a takeover threat. This is where an eclectic approach proves most useful by combining principles from the leading theories. Perhaps management self-dealing can be restrained by implementing Lipton's suggestion that management thoroughly investigate the tender offer before making a decision whether to accept or reject an offer while cautiously implementing mechanisms in the decision-making process which assure the objectivity of the process. In addition, management decisions deserve varying degrees of scrutiny depending upon their timing. As Easterbrook and Fischel suggest, action taken after management is aware of a takeover threat should be viewed with more suspicion than precautions implemented before a specific threat is identified.

Gilson's perception of management's role in response to a tender offer also deserves serious consideration. By limiting management's role to that of providing information to shareholders and seeking to obtain the highest bid, management's opportunity for self-dealing is seriously constrained.

## V. CONCLUSION

Tender offers promise to remain a popular method for outsiders to seize control of a target corporation. It also appears inevitable that management will fear the effect of a control change on their positions with the target and, therefore, implement creative defensive strategies to thwart the takeover bid. There are a divergence of opinions about the propriety of management employing defensive tactics in response to a takeover threat. This Comment has presented three of the leading economic theories which differ in their perception of the function of tender offers in the marketplace and the proper role of management in the context of a takeover threat. It remains to be seen, however, whether courts and legislatures will align themselves with one of these theories or instead choose to regulate tender offers and related issues based upon other policy issues and economic principles.

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