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A REAPPRAISAL OF CURRENT REGULATION OF MERGERS AND ACQUISITIONS

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INTRODUCTION

Every year the control of many United States corporations shifts from one shareholder or group of shareholders to another. More and more of these transactions are conducted as unsolicited tender offers,

resulting each year in the change of control of multimillion dollar business enterprises employing thousands of individuals.¹ Yet current regulation of corporation acquisitions consists largely of a curious joinder of a federal statute designed to regulate substantively only one mechanism for acquiring corporate control² and long-standing state law concepts of fiduciary responsibility developed to regulate corporate behavior in different and more general contexts. By focusing on the five most significant problems presented by current federal and state regulation, this Article will first discuss why the regulatory system is not adequate, then will critique the most substantial recent proposals for improving it, and finally will offer alternate reform recommendations that respond directly to those problems.

Our subject is relatively new. It is only in the last two decades that the unsolicited tender offer has emerged as an important weapon for acquiring corporate control.³ Unlike a statutory merger, tender offers commonly are launched without the prior approval of the target's board of directors.⁴ By purchasing sufficient shares by tender offer, a bidder can elect new directors of the target who will vote in favor of the combination; the bidder can then vote the shares it acquired in the tender offer to implement the desired combination.

The Williams Act,⁵ enacted by Congress in 1968, was the first

¹ See Liman, *Has the Tender Movement Gone Too Far?*, 23 N.Y.L. SCH. L. REV. 687 (1978).

² This statute is the Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d), 78m(e), 78n(d)-78n(f) (1982)). The Act substantively regulates tender offers and also provides some disclosure requirements for other large acquisitions of securities. These provisions are discussed *infra* notes 69-107 and accompanying text.

³ In 1960, there were eight tender offers to acquire control of corporations with securities listed on national exchanges. H.R. REP. NO. 1711, 90th Cong., 2d Sess. 2 (1968), reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2812 [hereinafter cited as HOUSE REPORT]. By 1966, the number of tender offers had increased to more than 100. *Id.* A recent tabulation indicates that there were 94 tender offers undertaken in 1982, a decrease from the 123 tender offers pursued in 1981. See Austin, *Tender Offer Movement Off in 1982*, Nat'l L.J., Jan. 16, 1984, at 15, col. 1. The value of the transactions also increased dramatically. See D. VAGTS, BASIC CORPORATION LAW 642-43 (1979).

⁴ Before the tender offer movement, businesses were usually combined under state law in a merger, consolidation or sale of assets transaction. These methods of combination are outlined in D. VAGTS, *supra* note 3, at 715-28. Under state law, management had total discretion to submit a proposed combination to shareholders. The role of shareholders was to vote; shareholder initiative was not possible. Thus, if a target's board happened not to approve an acquiror's proposal, it would proceed no further unless the acquiror or dissident shareholders were able to elect new directors willing to support the combination. See *infra* notes 317-28 and accompanying text.

⁵ Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d), 78m(e), 78n(d)-78n(f) (1982)). The substantive requirements for conducting a tender offer are set out *infra* note 38.

federal regulatory response to the new style of corporate acquisitions.⁶ The statute was passed to remedy the secrecy and near panic with which corporate acquisitions had been conducted.⁷ Acquisitions were to be regulated according to the form in which they are conducted:⁸ for tender offers, material terms must be disclosed at the time the offer is commenced and the offer itself must be conducted according to certain minimum standards;⁹ for open market purchase programs, post-acquisition disclosure of the purchaser's identity as well as its plans and purposes in making the acquisition is all that is required.¹⁰ That dichotomy has created a number of problems that we will address.¹¹

State regulation of corporate control acquisitions has existed in two different forms. First, state corporation law traditionally has governed the formation and operation of corporations.¹² Charters to engage in business in corporate form are readily available under general enabling statutes.¹³ Once formed, the corporation is managed by the directors, pursuant to statutory authority, on behalf of the shareholders who elect them to office.¹⁴ Directors generally are not elected on the basis of any platform.¹⁵ As a consequence, directors have enormous discretion, limited only by the fiduciary duty of loyalty and care to shareholders imposed by the relevant corporate statutes.¹⁶ These fiduciary duties of management and majority shareholders were not originally intended to regulate corporate conduct during the acquisition of control¹⁷ and, in

⁶ See, e.g., Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 330 (1974).

⁷ See HOUSE REPORT, *supra* note 3, at 2, reprinted in 1968 U.S. CODE CONG. & AD. NEWS at 2812.

⁸ Application of the regulations depended on whether the acquisition was a tender offer. Interestingly, however, the term "tender offer" was not defined. The lack of a definition has led to problems in regulating acquisitions. See *infra* notes 94-107 and accompanying text.

⁹ The requirements for tender offers are discussed *infra* notes 38-43.

¹⁰ The requirements for large acquisition programs other than tender offers are discussed *infra* notes 94-107.

¹¹ See *infra* notes 165-93 and accompanying text.

¹² See D. VAGTS, *supra* note 3, at 3-4.

¹³ *Id.* at 73-74.

¹⁴ See, e.g., MODEL BUSINESS CORP. ACT § 35 (1980).

¹⁵ However, in making decisions, directors owe shareholders a duty of care and loyalty. In the event that a shareholder charges in a lawsuit that a director has breached the duty of care, the director may assert as a defense the business judgment rule, which presumes that directors' actions are consistent with their responsibilities. This rule is discussed and criticized *infra* notes 317-47 and accompanying text. See also D. VAGTS, *supra* note 3, at 221-22.

¹⁶ See R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 700-06, 751-52 (2d ed. 1981).

¹⁷ Certain state statutes regulate changes in the control of companies in industries which have historically been of concern to state governments. Such industries include insurance, banking, gambling, and liquor. For an explanation of the operations of such

fact, they have not provided effective limitations on such discretion.¹⁸

The second form of state regulation developed much more recently and was much more direct. Witnessing the same increase in tender offers that had prompted the Williams Act,¹⁹ many states acted to protect incumbent corporate management²⁰ and passed a variety of antitakeover statutes.²¹ This direct regulation by the states raised substantial constitutional questions because the impediments such statutes imposed on tender offers seemed to interfere with the regulatory scheme Congress had devised. The Supreme Court resolved this issue in *Edgar v. MITE Corp.*²² and concluded that the anti-takeover statutes were, in fact, unconstitutional.²³

MITE, and the legal community's anticipation of it,²⁴ caused a

statutes, see *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979) (insurance); *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969) (insurance); *United States v. Crocker Nat'l Corp.*, 656 F.2d 428 (9th Cir. 1981) (banking).

¹⁸ See *infra* notes 317-47 and accompanying text.

¹⁹ See *supra* note 3.

²⁰ See Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213, 217-18 (1977).

²¹ These state statutes are discussed in detail in Langevoort, *supra* note 20. Generally, the statutes required that any purchase of securities resulting in the ownership of ten percent or more of a class of equity securities be conducted as a "takeover bid." The purchaser making the takeover bid was required to submit a disclosure statement to a state official and the subject company 20 days before the offer started, *id.* at 226-33; to undergo lengthy administrative hearings, often at the request of incumbent management, *id.*; to hold the bid open for a fixed period of time (usually 20 days), *id.*; to purchase shares tendered during the offer on a pro rata basis, *id.* at 223; and to give all selling shareholders withdrawal rights and the benefit of price increases, *id.* The state statutes generally exempted from the definition of "takeover bid" programs having the support of the board of directors of the subject company. *Id.* at 224-25. The state statutes were extraterritorial in nature: they purported to bar the making of a bid anywhere in the country, unless the requirements of the state statute had been met. *Id.* at 219-26. Given their objective, the states had no other choice. If their statutes were not extraterritorial in scope, bidders would simply have excluded stockholders resident in that state (who could always sell in the market).

State anti-takeover statutes are also discussed in Bartell, *State Take-Over Laws: A Survey*, in 1 NINTH ANNUAL INSTITUTE OF SECURITIES REGULATION 339 (A. Fleischer & M. Lipton eds. 1977).

²² 450 U.S. 624 (1982).

²³ *Id.* at 643.

The lower courts have warmly received the *MITE* opinion, applying it to a variety of statutory schemes. For example, the Sixth Circuit relied on *MITE* to invalidate the application of the antifraud provisions of the Michigan blue sky statute to national tender offers, even though the state limited its role to the protection of local shareholders. See *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558, 567 (6th Cir. 1982). Similarly, the Maryland district court applied *MITE* in striking down the Maryland takeover statute in *Bendix Corp. v. Martin-Marietta Corp.*, 547 F. Supp. 522 (D. Md. 1982). Finally, the Second Circuit applied *MITE* to strike down provisions of the Connecticut Liquor Control Act in *United States Brewers Ass'n, Inc. v. Healy*, 692 F.2d 275 (2d Cir. 1982).

²⁴ See, e.g., Langevoort, *supra* note 20; Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1 (1976).

dramatic change in the takeover environment. Under most state regulation, target management was given a big advantage in fighting off unsolicited tender offers. State regulation generally delayed tender offers long enough for unwanted suitors to be repulsed.²⁵

The federal law that replaced such state regulation allows tender offers to proceed much more quickly.²⁶ That gives tender offerors a large advantage by depriving target management of the time needed to respond to unwanted bids. The response to that has been the development of new defense tactics as target management has tried to regain the competitive advantage it had under the now preempted state statutes.²⁷ Those new defensive tactics, generally conducted without shareholder consent, have been challenged by target shareholders as violative of state corporation law.²⁸ Courts have been unreceptive to such challenges, holding that the "business judgment rule"²⁹ gives target directors virtually unreviewable discretion. The real issue, we argue, is how much and how soon target shareholders should participate in corporate changes of control.

In recognition of the inadequacies of the present system, the Securities and Exchange Commission (the "Commission" or "SEC") established, on February 25, 1983, the Advisory Committee on Tender Offers (the "Committee").³⁰ The Committee was directed to identify and propose solutions for the deficiencies in current acquisition regulation.³¹ Prepared under an abbreviated timetable,³² the Committee's final report essentially endorsed the existing regulatory structure without acknowledging many of its problems.³³ Perhaps because it assumed that its task was only to streamline current rules, the Committee did not discuss whether there was a need for a fundamental reallocation of reg-

²⁵ See Wilner & Landy, *supra* note 24, at 9-10.

²⁶ See *infra* note 38.

²⁷ See *infra* notes 266-96 and accompanying text.

²⁸ See *infra* notes 317-47 and accompanying text.

²⁹ See *infra* notes 317-28 and accompanying text.

³⁰ See SEC Release No. 34-19,528, 48 Fed. Reg. 9111 (1983). The Committee was established in accordance with the provisions of the Federal Advisory Committee Act, as amended, 5 U.S.C. app. § 1 (1982). The Committee's 18 appointed members included prominent merger-and-acquisition experts from the business community, academia, and the legal and accounting professions.

³¹ See SEC Release No. 34-19,528, 48 Fed. Reg. 9111, 9111 (1983).

³² Although the Committee's charter allotted 10 months for completion of its work, *id.*, a letter from the Senate Committee on Banking, Housing, and Urban Affairs requested the final report be completed by the end of July, 1983. Letter of Senate Committee on Banking, Housing, and Urban Affairs to John Shad, Chairman of the SEC (February 1, 1983), *reprinted in* ADVISORY COMMITTEE ON TENDER OFFERS, REPORT OF RECOMMENDATIONS 134, 136 (July 8, 1983) [hereinafter cited as ADVISORY COMMITTEE REPORT].

³³ See ADVISORY COMMITTEE REPORT, *supra* note 32.

ulatory power.

This Article is intended to provide an alternate analysis of the problems posed by federal and state regulation of acquisitions. By considering the policy concerns raised by inadequate regulation and by critiquing the Committee responses to the problems that result from such regulation, we hope to provide recommendations for a more coherent reform of the regulatory system.

The Article is divided according to the most prominent problems in the acquisitions area. Part I considers open market purchases of corporate control. Part II discusses two-tier and partial tender offers. Part III discusses the increased use of tender offers in negotiated or friendly acquisitions. Part IV considers corporate defensive responses to tender offers and corporate raiders. Finally, Part V considers some neglected constituencies affected by acquisitions.

I. OPEN MARKET PURCHASES AS AN ACQUISITION TECHNIQUE

Congress decided, in adopting the Williams Act,³⁴ to regulate tender offers as it regulated another technique to acquire control, proxy fights.³⁵ Regulations in both situations require each shareholder to be provided the information and time necessary to decide whether to tender or vote his shares;³⁶ the Williams Act further gives each shareholder the opportunity to have at least some of his shares purchased in the tender offer.³⁷ Application of the Williams Act, however, depends entirely on whether the acquisition is structured as a "tender offer."³⁸

³⁴ Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 455 (codified at 15 U.S.C. §§ 78m(d), 78m(e), 78n(d)-78n(f) (1982)). The enactment of the Williams Act is discussed *supra* notes 5-10 and accompanying text.

³⁵ The similar need for information in the proxy and tender offer contexts was specifically considered by Congress when enacting the Williams Act. See HOUSE REPORT, *supra* note 3, at 3, reprinted in 1968 U.S. CODE CONG. & AD. NEWS at 2813.

³⁶ Compare Rule 14a-3, 17 C.F.R. § 240.14a-3 (1983) (information to be disclosed in a proxy) with Rule 14d-6, 17 C.F.R. § 240.14d-6 (1983) (information to be disclosed during a tender offer). It is certainly true that there are important differences in the content and timing of disclosure in these two contexts. These differences and the problems they present are discussed *infra* notes 69-107 and accompanying text. See generally Freund & Greene, *Substance Over Form S-14: A Proposal to Reform SEC Regulation of Negotiated Acquisitions*, 36 BUS. LAW. 1483 (1981).

³⁷ See *infra* note 38.

³⁸ Section 14(d)(1) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78n(d)(1) (1982), applies to any tender offer for more than five percent of any class of equity security registered under § 12 of the Exchange Act, 15 U.S.C. § 78l (1983). At the time the offer is first published, sent or given to shareholders, the bidder must file a disclosure statement meeting the Commission's requirements. See § 78n(d)(1) (1982). The bidder's statement must include information about the bidder's background, financing plans and proposals for the issuer, as well as any regulatory requirements and legal proceedings relating to the offer. Rule 14d-6, 17 C.F.R. §

In contrast, large acquisitions of stock either on the open market or through privately negotiated deals are minimally regulated. Section 13(d) of the Securities Exchange Act³⁹ provides the marketplace with information as to possible changes in their corporation's control only after a person⁴⁰ purchases five percent of any class of a company's equity securities.⁴¹ The less stringent requirements probably resulted from Congress's focusing on the more obvious problems associated with tender offers and neglecting the less obvious, but equally significant, problems with open market and negotiated acquisitions of control.⁴²

The different treatment of tender offers and proxy fights on the one hand and large scale open market or privately negotiated purchases on the other merits reevaluation. In our judgment, purchasers should acquire control only pursuant to a bid to all shareholders.

A. Unaddressed Problems

The fact that open market and privately negotiated acquisitions

240.14d-6 (1983).

An offer is deemed to commence when its material terms are first disclosed to the public. *See* Rule 14d-2(a), 17 C.F.R. § 240.14d-2(a) (1983). Material terms include the identity of the bidder, the price to be offered and the number of shares to be purchased. *See* Rule 14d-2(c), 17 C.F.R. § 240.14d-2(c) (1983). The bidder must file its disclosure statement and open its depositary within five business days. The offer must be open for at least 20 business days and must be extended by 10 business days if the bidder increases the offering price. Rule 14e-1, 17 C.F.R. § 240.14e-1. Shareholders have a right to withdraw any tendered shares for at least the first 15 business days of the offer, Rule 14d-7(a)(1), 17 C.F.R. § 240.14d-7(a)(1) (1983), for at least 10 business days after the commencement of competing bids (other than one made by the target company), *see* Rule 14d-7(a)(2), 17 C.F.R. § 240.14d-7(a)(2) (1983), and at any time after 60 days from the date of the offer's commencement. 15 U.S.C. § 78n(d)(5) (1982). If a bid is for less than all of the outstanding stock of a class, the bidder must purchase any shares tendered before the expiration date of the offer on a pro rata basis. Rule 14d-8, 17 C.F.R. § 240.14d-8 (1983). Increases in the consideration offered must be paid to all shareholders from whom shares are purchased. 15 U.S.C. § 78n(d)(7) (1982). No purchases can be made except pursuant to the tender offer. Rule 10b-13, 17 C.F.R. § 240.10b-13 (1983).

Federal law also requires that management of the target company disclose its position with respect to the offer together with certain other information not later than 10 business days after commencement. *See* 17 C.F.R. § 240.14d-9(a) (1983); *id.* § 240.14d-10; *id.* § 240.14e-2.

³⁹ 15 U.S.C. § 78m(d) (1982).

⁴⁰ The definition of person also includes groups of persons acting together to purchase securities. *See id.* § 78m(d)(3).

⁴¹ 15 U.S.C. § 78m(d) (1982).

⁴² This conclusion can be inferred from the fact that large acquisitions pursued by means other than tender offers received little analysis or discussion in the legislative history of the Williams Act. *See* HOUSE REPORT, *supra* note 3, at 4, *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS at 2814. The disclosure requirements for large acquisitions were enacted with the tender offer requirements in the Williams Act. *See* Pub. L. No. 90-439, § 2, 82 Stat. 455, 455 (1968) (codified at 15 U.S.C. § 78m(d) (1982)).

have to meet relatively minimal regulatory requirements raises important policy concerns. Those concerns are strongest when massive purchases are made in competition with an announced tender offer.

1. Competitive Equality Among Acquirors

When two parties are competing to acquire control of a target company, success should not depend on one competitor's ability to use an acquisition technique that is, in many relevant senses, unregulated.⁴³ The different treatment of tender offers as against open market or privately negotiated deals means, however, that well-advised purchasers may be able to compete successfully with a traditional tender offer by structuring acquisitions to avoid the tender offer regulations.⁴⁴ Such acquisitions may defeat that tender offer either by preventing the attainment of the minimum share condition or by acquiring control outright.

When pursued during a competing tender offer, an open market purchase program has two important competitive advantages. First, the competing bidder is disadvantaged by having to conduct its tender offer in compliance with the prescribed timing requirements. The bidder is not permitted to buy any shares for at least fifteen days,⁴⁵ and may only buy in the tender offer itself,⁴⁶ while the open market competitor is free to purchase stock accumulated by arbitrageurs as a result of the market activity stimulated by the announcement of the conventional

⁴³ *But see infra* notes 127-30 and accompanying text (proposing that certain private deals be exempt from the proposed new regulatory requirements because of the unique circumstances presented by such deals).

⁴⁴ This careful structuring of an acquisition program was pursued by Harsco Corporation when it decided to purchase a substantial block of its own stock from arbitrageurs after Crane Corporation had commenced a formal tender offer for Harsco stock. In Harsco's acquisition, public announcements were held to the minimum required by law, did not precede the commencement of purchases, and expressly stated that the purchases were to be made only from arbitrageurs. These measures were aimed at avoiding the publicity and widespread solicitation elements of the Commission's test. The details of the test are set out *infra* notes 79-93 and accompanying text. Harsco also tried to minimize the number of shareholders who participated and to assure a higher degree of sophistication (and hence, a lower susceptibility to pressure, another element of the Commission's test), by crossing the trades on the Pacific Stock Exchange rather than the New York Stock Exchange, where Harsco may have been required to "clear the books" of the New York Stock Exchange specialist—that is, to purchase all shares as to which a sell order had been placed at a lower price than the negotiated purchase price. In support of its determination that Harsco's purchase program did not constitute a tender offer under the Commission's eight-factor test, the district court relied on these aspects of the deal. *See Crane Co. v. Harsco Corp.*, 511 F. Supp. 294, 302-03 (D. Del. 1981). In the words of the court, the payment of a premium, the only factor present, "does not a tender offer make." *Id.* at 303.

⁴⁵ *See* Rule 14d-7(a)(1), 17 C.F.R. § 240.14d-7(a)(1) (1983).

⁴⁶ *See* Rule 10b-13, 17 C.F.R. § 240.13 (1983).

bid.⁴⁷ Second, the open market purchaser does not have to prorate if there are more shares available than he is willing to buy. This makes his offer extremely attractive to arbitrageurs, who want to dispose of their entire accumulated position quickly for cash. The two advantages together mean that the open market purchaser will have an easy time purchasing shares, possibly gaining control, before the tender offeror is able to purchase any stock under the terms of its offer.

In order to equalize the competitive position of tender offerors and open market or negotiated purchasers,⁴⁸ one of two things can be done: either the regulations concerning tender offers can be loosened, or new regulations on control acquisitions through open market or negotiated purchases can be imposed. The prevailing legislative climate, buttressed by solid arguments, precludes the former. Moreover, there are good reasons for pursuing the latter course. Those reasons involve problems with unfettered open market and negotiated acquisitions that are present regardless of whether a prior tender offer by a competing purchaser is outstanding. The next three sections examine those problems.

2. Informed Decisionmaking and the Orderly Transfer of Control

The acquisition of control through open market purchases may foster a frenzied, uninformed trading atmosphere that is inconsistent with informed shareholder decisionmaking and the orderly and efficient transfer of control of major business enterprises.

Aggressive acquirors may buy control positions through a series of open market purchases that are carefully timed to coincide with vague announcements of their plans.⁴⁹ In such a market, some shareholders will rush to sell in order to take advantage of the higher prices resulting from the mere possibility of further purchases. Others may sell to avoid being left as a minority shareholder in a company dominated by a controlling shareholder who may be personally unpopular or threatens to adopt radical policies of uncertain result.⁵⁰

The tender offer rules provide three major responses to the volatile market conditions that result when there is an effort to acquire control of a corporation. First, the rules require disclosure, prior to the actual purchase of any securities, of significant information about the bidder,

⁴⁷ See *infra* note 50 and accompanying text.

⁴⁸ See *infra* text accompanying note 86.

⁴⁹ The current regulatory requirements that purchasers of large amounts of shares disclose their intentions are difficult to enforce. See *infra* notes 98-99 and accompanying text.

⁵⁰ This phenomenon is well-documented in the popular press. See, e.g., Pauly, *Gulf Oil: Pickens's Charge*, *Newsweek*, Oct. 31, 1983, at 57-58.

the price it is offering for shares, and the number of shares it intends to purchase.⁵¹ That allows all shareholders the chance to make thoughtful investment decisions. Second, the rules ensure that shareholders have adequate time to make their decisions by permitting them to change their minds for a specified time period after an initial decision to tender their shares.⁵² That provision tends to counteract any initial pressure to tender that is occasioned by volatility in the market. Finally, the tender offer rules allow for a more orderly market by preventing the bidder from actually purchasing any shares for a prescribed number of days,⁵³ and by requiring him, if more shares are tendered than he wants, to purchase shares pro rata from all tendering shareholders.⁵⁴ These requirements allow an assessment of the bidder's offer to be made by the target's shareholders, free from the pressure of having to tender immediately. Thus, while unregulated open market and negotiated acquisitions may lead to disorderly market conditions, acquisitions by tender offer take place in a more informed and open environment.

3. Predictability in the Application of Regulatory Requirements

If tender offers continue to be regulated more vigorously than open market or privately negotiated acquisitions, the elusive concept of what constitutes a "tender offer," and thus is subject to regulation, will also continue to have significant consequences for investors and their advisors. Uncertainty about the precise contours of the definition will unnecessarily promote litigation and complicate the planning of transactions. Such consequences are greatly reduced if similar regulations are imposed on both tender offers and significant open market or negotiated acquisitions.⁵⁵

4. Control Premium Sharing

When control of a corporation is acquired, the difference between the total price paid and the market price per share before the transaction is announced multiplied by the number of shares that were purchased, is equal to the premium attached to the control of that corporation.⁵⁶ Recent experience shows that control premiums may be paid in

⁵¹ See Rule 14d-3, 17 C.F.R. § 240.14d-3 (1983).

⁵² See *id.* § 240.14d-7(a).

⁵³ See *id.*

⁵⁴ See *id.* § 240.14d-8. This provision applies, of course, only if the bidder is offering to buy less than all of the target's outstanding securities. *Id.*

⁵⁵ Similar consequences would also flow from a rule that defined tender offers according to quantitative rather than qualitative factors.

⁵⁶ The theory of the control premium and the problem of control premium shar-

open market transactions, where sharing is not now required, as well as in conventional tender offers, where it is.⁵⁷ The Williams Act adopts a regulatory scheme that allows all shareholders faced with a tender offer to have an equal chance to sell their shares to the offeror, so that the bidder is not permitted to allocate the control premium to a select group of shareholders, either by buying on a first come, first served basis or by negotiating a deal with some limited number of stockholders.⁵⁸

The regulation of open market and privately negotiated acquisitions, however, allows the acquisition of corporate control without any requirement that all shareholders be given an opportunity to share whatever premium was paid for control.⁵⁹

ing have been extensively discussed by commentators. See generally Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Bayne, *The Sale-of-Control Premium: The Intrinsic Illegitimacy*, 47 TEX. L. REV. 215 (1969); Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212 (1958); Brudney & Chirelstein, *supra* note 6; Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956); Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 955 (1978); Note, *Individual Pro Rata Recovery in Stockholder's Derivative Suits*, 69 HARV. L. REV. 1314 (1956).

⁵⁷ See *S-G Securities, Inc. v. Fuqua Inv. Co.*, 466 F. Supp. 1114, 1119-20 (D. Mass. 1978).

⁵⁸ Although sharing of the control premium is an important result of the Williams Act, its legislative history does not address explicitly the desirability of mandatory control premium sharing. Its principal policy goal is to ensure that all shareholders have an opportunity to make informed, unhurried decisions with respect to conventional tender offers for their securities. See HOUSE REPORT, *supra* note 3, at 2-4, reprinted in 1968 U.S. CODE CONG. & AD. NEWS at 2812-14; see also *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975). In fact, there is nothing in the Williams Act which compels a bidder to make its offer to all shareholders. Conceivably, a bidder could, in a partial bid, limit its offer to holders of more than 10,000 shares, to reduce proration risk faced by those who are eligible to participate. In Securities Exchange Act Release No. 34-16,384, 44 Fed. Reg. 70,349 (1979) (proposed rule to be codified at 17 C.F.R. § 240.14e-4), the Commission solicited public comment on proposed Rule 14e-4 which would have required an offeror to extend the offer to all shareholders. *Id.* at 70,359. The SEC justified the proposal on the grounds that it makes explicit what is implicit in the Williams Act. Although the implication of the Williams Act is not entirely clear, no one has actually tested its impact by, for example, making an offer only to arbitrageurs.

⁵⁹ Senator Harrison A. Williams, Jr., for whom the Williams Act is named, stated:

Substantial open market or privately negotiated purchases of shares may precede or accompany a tender offer or may otherwise relate to shifts in control of which investors should be aware. . . . [D]isclosure after the transaction [as required by § 13(d)] avoids upsetting the free and open auction market where buyer and seller normally do not disclose the extent of their interest and avoids prematurely disclosing the terms of privately negotiated transactions.

Respectable arguments favor the imposition of a sharing requirement in all control transactions, whether conducted as a tender offer, open market purchase program, or privately negotiated purchase program. First, it seems fundamentally unfair that a purchaser should be able to decide which limited group of shareholders is to receive a control premium when the purchaser, in fact, is buying the opportunity to manage assets belonging to all shareholders.⁶⁰ When a bidder buys less than all of the outstanding shares, yet enough to obtain control, "he is acquiring a business worth more than what he pays in cash, and is financing the difference by leaving the minority shares outstanding."⁶¹ Yet the owners of the minority shares have a vital interest in the control acquisition. The operating policies of the new control person—which the minority is powerless to change—will affect the profits which the minority thereafter is entitled to share. Indeed, the remaining shareholders are forced to accept the risk that the new control person is inexperienced, has a poor management record, will loot the corporation or will run it solely to benefit his business.⁶² An equal opportunity to share in the control premium paid may thus be viewed as compensation to the minority for the new risks they assume due to the change in control.

The acquisition of a control block by one person may also reduce the possibility that some other purchaser will attempt to assemble a competing control block. The success of the initial control bidder may encourage other potential purchasers to pursue other companies with

113 CONG. REC. 856 (1967).

⁶⁰ See Berle, *supra* note 56, at 1220-22; Hill, *supra* note 56, at 1012-28. Professors Berle and Means, with remarkable prescience, first wrote that control belongs to the entire corporation, not just those shareholders who, by selling their shares, can deliver it. See A. BERLE & R. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 244 (1932). This notion was arguably applied by the Second Circuit in *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955). But see *Clagett v. Hutchison*, 583 F.2d 1259, 1263 (4th Cir. 1978) (sharing of premium, "while nice theoretically, . . . [is] simply not the law"); *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684, 397 N.E.2d 387, 421 N.Y.S.2d 877 (1979) ("so radical a change" should be made by legislature, not courts).

Berle's "corporate asset theory" is consistent with, yet distinct from, that presented here. Berle hypothesizes that "control" is a legally cognizable commodity that belongs to all shareholders. The above theory focuses mainly on the premise that all shareholders ratably own the corporation's physical assets. This theory is not subject to the criticisms of the corporate asset theory. See Jennings, *supra* note 56, at 9-13.

⁶¹ Andrews, *supra* note 56, at 520. Professor Andrews posits the rule that, whenever a controlling shareholder sells his shares, every other holder of shares (of the same class) is entitled to have an equal opportunity to sell his shares, or a pro rata part of them, on substantially the same terms. He identifies the tender offer as a method for implementing this rule. Professor Andrews adduces several economic and practical arguments in support of his rule. *Id.* at 517-45.

⁶² See Berle, *supra* note 56, at 1218-20; Hill, *supra* note 56, at 1022.

decentralized ownership. In fact, if another purchaser had known that the first bidder was seeking control in the market, he might have made a tender offer at a hefty premium, which all shareholders would have had an equal opportunity to share. The open market purchaser who obtains control deprives all shareholders of this opportunity.

Finally, a competing open market purchase program affects distribution of the control premium. This premium, which is included in the market price paid by the purchaser, is paid primarily to arbitrageurs and other professional investors (and indirectly to those shareholders who sold in the market to them) rather than being fairly distributed to the shareholders at large by tender offer.⁶³

Arguments against adopting a policy of control premium sharing are chiefly economic. Bids for corporate control are seen as promoting the efficient use of resources and the replacement of inefficient management.⁶⁴ Allowing shareholders to share in all control premiums may reduce the number of control bids and decreases the percentage of successful bids.⁶⁵ Obviously, it is more efficient for the purchaser to make its offer to only a few large shareholders, rather than to the shareholders at large. Chances of acceptance are much better, the transaction takes only days to complete (as opposed to the twenty business day minimum tender offer period), the bidder is much less vulnerable to competing bidders, and, finally, the bidder saves the expenses of conducting the tender offer.⁶⁶ Indeed, to impose a sharing requirement in open market and privately negotiated transactions would be to eliminate the use of those techniques to acquire control, for it is difficult, if

⁶³ This effect can be observed in the competitive acquisition situation described *supra* note 44. After Crane Corporation had commenced a formal tender offer for Harsco Corporation, Harsco itself began purchasing a substantial block of its stock from arbitrageurs in a so-called "street sweep" transaction. The arbitrageurs sold their stock to Harsco at a substantial premium over the then market and tender offer prices, while the company's long-term shareholders were left in ignorance of the transaction and were unable to participate. Furthermore, the street sweep made consummation of the Crane tender offer less likely, thereby depriving shareholders of an opportunity to sell their shares in that offer. See *Crane Co. v. Harsco Corp.*, 511 F. Supp. 294, 297 (D. Del. 1981).

In a similar situation, Grumman Corporation and its employees' pension plan made substantial open market purchases of Grumman stock during an ongoing tender offer as part of an effort to defeat LTV's bid for Grumman. See *LTV Corp. v. Grumman Corp.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,344 (E.D.N.Y. 1981).

⁶⁴ See, e.g., Easterbrook & Fischel, *supra* note 56, at 715-20.

⁶⁵ Comment, *Sale of Corporate Control*, 19 U. CHI. L. REV. 869, 871 (1952).

⁶⁶ Those are the costs of preparing tender offer documents, sending them to shareholders, and defending them in court. These economic and practical considerations commonly motivate privately negotiated purchase programs.

not impossible, to apply a sharing requirement to such transactions.⁶⁷ Regarding the "financing" argument, one may argue that many of life's inequities do not necessarily result in an "abuse" requiring legal correction, especially if that correction reduces the number of such transactions.⁶⁸

It may also be argued that the possibility of a takeover by inexperienced or dishonest management is simply an ever-present fact of life for corporate shareholders, the risk of which they accept with open eyes when they decide to buy stock.

On the whole, however, we tend to agree with those who favor a system of shared control premiums.

5. Conclusion

With this understanding of the policy concerns about open market and privately negotiated acquisitions, we can now assess current regulation of the various methods of acquiring corporate control.

B. Current Regulation

Evaluating current regulation in light of the policy concerns just outlined leads one to focus primarily on the scope of the tender offer regulations and on the adequacy of present requirements for open market and privately negotiated purchases.

1. The Scope of Tender Offer Regulation

The Williams Act contains no definition of the term "tender offer." Yet the meaning of the term has enormous consequences for investors and their advisors in the conduct of their transactions.⁶⁹

It appears that when the Williams Act was enacted, a "tender offer" was commonly understood to be a publicly made invitation addressed to all shareholders of a corporation to tender shares at a given price.⁷⁰ The conventional tender offer was ordinarily open for only a limited period of time, contained various conditions (such as a requirement that a minimum number of shares be tendered), and involved a

⁶⁷ See *Brascan, Ltd. v. Edper Equities, Ltd.*, 477 F. Supp. 773, 790-91 (S.D.N.Y. 1979).

⁶⁸ See, e.g., Easterbrook & Fischel, *supra* note 56, at 718-19 (arguing that extensive regulation of prospective buyers might eliminate those buyers most skilled in restructuring firms for the good of the shareholders).

⁶⁹ See *supra* note 38.

⁷⁰ See Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1251 (1973).

premium over the market price.⁷¹ The ingenuity of purchasers, however, led to transactions which had the speed and pressure of a tender offer but which were styled as massive open market or privately negotiated purchase programs. It is not clear whether Congress intended that the term "tender offer" include these unconventional transactions.⁷² This lack of certainty has spawned considerable litigation.⁷³

a. Case Law

Current case law establishes rough parameters as to the scope of the term "tender offer." It is now fairly well established, after fifteen years of litigation, that large open market purchase programs, even when resulting in change of control, generally do not constitute tender offers.⁷⁴ Courts have been unwilling to protect shareholders who independently have decided to sell in faceless market transactions without solicitation.⁷⁵

It is only when large-scale purchase programs have been accompanied by active and widespread solicitation⁷⁶ or pressure on shareholders to accept or reject the offer quickly⁷⁷ that courts have been willing to conclude that the transactions constitute tender offers. Those transactions are fundamentally different from trades on the national market system.⁷⁸ On the whole, however, courts have been fairly conservative in deciding what constitutes a "tender offer."

⁷¹ See *id.*; see also Aranow & Einhorn, *Essential Ingredients of the Cash Tender Offer Invitation*, 27 BUS. LAW. 415 (1972).

⁷² See Note, *supra* note 70, at 1260-61.

⁷³ See cases collected in *id.* at 1250 n.4.

⁷⁴ See, e.g., *Chromalloy Am. Corp. v. Sun Chemical Corp.*, 474 F. Supp. 1341, 1343-46 (E.D. Mo.) (ordinary New York Stock Exchange purchase plus one large institutional block purchase), *aff'd*, 611 F.2d 240 (8th Cir. 1979); *Brscan, Ltd. v. Edper Equities, Ltd.*, 477 F. Supp. 773, 789 (S.D.N.Y. 1979) (large open market accumulation of stock that avoided excessive increase in price not a tender offer).

⁷⁵ See, e.g., *Brscan, Ltd. v. Edper Equities, Ltd.*, 477 F. Supp. 773, 789 (S.D.N.Y. 1979).

⁷⁶ E.g., *Hoover v. Fuqua Indus., Inc.*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CGH) ¶ 97,107 (N.D. Ohio 1979) (tender offer where 100 family members owning 41% of company's stock were solicited); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979) (tender offer where a series of purchases were made on one day from 33 major shareholders, mainly financial institutions, at a uniform premium over the then current market price, conditioned on a specific number of shares being purchased, but not accompanied by any prepurchase publicity, which resulted in an aggregate acquisition of 34% of the target's stock), *aff'd*, 682 F.2d 355 (2d Cir. 1982); *S-G Securities, Inc. v. Fuqua Inv. Co.*, 466 F. Supp. 1114 (D. Mass. 1978).

⁷⁷ E.g., *Wellman v. Dickinson*, 475 F. Supp. 783, 824-25 (S.D.N.Y. 1979) (shareholders given only a short time to decide whether to sell their stock), *aff'd*, 682 F.2d 355 (2d Cir. 1982).

⁷⁸ See *id.* at 817.

b. *Administrative Guidelines*

The SEC has always taken the position that the Williams Act applies to so-called "unconventional" tender offers.⁷⁹ In 1979 it suggested eight factors which one could use to determine whether or not a transaction was an "unconventional" tender offer.⁸⁰ The factors attempt to identify those open market and privately negotiated transactions that place shareholders under the same pressure to make investment decisions usually associated with conventional tender offers. The premise of the eight-factor test is that such shareholder pressure creates the need for the substantive protections of section 14(d) of the Williams Act.⁸¹

The test is to be applied flexibly—all indicia need not be present in each transaction and the weight accorded each factor is determined on a case-by-case basis, resulting in after-the-fact, *ad hoc* judgments by courts.⁸² These indicia, after receiving a mixed initial review,⁸³ have had a favorable reception in some courts,⁸⁴ helping to make clear that

⁷⁹ See generally Note, *Defining Tender Offers: Resolving a Decade of Dilemma*, 54 ST. JOHN'S L. REV. 520, 531-33 (1980).

⁸⁰ Those factors are: (1) whether there is an active and widespread solicitation of public shareholders; (2) whether the solicitation is made for a substantial percentage of the issuer's stock; (3) whether the offer to purchase is made at a premium over the prevailing market price; (4) whether the terms of the offer are firm rather than negotiable; (5) whether the offer is contingent on the tender offer of a fixed minimum number of shares, and, perhaps, is subject to the ceiling of a fixed number of shares to be purchased; (6) whether the offer is open only for a limited period of time; (7) whether the offerees are subject to pressure to sell their stock, and (8) whether public announcements of a purchasing program concerning the target company precede or accompany a rapid accumulation of large amounts of target company securities.

The Commission advanced these criteria in its Memorandum of Law (*amicus curiae*), *Brscan Ltd. v. Edper Equities*, 477 F. Supp. 773 (S.D.N.Y. 1979), and in its Post Trial Memorandum in *SEC v. Sun Co.*, reported *sub nom.* *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979).

⁸¹ See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 597-98 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974).

⁸² See sources cited *supra* note 80.

⁸³ Among the early cases, one court questioned the validity of the indicia, *Brscan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773, 791 (S.D.N.Y. 1979); another regarded them as useful, *Hoover Co. v. Fuqua Indus.*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,107 (N.D. Ohio June 11, 1979), and a third adopted and applied them, *Wellman v. Dickinson*, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979).

⁸⁴ See, e.g., *Polinsky v. MCA, Inc.*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,761 (9th Cir. 1982) (applying the Commission factors to find that defendant's pre-tender offer market purchases of target company stock could not be considered a tender offer for purposes of bringing a fraud claim under § 14(e) of the Exchange Act); *Astronics Corp. v. Protective Closures Co.*, [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,176 (W.D.N.Y. 1983); *Mid-Continent Bancshares, Inc. v. O'Brien*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,734 (E.D. Mo. Dec. 11, 1981) (used Commission factors to find active and widespread solicitations at a premium over the prevailing market price of a substantial amount of target's stock constituted a tender offer, notwithstanding the fact that the terms of the offer were not firm and nonnegotiable, the offer was open only for a limited period of time, and the

the applicability of the tender offer rules does not depend on whether the bidder identifies the transaction as a tender offer. Such a test, however, invites litigation, makes planning difficult, and implicitly acknowledges interstices in the structure of the Williams Act which bidders will continually exploit to escape pervasive regulation. In addition, it forces judges to unscramble completed transactions, which judges are reluctant to do unless the behavior is egregious. Because of the competitive disadvantage that an open market acquisition enjoys over a tender offer, private litigants and the SEC have for some time urged courts to classify such open market purchases as tender offers within the meaning of the Williams Act.⁸⁵ As one noted takeover lawyer has stressed,

[I]f the purposes of the Williams Act are to be achieved, large-scale open-market purchases to obtain control should be held to be tender offers. Where such purchases are made for the purpose of defeating another's tender offer, the argument for finding them to be a tender offer is compelling. To hold that these purchases are not tender offers is to handicap severely the person making the formal tender offer in compliance with the Williams Act and to subject the public shareholders to the disadvantages that the Williams Act was intended to remedy.⁸⁶

The legislative history of the Williams Act, however, adds little force to those arguments because it focuses primarily on the protection of shareholders from undue pressure, and not on the importance of a competitive balance between bidders or the equitable distribution of control

purchases were not contingent on the tender of a fixed number of shares). Cf. *Liberty Nat'l Ins. Holding Co. v. The Charter Co.*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,671 (N.D. Ala. 1982) (applied the eight-factor test to find defendant's active and widespread solicitation of an issuer's security holders did not by itself constitute a tender offer within the meaning of § 14 of the Exchange Act).

⁸⁵ See, e.g., Brief for the Securities and Exchange Commission (*amicus curiae*), *Wien Air Alaska, Inc. v. Alaska Airlines, Inc.*, C.A. No. 79-4565 and 79-4583 (9th Cir. 1979) (dismissing appeal as moot). This viewpoint supported a finding of a tender offer in *Loew's Corp. v. Accident & Casualty Ins. Co.*, Civ. No. 74-C-1396 (N.D. Ill. July 11, 1974) (bench opinion), discussed in 1 M. LIPTON & E. STEINBERGER, *TAKEOVERS AND FREEZEOUTS* § 2.3.1.6, at 121 (1978) and in Lipton, *Open Market Purchases*, 32 BUS. LAW. 1321, 1323 (1977), in which the purchaser bought substantial amounts of target company shares in the open market and in privately negotiated purchases with the publicly announced intention of defeating a competing tender offer. "The court—applying the 'shareholder impact' test—held that such open market purchases coupled with the publicized intention to acquire a specified percentage of the target company's shares" to prevent third persons from acquiring control "constituted a 'tender offer,'" although the court enjoined only future block and private purchases. 1 M. LIPTON & E. STEINBERGER, *supra*, § 2.3.1.6.

⁸⁶ Lipton, Book Review, 72 MICH. L. REV. 358, 367 (1973) (citation omitted).

premiums.⁸⁷

The Commission has recognized the ambiguity of its eight-factor test and has proposed both a statutory⁸⁸ and a rulemaking⁸⁹ solution to the problems created by the lack of a workable definition. The rulemaking proposal would have defined a tender offer to be any purchase within forty-five days of ten percent or more of an outstanding class of securities from ten or more sellers.⁹⁰ Under that proposal, however, a purchaser would still be able to purchase more than ten percent of a corporation's shares and avoid tender offer regulation by either slowing down the rate of purchase or limiting the number of sellers.

The statutory proposal dispensed with the idea of a definition.

⁸⁷ See HOUSE REPORT, *supra* note 3, at 3, reprinted in 1968 U.S. CODE CONG. & AD. NEWS at 2813.

⁸⁸ In 1980, the Commission recommended the adoption of the Tender Offer Improvements Act of 1980, a bill governing the conduct of tender offers and other acquisition programs. This bill, which was introduced in the Senate, S. 3188, 96th Cong., 2d Sess., 126 CONG. REC. 14,059 (1980), proposed to define the term "statutory offer" to mean all offers to acquire the beneficial ownership of equity securities of a public issuer by a person who is, or could thereby become, the beneficial owner of more than 10% of the class. See SECURITIES & EXCHANGE COMM., REPORT ON TENDER OFFER LAWS (1980) (printed for the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess.). The proposed statute made it unlawful for any person to conduct a "statutory offer" unless that person in essence made a tender offer, that is, undertook certain specified filing and disclosure obligations and provided specific substantive protections (i.e., withdrawal, proration, and best price protections) for shareholders. Exceptions to the definition were made for: (1) offers pursuant to a statutory merger or acquisition; (2) the solicitation of voting proxies; (3) acquisitions of two percent per year; (4) acquisitions from the issuer, and (5) acquisitions from no more than 10 persons in any 12 months pursuant to privately negotiated transactions. See generally Fogelson, Wenig & Friedman, *Changing the Takeover Game: The Securities and Exchange Commission's Proposed Amendments to the Williams Act*, 17 HARV. J. ON LEGIS. 409 (1980).

⁸⁹ In 1979 the Commission proposed to define the term tender offer in order "to provide guidance to members of the financial community and their advisors." Securities and Exchange Act Release No. 34-16,384, 44 Fed. Reg. 70,326 (1979). The Commission's proposed rule would have set forth a two-part definition of the term tender offer. An offer falling into either part would meet the definition.

Under the first part, an acquisition is a tender offer if the following four conditions are met: (1) there are one or more offers to purchase, or solicitations of offers to sell, securities of a single class (2) during any 45-day period (3) directed to more than 10 persons and (4) seeking the acquisition of more than five percent of the class of securities. *Id.* at 70,330.

Under the second part, one or more offers to purchase, or solicitations of offers to sell, securities of a single class would constitute a tender offer if three conditions are present. First, the offers to sell must be widely disseminated. Second, the price offered must represent a premium that is in excess of either five percent of the current market price of the securities being sought or two dollars above that price, whichever is greater. Third, the offers do not provide for a meaningful opportunity to negotiate the price and terms. Thus, truly negotiated purchases of securities would not be regulated as a tender offer under the second tier. *Id.* at 70,350-51.

⁹⁰ This is the first part of the definition outlined *supra* note 89.

Based upon prior state statutes⁹¹ it would have required, with certain exceptions, any acquisition resulting in ownership of more than ten percent of an outstanding class of securities to be conducted with the basic safeguards of a conventional tender offer: a bid to all shareholders with proration and withdrawal rights.⁹² That proposal would not have allowed a purchaser to modify the structure of its acquisition to avoid regulation once there was a purchase of the minimum quantity of shares.⁹³

2. The Adequacy of Requirements for Open Market and Privately Negotiated Purchases

Congress adopted section 13(d) of the Exchange Act in 1968 to give shareholders and the market notice of the identity and intentions of large shareholders in situations involving potential change of corporate control.⁹⁴ Whether section 13(d) is actually effective in achieving this purpose is questionable for several reasons.

First, section 13(d) only requires purchasers to make the necessary disclosures no later than ten days after the acquisition of five percent of a class of registered equity securities.⁹⁵ During the ten-day disclosure lag, acquisitions in the open market, or in privately negotiated purchases, of substantial amounts of securities (in excess of the original five percent) may be, and commonly are, made without immediate public notification.⁹⁶ The Commission itself has noted that this ten-day disclosure gap may "deprive security holders of a fair opportunity to adjust their evaluation of the securities of a company with respect to potential change in control of that company."⁹⁷

Second, section 13(d) does not produce meaningful disclosure of the purchaser's intentions regarding control of the corporation. Although the necessary disclosure documents call for information about

⁹¹ See *infra* notes 180-82 and accompanying text. There is a certain irony in this SEC proposal, given the fact that these earlier state statutes were challenged by the SEC as unconstitutional. See, e.g., Brief for SEC (*amicus curiae*), *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

⁹² See proposed Tender Offer Improvements Act of 1980 § 13(3)(3)(A), *reprinted in* 542 SEC. REG. & L. REP. (BNA) Spec. Supp. 21-22 (Feb. 27, 1980).

⁹³ See *id.*

⁹⁴ See HOUSE REPORT, *supra* note 3, at 5, *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS at 2814.

⁹⁵ See Securities Exchange Act of 1934 § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1982).

⁹⁶ See SEC Memorandum Proposing Amendments to the Williams Act [hereinafter cited as SEC Amendments], *reprinted in* Legislative Proposals on Tender Offers, Beneficial Ownership, Issuer Repurchasers, 542 SEC. REG. & L. REP. (BNA) Spec. Supp. 11, 18 (Feb. 27, 1980).

⁹⁷ *Id.* at 12, 14.

plans to acquire more securities and plans regarding the composition of the board of directors,⁹⁸ the actual information disclosed is not helpful. Typically, the disclosure which results is a model of obfuscation, rather than clarity, in part because large purchasers tend to copy the content of their predecessors' disclosure, especially when it has withstood a litigation attack. Many filers simply assert that the securities have been acquired for "investment" (though not necessarily "passive investment") and describe a variety of investment strategies ranging from simply holding the securities for an indefinite term to cashing in on the "investment" by mounting a proxy fight and threatening to liquidate the company if successful.⁹⁹ Thus, there is a great deal of disclosure about options, but little about probabilities, and management and shareholders are left with little information on which to base their important financial decisions. Enforcement of the disclosure requirements under Schedule 13D has not been able to change this result.

Third, private enforcement of claims based on inadequate disclosure in a section 13(d) filing has been hampered by the reluctance of courts to recognize a private right of action on the part of the issuer (which, as a surrogate for all shareholders, logically should have a right of action).¹⁰⁰ Although the Commission has recently urged a contrary result in a series of *amicus curiae* briefs,¹⁰¹ the courts remain divided on the existence of the private right of action. The federal appellate cases deciding the issue have held that an implied right of action for equitable relief exists in favor of an issuer under that section.¹⁰² The district court decisions considering the issue, many of which were decided after recent Supreme Court cases expressing a restrictive view on the judicial implications of implied rights of action,¹⁰³ are more evenly

⁹⁸ Item 4 of Schedule 13D requires an owner of five percent or more of a class of outstanding equity securities to disclose his "plans or proposals" which would result in "[t]he acquisition . . . or the disposition of [additional] securities of the issuer," as well as "[a]ny change in the present board of directors or management of the issuer." Special Instructions for Complying with Schedule 13D, Item 4, 17 C.F.R. § 240.13d-101, Item 4 (1983). See also Block & Rudoff, *Schedule 13D Problems Associated With Large Accumulations of Stock*, 10 SEC. REG. L.J. 3, 15, 18 (1982). To the extent the open market purchaser can cloud these intentions in obscurity, management and shareholders are unable to make accurate assessments of probable outcomes.

⁹⁹ See, e.g., *Transcon Lines, Inc. v. A.G. Becker, Inc.*, 470 F. Supp. 356, 376-79 (S.D.N.Y. 1979).

¹⁰⁰ See *infra* notes 102-04 and accompanying text.

¹⁰¹ See SEC Amendments, *supra* note 96, at 19-20 & § 8, reprinted in 542 SEC. REG. & L. REP. (BNA) Spec. Supp. 12, at 23 (Feb. 27, 1980).

¹⁰² See, e.g., *Indiana Nat'l Corp. v. Rich*, 712 F.2d 1180, 1184 (7th Cir. 1983); *Dan River, Inc. v. Unitex Ltd.*, 624 F.2d 1216, 1222-24 (4th Cir. 1980), *cert. denied*, 449 U.S. 1101 (1981).

¹⁰³ See, e.g., *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19-24 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568-78 (1979).

divided.¹⁰⁴

A lack of effective remedies further hamstrings private enforcement of section 13(d). The usual remedy—corrective disclosure—does nothing to repair the damage to market integrity that occurred when the misleading or incomplete section 13(d) disclosures were made. Corrective disclosure allows a bidder to keep the gains of what might have been a bargain purchase. Some courts have, however, been willing to go beyond corrective disclosure. In *General Steel Industries, Inc. v. Walco National Corp.*,¹⁰⁵ for example, the court, as a remedy for inadequate section 13(d) disclosures, required divestiture of the shares purchased during the time that the misleading Schedule 13D disclosures were alive in the marketplace. Such a result, although becoming more frequent,¹⁰⁶ is still relatively uncommon.

Finally, the adequacy of section 13(d) may be challenged because it does not impose stricter requirements on purchases made in competition with a tender offer. That failure leads to the significant policy

¹⁰⁴ The following cases uphold an implied private right of action: *Jacobs v. Pabst Brewing Co.*, 549 F. Supp. 1050, 1054-62 (D. Del. 1982); *Hanna Mining Co. v. Norcen Energy Resources Ltd.*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,878, at 94,584-88 (N.D. Ohio June 11, 1982), *appeal dismissed per stipulation*, No. 82-3336 (6th Cir. July 8, 1982); *Mid-Continent Bancshares, Inc. v. O'Brien*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,734, at 93,706-07 (E.D. Mo. Dec. 11, 1981); *Spencer Cos. v. Agency Rent-A-Car, Inc.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,301, at 91,894-95 (D. Mass. Sept. 21, 1981); *Ludlow Corp. v. Tyco Laboratories, Inc.*, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,382, at 92,302 (D. Mass. July 2, 1981); *Saunders Leasing Sys., Inc. v. Societe Holding Grey D'Albion, S.A.*, 507 F. Supp. 627, 632-33 (N.D. Ala. 1981); *Kaufman and Broad, Inc. v. Belzberg*, 522 F. Supp. 35, 41 (S.D.N.Y. 1981); *Kirsch Co. v. Bliss & Laughlin Indus., Inc.*, 495 F. Supp. 488, 490-92 (W.D. Mich. 1980); *W.A. Krueger Co. v. Kirkpatrick, Pettis, Smith, Polian, Inc.*, 466 F. Supp. 800, 802-03 (D. Neb. 1979).

The following cases concluded that no private right of action exists: *Equity Oil Co. v. Consolidated Oil & Gas Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,425, at 96,434-38 (D. Utah June 24, 1983); *Leff v. CIP Corp.*, 540 F. Supp. 857, 863-65 (S.D. Ohio 1982); *First Ala. Bancshares, Inc. v. Lowder*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,015 (N.D. Ala. May 1, 1981); *American Bakeries Co. v. Pro-Met Trading Co.*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,925 (N.D. Ill. Mar. 27, 1981); *Gateway Indus., Inc. v. Agency Rent-A-Car, Inc.*, 495 F. Supp. 92 (N.D. Ill. 1980); *Sta-Rite Indus., Inc. v. Nortek, Inc.*, 494 F. Supp. 358 (E.D. Wis. 1980).

¹⁰⁵ [1981-1982 Transfer Binder] FED. SEC. L. REP. ¶ 98,402 (E.D. Mo. Nov. 24, 1978).

¹⁰⁶ See, e.g., *Hanna Mining Co. v. Norcen Energy Resources Ltd.*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,878 (N.D. Ohio June 11, 1982) (court preliminarily enjoined tender offer because of false Schedule 13D disclosures of "investment intentions" and indicated that divestiture of purchases might be appropriate final remedy); *Financial Gen. Bankshares v. Lance*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,798 (D.D.C. Mar. 9, 1979) (rescission ordered as remedy for § 13(d) violations).

concerns already discussed.¹⁰⁷

C. SEC Advisory Committee Recommendations

The SEC Advisory Committee made several recommendations intended to redefine in clearer terms the scope of tender offer regulation and to improve the regulation of purchases under section 13(d).

1. The Scope of Tender Offer Regulations

The Committee's most important proposal was to require that any acquisition of stock which would give the acquiror ownership of more than twenty percent of a class of equity securities be done by means of a tender offer made to all shareholders.¹⁰⁸ Purchases from the issuer would be expressly exempt from that requirement.¹⁰⁹ The Committee showed that it was aware of the desirability of allowing sellers to dispose freely of large holdings in privately negotiated transactions by recommending that the SEC retain broad authority to grant exemptions.¹¹⁰ The Committee premised its proposal on the desirability of control premium sharing.¹¹¹

The Advisory Committee's proposal also assumes that a bidder does not have control when he buys less than twenty percent of the shares but that control will be gained when that threshold is crossed. The incremental shares which give a purchaser control may involve payment of a control premium which should be shared among all those willing to sell the incremental shares. The recommended control threshold results from a compromise and merits extended empirical inquiry. The Committee report states that there was "strong disagreement" as to what ownership level carried with it effective control.¹¹² The final recommendations that ownership of twenty percent or more of a class of equity securities triggers the tender offer requirement was adopted because a majority of Committee members found that level to be "appropriate."¹¹³ The report, however, does not indicate why twenty percent is the proper level.

¹⁰⁷ See *supra* notes 43-48 and accompanying text.

¹⁰⁸ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 23 (Recommendation 14). This recommendation closely parallels the SEC's recommendation to Congress in 1980, except that the SEC favored a 10% threshold. See *supra* note 88.

¹⁰⁹ ADVISORY COMMITTEE REPORT, *supra* note 32, at 23 (Recommendation 14).

¹¹⁰ *Id.*

¹¹¹ See *id.* at 22-23.

¹¹² *Id.* at 23.

¹¹³ *Id.* In fact, the Committee suggested that there was some support for either a 10% or 15% level. *Id.*

A systematic study examining the relationship between various levels of ownership and the attributes of control that attach to them would have been preferable to the Advisory Committee's determination of the appropriate threshold level by majority vote of its members. It is clear that there is no uniform percentage at which control of any corporation can be said to exist. Smaller amounts of ownership are likely to have more "pull" in giant corporations where shares are widely dispersed than in smaller companies where there may already be significant concentration in the hands of management or family holders. Before new statutory or regulatory requirements are established, there should be more rigorous analysis of what level of ownership could constitute control. For example, capitalization may be a more important factor in determining control. Control could also depend upon the percentage of shares held by nonaffiliates: the more shares held by nonaffiliates, the more likely it is that a low percentage would constitute control.

The second question is what is accomplished by this proposal. If the threshold is set at any significant percentage, the bidder will simply buy just less than the threshold amount of stock in the open market. The price of those shares may not reflect the value associated with control of a corporation because the market will usually have inadequate information.¹¹⁴ To then cross the threshold, the bidder would only have to offer to buy any additional shares from all shareholders at a price at or near market value. The Committee proposal assumes that to acquire control, a bidder will always have to offer a premium, but a bidder, in fact, is never compelled to pay that premium, nor is it compelled to purchase the shares of the other minority shareholders once control shifts. Even if the bidder finds that it must offer a premium, it will only have to pay the premium for those incremental shares necessary to achieve control. A bidder does not have to share the premium with the earlier sellers, or offer other than market price for the minority shares that remain outstanding.

In reality, the Committee's proposed remedy, because of its high threshold, seems to ensure only that if the bidder wants to increase its stake beyond a certain level, everyone should have the right to participate, and assumes that such a right (which may involve receipt of a portion of the control premium, depending on when the sale is made) will compensate shareholders for the abuse that may result from the exercise of control with less than 100% ownership. That result is certainly ironic. An approach initially developed by the states to slow

¹¹⁴ See *supra* text accompanying note 99.

down aggressive bidders¹¹⁵ is being espoused as a "fairness" measure. Yet it seems a halfway house, endorsing partial bids and exercise of control through minority ownership without at the same time codifying at the federal level the obligations of fair dealing which should be incumbent on the bidder once it achieves control.

Finally, while the adoption of the Committee's approach would largely obviate the need for a definition of the term "tender offer," the current problems associated with aggressive open market purchase programs will in all likelihood continue if the recommended twenty percent threshold is selected. For example, it is likely that an aggressive purchase program that succeeded in securing slightly less than twenty percent of a target company's shares would remain an unfair competitive threat to a conventional partial tender offer being conducted in accordance with the Commission's tender offer rules. In this respect, the ten percent threshold, originally proposed by the Commission in 1980, would be preferable.¹¹⁶ In fact, a better solution might be to prohibit all purchases of five percent or more except by tender offer once another tender offer has commenced, and then allow "piggybacking" of the competing tender offer time periods. In testimony before the House Subcommittee on Telecommunications, Consumer Protection and Finance on March 28, 1984, the SEC stated that it has "serious reservations about this recommendation. Further study of the economic implications is warranted."¹¹⁷

2. The Adequacy of Requirements for Open Market and Privately Negotiated Purchases

The most important Advisory Committee recommendation in this area was to decrease the incentives for open market purchases by removing the ten-day disclosure lag in section 13(d) that allows an acquiror to purchase large blocks of a company's stock before making any disclosure.¹¹⁸ To provide shareholders with adequate notice of an acquiror's plans for the target, the Advisory Committee suggested that section 13(d) be amended to require the acquiror to file its disclosure statement two days before purchasing the stock that would give the

¹¹⁵ See *supra* note 91.

¹¹⁶ See *supra* note 88 and text accompanying notes 91-92.

¹¹⁷ Statement of John R.S. Shad, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications, Consumer Protection, and Finance 14 (March 28, 1984) (copy on file with *The University of Pennsylvania Law Review*) [hereinafter cited as Shad Statement].

¹¹⁸ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 22.

purchaser more than five percent ownership of the corporation.¹¹⁹

The Advisory Committee did not recommend any changes in the content of disclosure under section 13(d) nor did it deal with the issue of what constitutes a "material change" for purposes of requiring an acquiror to amend his 13(d) statement. Indeed, the Committee report does not contain any discussion regarding the adequacy or quality of current disclosure under section 13(d), an area in which real problems exist. Moreover, it is silent on the question of who has standing to enforce the rules, a question which also needs to be addressed.¹²⁰

The Committee made only one other proposal about how current regulation of large open market purchases should be improved. It suggested strengthening the definition of "group" for purposes of section 13(d).¹²¹ The Committee expressed concern that the section's provisions were being evaded due to the dilution of the concept of a "group,"¹²² and suggested that the definition should ensure regulation of concerted acquisition activity.¹²³ Unfortunately, no concrete suggestions were made with respect to this almost insoluble problem.

In its House testimony, the SEC endorsed closing the ten-day window period. However, it opposed a pre-acquisition filing requirement "because of its effect on the transferability of blocks of stock." The Commission proposed instead a requirement of "immediate public announcement, next day filing of the Schedule 13-D and/or a standstill until filing."¹²⁴

D. Authors' Recommendations

1. The Scope of Tender Offer Regulation

Since the enactment of the Williams Act, changes in the marketplace have raised questions about whether tender offer regulation

¹¹⁹ *Id.* (Recommendation 13). This is another example of the Advisory Committee adopting the substance of a previous SEC proposal. In 1980, the SEC recommended the following three amendments to the section 13(d) filing requirements: (1) persons crossing the five percent ownership threshold would be required to make a prompt public announcement (not later than one business day following the purchase which raises the level of ownership in excess of five percent); (2) the filing period would be reduced from ten days to five business days, or one calendar week, and (3) persons who become obligated to file a statement would be precluded from purchasing any additional stock before the necessary filing was made and until a short time thereafter. See SEC Amendments, *supra* note 96, §§ 3, 4, reprinted in 542 SEC. REG. & L. REP. (BNA) Spec. Supp. 20 (Feb. 27, 1980).

¹²⁰ See *supra* notes 98-104 and accompanying text.

¹²¹ ADVISORY COMMITTEE REPORT, *supra* note 32, at 24 (Recommendation 15).

¹²² *Id.* at 23.

¹²³ See *id.* at 24 (Recommendation 15).

¹²⁴ Shad Statement, *supra* note 117, at 14.

should do more than protect shareholders from high-pressure buying programs. As discussed above, policy concerns such as (1) fair competition in the marketplace for corporate control, (2) the need for certainty as to the scope of regulation, (3) the maintenance of fair and orderly markets for securities, and (4) the desirability of sharing control premiums indicate that a wider range of transactions than was envisioned in 1968 should be conducted as tender offers.

The correct reform of regulation requires Congress to determine the relative importance of those various interests, particularly in light of the competing economic efficiency argument.¹²⁵ At a minimum, however, the present structure, given the absence of a definition of tender offer, must be changed because it creates considerable uncertainty in the planning of transactions and needless possibilities for litigation. In addition, it permits control to be bought in faceless transactions on the open market without effective disclosure of the identity and purposes of the purchaser.

Of the two feasible regulatory responses to this problem, the qualitative approach, typified by the SEC's eight-factor test proposed in 1979,¹²⁶ seems less desirable because it leads to difficult, unpredictable determinations about the nature of an already completed transaction that has been carefully structured to avoid regulation. The better approach, which is also the approach adopted by the Committee and generally recommended by the authors, is to require any transaction resulting in the acquisition of a certain percentage of a class of equity securities to be pursued only by means of a tender offer made to all shareholders. That obviates the need for a definition and eliminates, at least in the large majority of cases, the open market purchase as an option for securing control of a publicly held company.¹²⁷

This approach provides bright-line certainty, discloses to investors information that is significant for planning their investments, and allows control premiums to be distributed among all shareholders.

¹²⁵ Expanding the scope of tender offer regulation will likely diminish the use of the open market purchase program as a technique for acquiring control or influencing corporate affairs, which may in turn insulate incumbent management from the pressure of such programs. This result is not necessarily harmful, for would-be acquirors can still bid for control by making a tender offer. Moreover, any resulting advantage to incumbent management might be offset by new restrictions on defensive strategies.

¹²⁶ See *supra* notes 79-80 and accompanying text.

¹²⁷ If the quantitative definition uses as its only measure a percentage of securities acquired, then it is indistinguishable from the second threshold approach; to the extent it adds measures such as numbers of persons from whom purchases are made or a period of time during which the purchases must occur, a buyer can easily control whether or not it makes a tender offer. An example of a quantitative approach looking to several factors is the SEC's rulemaking proposal, discussed *supra* notes 89-90 and accompanying text.

Clearly, the economic costs of adopting this type of proposal should be assessed before action is taken.¹²⁸ We have already argued that an assessment also must be undertaken of the level of ownership that should determine when tender offer regulations apply.¹²⁹

A difficult problem in implementing this proposal will be developing the contours of the exemptions for privately negotiated transactions involving control groups or family members to ensure that such persons or groups are not blocked in their ability to sell their positions. Also, it is not clear that implementing this approach would actually result in regulating all large open market purchase programs as tender offers. Rather, it might result in attempts at exercising control earlier through proxy contests.

Finally, this approach needs to be augmented by restrictions on buying programs conducted amid a conventional offer even if the program would not otherwise be subject to the tender offer rules. The open market purchaser's unreasonable competitive advantage in such situations should not be allowed to undermine the tender offer even if the purchase is far less than the threshold amount of shares.¹³⁰

2. The Adequacy of Requirements for Open Market and Privately Negotiated Purchases

The most important reform that Congress can make in this area is to eliminate the ten-day disclosure lag in section 13(d) which delays disclosure of information regarding the identity of those who have acquired more than five percent of the outstanding common stock of a publicly held company and allows purchasers to buy stock in an under-informed market. We support the Advisory Committee's recommendation in this area¹³¹ because it requires advance notification of the closing of the purchase, allowing the market to adjust more quickly to the news. Although the SEC opposed advance notice because of a concern about block trading, it presented no evidence in its House testimony

¹²⁸ See Wall St. J., Aug. 21, 1983, at 10 (remarks of William Baxter, Assistant Attorney General). This approach may make bids more costly or deter bidders from trying to wrest control from management by designing a purchase program that would not run afoul of any definition. In any event, these economic costs seem far lower than those resulting from a flat prohibition on partial bids or a requirement that a purchaser, upon crossing a control threshold, must make a bid for all remaining shares.

¹²⁹ See *supra* text following note 113.

¹³⁰ This approach is an integral part of the regulation of partial bids. If partial bids continue to be allowed, and if control premium sharing is desirable, then it will be important to set the threshold level low enough to result in sharing and to oversee at the federal level the fiduciary obligations of the bidder. See *infra* notes 133-226 and accompanying text.

¹³¹ See *supra* note 119 and accompanying text.

that ordinary block trading would in fact be hampered. The number of block trades equal to five percent of an issuer's outstanding shares may be negligible. If a block is to be executed to carry one over five percent, advance notice should be given.

To the extent that acquisitions of more than the prescribed threshold must be conducted as a tender offer, pressure on the section 13(d) disclosure system will be reduced. It continues to be important, however, to ensure truthful disclosure for purchases that surpass the five percent threshold of section 13(d) but do not cross the threshold that triggers tender offer regulation. Thus, we recommend that Congress set forth an express right of action in section 13(d) for target companies and make clear that the remedy for nondisclosure is not limited to filing corrections, but may include other sanctions, including forced disposition in egregious cases.¹³²

II. PARTIAL TENDER OFFERS AND TWO-TIER PRICING

The Williams Act does not distinguish between full and partial tender offers. Yet partial tender offers raise special policy concerns.¹³³ In a partial bid, the bidder acquires control of 100% of a target's assets if it acquires fifty-one percent of the target's shares. The bidder may have a questionable reputation or may be unfamiliar with the issuer's business. The presence of a new majority shareholder may discourage potential purchasers of the shares that continue to be held by minority shareholders. These factors, together with the fact that the bidder has no obligation to take out the remaining minority, may pressure shareholders to tender in the partial bid, especially if a premium above market is offered. Moreover, once the bidder has control, it may adopt unpopular policies, or worse, attempt to overreach and run the corporation primarily for its own benefit, rather than for the benefit of all shareholders. The only restraint on the bidder in this situation—derivative litigation by minority shareholders—is so fraught with costs and uncertainties that its deterrent effect is questionable.¹³⁴

¹³² Even if this recommendation is not adopted, courts should continue to be forceful in remedying cases of inadequate disclosure. For examples of such judicial remedies, see *supra* notes 105-06 and accompanying text.

¹³³ See generally Comment, *Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique*, 131 U. PA. L. REV. 389 (1982).

¹³⁴ In addition to his own litigation costs, a shareholder may also be required under some state statutes to pay an amount as security for the defendants' expenses. See A. FREY, J. CHOPER, N. LEECH & C. MORRIS, *CASES AND MATERIALS ON CORPORATIONS* 702-04 (2d ed. 1977). While there are methods to circumvent these state laws, see *id.* at 705-06, other commentators have noted that shareholder derivative suits are

A recent refinement of the partial tender offer is its use as the first step in a two-step acquisition program having the ultimate objective of gaining 100% ownership of the target.¹³⁵ The second step is commonly a merger involving the issuance of securities or the payment of cash in exchange for the shares not purchased in the first step partial tender offer. Bidders using this two-step acquisition strategy commonly offer more consideration in the first-step tender offer than in the second-step merger. For example, rather than pay all shareholders the average price of fifty dollars in a one-step merger, the bidder may buy fifty percent of the shares in a partial tender for sixty dollars and then pay only forty dollars for each share in the merger. A key objective of this pricing structure is to induce a "stampede" of tendering shareholders who face the difficult decision of tendering or risking the loss of the high front-end price. Unless every shareholder tenders in the first step, some will receive a lower average price per share, even though the bidder has paid the same total amount. Those who receive the lower average price per share have therefore subsidized certain of their fellow shareholders. Thus, such front-end loaded transactions give the bidder certain tactical advantages, and may result in the unfair coercion of shareholders.¹³⁶

A. Regulatory Considerations

An appropriate regulatory response to the use of partial bids and two-tier tender offers can only be framed after several issues are considered.

1. The "Fairness" of Partial Bids

On an intuitive level, there seems to be something fundamentally

now facing a new threat from the courts. In recent cases, the courts have extended the business judgment rule and permitted special litigation committees, comprised of supposedly "disinterested" directors of the corporation, to terminate the derivative suit if, in their business judgment, the suit is not in the corporation's best interests. See Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959. See generally H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 749-813 (2d ed. 1970) (discusses origins, prerequisites, and costs of shareholder derivative suits).

¹³⁵ See, e.g., Lederman & Vlahakis, *Pricing and Proration in Tender Offers*, 14 REV. OF SEC. REG. 813, 817-818 (1981); Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485 (1982). An increase in the number of partial offers followed by second step mergers was noted as early as 1974. See Brudney & Chirelstein, *supra* note 4, at 330.

¹³⁶ See *infra* notes 140-48 and accompanying text.

unfair about a legal system that allows a buyer to acquire control of all of the assets of a corporation by acquiring less than all of the corporation's stock. Any such control opportunity, however, can arguably be justified as simply the result of the "one-share, one-vote" principle of corporate governance. That the majority shareholder has more votes, and hence more control, than other shareholders, is the result of a superior financial commitment to the enterprise, not of overreaching or fraud. Viewed in this light, the control opportunity reflects corporate democracy in action, rather than unfairness requiring legal correction. The minority, it may be argued, suffers no more harm when one shareholder, by virtue of his ownership of fifty-one percent of the stock, exercises control than when several minority shareholders join together, through the proxy process, to exercise control of the corporation. Thus, a partial offer, although offering a clear control opportunity to the bidder, inflicts no corresponding injury on the minority. This analysis would suggest that shareholders should not reasonably expect any special protection against partial bids because the possibility that a single shareholder could amass and exercise a control position is apparent when stock is purchased.

2. Overreaching and Looting

Partial bids also force minority shareholders to accept the risk that the bidder, after taking control, will adopt policies that are unpopular with the minority, or worse, will loot the corporation. Disclosure of the bidder's reputation and past business practices may fuel those concerns in a particular transaction.

The principles of fair dealing and loyalty applicable to officers, directors, and controlling shareholders mitigate such concerns. Such persons owe other shareholders a fiduciary obligation not to use their control position to loot the corporation or otherwise injure the minority.¹³⁷ That obligation, coupled with the role of shareholder derivative actions, may deter overreaching, although it is difficult to maintain that a system that relies heavily on litigation affords sufficient protection for all minority shareholders.¹³⁸ We believe that the "looting" concern should not be dismissed, but should inform the regulatory response to partial bids.¹³⁹

¹³⁷ See, e.g., *Clagett v. Hutchison*, 583 F.2d 1259, 1263 (4th Cir. 1978) (Maryland law); *Perlman v. Feldmann*, 219 F.2d 173, 175-76 (2d Cir.) (Illinois law), *cert. denied*, 349 U.S. 952 (1955). See also *infra* note 183.

¹³⁸ The effectiveness of shareholder derivative actions is being seriously questioned. See *supra* note 134.

¹³⁹ In fact, concern about overreaching and looting forms a key basis for our rec-

3. Shareholder "Coercion" in Two-Tier and Partial Tender Offers

Any offer to purchase stock that involves payment of a premium over the market price results in pressure on shareholders to tender their shares. Indeed, the district court in *Radol v. Thomas*¹⁴⁰ recognized that "any tender offer is likely to be coercive to some degree" and that such coercion is "inherent" in the tender offer process.¹⁴¹

The use of two-tier and partial tender offers, however, may result in such heightened pressure on shareholders that they will sell their interests before evaluation of the merits of the sale. As outlined above, by paying a significantly higher cash price per share in the first-step, partial tender offer than in the second-step merger, bidders may pressure shareholders to tender hastily or risk forever losing the higher "front-end" price.¹⁴² Such two-tier deals, although rare in the 1960's, are increasingly common, precisely because shareholders and tender offer professionals *perceive* that two-tier pricing applies heightened pressure that leads to successful acquisitions.¹⁴³

Professors Brudney and Chirelstein have described this coercive or "whipsaw" effect in the context of a fully disclosed two-step acquisition by company *P* of a target company *S*:

Given the inability of *S*'s dispersed stockholders to communicate with one another during the tender offer, the act of offering a higher price on tender than would be paid on merger would have a 'whipsaw' effect on *S*'s stockholders. Individual stockholders would find it difficult or impossible to refuse a tender price of \$40 when they are also made aware that if the tender succeeds, the remaining shares will be merged out at \$30. In effect, an announced disparity between the tender and the merger figure would deprive *S*'s stockholders of their ability to make an unforced, independent judgment on whether an average of \$35 per share is an acceptable overall price for the assets of the firm. Hence, al-

ommendation in Part IV that directors have relatively wide discretion in resisting partial bids. See *infra* text following note 400.

¹⁴⁰ 534 F. Supp. 1302 (S.D. Ohio 1982). *Radol* held that a two-tier pricing structure, despite its undeniable "coercive" quality, did not constitute a "fraudulent, deceptive or manipulative" act or practice in violation of § 14(e) of the Exchange Act, 15 U.S.C. § 78n(e) (1982). See *infra* notes 175-77 and accompanying text.

¹⁴¹ *Id.* at 1312.

¹⁴² See *supra* notes 135-36 and accompanying text.

¹⁴³ See, e.g., Grienberger & Walter, *Recent Developments in Takeover Techniques: The Front-End Loaded Offer & The Pac-Man Defense*, in SEC '83 (1982); Fleischer, *Sun Shines on Bidders in Corporate Takeover World*, *Legal Times of Wash.*, Jan. 25, 1982, at 19, col. 4.

though the presence of a concealed disparity must be regarded as unfair, the presence of an announced differential is plainly coercive.¹⁴⁴

Deliberate obscurity in the disclosure of the details of the second-step merger intensifies that coercive effect. Obscurity will create serious questions in shareholders' minds regarding the value and form (cash or stock) of consideration to be offered in the second step and the date on which such consideration will be received. The coercion results from the potentially unequal treatment of shareholders in what is in essence a "unitary" transaction—treatment which would not be permitted if the transaction were structured as a one-step merger under state law in which cash and stock were issued.¹⁴⁵

To remedy that, Professors Brudney and Chirelstein recommend that the price paid in the second-step merger be required to be equivalent to that paid in the initial tender.¹⁴⁶ This rule is a conceptual analogue to the British approach to partial offers and buyout requirements.¹⁴⁷ The result would be that target shareholders could hold back

¹⁴⁴ Brudney & Chirelstein, *supra* note 6, at 337.

¹⁴⁵ In this respect, the federal regulatory scheme, by permitting two-tier strategies, renders impotent state regulation mandating equal treatment of all shareholders upon management approval of the merger transaction. See, e.g., COLO. REV. STAT. § 11-51.5-103 (Supp. 1983); *infra* notes 180-82 and accompanying text.

Furthermore, tender-offer disclosures of second-step mergers involving the issuance of securities tend to be quite limited, and usually do not go beyond a technical description of the plan of merger and the securities to be offered. Bidders generally do not include detailed historical information, pro forma combined financial information, or estimates of likely market values for second-step mergers. See *Prudent Real Estate Trust v. Johncamp Realty, Inc.*, 599 F.2d 1140 (2d Cir. 1979); *Corenco Corp. v. Schiavone & Sons, Inc.*, 362 F. Supp. 939, 948-50 (S.D.N.Y.), *aff'd*, 488 F.2d 207 (2d Cir. 1973).

¹⁴⁶ See Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1361-62 (1978).

¹⁴⁷ The City Code on Takeovers and Mergers, which governs takeovers in the United Kingdom, bars the owner of a control block of shares (presumed to be 30%) from exercising control over all of the assets without first offering to buy out the remaining shareholders at the highest price at which any of the shares were purchased. COUNCIL FOR THE SECURITIES INDUSTRY, *THE CITY CODE ON TAKE-OVERS AND MERGERS* 33 (1981) (General Principle 34) [hereinafter cited as CITY CODE]. The Code is not law in the United Kingdom; it is a voluntary system of self-regulation that provides rules of professional conduct that those in the securities market are expected to follow. Its provisions are administered and enforced by the Panel on Take-Overs and Mergers. See Prentice, *Take-Over Bids—The City Code on Take-Overs and Mergers*, 18 MCGILL L.J. 385, 386-87 (1972).

The Code prohibits the commencement of partial bids without the prior approval of the Board on Take-Overs and Mergers and requires that the offer be conditioned on the approval of shareholders holding at least 50% of the outstanding shares. CITY CODE, *supra* (Rule 27). The Board is inclined to consent to partial bids seeking less than 30% of the outstanding stock but not to consent to partial bids seeking more than 30%. *Id.* The original basis for this position was the view that "a shareholder should

but still receive the same value per share.¹⁴⁸

It must be recognized that it is not only the two-tier offer which confronts the shareholder with substantial pressure to tender quickly. In fact, the coercive effect of an offer in which the consideration paid in the second-step merger is greater than the historical market price of the company's securities should actually be less than the coercive effect of a straight partial offer not followed by a merger. In the case of the partial offer, the market price of the target company's securities predictably tumbles to pre-offer levels after expiration of the offer and the remaining shareholders' only options are either to hold minority stock or to sell at pre-offer prices. The two-tier strategy at least gives any such remaining shareholders an opportunity to sell their shares in the second-step merger at prices better than those available in the market.

Commentators have hardly been unanimous in their criticism of the increased pressure on shareholders that certain types of tender offers present. Professors Easterbrook and Fischel, for example, dismiss the argument that such coercion is improper in two-tier offers by noting that "[w]hat Brudney and Chirelstein describe as 'deception' and 'whipsaw' . . . is actually nothing more than compensation offered to those who facilitate the movement of control at some risk."¹⁴⁹ This risk-compensation analysis could also be applied to the coercion that occurs in the partial tender offer context.¹⁵⁰

Although risk compensation may often describe the nature of the premium offered to shareholders in a two-tier offer, it is important to remember, as Brudney and Chirelstein note,¹⁵¹ that the premium offered will discourage and may preclude the shareholders' objective consideration of the total offer. This balanced consideration by shareholders was, of course, the primary result of the Williams Act.¹⁵²

not be left locked into a company in a minority position without his consent." PANEL ON TAKE-OVERS AND MERGERS, REPORT TO THE COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS 39 (1978), quoted in DeMott, *Current Issues in Tender Offer Regulation: Lessons From the British*, 14 n.76 (forthcoming 58 N.Y.U. L. REV., No. 5 (Nov. 1983)). See also Prentice, *supra*, at 392-93.

¹⁴⁸ Similar suggestions have been made for the elimination of coercion in "going private" transactions. See Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987, 1005-06 (1974).

¹⁴⁹ Easterbrook & Fischel, *supra* note 56, at 727. Compare the conclusion that Martin Marietta's two-tier offer for the shares of Bendix was permissible: "[i]f Martin-Marietta's counter offer is in fact 'coercive,' it would be because its two tier structure is revealed all too well." *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 630 (D. Md. 1982).

¹⁵⁰ See *supra* text accompanying notes 140-45.

¹⁵¹ See *supra* text accompanying note 146.

¹⁵² See *supra* notes 57-58 and accompanying text.

4. Defensive Tactics by Target Companies

As discussed in Part IV,¹⁵³ the current regulatory system permits target management to pursue a wide range of defensive strategies that are difficult to challenge. The ability of management to respond by protecting the interests of the shareholders may ameliorate concerns about fairness, looting, and coercion.

First, incumbent management is required to advise shareholders of its response to any tender offer no later than ten business days after its commencement.¹⁵⁴ Management may advise shareholders of the progress of its efforts to find a bidder willing to pay a higher price. Second, federal law gives incumbent management a right of action to contest the adequacy of disclosure made by the bidder regarding its intentions and policies.¹⁵⁵ Management thus has incentive to investigate the bidder's background to see if its disclosure in this regard is adequate. Ensuring full and proper disclosure will tend to reduce the pressure to sell experienced by shareholders.¹⁵⁶ Third, the management of target companies may communicate with the shareholders to advise them if the bidder has a reputation for looting or overreaching. Fourth, management may represent the shareholders by acting as their bargaining agent in negotiations with other bidders. This process may result in the emergence of a more trustworthy bidder or one willing to make a bid for any and all outstanding shares. Finally, management may attempt to frustrate the partial bid by engaging in defensive strategies such as giving options to buy stock or assets to third parties.¹⁵⁷

5. The Economic Value of Partial Bids

The proper scope of regulation of partial bids will depend on how valuable such bids are to the economy. It may be argued that regulations that obstruct changes in corporate control help to entrench inefficient management and therefore discourage the efficient use of capital.¹⁵⁸ When applied to proposals to limit or to bar partial offers, this economic efficiency argument rests on the following premises: (1) partial bids facilitate changes in control; (2) changes in control oust inefficient management; (3) the ouster of inefficient management and its re-

¹⁵³ See *infra* notes 297-347 and accompanying text.

¹⁵⁴ Rule 14e-2, 17 C.F.R. § 240.14e-2 (1983).

¹⁵⁵ See generally Jorden & Woodward, *Appraisal of Disclosure Requirements in Contests for Control Under the Williams Act*, 46 GEO. WASH. L. REV. 817 (1978).

¹⁵⁶ See *supra* note 144 and accompanying text.

¹⁵⁷ These defenses are discussed *infra* notes 266-90 and accompanying text.

¹⁵⁸ See *supra* note 65 and accompanying text.

placement (presumably with more efficient management) promote desirable objectives, primarily the optimal use of capital, and (4) realizing those objectives will benefit the entire body of shareholders (those owning shares in either bidders or targets). If this efficiency argument is correct, any restraining of partial bids seemingly results in protection only of some target company shareholders to the detriment of the universe of shareholders.¹⁵⁹

Because the theory has such important ramifications, its premises deserve careful examination. Although the initial premise seems clearly true, the other three lack empirical support and are far from clearly true even on an intuitive level. For example, the second part of the argument presumes that acquisition-oriented companies select target companies primarily according to an analysis of the competence of incumbent management and that the premium paid simply reflects the efficiencies to be realized by new, competent management. Clearly, however, other facts may be just as important to the selection. Such additional factors would include the particular diversification requirements of the bidder,¹⁶⁰ the natural desire of managers to expand the size of the corporate enterprise under their control,¹⁶¹ the prospective target's ownership of an asset of particular attractiveness to the bidder,¹⁶² and the prospective target's ownership of a cash horde that could provide liquidity for other corporate transactions. Moreover, premiums may reflect the fact that the price of a company as a choice acquisition in a publicized auction is different from a market capitalization figure determined by multiplying the closing price of a 100-share trade on the New York Stock Exchange by the number of outstanding shares.

The third premise, that changes in control improve management efficiency, also is open to doubt and has not been empirically established.¹⁶³ Solid empirical answers to these concerns would go far to re-

¹⁵⁹ Proponents of this line of thinking have argued that it supports rules to outlaw defensive strategies designed to make changes of control more difficult to achieve. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1181 (1981).

¹⁶⁰ See, e.g., *Mobil Corp. v. Marathon Oil Corp.*, 669 F.2d 336, 345 (6th Cir. 1982), discussing the reasons that U.S. Steel bid for Marathon Oil. U.S. Steel desired to diversify its operations by acquiring interests in fields other than steel production.

¹⁶¹ Morris & Mueller, *The Corporation, Competition and the Invisible Hand*, 18 J. ECON. LIT. 32, 41-45 (1980); Speech by Harold M. Williams, former Chairman of the SEC, *Tender Offers and the Corporate Directors*, reprinted in [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445, at 82,876-77 (Jan. 17, 1980).

¹⁶² See, e.g., *Mobil Corp. v. Marathon Oil Corp.*, 669 F.2d 326 (6th Cir. 1982); *Whitaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill.), *aff'd mem.*, No. 72-C-443 (7th Cir. March 5, 1982).

¹⁶³ See, e.g., Note, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1031 (1982).

move the doubts that currently preclude widespread acceptance of the economic efficiency argument as a rationale for reducing regulation.¹⁶⁴

6. Conclusion

With this understanding of the policies that must be considered when regulating partial bids and two-tier tender offers, we can begin an assessment of the current regulatory systems and alternatives.

B. *Current Regulation of Partial and Two-Tier Tender Offers*

1. Federal Law

Federal law imposes only one restriction on partial bids: if shares are tendered in excess of those sought, all shares purchased must be taken on a pro rata basis.¹⁶⁵ Section 14(d)(6) of the Exchange Act¹⁶⁶ provides that a bidder making a partial offer must purchase on a pro rata, rather than a first-come, first-served basis, all shares tendered during (i) the first ten calendar days after commencement of the offer¹⁶⁷ and (ii) the first ten calendar days following a price increase. Congress believed that by requiring pro rata treatment during some portion of the partial offer, it would enable shareholders to make informed investment decisions without the pressure imposed by the tender offers which typified the pre-Williams Act era.¹⁶⁸

For several years, state takeover statutes¹⁶⁹ masked the effects of the ten calendar day proration provision in the Williams Act because those statutes required a bidder to hold its offer open for twenty to thirty days and to accept on a pro rata basis all shares tendered during

¹⁶⁴ *Id.*; see also Lipton, *Takeover Bids in the Target's Boardroom, An Update After One Year*, 36 BUS. LAW. 1017, 1024-25 & n.30 (1981).

Our own reluctance to accept the economic efficiency argument at face value was anticipated by at least one early commentator who pondered the propriety of the payment of control premiums. As early as 1956, Professor Leech conceded that insistence on mandatory offers to all shareholders may block some control transfers. Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 838 (1956). Yet he believed that without empirical evidence of this harm, changes in the regulatory system were not justified. *Id.*

¹⁶⁵ See Rule 14d-8, 17 C.F.R. § 240.14d-8 (1983).

¹⁶⁶ 15 U.S.C. § 78n(d)(6) (1982).

¹⁶⁷ See *id.*

¹⁶⁸ Senator Williams stated that the purpose of § 14(d)(6) was to "outlaw tender offers on a first-come, first-served basis and thus eliminat[e] pressure on shareholders to make hasty deposits." 113 CONG. REC. 856 (1967). *Accord* Piper v. Chris-Craft Indus., 430 U.S. 1, 23 (1977); *Indiana Nat'l Bank v. Mobil Oil Corp.*, 457 F. Supp. 1028, 1031 (S.D. Ind. 1977), *aff'd*, 578 F.2d 180 (7th Cir. 1978).

¹⁶⁹ See generally Langevoort, *supra* note 20.

that period.¹⁷⁰ The purpose was to end the use of short tender offers (called "Saturday Night Specials"), often lasting only as long as the ten-day federal proration provision, by infusing additional delay into the tender offer process.¹⁷¹ Those state provisions were successful in controlling Saturday Night Specials, but were soon invalidated on constitutional grounds.¹⁷² That preemption, coupled with the Commission's oversight in amending the tender offer rules, resulted in a return to the use of the higher pressure, ten calendar day proration period.

Recently, the Commission recognized that the ten calendar day proration period forced shareholders to make hurried, uninformed decisions about whether to tender their shares, particularly when faced with a two-tier offer.¹⁷³ On December 15, 1982, the Commission by rule required a bidder in an oversubscribed partial tender offer to accept securities on a pro rata basis during the *entire* period that the offer is open.¹⁷⁴ The result is that any shareholder tendering during the term of the offer will have some of his shares purchased in the partial (or first-tier) bid, even if the offer is oversubscribed. Despite the Commission's new rule, two-tier offers are likely to continue because of the coercive impact the higher front-end price has on shareholders.¹⁷⁵

While federal law contains no express prohibition against two-tier offers, some litigants have argued that such offers are nevertheless improper because they constitute "fraudulent, deceptive or manipulative acts or practices" within the meaning of section 14(e) of the Exchange Act.¹⁷⁶ The only two courts to have considered the issue have, however, rejected that argument.¹⁷⁷ Those district courts held that, when fully and fairly disclosed, strategies yielding competitive advantages do not

¹⁷⁰ One study reports that 15 states required pro rata acceptance of all shares tendered during the course of the offer, while Delaware required pro rata acceptance of all shares tendered during the first 21 days of the offer. See E. ARANOW, H. EINHORN, & G. BERSTEIN, *DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL* 207-45 (1977).

¹⁷¹ See generally Langevoort, *supra* note 20.

¹⁷² See *Edgar v. MITE Corp.*, 457 U.S. 624 (1982); *supra* notes 22-29 and accompanying text.

¹⁷³ See SEC Rel. No. 34-19, 336, 47 Fed. Reg. 57,679 (1982).

¹⁷⁴ Rule 14d-8, 17 C.F.R. § 240.14d-8 (1983).

¹⁷⁵ See *supra* notes 133-45 and accompanying text.

¹⁷⁶ Section 14(e) of the Securities Exchange Act makes it unlawful "for any person to make any untrue statement of a material fact or omit to state any material fact . . . or to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer." 15 U.S.C. § 78n(e) (1982).

¹⁷⁷ See *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982); *Radol v. Thomas*, 534 F. Supp. 1302 (S.D. Ohio 1982). These decisions reject the argument that two-tier pricing structures coerce shareholders into tendering into the first tier and thus constitute an illegal "manipulative" act under § 14(e) of the Exchange Act. 15 U.S.C. § 78n(e).

violate the antifraud provisions of the federal securities law, even though the strategies are plainly coercive.¹⁷⁸

2. State Law

States have developed a variety of requirements for partial and two-tier tender offers that generally focus on two events: the initial partial bid, and when applicable, the second-step merger. Regulation of the initial bid covers a whole range of responses. Hawaii, for example, flatly prohibits partial offers.¹⁷⁹ Other states permit partial offers,¹⁸⁰ and some, in fact, require them in certain circumstances. This latter requirement flows from state statutes passed in the 1970's that required persons holding ten percent or more of a class of outstanding equity securities to buy additional securities only by means of a tender offer.¹⁸¹ This provision was not intended to improve the position of bidders, but sought rather to ensure that (1) additional purchases by a large holder took longer to consummate than if accomplished by open market or privately negotiated purchases and (2) all shareholders had an equal opportunity to share in the payment of premiums paid over market prices.¹⁸²

Partial and two-tier bids are also affected by state law provisions that treat mergers that follow partial bids or that are the second step in a two-tier transaction differently from one-step combination transactions involving unrelated parties. Because the merger may involve the majority unilaterally expelling the minority, there have traditionally been the following two protections against majority overreaching: requirements that majority shareholders meet a "requisite purpose" test that evaluates the substantive fairness of the majority's conduct, based on fiduciary duties owed by the majority to minority shareholders,¹⁸³

¹⁷⁸ *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 630 (D. Md. 1982); *Radol v. Thomas*, 534 F. Supp. 1302, 1315 (S.D. Ohio 1982).

Although federal law does not prohibit two-tier pricing structures, the second-step merger may constitute a "going private" transaction under Rule 13e-3, 17 C.F.R. § 240.13e-3 (1983).

¹⁷⁹ Hawaii Take-over Bid Disclosure Law, HAWAII REV. STAT. § 417E-2(3) (1976).

¹⁸⁰ See, e.g., NEV. REV. STAT. § 78.3772(3) (1979). See generally Langevoort, *supra* note 20, at 233-36.

¹⁸¹ See, e.g., COLO. REV. STAT. § 11-51.5-103 (Supp. 1983). See generally Langevoort, *supra* note 20, at 236.

¹⁸² See Langevoort, *supra* note 20, at 236.

¹⁸³ The states impose purpose and fairness requirements in an effort to ensure that controlling shareholders act fairly toward minority shareholders when ejecting them (in so-called "freeze-out" or "going private" transactions). Purpose and fairness requirements are based on the well-established fiduciary duty owed by majority shareholders to minority shareholders, an obligation assumed by an acquiror after acquiring

and state appraisal rights.¹⁸⁴ The principal differences between those two remedies is that state appraisal proceedings seek to determine only the adequacy of the price offered in exchange for the minority shares,¹⁸⁵ while state fiduciary principles provide a legal basis for compensatory and injunctive relief on grounds other than simply an inadequate price.¹⁸⁶

The requisite purpose test, which clearly offered the better chance of meaningful remedies for minority shareholders, has, however, become meaningless in application. Its effectiveness has been lost because courts have held that the sole purpose of benefitting the parent corporation is sufficient to meet the requirements of the test.¹⁸⁷ Perhaps for that reason, the Delaware Supreme Court in *Weinberger v. UOP, Inc.*,¹⁸⁸ eliminated entirely the requisite purpose test¹⁸⁹ and held that, to meet fiduciary requirements, a merger must evidence "entire fairness."¹⁹⁰ To meet this standard, a merger must evidence "fair dealing" (full disclosure) and "fair price" (established in a manner consistent with the standards invoked in Delaware appraisal proceedings).¹⁹¹ The court stressed that perceived unfairness in a second-step merger is not actionable unless a litigant is able to come forward with allegations of "specific acts of fraud, misrepresentation, or other items of misconduct."¹⁹² The result of this narrow approach to the fiduciary duties of majority shareholders is, of course, to limit actual state regulation of the second-step merger to only the appraisal action and the limited relief

more than 50% of the outstanding common shares in a first-tier tender offer.

¹⁸⁴ See R. HAMILTON, *supra* note 16, at 1036.

¹⁸⁵ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713-15 (Del. 1983).

¹⁸⁶ Shareholders may not bring a class action for the appraisal remedy; it is solely the initiative of an individual shareholder. See *id.* However, shareholders may bring class actions challenging corporate action for absence of legitimate corporate purpose. See *id.* at 701-12.

¹⁸⁷ See Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 500-02 (1976).

¹⁸⁸ 457 A.2d 701 (Del. 1983). The law of other states provides that resort by a dissenting shareholder to the appraisal remedy constitutes a statutory election of remedies and bars resort to other remedies otherwise available under common law. See, e.g., *Twenty Seven Trust v. Realty Growth Investors*, 533 F. Supp. 1028, 1038 (D. Md. 1982) (Maryland); *Breed v. Barton*, 54 N.Y.2d 82, 85-86, 429 N.E.2d 128, 129-30, 444 N.Y.S.2d 609, 610-11 (1981) (New York); *Johnson v. Baldwin*, 221 S.C. 141, 155-56, 69 S.E.2d 585, 591-92 (1952) (South Carolina).

¹⁸⁹ *Weinberger*, 457 A.2d at 715. The requisite purpose test had previously been applied in *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Tanzer v. International Gen. Indus.*, 379 A.2d 1121 (Del. 1977).

¹⁹⁰ *Weinberger*, 457 A.2d at 711.

¹⁹¹ *Id.*

¹⁹² *Id.* at 703.

made available through it.¹⁹³

C. SEC Advisory Committee Recommendations

Advisory Committee members argued both for and against partial tender offers.¹⁹⁴ The Committee's final position was in fact a compromise rather than a studied endorsement of either the economic argument favoring no restraints on partial bids¹⁹⁵ or the equitable arguments favoring such restrictions.¹⁹⁶ The Committee rejected the regulatory extremes of outright prohibition or complete relaxation of regulations and instead settled on two recommendations aimed at providing a disincentive to the use of partial offers and at protecting smaller investors once such offers have commenced.¹⁹⁷

The proposed disincentive consists of extending the minimum offering period for partial tender offers for fourteen days longer than the corresponding period prescribed for full tender offers.¹⁹⁸ Although the Committee report briefly outlined the pros and cons of partial bids, concluding that the benefits from such bids did not outweigh the coercive and potential abuses of their use,¹⁹⁹ the report provided no analytical support for its proposed solution.

There are several problems with that recommendation. First, the discussion of partial bids does not address the regulatory disincentive that already applies to such bids. Currently, the bidder in an offer for all outstanding shares can start buying shares at the end of the withdrawal period (that is, fifteen business days after the offer's commencement),²⁰⁰ while a partial bidder must wait until the expiration of his offer, which may occur no earlier than the twentieth business day after

¹⁹³ In fact, the *Weinberger* court noted that a disgruntled shareholder unable to make such allegations must resort to an appraisal proceeding for relief. *Id.* at 715.

¹⁹⁴ ADVISORY COMMITTEE REPORT, *supra* note 32, at 24-25.

¹⁹⁵ See *supra* notes 158-97 and accompanying text.

¹⁹⁶ See *supra* text accompanying notes 137-52.

¹⁹⁷ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 25.

¹⁹⁸ *Id.* at 26 (Recommendation 16). The authors strongly oppose an interpretation of the Advisory Committee's recommendation that would result in the proration periods for partial offers being tied to the minimum offering periods for such offers rather than having proration periods throughout the duration of the offer as is presently the case under Rule 14d-8, 17 C.F.R. § 240.14d-8 (1983). Such an unwarranted view of the Committee's recommendation would again create the problem of multiple proration pools and would yield no compensating advantage.

¹⁹⁹ ADVISORY COMMITTEE REPORT, *supra* note 32, at 25.

²⁰⁰ Under Rule 14d-7(a)(1), "any person who has deposited securities pursuant to a tender offer has the right to withdraw any such securities . . . until the expiration of fifteen business days from the date of commencement of such tender offer." 17 C.F.R. § 240.14d-7(a)(1) (1983).

commencement.²⁰¹ The Advisory Committee does not explain why this existing disincentive is insufficient. Likewise, it does not explain how it arrived at the two-week, as opposed to a shorter or longer, extension period. By offering no supportive analysis, the Committee missed a valuable opportunity for persuasion.

Another problem with the Committee's proposal is that the regulatory disincentive reduces, but does not eliminate, the policy harms that prompted some Committee members to vote for the disincentive in the first place.²⁰² To the extent that the extended minimum offering period discourages certain bidders from making partial offers, there will simply be fewer offers of this type. For any such offers, however, the coercion and unfairness concerns will remain just as acute.

Finally, the question of the effect of the Committee's recommendation on the selection of target companies should be considered. Recent experience suggests that some companies are so large that a cash bid for all their outstanding shares is not affordable.²⁰³ For those companies, the partial bid is clearly the more attractive, if not the only, takeover technique. The adoption of additional restrictions on the use of partial offers may insulate large companies from takeover attempts and focus acquisition activity on small or medium-sized companies.²⁰⁴ That result would be undesirable.

In addition to extending the minimum offering period for partial bids, the Committee attempted to ensure fairer treatment of small shareholders by advocating changes in the minimum withdrawal and proration period. Under the Committee's recommendations, shareholders would have withdrawal and proration rights during the entire minimum offering period.²⁰⁵ This would result in extending the withdrawal period, which is now fifteen business days,²⁰⁶ but shortening the proration period, which is now the length of the offer, to the new thirty-day minimum offering period.²⁰⁷ The idea is that small investors should have the same opportunity to participate in the offer as market professionals. To further that goal, the Advisory Committee also recommended there be a five-day "window" after announcement of an in-

²⁰¹ See Rule 14e-1, 17 C.F.R. § 240.14e-1 (1983).

²⁰² The Committee did note that two-step transactions offering each shareholder substantially equivalent consideration could be excepted from the partial tender offer rule. See ADVISORY COMMITTEE REPORT, *supra* note 32, at 25 n.21.

²⁰³ See Lederman & Valhakis, *supra* note 135, at 817-18.

²⁰⁴ See *id.*

²⁰⁵ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 28 (Recommendation 17).

²⁰⁶ See *supra* note 200.

²⁰⁷ See *supra* note 201 and accompanying text.

crease in the price offered or the number of shares sought.²⁰⁸ During those five days, the minimum offering and proration periods would continue. The Committee's recommendations differ from the current rules with respect to proration and extension if there is a competing bid or an increase in price.²⁰⁹ The Committee, however, provided no detailed discussion as to why the Commission's existing rules, especially on proration, are defective.

The Committee's recommendations relating to partial and two-tier bids are important, in part, because they reflect an intent to protect the small shareholder. In the past, some have argued that since only a small percentage of shareholders, usually those with very small holdings, are disadvantaged by the current regulation of partial offers, increased regulation to protect those disadvantaged should be avoided because it might deter bidders from making bids in the first place.²¹⁰ The Committee's recommendations to extend the minimum offering period for partial tender offers by two weeks and to allow withdrawal and proration throughout the minimum period (as opposed to a shorter period) implicitly acknowledge that federal regulation should be concerned with fair treatment of shareholders even if they hold insubstantial amounts of stock.

Finally, the Committee also recommended changes that would reduce the incentives for two-tier offers by equating the regulatory treatment of cash offers and exchange offers.²¹¹ Current law makes it far less attractive to offer securities as consideration in a tender offer because of the requirement that securities offered in exchange for those of another company be registered with the Commission.²¹² The exchange offer cannot commence until the registration statement has been declared effective, a process that generally takes a minimum of four to six weeks, given current staffing levels. In order to put exchange offers on the same timetable as cash offers, the Committee recommended that the Commission integrate the disclosure requirements of the Securities Act of 1933 and the Exchange Act in the tender offer context in the same manner that it did with respect to public offerings of securities for cash.²¹³ In addition, bidders would be permitted to commence their bids and receive tenders immediately after filing the registration statement,

²⁰⁸ ADVISORY COMMITTEE REPORT, *supra* note 32, at 28 (Recommendation 18).

²⁰⁹ See *supra* note 38.

²¹⁰ See, e.g., Easterbrook & Fischel, *supra* note 56, at 708-14.

²¹¹ ADVISORY COMMITTEE REPORT, *supra* note 32, at 21 (Recommendations 11 & 12).

²¹² See Securities Act § 5, 15 U.S.C. § 77e (1982).

²¹³ ADVISORY COMMITTEE REPORT, *supra* note 32, at 21 (Recommendation 11).

rather than having to wait for its effective date.²¹⁴ These proposals, if adopted through regulation or legislation, would improve the current regulatory system.

In its House testimony, the SEC did not comment on the difficult issue of the appropriate role of the partial bid. With respect to the recommended differences in tender offer time periods for such bids, it simply said "that it is not certain that the Committee's recommendation is the best way to address [the Committee's] concerns. This issue requires further study."²¹⁵ The Commission, however, did not indicate how it would approach such a study.

The Commission rejected the Committee's recommendation on proration and withdrawal, and recommended withdrawal and proration rights through the duration of the offer.²¹⁶ The Commission also supported the recommendation to remove regulatory disincentives applicable to exchange offers.

Other witnesses were less equivocal. Martin Lipton, a noted takeover lawyer and a member of the Advisory Committee, testified that Congress should prohibit acquisitions above the ten percent level unless the purchaser offers to purchase all remaining shares at the highest price paid by the purchaser in the prior twelve months.²¹⁷ Lipton's proposal amounts to a flat prohibition on the use of partial bids to acquire control.

D. *Authors' Recommendations*

As already discussed, partial and two-tier offers may be very unfair to some shareholders.²¹⁸ At the same time, there are important arguments, although not yet supported by conclusive evidence, that such bids also significantly benefit the economy²¹⁹ and shareholders as a class. Thus, the correct response is to regulate partial and two-tier offers in a way that minimizes their potential abuses, but that simultaneously allows such offers to proceed when bidders believe that economic benefits can be secured by tendering only for a part of a company's shares.

²¹⁴ *Id.* (Recommendation 12). The Committee did recommend, however, that all shares tendered should be able to be withdrawn by shareholders prior to the date the registration statement is declared effective.

²¹⁵ Shad Statement, *supra* note 117, at 15.

²¹⁶ *Id.* at 16.

²¹⁷ Statement of Martin Lipton Before the House Subcommittee on Telecommunications, Consumer Protection, and Commerce 14 (March 28, 1984) (copy on file with *The University of Pennsylvania Law Review*).

²¹⁸ See *supra* notes 140-52 and accompanying text.

²¹⁹ See *supra* notes 158-64 and accompanying text.

1. Informed Decisionmaking

The need to provide shareholders with adequate time to make their investment decisions clearly is at the heart of the securities laws and demands regulatory attention. The Commission has already acted to eliminate the pressures of short proration periods. In revising Rule 14d-8 to require mandatory pro rata acceptance of all shares tendered during the time the offer is open,²²⁰ the Commission eliminated (1) the pressure imposed by the ten-day statutory proration period to make decisions before shareholders had a reasonable opportunity to obtain and read the tender offer materials and (2) the prorating scheme that gave rise to a number of proration pools and proration dates. Revised Rule 14d-8 improves the ability of management to respond to partial bids by giving more time to find a competing bidder. Rule 14d-8 should be continued and the modification suggested by the Advisory Committee²²¹ should be rejected.

2. Front-End Loading

Front-end loading creates a stampede atmosphere that is inconsistent with informed decisionmaking. The current system in no way minimizes that coercion. To remedy this abuse without imposing undue costs on the tender offer process, we recommend that Congress prohibit the commencement of two-tier bids unless equivalent value is offered in each tier. To make such a prohibition effective, elimination of the minority at a lower price within a certain time should be prohibited. Two-tier deals should be treated as unitary transactions in which each shareholder receives the same price per share.²²² If this alternative is not adopted, the partial bid should be required to remain open for a substantial period (perhaps several months) to allow target management to find buyers for the company on a one-step basis.

3. Looting and Overreaching

Partial bids pose to shareholders the threat of overreaching and

²²⁰ See *supra* notes 165-68 and accompanying text.

²²¹ The Committee suggested making the proration period their longer minimum offering period, instead of, as now, the entire offering period. See *supra* text accompanying note 207.

²²² Although supporting a system of traditional state corporation law, ADVISORY COMMITTEE REPORT, *supra* note 32, at 34 (Recommendation 33), the Committee recommended that any state laws interfering with a company's ability to make tender offers should be prohibited. *Id.* at 35 (Recommendation 34).

looting by the new control person.²²³ Shareholder derivative suits, the classic common law response to this threat, may not be completely effective.²²⁴ Disclosure by incumbent management of bidders and the proper use of defensive tactics,²²⁵ however, constitute important checks on this danger. In fact, we contend that, because of the adequacy of the response now available to target management, no additional regulations are needed to prevent looting and overreaching.

4. Conclusion

In conclusion, three approaches to the problems of partial bids are available. The first approach would be to refrain from adopting additional regulation of partial offers. The second approach is a regulatory disincentive such as that adopted by the SEC Advisory Committee. Finally, the ultimate panacea to partial tender offer problems is of course a flat prohibition of partial bids.

The Advisory Committee's recommendations amount to tinkering with the existing system, rather than a comprehensive analysis of the problems posed by partial and two-tier offers. Their implementation will implicitly ratify the use of partial deals. Before such a step is taken, Congress should study in greater detail both the costs and benefits of partial bids. Both tinkering and draconian responses should be deferred pending the development of some well-grounded consensus about what the appropriate economic tradeoffs are. If partial bids are allowed to continue, however, shareholders must be protected with the following regulatory change: in two-tier offers, a bidder should be compelled to pay a price in the second step that is equivalent to the price offered in the first.

III. TENDER OFFERS IN NEGOTIATED CONTROL TRANSACTIONS

Because hostile tender offers have attracted so much attention in recent years,²²⁶ it is easy to overlook the fact that most acquisitions are still the product of successful negotiations between management teams representing the purchasing and selling companies.²²⁷ The traditional

²²³ See *supra* text accompanying note 137-39.

²²⁴ See *supra* note 134.

²²⁵ See *infra* notes 261-400 and accompanying text.

²²⁶ See, e.g., N.Y. Times, Aug. 26, 1982, at D1, col. 3 (Bendix Corp. \$1.6 billion tender offer for Martin Marietta); Wayne, *The Corporate Raiders*, *id.*, July 18, 1982, § 6 (Magazine), at 18, col. 1 (hostile takeovers); Wall St. J., Aug. 11, 1981, at 21, col. 3 (Seagram tender offer for Conoco, Inc.); Metz, *The Unfriendly Tender Studied*, N.Y. Times, Feb. 6, 1980, at D8, col. 2.

²²⁷ See Bradley, *Interfirm Tender Offers and the Market for Corporate Control*,

negotiated acquisition is one that involves a single-step, merger-type transaction²²⁸ approved by the shareholders of the company to be acquired based upon the recommendations of its board of directors. If the shareholders approve the merger, they all receive the same consideration, unless they seek appraisal under state procedures.²²⁹ If the company to be acquired is a public company, the proxy rules²³⁰ apply to the solicitation of votes necessary to approve the merger.

A. *Recent Changes in Negotiated Acquisitions Practice*

The form of the negotiated acquisition has changed dramatically. The use of the tender offer in negotiated acquisitions has grown steadily since the mid-1970's, primarily because there is such intense competition for desirable acquisition candidates.²³¹ Tender offers are usually one part of a three-step transaction negotiated by the parties. The transaction typically begins with a negotiated private purchase, often from an insider, of a sizable block of the target's stock.²³² The purchase agreement usually provides that the purchaser will use its best efforts to make a tender offer to all other stockholders for any and all shares tendered at the same price the blockholder receives. Upon signing of the agreement, a press release is issued announcing the bidder's purchase of the block and its undertaking to make a tender offer on comparable terms in the immediate future.²³³

The second step is the "friendly" tender offer itself.²³⁴ Ideally, the target's board of directors will recommend acceptance of the offer to stockholders—or at least not oppose it—and cooperate in its implementation.

Finally, the three-step acquisition concludes with a merger transaction that secures 100% ownership of the target.²³⁵ At that stage, assuming the bidder has acquired the requisite number of shares in the first two steps, the target's remaining shareholders can be involuntarily

53 J. BUS. 345, 347 (1980); Kummer & Hoffmeister, *Valuation Consequences of Cash Tender Offers*, 33 J. FIN. 505 (1978).

²²⁸ This includes mergers, consolidations, and sales of substantially all assets. See *supra* note 4.

²²⁹ See, e.g., DEL. CODE ANN. tit. 8, § 262 (1983).

²³⁰ The proxy rules are promulgated under § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a) (1982), and are set forth at 17 C.F.R. §§ 240.14a-1 to 240.14a-12 (1983).

²³¹ See Freund & Easton, *The Three Piece Suit: An Alternative Approach to Negotiated Control Acquisitions*, 34 BUS. LAW. 1679, 1682 (1979).

²³² *Id.* at 1683.

²³³ *Id.*

²³⁴ *Id.* at 1684.

²³⁵ *Id.*

eliminated, if necessary, because the bidder has sufficient shares to compel the merger.²³⁶

Although there are disadvantages to this multistep approach,²³⁷ it offers an alternative for implementation of negotiated transactions that is better suited for the present competitive takeover market than the traditional merger transaction with its incumbent delays. For example, the multistep transaction was designed to secure for the bidder control of the target (or at least a leg up on any competition which might emerge once the negotiated deal was announced) much faster than through the traditional merger. The traditional single-step merger takes roughly three months to complete from the publicly announced agreement in principle to the closing.²³⁸ During that period, it is not clear that the acquiring company will be able to complete the deal.²³⁹ For the first month, the target may not even be bound contractually by a definitive merger agreement. Yet the press release announcing the agreement in principle has signalled to third parties that the target is for sale and at least one buyer is willing to pay a substantial premium for its shares. The multistep transaction is designed to shorten this period of vulnerability.²⁴⁰

The multistep method improves the bidder's chances of successfully consummating the transaction in another way. In a conventional merger, the acquiring company does not participate in the voting since it does not own any of the target shares. Thus, the purchaser cannot be certain of achieving the requisite majority or two-thirds vote usually required to approve the merger.²⁴¹ The multistep purchaser, on the other hand, is likely to obtain through the block purchase and subsequent tender offer enough ownership of the target to authorize the final-step merger single-handedly, thereby lessening the risk that the deal will collapse.

B. *Regulation of Multistep Acquisitions*

Federal law regulates negotiated acquisitions on two levels. Transactions requiring shareholder approval, such as mergers, must comply with the proxy rules; those involving tender offers must comply with

²³⁶ *Id.*

²³⁷ For example, at the time the purchaser buys the blockholder's stock, it cannot know for certain whether it will be able to complete successfully the balance of the transaction and achieve 100% ownership. The purchaser therefore risks being left with a substantial investment, purchased at a premium, yet without control of the seller.

²³⁸ See Freund & Easton, *supra* note 231, at 1690.

²³⁹ For a discussion of this problem, see *id.* at 1688-90.

²⁴⁰ See *supra* text accompanying notes 238-39.

²⁴¹ See R. HAMILTON, *supra* note 16, at 1036, 1056-58.

the tender offer rules. Tender offers are functionally identical to mergers in that both eliminate the shareholders of the acquired company. Yet the different treatment of each under current law produces important disclosure and timing anomalies.

Section 14(a) of the Exchange Act provides the Commission with authority to adopt disclosure rules regulating proxy solicitations for approval of mergers.²⁴² The Commission has promulgated detailed rules and a schedule of information to be included in a proxy statement when the vote or consent of shareholders in the acquired company is sought.²⁴³ All material information must ordinarily be contained in the proxy, and no solicitation of shareholder votes may be made unless the person solicited has been furnished with the proxy.²⁴⁴

Companies will normally decide to announce in press releases the existence of agreements in principle with respect to major acquisitions. Because solicitation is defined broadly,²⁴⁵ however, companies are reluctant to issue more than a bare-bones press release prior to delivery of the proxy statement. Moreover, the rules require that all soliciting materials, including the proposed forms of proxy statement, be prefiled and cleared by the Commission.²⁴⁶

The press release, therefore, is the only information normally available to shareholders until two or three months after the agreement is reached, when the proxy finally is distributed to them. This disclosure typically overwhelms shareholders because of its size, particularly if securities are to be issued in the transaction.²⁴⁷ Form S-14,²⁴⁸ on which the securities are to be registered, often includes a prolix and unwieldy prospectus that can run up to 200 pages. It contains detailed information about both companies' management and business, financial state-

²⁴² See 15 U.S.C. § 78n(a) (1982).

²⁴³ These requirements are currently codified at 17 C.F.R. §§ 240.14a-1 to 240.14a-12 & Schedule 14A (1983).

²⁴⁴ See 15 U.S.C. § 78n(a) (1982); Rule 14a-3, 17 C.F.R. § 240.14a-3 (1983).

²⁴⁵ Solicitation is defined to include, among other things, "[t]he furnishing of a form of proxy or other communication . . . under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." Rule 14a-1(f), 17 C.F.R. § 240.14a-1(f) (1983). For examples of the Commission's liberal interpretation of this definition, see *Dyer v. SEC*, 291 F.2d 774 (8th Cir. 1961); *SEC v. Okin*, 132 F.2d 784 (2d Cir. 1943).

²⁴⁶ See Rule 14a-6, 17 C.F.R. § 240.14a-6 (1983).

²⁴⁷ It is somewhat ironic that the Commission recognized these concerns when state statutes attempted to impose a block-out in 'bidders' communications. The announcement of a hostile tender offer causes a flurry of trading by arbitrageurs and average shareholders. The Commission adopted Rule 14d-2(b), 17 C.F.R. § 240.14d-2(b) (1983), to compel timely disclosure in this situation. The same type of trading, and the same need for disclosure, occurs when a merger is announced.

²⁴⁸ For a discussion of the evolution of S-14 disclosure, see Freund & Greene, *supra* note 36, at 1491-95.

ments of each company as well as a pro forma financial statement of the combined entity, a description of the securities to be issued and the merger transaction and procedures to be followed, and, if available, the procedure for perfecting one's appraisal remedy.²⁴⁹

Federal regulation of tender offers results in the disclosure of significantly different information at a significantly different time.²⁵⁰ The information that a bidder must disclose in its tender offer documents focuses on its identity, the number of shares it wishes to purchase, and the price it will pay for those shares.²⁵¹ Little, if any, information will be provided about the target, the securities to be issued in the second step, what the companies will be like once they have merged, or even when or how the second step is to occur.

The tender offer rules also require that this information be disclosed at the very outset of the bid.²⁵² Those rules correctly assume that there will be an active trading market after the initial press release, and as a result a bidder must furnish the necessary information within five days of a public announcement of the material terms of the tender offer.²⁵³

The application of this federal regulatory scheme to negotiated acquisitions leads to anomalies in both the content and the timing of the disclosure. In a traditional merger transaction involving the issuance of securities, the shareholders of the target finally do receive abundant information, although not until two or three months after the initial public announcement of the deal, which typically contains only sparse in-

²⁴⁹ See *id.* at 1524.

²⁵⁰ See generally Freund & Greene, *supra* note 36.

²⁵¹ See, e.g., Rule 14d-2, 17 C.F.R. § 240.14d-2 (1983).

²⁵² See *id.*

²⁵³ In 1979, the Commission adopted Rule 14d-2(b), 17 C.F.R. § 240.14d-2(b) (1983), to address the problem of uninformed decisionmaking during the period between a bidder's public announcement of an intention to commence a tender offer in the future and the bidder's filing of Schedule 14D-1, the date of which marks the opening of the bidder's depository and starts running the periods for withdrawal prior to pro rata acceptance of tendered shares. Public announcement of the material terms of the bid were often mandated by state takeover statutes. See *Edgar v. MITE Corp.*, 457 U.S. 624, 627 (1982). Such announcements typically spurred sharp increases in trading of target company shares. The Commission became concerned that during such periods (which could last as long as 20 days under some state statutes), investors needed but did not have the information necessary for informed decisionmaking. Thus, in 1979, it adopted Rule 14d-2(b) which requires that a tender offeror file its Schedule 14D-1 no later than five business days after the date of public announcement of the offer's material terms, which are defined as the identity of the target company, the price offered per share, and the number of shares sought. See 17 C.F.R. § 240.14d-2(b), (c) (1983). In adopting Rule 14d-1(b) the Commission acknowledged that it was impossible simultaneously to comply with both Rule 14d-2(b) and state advance-disclosure provisions, and that the adoption of the rule argued for the preemption of such provisions. See SEC Release Nos. 33-6158 & 34-16,384, 44 Fed. Reg. 70,326, 70,329-30 (1979).

formation. During this interim period, however, the target's shareholders must make important decisions about whether to sell their shares into an overheated market. The disclosure rules for traditional mergers appear to be based on the incorrect assumption that the target's shareholders will not sell in the interim but will wait to receive the proxy statement and vote on the merits of the merger.

By contrast, when a tender offer is part of a negotiated transaction, a large quantity of information is made immediately available to investors. The tender offer rules compelling this disclosure²⁵⁴ may, however, be difficult to meet in the setting of a negotiated acquisition where the terms of the transaction are the subject of negotiation between a purchaser and seller dealing at arm's length. Based on the assumption that all tender offers are hostile, the present rules require the bidder to commence its offering period within five days of the public announcement, so that all information required to be disclosed under the rules must be made available to shareholders.²⁵⁵ Although a public announcement is generally required after an agreement in principle is reached,²⁵⁶ by the time of that announcement the parties may not have completed all their negotiations on the terms of the transaction or the financing arrangements.

As already mentioned, the type of information that must be provided by the offeror to shareholders is also less helpful in a negotiated acquisition. When a multistep acquisition is undertaken, it is important for the shareholders to learn about the nature of the intended merger if they are to be able to make properly informed investment decisions.

To illustrate the anomalies of the present regulatory system,²⁵⁷ it is interesting to compare (1) a cash-election merger, in which shareholders can elect to receive up to forty-nine percent cash as part of a single merger-type transaction, with the balance in stock, with (2) a stock merger following a prior "friendly" cash tender offer for forty-nine percent of its shares. Although the ultimate outcomes of these transactions and their effects on shareholders are very similar (the principal difference being the timing of the cash portion), quite different disclosure ensues. In the cash-election merger, there is no public disclosure for the two or three months until the proxy prospectus is mailed to shareholders; but at that point shareholders have the necessary infor-

²⁵⁴ See Rule 14d-2(b), 17 C.F.R. § 240.14d-2(b) (1983).

²⁵⁵ See *id.*

²⁵⁶ See NEW YORK STOCK EXCHANGE COMPANY MANUAL § A-2; AMERICAN STOCK EXCHANGE COMPANY GUIDE § 402; Securities Exchange Act Release No. 34-5092, [1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,915 (Oct. 15, 1970).

²⁵⁷ This example is also discussed in Freund & Greene, *supra* note 36, at 1483-85.

mation to make the choice between cash and stock. With a prior tender offer, there is information published within five days, but it does not include necessary information relating to the target, the merger, the securities to be issued, or the resulting company, against which the shareholder can measure the desirability of tendering. The present regulatory system, therefore, appears to elevate the form of the transaction over its substance.

C. SEC Advisory Committee Recommendations

The Advisory Committee did not specifically address the increasing use of the tender offer as a technique for negotiated acquisitions, the disclosure delay in merger proposals, or the difficulty of complying with Rule 14d-2(b) when the tender offer is one part of a negotiated acquisition.

D. Authors' Recommendations²⁵⁸

Because the negotiated multistep acquisition is significantly different in concept and effect from a hostile takeover, current regulations need to distinguish between the two transactions. The basic distinction ought to be functional, rather than one based on the form of the deal. Thus, a tender offer which is part of a negotiated acquisition is more appropriately regulated under rules specifically applicable to negotiated transactions rather than under rules designed to deal with hostile takeovers. The content and timing of disclosure in a negotiated transaction should not depend on the form of the transaction.

With respect to all negotiated acquisitions, the Commission should mandate minimum disclosure about the transaction when it is first announced and encourage disclosure before the actual combination. Such disclosure should be intended to allow shareholders to make informed decisions about whether to tender prior to their receipt of the proxy statement. A workable regulatory scheme, applicable in any negotiated deal (whether by way of tender offer, merger, or otherwise), would be to prescribe disclosure of significant information in a press release about the transaction and both parties. Disclosure should be required early in the process, well before shareholders are required to take action, in order to allow them voluntarily to sell their shares and to allow other investors to buy shares of the subject company, with all participants informed about significant aspects of the acquisition. In order to

²⁵⁸ For further discussion of possible reforms to SEC regulation of tender offers in negotiated acquisitions, see *id.* at 1507-29.

implement this type of proposal, one of several necessary changes will, of course, be a new exception to the five-day rule on disclosure during a tender offer.²⁵⁹

IV. NEW DEVELOPMENTS IN DEFENSES AGAINST TAKEOVERS AND CORPORATE RAIDERS

The defensive tactics employed by corporations faced with tender offers or corporate raiders raise significant questions about whether existing federal and state law provides adequate scrutiny of such tactics.²⁶⁰ The most notable example of such behavior occurred after Bendix Corporation made a tender offer for the common stock of Martin Marietta Corporation.²⁶¹ To fend off the Bendix bid, Martin Marietta responded by borrowing enormous sums and commenced a tender offer for Bendix.²⁶² Federal and state law subjected that counter tender offer to no serious scrutiny. Federal law was not violated since Martin Marietta committed no disclosure violation.²⁶³ The district court also found that no case had been made under state law.²⁶⁴

The *Bendix* litigation indicates the lengths to which incumbent management can go in an effort to resist a tender offer. The current lack of consensus²⁶⁵ regarding the appropriate behavior of management under siege permits the survival instinct to govern the response of target companies. Unless corporate managers are to be given unfettered discretion in responding to tender offers, thereby threatening the value of

²⁵⁹ See *supra* note 253 and accompanying text.

²⁶⁰ See, e.g., Murray, *Do Mergers Make Sense?*, *Dun's Business Month*, Oct. 1982, at 88; *Proposed Purchase of Marathon Oil Co. by Mobil Oil Corp.: Joint Hearings Before Senate Comm. on Commerce, Science, and Transportation and House Comm. on Energy and Commerce*, 97th Cong., 1st Sess. (1981).

²⁶¹ See *Martin Marietta Corp. v. Bendix Corp.*, 690 F.2d 558 (6th Cir. 1982).

²⁶² A Bendix lawyer said of Martin Marietta management: "They've debilitated their corporation, depleted their earnings. They paid an enormous price, and by their standards, they won." Masters, *Lawyers Debate Best and Worst of Bendix Takeover Maneuvers*, *Legal Times of Wash.*, Oct. 11, 1982, at 1 (quoting Mr. Harvey Pitt). The price to which the lawyer referred was not paid by Martin Marietta's management, but rather by its shareholders.

²⁶³ See *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982).

²⁶⁴ In denying a motion by Bendix for a preliminary injunction against the offer, Judge Young found "no credible evidence . . . that . . . [Martin] Marietta's board was not acting . . . in furtherance of what they reasonably believed to be a good corporate purpose," that is, keeping the management of Bendix—who Martin Marietta's board believed to have "little managerial competence or experience in Marietta's business,"—from taking control of Martin Marietta. *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 633-34 (D. Md. 1982).

²⁶⁵ The American Law Institute's Corporate Governance Project has not developed rules regarding the duty of loyalty in takeover situations, even though it has developed elaborate rules for situations not involving a tender offer.

shareholder investments, regulations must clearly limit the range of permissible defensive tactics.

This section: (1) briefly reviews recent developments in defensive tactics; (2) discusses the orientation of federal securities law (which reflects a policy judgment not to review the substantive merits of business decisions but to rely instead upon full corporate disclosure); (3) criticizes the state business judgment rule because it fails to provide adequate legal standards for evaluating defensive tactics, and (4) presents and evaluates proposed changes in the regulatory system.

A. *New Defensive Developments*

1. Defending Against Tender Offers

Defensive strategies fall into two categories: financial transactions designed to reduce the attractiveness of a corporation to a bidder²⁶⁶ and structural defenses embedded in the bylaws or charter of the corporation designed to make changes in control more difficult to accomplish.

a. *Financial Defenses*

Virtually all financial defenses are undertaken only after a corporation is faced with a takeover bid, either by tender offer or open market purchase program. Those defenses may involve any of a variety of courses of action. Management may decide to liquidate the company in whole or in part (the classic "scorched earth" defense),²⁶⁷ it may decide to sell an attractive subsidiary or property to a friendly suitor who may subsequently make an offer which it favors (the so-called "Crown Jewel" sale);²⁶⁸ it may decide to give a friendly suitor an option to buy treasury shares at an attractive price;²⁶⁹ it may elect to start a tender offer or open market purchase program for its own shares (in order to make it more difficult for the raider to meet minimum share condi-

²⁶⁶ See *infra* notes 267-76 and accompanying text. A variant of this first category involves the increased use of special compensation agreements, also known as "golden parachutes," designed to give target officers and employees a measure of financial security if they lose their positions as the result of a change in control.

²⁶⁷ E.g., *Joseph Seagram & Sons, Inc. v. Abrams*, 510 F. Supp. 860 (S.D.N.Y. 1981).

²⁶⁸ E.g., *Mobil Corp. v. Marathon Oil Corp.*, 669 F.2d 366 (6th Cir. 1982); *Marshall Field & Co. v. Icahn*, 537 F. Supp. 413 (S.D.N.Y. 1982); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982).

²⁶⁹ E.g., *Mobil Corp. v. Marathon Oil Corp.*, 669 F.2d 336 (6th Cir. 1982); *Heit v. Baird*, 567 F.2d 1157 (1st Cir. 1977); *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769 (Del. Ch. 1967).

tions);²⁷⁰ or it may choose to launch a tender offer for the bidder (the so-called "Pac Man" defense).²⁷¹

Such transactions may frustrate a bid in several ways. First, they may change the target's financial condition in a manner which makes it less attractive (substantial indebtedness may be incurred or an attractive asset or subsidiary may be sold). Second, the issuer tender offer or repurchase program for its own shares may cause the shares to trade at a price in excess of the tender price, thus forcing the raider to increase its price to remain competitive.²⁷²

Finally, certain of these transactions may result in the accumulation of large amounts of target stock in friendly hands who are unwilling to tender to the raider. This accumulation may directly defeat the hostile bid by making it impossible for the bidder to buy a controlling interest. Or it may indirectly defeat the raider by acquiring stock for the corporate treasury which can be used in connection with a subsequent issuance of shares as a defensive action or by setting the stage for an issuer or white knight tender offer.²⁷³

Each of these financial defenses may be implemented by the board of directors without shareholder approval,²⁷⁴ yet may negatively impact the shareholders of the subject company in at least two ways. First, they may, by frustrating the raider's bid, deprive at least some target company shareholders of the opportunity to sell their shares at a profit.²⁷⁵ Second, the defenses may weaken the target's financial condi-

²⁷⁰ *E.g.*, *Schilling v. Belcher*, 582 F.2d 995 (5th Cir. 1978); *Pogo Producing Co. v. Northwest Indus.*, Civ. No. H-83-2667 (S.D. Tex. May 24, 1983) (self tender offer); *LTV Corp. v. Grumman Corp.*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,344 (E.D.N.Y. Oct. 16, 1981) (open market purchases); *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964).

²⁷¹ *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982); see also *Getschow & Metz, Houston Natural and Coastal End Takeover Offers*, Wall St. J., Feb. 14, 1984, at 3, col. 1 (counterbid by Houston Natural Gas to Coastal's tender offer; both bids settled by Houston Natural buying out Coastal's position).

²⁷² The target also benefits from this response because the shares it is able to purchase may include "loose stock" from arbitrageurs and others that would likely be tendered to the bidder.

²⁷³ For example, if 33% of the outstanding stock is in friendly hands, a white knight needs to acquire only slightly more than 17% to prevent the raider from taking control. If the issuer buys another 17% of the stock and retires it, the percentage holding of the friendly holder automatically goes to 38% as a result of the reduction of outstanding shares; and if the issuer buys and retires 33%, the holdings of the friendly holder increase to 50% of the then outstanding securities.

²⁷⁴ See *Lipton*, *supra* note 164, at 1025.

²⁷⁵ See *Easterbrook & Fischel*, *supra* note 159. The opposing argument is that such maneuvers sometimes are necessary to procure a friendly bidder willing to make a higher bid. See generally *Bebchuk, The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); *Lipton, Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979).

tion with the result that the market may value the target's shares at a lower price in the aftermath of the takeover battle.

Another result, as well as the purpose, of any successful defense is, of course, the target's continued independence as a business entity and the continuing tenure of its directors and top managers. Whether or not the price paid for independence is (or is likely to be) too high in terms of shareholder welfare is a frequent topic of litigation under federal and state law.²⁷⁶ The absence of clear guidelines as to what directors should do compounds the problem by encouraging extreme actions by management that often have no rational connection to the achievement of shareholder interests.

b. *Structural Defenses*

Defenses in this second category are usually pursued well before a tender offer is commenced. They are intended to make it much more difficult to ratify a change in corporate control. Several examples indicate the range of structural responses.

First, the directors may classify the board into two or more subgroups whose terms of office expire at different times.²⁷⁷ The board may also recommend to the shareholders that they add a supermajority provision to the charter to provide that more than the minimum vote required by law (usually a majority of two-thirds) be obtained to approve any merger with or sale of substantially all of the target's assets to an entity owning more than a certain percentage of the target's stock (usually ten percent).²⁷⁸ An interesting paradox of the supermajority provision is that it can be installed with the vote of only a simple majority of the shareholding body.²⁷⁹

Another response is the "fair price" provision, which sets forth pricing²⁸⁰ and procedural²⁸¹ requirements for the purchase of shares,

²⁷⁶ For a most egregious example, see *Panther v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). Such battles are often conducted with a certain irony. The directors believe it is in the best interests of the company to be independent, yet in many instances the shareholders may very well be willing to accept the premium proffered if given the chance.

²⁷⁷ This action requires that even a majority shareholder must wait for at least two successive annual meetings to elect a majority of the board, presuming three classes of equal size. This is an important strategy if a partial bid is expected. In reality, most directors in all likelihood would resign once there was a new controlling shareholder rather than spend the subsequent year in open warfare.

²⁷⁸ The deterrent effect of a supermajority provision is particularly high where management controls enough shares to block the "supermajority" vote even if the offeror tenders for all outstanding shares.

²⁷⁹ It then requires, of course, a supermajority to remove such a provision.

²⁸⁰ A minimum price provision, the most common fair price formula, provides that the amount of consideration that each stockholder receives be no less than the

[Footnote 281 appears on page 704]

which, if met, result in the supermajority voting requirement not being applicable. Those provisions deter front-end loaded tender offers by forcing the bidder to pay more in the second step.²⁸²

Related to "fair price" provisions are compulsory redemption provisions which grant stockholders the right to cause a corporation to repurchase their shares at a particular price.²⁸³ They are triggered when a tender offer for more than a specified percentage of the corporation's outstanding shares succeeds despite the disapproval of the target's board of directors.²⁸⁴ The potential expense associated with compulsory redemption provisions is designed to encourage potential offerors to negotiate with management. Potentially, compulsory redemption provisions have a broader deterrent effect than either supermajority or fair price provisions because compulsory redemption raises the price of the transaction and also removes the offeror's ability to forego a second-step transaction. Despite these advantages to incumbent management, compulsory redemption provisions are far less common than fair price provisions, in part because they raise far more questions as to their

equivalent of the highest consideration received by any stockholder for his stock. A minimum market premium clause is frequently used in combination with minimum price provisions and requires that the ratio of the offeror's premium to the fair market value of the target's stock immediately prior to the date of the first public announcement of the acquisition be at least as great as the ratio of the highest price paid by the offeror at any time for the target's stock to the fair market value of such stock immediately prior to the commencement of the acquisition of the target's stock by the offeror. Premium to book value is another formula used in fair price amendments providing that any offer be in excess of stated book value.

²⁸¹ Fair price amendments generally contain various procedural requirements unrelated to price that must also be fulfilled by an offeror to avoid the prescribed supermajority vote requirement. Dividend floors are frequently set in fair price amendments as a means to prevent the bidder, after obtaining control via a first-step tender offer, from attempting to depress the market price of the voting stock prior to proposing a second-step merger. The bidder is prevented from reducing the dividends of the target's stock and thereby reducing the consideration required to be paid pursuant to the minimum price requirements. Fair price amendments often provide that, regardless of the price offered, supermajority requirements will be imposed if the bidder acquires any additional shares of voting stock in any transaction after it becomes a controlling shareholder. A common procedural requirement is a provision designed to prevent self-dealing providing that a new controlling shareholder may not receive loans, financial assistance, or tax advantages from the target (other than proportionately, solely in its capacity as a stockholder). Provisions against asset transfers are designed to discourage the slow liquidation and acquisition of a target by a new controlling shareholder.

²⁸² These provisions are especially well suited to discourage front-end loaded tender offers or partial bids because they ensure fair treatment of minority shareholders after a partial bid by restricting the price payable in the second-step merger.

²⁸³ The repurchase price can be set in a manner similar to that of "fair price" provisions, including: (i) highest per share price paid for any share of stock previously acquired; or (ii) specified premiums to market or book value per common share.

²⁸⁴ As with fair price amendments, the compulsory redemption provision can discourage two-tiered offers by requiring an offeror to buy a greater number of shares, at a higher price, than it would otherwise acquire.

validity.²⁸⁵

The board may also defend by seeking shareholder approval to amend the corporate charter to increase the number of authorized common or preferred shares for later issuance into friendly hands (sometimes in conjunction with a "Crown Jewel" asset option).²⁸⁶ Or the board may distribute to its common shareholders a dividend in the form of a convertible preferred stock (assuming the board has previously requested shareholder approval of the creation of a class of preferred to be issued upon such terms and with such preferences as may be set by the board) that contains a "flipover" provision permitting, in the event of a tender offer followed by a freezeout merger, the preferred to be convertible into the common stock of the bidder, thus presenting the would-be bidders with the prospect of earnings dilution if the tender offer is successful (the so-called "poison pill" dividend).²⁸⁷ The preferred is usually noncallable for ten or fifteen years, has a dividend rate based on the common stock such that there is a disincentive to convert, and, if a third party acquires a significant percentage of the issuer's common stock, is redeemable at the highest price paid by such third party in transactions to acquire its position.²⁸⁸ It is also possible to include among the terms of the preferred stock various shark-repellant or supermajority provisions. However, to the extent the shareholders have not voted to approve these provisions, they have generally not been included to date.

These examples suggest why structural defenses differ significantly from the financial defenses: structural defenses generally reflect the consent of some of the shareholders.²⁸⁹ In fact, the likelihood of share-

²⁸⁵ The validity of compulsory redemption provisions has not been tested in the courts. Both New York and Delaware law seem to prohibit the issuance of common stock redeemable at the option of the holder. *See* N.Y. BUS. CORP. LAW § 512 (McKinney 1982); DEL. CODE ANN. tit. 8, § 151(b) (1983). The redemption of stock would also be prohibited if the repurchase would impair a corporation's capital. *See* DEL. CODE ANN. tit. 8, § 160 (1983); N.Y. BUS. CORP. LAW § 513 (McKinney 1982). Furthermore, if the redemption required a reduction in capital or the liquidation of assets, the procedure would be subject to challenge on the ground that the expenditures constituted waste and failed to serve a valid corporate purpose, despite charter authorization.

²⁸⁶ *See* Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1982), where Marathon issued stock and "Crown Jewel" asset options to U.S. Steel in order to induce it to make a friendly bid. *See also* Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980).

²⁸⁷ *See, e.g.,* Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979).

²⁸⁸ A recent innovation is to have the "flipover provision" permit conversion not into the bidder's common but into a new class of convertible preferred.

²⁸⁹ Such shareholder support, evidenced by placement of the structural defenses in the corporate charter, makes such corporations substantially less vulnerable to legal attack. *Compare* Joseph E. Seagram & Sons, Inc. v. Conoco, Inc., 619 F. Supp. 506

holder approval of a particular defense is obviously a crucial factor in the directors' decision about whether to submit the structural changes to shareholders for a vote. Shareholders, especially institutional investors, recently have shown reluctance to vote in favor of such provisions.²⁹⁰

2. Defending Against Corporate Raiders

In the typical corporate raider scheme, an investor buys a significant block of a company's stock on the open market, and then announces that he wants to be bought out by the company at a premium. This attempt to "greenmail" the company raises serious concerns. If the target's management balks, the greenmailer can threaten to mount a proxy fight either to elect new management or to "bust up" the company, i.e., sell the assets piecemeal, or launch a tender offer in order to win control and then liquidate the company. The goal is so to preoccupy management that it will buy out the investor's shares in order not to be diverted from running the company's business. In defense of management, the assault can be so time consuming, the publicity (and greenmailers relish publicity) so unfavorable, that management may realistically have no choice but to find a buyer for the company or buy out the greenmailer's position. It is difficult to justify the greenmail practice on other than the most crass "free market" rationale.²⁹¹

Current regulation does not deter greenmail transactions. The

(D. Del. 1982) (invalidating bylaw restricting alien ownership of stock adopted amid tender offer by Canadian company on ground that there was no shareholder approval) and *Coalition to Advocate Pub. Util. Responsibility, Inc. v. Engels*, 364 F. Supp. 1202 (D. Minn. 1973) (invalidating an attempt to reduce the number of directors immediately prior to annual meeting) with *Seibert v. Milton Bradley, Inc.*, 380 Mass. 656, 405 N.E.2d 131 (1980) (upholding a supermajority bylaw, which provided that vote of at least 75% of the outstanding shares was necessary for the adoption of a merger proposal, chiefly on the ground that the shareholders had approved the bylaw). Moreover, under most state corporation laws, shareholders have or retain the right to amend the bylaws, e.g., N.Y. BUS. CORP. LAW § 601(a) (McKinney 1982), so that there may be an inference of continuing shareholder approval when the structural defenses are retained in the bylaws over time.

Defensive transactions involving issuances of shares may be less vulnerable since shareholders have not only voted on the capitalization, but in the case of preferred explicitly granted the directors discretion as to the timing and terms of issue. On the other hand, the legitimacy of such shareholder approval is much more tenuous than it is when supermajority provisions are submitted to the shareholders for a vote.

²⁹⁰ See, e.g., *Masters, Interest, Doubts Sparked by Season's Proxy Contests*, *Legal Times of Wash.*, May 23, 1983, at 1, col. 3; see also *Blustein, Measures to Discourage Takeovers Stir Controversy at Annual Meetings*, *Wall St. J.*, April 18, 1983, at 29, col. 1.

²⁹¹ See *Icahn, Stop the Oppression of Shareholders*, *N.Y. Times*, May 22, 1983, at 2F, col.1.

stock exchanges have not adopted any rules prohibiting it.²⁹² State blue sky laws or corporate laws do not require that shareholders approve the transaction, with the result that there is little check on the price management may pay to rid itself of the meddlesome holder.²⁹³ Any subsequent derivative actions are not likely to succeed given the wide latitude the "business judgment" rule accords to good faith decisions of the board.²⁹⁴ Indeed, the case law seems to suggest that the worse the "greenmailer" behaves, the worse his reputation, the easier it will be for the board to withstand subsequent attack on its decision to repurchase shares at a high premium.²⁹⁵ Such a rule of law encourages the bidder to cultivate the reputation of a pirate. Compounding the problem, courts have struck down on commerce clause grounds state efforts to deal with the problem through takeover statutes.²⁹⁶

B. Current Regulation of Defensive Tactics

We will now briefly outline how takeover defenses are regulated at both the federal and state level. These regulations are most relevant to the financial defenses pursued by directors of corporations that do not have existing structural defenses approved by shareholders.

²⁹² *But cf.* Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977) (indicating that the New York Stock Exchange took the position that management should obtain shareholder approval of proposed repurchase of shares held by vexatious shareholder).

²⁹³ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 38-39.

²⁹⁴ See *infra* notes 317-47 and accompanying text.

²⁹⁵ Federal law imposes no substantive regulation on such practices. All that is called for is full disclosure of the greenmailer's "plans and proposals," which the greenmailer is delighted to make, for compliance seems to further the greenmailer's objectives. The recent case of *Dan River, Inc. v. Icahn*, [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,043 (4th Cir. Jan. 7, 1983), is a good example of this effect and demonstrates the ineffectiveness of a disclosure system dealing with subjective intentions. The Icahn group filed a Schedule 13D that bluntly stated the group's alternate intentions of, among others, either (i) seeking control or (ii) seeking to sell the acquired shares to the issuer. *Id.* at 94,955 n.2. The Fourth Circuit termed the disclosure "extraordinarily frank," and held that it did not violate § 13(d) or the antifraud provisions. *Id.* at 94,959. The Court stated:

We doubt that such frankness will be found to violate section 10(b) and Rule 10b-5 and pause only to highlight a potential irony. Were Icahn's conduct to be held unlawful, we would be left with the peculiar result that the tender offeror who openly informs the investment community that a buy-out is a distinct possibility is dammed [sic] while the tender offeror who conceals the same information proceeds unimpugned.

Id.

²⁹⁶ See *Agency Rent-A-Car, Inc. v. Connolly*, 542 F. Supp. 231 (D. Mass.), *re-manded*, 686 F.2d 1029 (1st Cir. 1982) (vacating preliminary injunction for further factfinding); *Vista Resources Inc. v. Connolly*, No. 82-0707-MC (D. Mass. March 26, 1982) (entering temporary restraining order against enforcement of statute).

1. Federal Abstention from Regulation of Defense Tactics: The *Santa Fe* Doctrine

During the early and mid-1970's, it was thought that the federal securities laws placed substantive limits on corporate responses to acquisitions. It was argued that the Commission had the power to impose, and section 14(e) itself contained implicitly, substantive standards applicable to defensive tactics by directors to prevent fraud or the possibility of fraud. For example, in *Applied Digital Data Systems, Inc. v. Milgo Electronic Corp.*,²⁹⁷ the district court held that a subject company may have violated section 14(e) by issuing a large block of stock to a friendly suitor without shareholder approval solely as a defensive measure against a hostile bid.²⁹⁸

*Santa Fe Industries v. Green*²⁹⁹ brought an abrupt end to the broad readings of the antifraud provisions of the securities laws and sharply limited the ability of a plaintiff to challenge corporate decision-making.³⁰⁰ The case presented the claim of minority shareholders that a corporation had violated Rule 10b-5 because the terms of a proposed short-form merger (which could be implemented without a shareholder vote) were inherently unfair.³⁰¹ The Second Circuit had previously concluded that Rule 10b-5 was applicable to a "breach of fiduciary duty owing by the majority to the minority . . . without a showing of misrepresentation or lack of disclosure."³⁰²

The Supreme Court reversed, holding that the merger itself was

²⁹⁷ 425 F. Supp. 1145 (S.D.N.Y. 1977). See also *Royal Indus. v. Monogram Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CGH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976) (defensive acquisition, the sole or primary purpose of which is to thwart hostile bid, violates § 14(e)).

²⁹⁸ The high point of this approach to the federal securities laws was the Commission's action in promulgating for public comment proposed Rule 13e-3, which would have required, if adopted, that the terms of "going private" transactions be substantively fair to shareholders. See SEC Release No. 34-17,222, 45 Fed. Reg. 70,890 (1980). Section 13(e) empowers the Commission to adopt rules that "define acts and practices which are fraudulent, deceptive, or manipulative" and "prescribe means reasonably designed to prevent such acts and practices." 15 U.S.C. § 78m(e) (1982). It followed, therefore, that if the Commission had decided to mandate substantive fairness under § 13(e), it could have imposed substantive fairness requirements on bidders and targets under § 14(e), since the language is similar.

²⁹⁹ 430 U.S. 462 (1977).

³⁰⁰ See generally Ferrara & Steinberg, *The Interplay Between State Corporation and Federal Securities Law—Santa Fe*, Singer, Burks, Maldonado, *Their Progeny and Beyond*, 7 DEL. J. CORP. L. 1 (1982); Ferrara & Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980); Gorman, *At the Intersection of Supreme Avenue and Circuit Street: the Focus of Section 10(b) and Santa Fe's Footnote Fourteen*, 7 J. CORP. L. 199 (1982).

³⁰¹ See 430 U.S. at 470.

³⁰² *Green v. Santa Fe Indus.*, 533 F.2d 1283, 1291 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

neither a "deceptive" nor "manipulative" transaction within the meaning of section 10(b) of the Exchange Act.³⁰³ Both terms, the Court held, as well as the statute as a whole, require that there be some element of nondisclosure, either by misrepresentation or omission, before a corporation's behavior is actionable.³⁰⁴ Accordingly, the Court concluded that, because the plaintiffs alleged no fault with the disclosure of the transaction, they failed to state a claim under Rule 10b-5.³⁰⁵

Since the *Santa Fe* decision, the federal courts have rejected several opportunities to characterize tender offer defensive tactics as "fraudulent, deceptive, or manipulative" acts or practices and thus violative of federal law.³⁰⁶ Only in *Mobil Corp. v. Marathon Oil*

³⁰³ See 430 U.S. at 474.

The other principal antifraud provision, applicable to tender offers, is § 14(e) of the Securities Exchange Act, which outlaws "fraudulent, deceptive, or manipulative acts or practices" in connection with any tender offer and gives the Commission rulemaking power to adopt rules "reasonably designed to prevent" the occurrence of such practices. 15 U.S.C. § 78n(e) (1982). Although the wording of §§ 10(b) and 14(e) is not identical—§ 14(e) includes the term "fraudulent" while § 10(b) does not—the courts have read these two sections in *pari materia*. See, e.g., *Mobil Corp. v. Marathon Oil Corp.*, 530 F. Supp. 315 (N.D. Ohio), *rev'd on other grounds*, 669 F.2d 366 (6th Cir. 1981). But see Junewicz, *The Appropriate Limits of Section 14(e) of the Williams Act*, 62 TEX. L. REV. No. 7 (April 1984) (forthcoming) (arguing that the term "fraudulent" in § 14(e) suggests that certain defensive tactics, at least those taken solely to perpetuate control, violate § 14(e)).

Thus, this limit on the scope of § 10(b) also effectively limits the scope of § 14(e) in the context of corporate behavior during tender offers.

³⁰⁴ 430 U.S. at 474. The Court noted in this regard that it:

repeatedly has described the 'fundamental purpose' of [the Exchange Act] as implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute.

Id. at 477-78.

³⁰⁵ *Id.* at 474-77.

The Court decided that a contrary rule would:

bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. . . . Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.

Id. at 478-79.

³⁰⁶ For example, in *In Re Sunshine Mining Co. Sec. Litig.*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,217 (S.D.N.Y. June 4, 1979), the court held that under *Santa Fe* there is no action under Rule 10b-5 or 14(e) against directors for opposing and frustrating a takeover bid even though the directors were acting *solely* for their own self-interest and totally in disregard of fiduciary duties to shareholders. *Accord* *Berman v. Gerber Products Co.*, 454 F. Supp. 1310, 1318 (W.D. Mich. 1978); *Altman v. Knight*, 431 F. Supp. 309, 313-14 (S.D.N.Y. 1977).

Decisions subsequent to *Santa Fe* also have not allowed the Court's holding to be undermined by allowing plaintiffs to allege that the board defrauded them by not disclosing that the transaction was in fact unfair, entered for a wrongful purpose, or in breach of a fiduciary duty, all of which they knew or should have known. See R. HAM-

Co.³⁰⁷ has a court relied on the Exchange Act to prohibit a defensive tactic employed in the context of a tender offer. There the Sixth Circuit Court of Appeals was faced with a challenge to two "lock up agreements" into which Marathon Oil had entered with United States Steel after Marathon Oil had become a target of a tender offer by Mobil.³⁰⁸ The court held that the agreements were "manipulative acts and practices" under section 14(e) because they had "the effect of creating an artificial price ceiling in the tender offer market" for Marathon's securities.³⁰⁹ The following syllogism captures the crux of the Sixth Circuit's reasoning in *Mobil*:

(1) "Manipulation," as proscribed by section 14(e), means any "artificial" action affecting the market price for a security.³¹⁰

(2) The Yates Field and stock option lock-up agreements "artificially" affected the market price for Marathon stock by interfering with free market forces and restraining bidders for the company's shares.³¹¹

(3) Hence, these lock-up agreements are "manipulative" and thus violate section 14(e).³¹²

The *Mobil* rationale has been rejected by many courts,³¹³ perhaps

ILTON, *supra* note 16, at 892. Such disclosure of course would amount to a confession of wrongdoing by the directors.

Courts have stated that directors are not required to disclose "true motives" in engaging in the transaction. *See, e.g., Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir. 1980) (no need to disclose motive "so long as motive is not manipulative or deceptive and the nature and scope of any stock transactions are adequately disclosed to those involved."); *Rodman v. Grant Found.*, 608 F.2d 64, 71 (2d Cir. 1979) ("much support" for position that subjective interest of officers and directors need not be disclosed); *Golub v. PPD Corp.*, 576 F.2d 759, 765 (8th Cir. 1978) ("true motivation" of management need not be disclosed).

³⁰⁷ 669 F.2d 366 (6th Cir. 1981).

³⁰⁸ Marathon Oil Co., which in October, 1980, was the subject of a hostile tender offer by Mobil Corp., began merger negotiations with United States Steel Corp. (USS). USS, however, was apparently unwilling to plunge into a bidding war with Mobil, a far richer combatant, without some competitive advantage. As an express condition, of the merger agreement, USS demanded that Marathon give USS an irrevocable option to purchase Marathon's 48% interest in the valuable Yates Oil Field (generally acclaimed as its "Crown Jewel" asset) for \$2.8 billion exercisable, if anyone other than USS acquired Marathon. USS also requested and received an irrevocable option to purchase up to 10 million unissued shares at \$90 per share. *Id.* at 369.

³⁰⁹ *Id.* at 375.

³¹⁰ *Id.* at 374 (emphasis in original).

³¹¹ *Id.* at 375.

³¹² *Id.*

³¹³ *See, e.g., Buffalo Forge v. Ogden Corp.*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,501, at 96,920 (2d Cir. Sept. 22, 1983) ("*Marathon* was an unwarranted extension of the Williams Act."); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp.

because of its questionable legal foundation,³¹⁴ and has been criticized by several courts and commentators as being unworkable and inconsistent with *Santa Fe*.³¹⁵ The disclosure underpinnings of current federal law are emphasized in cases involving the legality of two-tier tender offers, the coercive effect of which has been frequently criticized. One district court stated: "If the counter offer is in fact 'coercive,' it would only be because its two-tier structure is revealed all too well."³¹⁶

Thus, current federal regulation is largely limited to disclosure requirements.

2. The Business Judgment Rule and State Regulation

After *Santa Fe*, any substantial regulation of corporate responses to attempted acquisitions must be achieved at the state level. State regulation, however, is not likely to be effective because the business judgment rule is the method used to review those corporate actions.³¹⁷ This

623, 630 (D. Md. 1982) ("*Mobil* decision is an exceptionally strained interpretation of *Santa Fe*."); Radol v. Thomas, 534 F. Supp. 1302 (S.D. Ohio 1982).

³¹⁴ The Sixth Circuit's definition of "manipulation" is based upon a misconstruction of *Santa Fe*, overlooks the influence of full disclosure, and is without support in case law or the legislative history of § 14(e) or § 10(b), the statutory relative of § 14(e). In brief, *Santa Fe* states that manipulation "refers generally to practices . . . intended to mislead investors by artificially affecting market activity." 430 U.S. at 476 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)). In formulating its definition, the Sixth Circuit ignores the intention to deceive emphasized by the Court in *Hochfelder* and *Santa Fe*. The court thus disregards the question of whether the option agreements misled, deceived, or defrauded investors, a critical element of the Supreme Court's reasoning in *Santa Fe* and *Hochfelder*. It is also difficult to see why such "lock-up" agreements "artificially" affect market prices. Rather, their effect seems real and concrete. The Sixth Circuit's view of what constitutes a practice "artificially affecting market activity" amounts to the view that any corporate transaction having the effect of increasing or decreasing demand for its securities is a prohibited manipulation. See *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349 (N.D. Tex. 1979).

³¹⁵ See Nathan, *Novel Legal Questions Explored*, Nat'l Law J., Mar. 29, 1982, at 25, 30; see also Bialkin, *Court Casts Cloud Over Option Tactic in Takeovers*, Legal Times of Wash., Jan. 11, 1982, at 19, 27.

³¹⁶ *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 630 (D. Md. 1982).

³¹⁷ The business judgment rule is, in fact, used to evaluate a whole range of corporate decisions in the acquisitions area. In addition to the decision to engage in specific defensive tactics, the decision of the bidder to commence a bid, the selection of the subject company, the mode of the bid, be it tender offer or open market acquisition program, the price to be paid, the number of shares sought, are evaluated under this rule. Similarly, decisions as to whether the consideration is to be paid in cash or stock, to incur any debt to finance the transaction, no matter how costly, are only reviewable in this way.

The business judgment rule has been discussed extensively by commentators. See generally Brown, *Recent Developments Relating to the Business Judgment Rule*, 6 DEL. J. CORP. L. 538 (1981); Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View From the Inside*, 60 WASH. U.L.Q. 311 (1982); Eisenberg, *The Business Judgment Rule*, 14 INST. SEC. REG. 251 (1983); Hansen, *Business*

rule, articulated in various ways from jurisdiction to jurisdiction, provides in general that:

a court will not interfere with the judgment of the 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.³¹⁸

Because of the importance of this rule in the review of corporate defense tactics, an assessment of its effectiveness in this context is timely.

a. *Applicability of the Rule to Tender Offer Defenses*

Before evaluating the elements of the rule, it is questionable that the rule should even apply to decisions to resist a tender offer. The business judgment rule originated to test decisions made by directors to maximize profits. When applied to such decisions, it is unassailable. Shareholders give directors a broad mandate to manage or oversee the business, which involves countless business decisions. Because meaningful review of such decisions requires intimate financial and technical knowledge of the company, its products, and its industry, it is understandable that judges would apply a test that provides substantial deference to corporate decisionmakers.³¹⁹ But it is not at all clear that the same deference should apply when the decision under review relates not to the company's day-to-day operations but to whether a bidder should be able to purchase stock from shareholders on a fully disclosed basis. The directors mandate to make such decisions is far less clear

Judgment Rule and Maldonado [Zapata v. Maldonado, 430 A.2d 779 (Del. 1981)]—*Another Perspective*, 6 CORP. L. REV. 131 (1983); Higbee, *The Misapplication of the Business Judgment Rule to Dismiss Shareholder Derivative Suits Against Directors*, 33 U. FLA. L. REV. 589 (1981); Johnson, *Anti-Takeover Actions and Defenses: Business Judgment or Breach of Duty?*, 28 VILL. L. REV. 51 (1982); Veasey, *Seeking a Safe Harbor From Judicial Scrutiny of Directors' Business Decisions—An Analytical Framework for Litigation Strategy and Counselling Directors*, 37 BUS. LAW. 1247 (1982); Veasey, *Business Judgment Rule and Shareholder Derivative Actions: Background*, 6 DEL. J. CORP. L. 518 (1981); Walsh, *Defensive Tactics and the Fiduciary Obligations of the Target Board of Directors*, 7 J. CORP. L. 579 (1982); Comment, *The Misapplication of the Business Judgment Rule in Contests of Corporate Control*, 76 NW. U.L. REV. 980 (1982).

³¹⁸ *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (citation omitted).

³¹⁹ See generally 3A W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1039 (rev. perm. ed. 1975).

than their mandate to run the company. Nevertheless, the courts have used various formulations of the business judgment rule to evaluate change-of-control decisions without analyzing or even acknowledging this unique context.³²⁰

The majority opinion in *Panter v. Marshall Field & Co.*³²¹ is an example of this lack of attention to the important new context presented by takeovers. In *Panter*, the directors of Marshall Field rejected a takeover bid made by Carter Hawley Hall (CHH) at a handsome premium over prevailing market prices and engaged in a number of defensive maneuvers designed to thwart the upcoming bid, including the acquisition of a business likely to create antitrust law obstacles for CHH.³²² The two-judge majority upheld the directors' conduct by a straightforward application of the business judgment rule.³²³

Judge Cudahy, in dissent, argued that a court's role in evaluating decisions to discourage changes in control should for sound policy reasons be more intrusive than its role in evaluating day-to-day management decisions.³²⁴ He sharply criticized the majority for "adopt[ing] an approach which would virtually immunize a target company's board of directors against liability, provided that a sufficiently prestigious (and expensive) array of legal and financial talent were retained to furnish *post hoc* rationales"³²⁵

Judge Cudahy argued that a more rigorous test should apply in change-of-control cases in view of the undeniable self-interest of directors in any takeover attempt and favored the following rule:

³²⁰ See generally sources cited *supra* note 317.

³²¹ 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

³²² *Id.* at 278.

³²³ *Id.* at 297. The court held that:

[d]irectors of corporations discharge their fiduciary duties when in good faith they exercise business judgment in making decisions regarding the corporation. *When they act in good faith, they enjoy a presumption of sound business judgment*, reposed in them as directors, *which courts will not disturb if any rational business purpose can be attributed to their decisions*. In the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors.

Id. at 293 (emphasis added) (quoting the district court, 486 F. Supp. 1168, 1194 (N.D. Ill. 1980) (citations omitted)).

³²⁴ Judge Cudahy stated that day-to-day management decisions "involve[] corporate functioning in competitive business affairs in which judicial interference may be undesirable." The decisions about change in control were seen by Judge Cudahy as "involv[ing] only the corporation-shareholder relationship, in which the courts may justifiably intervene to insist on equitable behavior." *Id.* at 299-300 (quoting Note, *Protection for Shareholder Interests in Recapitalizations of Publicly Held Companies*, 58 COLUM. L. REV. 1030, 1066 (1958)).

³²⁵ *Id.* at 299.

Once a plaintiff has shown that the desire to retain control was 'a' motive in the particular business decision under challenge, the burden is then on the defendant to move forward with the evidence justifying the transaction as primarily in the corporation's best interest.³²⁶

Despite this and other arguments favoring closer scrutiny of defensive tactics,³²⁷ the law seems to be the "any business purpose" standard set forth by the *Panter* majority.³²⁸

b. *Effectiveness of the Rule in Regulating Tender Offers*

The business judgment rule is a rule of retroactive, not prospective, application. It amounts to a doctrine of judicial abstention from inquiry into the merits of business decisions so long as (a) the directors act in "good faith" and (b) a "rational business purpose" may be attributed to the decision under review. Analysis of the operations of the rule in modern takeover battles indicates that it fails to provide the analytical framework necessary to give officers and directors adequate guidance and to enable courts to conduct appropriate review of business decisions of enormous importance to the shareholders of the issuer and to the economy as a whole.

(i) The "Good Faith" Element

The good faith element of the business judgment rule was formulated to strip the rule's presumption of validity from an officer or director who had engaged in "self-dealing" or who had a "material personal interest" in the outcome of the transaction.³²⁹ Once the lack of good faith is shown, the decision is not automatically condemned as null, but it is declared suspect, and the burden shifts to the officer or director, who must demonstrate by a preponderance of the evidence that the transaction was "intrinsically fair" to the corporation and its

³²⁶ *Id.* at 304 (quoting *Johnson v. Trueblood*, 629 F.2d 287, 301 (3d Cir.) (Rosen, J., dissenting), *vacated on other grounds*, 629 F.2d 302 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981)).

³²⁷ For example, in *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975), the court of appeals approved the application of a rigorous rule which required directors of a target company to demonstrate a "compelling business purpose" for their actions.

³²⁸ E.g., Rosenzweig, *The Legality of "Lock-Ups" and Other Responses of Directors to Hostile Takeover Bids or Stock Aggregations*, 10 SEC. REG. L.J. 291, 294 (1983).

³²⁹ Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 115-16 (1979); *Lewis v. S.L. & E., Inc.*, 629 F.2d 764, 769 (2d Cir. 1980); *Blake v. Nat'l Research Assocs., Inc.*, 466 F.2d 570, 572 (4th Cir. 1972).

stockholders.³³⁰

It is clear that a director's receipt of a valuable corporate opportunity or association with the corporation in a profitable business transaction raises sufficient doubt about the good faith element to require the director to demonstrate that the transaction is "intrinsically fair" to the corporation and its shareholders. It would seem therefore that a decision that materially enhances an officer's job security and long-term financial security, like a decision to oppose a hostile takeover by a raider committed to a thorough housecleaning, would receive the same legal treatment. Instead, courts have increasingly concluded that the presumption of validity remains intact even though the retention of corporate control and position is the unquestionable effect of successful defensive strategies.³³¹ It is difficult to see, and no court has adequately explained, why a "rational business purpose test" should apply in change-of-control cases but not also in traditional self-dealing cases, or conversely why the more stringent test applied in self-dealing cases is not also applied in change-of-control cases.³³²

In *Johnson v. Trueblood*,³³³ the Third Circuit reasoned that, "by the very nature of corporate life a director has a certain amount of self-interest in everything he does"³³⁴ and his obvious self-interest in the retention of control would not, of itself, constitute bad faith.³³⁵ The court interpreted the rule as "postulating that if actions are arguably taken for the benefit of the corporation, then the directors are presumed

³³⁰ See generally Arsh, *supra* note 329.

³³¹ In part, courts may have reached this result because the recent cases have involved situations in which a majority of the board of directors are not full-time employees. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). As a result of this status, they are presumed "disinterested" and the transaction is treated as if it were an ordinary business decision. When evaluating boards containing a majority of outside directors these courts will not shift the burden to the defendants unless the plaintiff can establish, again by a preponderance of the evidence, that the director's "sole or primary purpose" underlying a defensive maneuver is to "retain control." See, e.g., *Panter*, 646 F.2d 271; *Trueblood*, 629 F.2d 287.

³³² In this regard, judges have also failed to explain why they are more willing to review directors' decisions to terminate litigation against other directors than they are decisions to prevent control shifting. In *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), the Delaware Supreme Court rejected the business judgment rule as the appropriate standard for reviewing the decision of a committee of disinterested directors (a so-called "special litigation committee") to terminate a shareholder derivative suit. The court laid down the following test: (1) is the committee composed of independent directors who acted in good faith after reasonable investigation?; and (2) does the reviewing court, after exercising its own independent business judgment, believe the action should be dismissed? *Id.* at 788-89.

³³³ 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

³³⁴ *Id.* at 292.

³³⁵ *Id.* at 293.

to have been exercising their sound business judgment rather than responding to any personal motivations.”³³⁶ Under this reasoning, which has been applied by other courts in forms only insignificantly different,³³⁷ the “good faith” element of the rule is effectively ignored in change-of-control cases.³³⁸

Because the judgment of directors is undeniably affected by their high professional and financial stake in the outcome of an acquisition contest,³³⁹ and the current bias against an uninvited bidder challenging the right of a company to be independent, it is apparent that there must be some new understanding of the good faith element of the business judgment rule. Even attempts at more restrictive formulations of the rule have provided only partial solutions to the problems presented by the good faith element. Judges Cudahy and Rosenn, dissenting in *Panter* and *Trueblood* respectively, formulated the rule so as to shift the burden of proof “[o]nce a plaintiff has shown that the desire to retain control was ‘a’ motive in the particular business decision under challenge.”³⁴⁰ This formulation is clearly more consistent with traditional applications of the rule. It does, however, suffer from problems inherent in any rule that focuses on the subjective intentions of a group of officers and directors.³⁴¹

³³⁶ *Id.* at 292.

³³⁷ See *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 702-03 (2d Cir. 1980); *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977) (“an issue of stock that has the collateral effect of enhancing the power of incumbent management is not invalid if the transaction has as its principal purpose some proper corporate goal”); *McPhail v. L.S. Starrett Co.*, 257 F.2d 388, 395 (1st Cir. 1958) (“it would be to ‘strain at a gnat, and swallow a camel,’ 23 Matt. 24, for us to infer some improper, ulterior or selfish purpose on the part of the directors” in stock issuance decision); *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 204 A.2d 795 (1964) (transaction sustained under business judgment rule because its principal purpose is a proper corporate goal, even though collateral effect enhances power of management).

³³⁸ *Rosenzweig*, *supra* note 328, at 294.

³³⁹ The financial interest of outside directors is admittedly less acute than that of inside directors given the minimal fees such directors normally receive. Even outside directors may, however, be interested in retaining the prestige and professional satisfaction that comes from being a member of the board of directors of a well-known public company. In addition, such directors probably have a bias against an uninvited bidder challenging the right of the company to be independent.

³⁴⁰ *Panter v. Marshall Field & Co.*, 646 F.2d 271, 304 (7th Cir. 1981) (Cudahy, J., dissenting) (quoting *Johnson v. Trueblood*, 629 F.2d 238, 301 (3d Cir. 1980) (Rosenn, J., dissenting), *cert. denied*, 450 U.S. 999 (1981)), *cert. denied*, 454 U.S. 1092 (1981). See also *supra* note 332.

³⁴¹ For example, the rule formulated by Judges Cudahy and Rosenn requires that the following difficult determinations be made. For which of the following must the retention of control have been a motive: each director; a majority of the board; the inside directors primarily responsible for presenting information, as well as legal and financial opinions, to the board; or the board as a whole?

(ii) Any Rational Business Purpose

By in effect reading the good faith element out of the rule, cases like *Panter* and *Trueblood* have resulted in a review of corporate defense tactics that focuses almost exclusively on the presence of "any rational business purpose" for the board's decision. Yet, analysis of the business purpose is itself freighted with ambiguities that preclude effective judicial review, appropriate guidance for directors, and protection for shareholders.

Merely to articulate the legal test as the existence of "any rational business purpose" raises suspicions about its adequacy. It is difficult to contend that a test that is passed by proof of "any business purpose" is an appropriate standard of scrutiny for whether the directors are loyal to shareholders. To pass legal muster, the directors' reason need not be particularly compelling or persuasive, or even the best of a variety of rationales in supporting alternative courses of conduct.

The existence of a "rational" business purpose doesn't necessarily mean that the shareholders' best interests have been served.³⁴² In prac-

³⁴² Indeed, the nominal requirement of the business judgment rule that an action be in the best interests of the corporation does not ensure protection of shareholder interests. First, the rule permits management to look to a wide variety of possible constituencies that may have conflicting, or at least inconsistent, interests. The interest of a "corporation" may be identified by looking toward the interests of several constituencies, including management, shareholders, employees, and local communities. In fact, under current law, the apparent interests of any of these disparate groups, divergent though they may be, may support the decision of the board to oppose a takeover bid. See, e.g., *Herald Co. v. Seawell*, 472 F.2d 1081 (10th Cir. 1972) (directors' motive to benefit public, the corporation, and employees); Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1817 (1976). In particular, one noted takeover practitioner states: "It is reasonable for the directors . . . to reject takeover on anyone of the following grounds: . . . (4) adverse impact on constituencies other than shareholders." Lipton, *supra* note 275, at 122. The result is that the full range of corporate responses, from recommending acceptance to engaging in the most vigorous financial defense tactics, can be justified under this purpose test.

For example, arbitrageurs, as shareholders, will always want the company to accept a hostile bid or sell to a white knight in order to maximize their short-term gain. They are shareholders in name only. Employees, including those who own shares, may wish management to take any action that will ensure continued employment, especially if the hostile bidder is committed to or has a reputation for consolidations which may result in an elimination of jobs. Long-term shareholders may believe, with management, that the price is inadequate and will support a defense allowing the company to remain independent in the hope that, by doing so, the corporation will realize its true value. The community may want management to oppose the bid because of the possibility that a significant plant may be closed or moved to another geographic location.

Second, as this example also indicates, even if one considers only the interests of shareholders, the range of permissible responses may be just as broad. The class of shareholders is likely to include long-term investors, employees, and arbitrageurs.

Finally, because these interests are not quantifiable, it is quite difficult to assess whether, and to what extent, the shareholder, employee, or societal interests purportedly served by the board's action have been served in fact. See Gelfond & Sebastian,

tice, it means simply that the directors need only adduce and document a single, plausible reason to support their action,³⁴³ and in almost every transaction they can plausibly decide that the bidder's opening price is inadequate (thus justifying defensive measures), because most bidders reduce the value of their original bid to allow for a subsequent increase that may be necessary because of negotiations or competition.

As one commentator has remarked, "[r]arely will a target corporation, particularly one advised by knowledgeable counsel, be unable to devise a plausible business purpose for its conduct."³⁴⁴

A more appropriate test of business purpose would be to require the corporation's response to the tender offer to be evaluated according to the rational purpose proffered or to account otherwise for the probable effect of defensive maneuvers on the ability of shareholders to sell their shares at a price that may far exceed the usual market price that reflects the performance of current management. Courts currently seem to assume that if any rational purpose is present, any response is acceptable. Directors are not required to justify each maneuver on a cost-benefit basis, for example, whether the target's continued independence was worth the interest costs on the debt incurred to finance an issuer

Reevaluating the Duties of Target Management in a Hostile Tender Offer, 60 B.U.L. REV. 403, 459 (1980).

The diversity of interests, plus the measurement difficulty, contribute to permissiveness since it is usually possible to find that any particular course of action—including one that causes the hostile bidder to withdraw a handsome bid, e.g., *Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 951 (N.D. Ill.), *aff'd mem.*, Nos. 82-1305, 82-1307 (7th Cir. Mar. 5, 1982)—may be in the best interests of at least one of these disparate interests.

Part V of this Article discusses in greater detail the problem of responding to the various constituencies with interests in a corporation when there is an attempt to acquire control of the corporation. See *infra* notes 399-411 and accompanying text.

³⁴³ A major fault of the rational business purpose analysis is that it focuses too much on the documentation that management is able to produce in support of its decision, rather than on the merits of the decision itself. See *infra* note 344.

³⁴⁴ Cohn, *Tender Offers and the Sale of Control: An Analogue to Determine the Validity of Target Management Defensive Measures*, 66 IOWA L. REV. 475, 499-500 (1981) (citations omitted).

It has also been argued:

The business purpose test poses a nearly insurmountable obstacle for plaintiffs challenging defensive tactics. Regardless of the tactic employed, management can easily manufacture a 'legitimate' corporate purpose for its action, even when it employed the tactic solely to perpetuate its own status. This is particularly true when management employs expert counsel to lay a foundation for and to structure its actions.

Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901, 926 (1979).

In fact, the failure of particular corporate actions to pass muster under the business purpose rule is often attributed to the failure to provide the transaction with the proper cosmetic appearance. See A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING* 88-26 to 88-34 (1980).

tender offer or counter tender offer.

In summary, current application of the rational business purpose requirement contributes to an excessively permissive legal environment because it affords directors unfettered discretion to select any of several interests to be protected according to the end they actually hope to achieve, requires primarily the articulation of an interest, rather than any demonstrated performance in pursuit of that interest, fails to require directors to balance the advantages for one group against the disadvantages for another group, and fails to deal with the problem of evaluating interests.

(iii) The Role of the Courts

As a common law rule of retroactive application, the business judgment rule depends for its enforcement on the willingness of courts to unravel, on an after-the-fact basis, consummated transactions often involving billions of dollars. Even assuming that current formulations of the business judgment rule are adequate, federal and state courts alike appear reluctant, absent tighter standards, to disrupt or unravel large transactions or to take action that might favor one side or the other in a takeover battle.³⁴⁵ It is clear that the ambiguity of the principles involved exacerbates this tendency.³⁴⁶

This reluctance seems to be intensified when the plaintiff is perceived to be seeking to interfere with normal marketplace operations or where the result would be to impose large damages on individuals. Especially in the supercharged atmosphere surrounding hostile, billion-dollar deals, courts face enormous pressure to do nothing. Time and time again, courts reject attempts by plaintiffs to hold directors responsible for deals that were not consummated because of their contumacious conduct.³⁴⁷

³⁴⁵ See, e.g., *Martin Marietta Corp. v. Bendix Corp.*, 547 F. Supp. 533 (D. Md. 1982); *Armour & Co. v. General Host Corp.*, 296 F. Supp. 470 (S.D.N.Y. 1969).

As former SEC Chairman Harold M. Williams observed: "[j]udges are, naturally, not comfortable second guessing directors in complex and delicate areas, such as takeovers, particularly when they may suspect that the judicial process is being used as a bargaining chip in a larger game." Address by Harold M. Williams, *Tender Offers and the Corporate Directors*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445, at 82,879 (Jan. 17, 1980).

³⁴⁶ In contrast, when the applicable legal principles are more precise, such as in antitrust law, courts are more willing to play an activist role. See P. AREEDA, *ANTI-TRUST ANALYSIS* 887-88 (3d ed. 1981) (discussing divestiture).

³⁴⁷ E.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981); *Pogo Producing Co. v. Northwest Indus.*, Civ. No. H-83-2667 (S.D. Tex. May 24, 1983) (issuer tender offer); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill.), *aff'd mem.*, Nos. 82-1305 and 82-1307 (7th Cir. Mar. 5, 1982); *Conoco Inc. v. Seagram Co., Ltd.*, 517 F. Supp. 1299 (S.D.N.Y. 1981).

3. Conclusion

Because of the limited reach of federal law after *Santa Fe*, state law remains the primary if not exclusive source for determining whether or not the board of directors of the target has breached any duty in the defensive strategies it pursues or the charter and bylaw provisions it invokes with respect to the bid.

State law, however, is hardly an effective limitation on the tactics of target companies. The business judgment rule, when applied in the new context of tender offers and acquisition programs, is simply not conceived or applied in a way that adequately protects shareholders' interests. Particularly in regard to the financial defenses,³⁴⁸ the views of the shareholders are not required to be sought. Their only role is either to vote the directors out, to sell their shares, or to institute litigation challenging the action taken.

C. *Possible Responses to Corporate Defense Tactics*

Commentators have come forward with a number of proposals for regulating corporate defense tactics. Some federal role in this area seems necessary. If Congress were to act, there would be uniform standards applicable to all major corporations, Professor Cary's call for federal standards for management conduct would be answered,³⁴⁹ and regulatory differences among states would be eliminated. An important, meaningful judicial review of board conduct would in all likelihood result.³⁵⁰ Whatever proposal is selected, shareholders should have a more significant role than they have today.

1. Absolute Prohibition on Defensive Tactics

The most extreme regulatory response would be to bar defensive tactics absolutely or, put differently, to require absolute passivity. This response would preclude incumbent management from taking any action that has the intended or unintended effect of frustrating the bid (unless perhaps there was a potential violation of antitrust law) and would thus invest the shareholders with unchallenged power to determine the success of the bid.

This response may not be desirable, however, because it would deprive shareholders of the use of managers in two key fiduciary capac-

³⁴⁸ See *supra* notes 267-76 and accompanying text.

³⁴⁹ Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 696-703 (1974).

³⁵⁰ See *id.* at 700-01.

ities. First, it would preclude management from rendering financial advice to shareholders regarding the attractiveness of the offer. Proponents of this approach would contend that this is no significant drawback because shareholders decide daily whether to sell shares in the market without the benefit of management's counsel. Nevertheless, the absolute prohibition seems inconsistent with current federal policy that mandates that target management publicly announce its recommendation with respect to a tender offer.³⁵¹ The current regulation reflects the policy view that management advice is valuable to shareholders.

Second, an absolute ban on defensive tactics would deprive shareholders of the services of managers as their bargaining agents. Management would not be able to seek a bidder willing to make a higher bid nor take any other action—for example, liquidation—calculated to result in higher per share payments to shareholders than the bidder is offering.

The loss of management's bargaining services is likely to be especially disadvantageous to shareholders faced with a partial bid. Each shareholder would have little choice but to tender to the partial bidder because with their wide geographic dispersal and limited time for action, shareholders could not act together to negotiate a better price. The shareholder would thus be required to assume both that all other shareholders will tender their shares, thereby passing control of the corporation to the partial bidder, and that, after obtaining control, the bidder would either make no further purchases, permitting share prices to return to pre-tender offer levels, or acquire the remaining shares in a second-step transaction (possibly undisclosed at the time of the initial bid) or a short-form freezeout merger (if a high percentage of the shares were acquired in the initial bid). The subsequent acquisition, even if it occurs, would therefore be assumed to be at a lower price than the first-step partial offer. This scenario would virtually ensure that enough shares would be tendered to guarantee the success of the initial bid.³⁵²

An absolute ban on defensive tactics may yield significant advantages, and thus may be a viable regulatory approach. If adopted, how-

³⁵¹ See Commission Rule 14e-2, 17 C.F.R. § 240.14e-2 (1983); Schedule 14D-9, 17 C.F.R. § 240.14d-101 (1983).

³⁵² These deleterious effects of an absolute ban on defensive tactics would be cured substantially by a provision requiring that a person that acquired a presumptive control position in the target's stock, for example, 20% of the outstanding shares, make a tender offer for all remaining shares at the highest price paid to acquire any share comprising the initial control position. This proposition, which amounts to a prohibition of partial offers, is discussed in Part II. See *supra* notes 218-23 and accompanying text.

ever, shareholders will still be adequately protected only if it is pursued in conjunction with a rule limiting partial offers. Prohibiting defensive tactics would drastically reduce the inefficient and acrimonious litigation that accompanies most modern hostile tender offers. It would also encourage target management to optimize share value, because defensive tactics would no longer be available as a way to preserve financial security.

2. Mandatory Managerial Passivity

Professors Easterbrook and Fischel have proposed a less extreme rule that "efforts undertaken by target management *primarily* to resist a takeover bid should not even be susceptible of the justification that they happen to benefit the target. Such efforts to resist should instead be proscribed completely."³⁵³ Under this approach, courts would presume that corporate actions that hindered an actual or expected takeover bid were taken primarily to resist the offer. The burden of proof would then shift to the target's managers to overcome the presumption "by a substantial demonstration that their actions were undertaken for the economic benefit of the target" and not "for the purpose of defeating the offer."³⁵⁴ Such blatant defensive tactics as shark-repellant charter and bylaw amendments would be prohibited *per se*.³⁵⁵

This approach has been seen as a significant and undesirable shift from the status quo,³⁵⁶ because it places the burden on management to justify its action as not "primarily" for the purpose of defeating the takeover bid. In fact, one advantage of this passivity rule is that it appears to give management wide latitude to respond to a tender offer through disclosure and various other defensive strategies, if it can demonstrate that its primary purpose was to ensure that if the corporation were sold, it was sold at the right price. Indeed, because the first bid of a hostile bidder is usually labeled "inadequate" by financial advisers retained by targets, this test would likely not preclude many of the financial transaction defenses.³⁵⁷ The real difficulty for a target, however, would be to persuade the court that the financial transaction was undertaken in good faith, particularly if the tactic resulted in the collapse of the tender offer rather than a higher price for the shares. Moreover, if the company were sold, it would seem hard to attack

³⁵³ Easterbrook & Fischel, *supra* note 159, at 1198 (emphasis added).

³⁵⁴ *Id.* at 1203.

³⁵⁵ *Id.* at 1203 n.122.

³⁵⁶ See Lipton, *supra* note 164, at 1024 n.30.

³⁵⁷ See *supra* notes 267-76 and accompanying text.

golden parachute contracts awarded during the fray.

Courts would, under this approach, continue to have the difficult task of discerning the subjective intentions of a management group. As discussed in regard to the business judgment rule,³⁵⁸ determining the subjective intention of a group may pose insurmountable problems.³⁵⁹ Also, objectives are not necessarily mutually exclusive: resisting one bidder frequently involves finding another bidder willing to pay a higher price. These interpretational problems aside, by focusing on subjective *intentions*, rather than *result*, the approach suggested by Professors Easterbrook and Fischel retains the heavy emphasis on the quality of documentation, rather than that of decisionmaking, that makes the business judgment rule easy to circumvent.

3. The United Kingdom Rule

No legislation regulates the making of takeover bids in the United Kingdom. Rather, the tender offer process is governed by the Panel on Take-Overs and Mergers, a self-regulatory body created in 1968 by the Stock Exchange, the Bank of England, and members of the financial and legal community.³⁶⁰ The Panel relies largely on adverse publicity and peer pressure to coerce compliance with the City Code on Take-Overs and Mergers, which sets forth rules to be allowed by participants in takeover contests.³⁶¹

Two basic rules apply to defensive tactics. General Principle 4 of the City Code generally prohibits defensive actions that (1) could frustrate any *bona fide* offer and (2) were undertaken without the approval of a majority of the shareholders.³⁶² General Principle 38 specifies cer-

³⁵⁸ See *supra* notes 317-47 and accompanying text.

³⁵⁹ In this context, interesting questions arise if discovery reveals that a particular board member intent on resistance—the Chairman, for example—wielded disproportionate influence over the board's decisions, or if a majority of the board acted to resist, or if a tie between warring, but economically motivated, board factions was broken by the vote of a venal director intent on resisting the takeover to maintain his corporate position.

³⁶⁰ See De Mott, *supra* note 147, at 7.

³⁶¹ See *id.* at 6-10.

³⁶² Principle 4 provides:

At no time after a *bona fide* offer has been communicated to the board of an offeree company or after the board of an offeree company has reason to believe that a *bona fide* offer might be imminent shall any action be taken by the board of the offeree company in relation to the affairs of the company, without the approval in general meeting of the shareholders of the offeree company, which could effectively result in any *bona fide* offer being frustrated or in the shareholders of the offeree company being denied an opportunity to decide on its merits.

CITY CODE, *supra* note 147 (General Principle 4).

tain target company transactions that are prohibited when a tender offer is in progress or imminent unless approved by a majority of the shareholders.³⁶³ These include many of the financial transactions already discussed³⁶⁴ such as the issuance of previously authorized shares,³⁶⁵ or the sale or acquisition of significant corporate assets.³⁶⁶

This British approach to defensive tactics differs from both of the approaches previously discussed. Unlike the business judgment rule and the Easterbrook-Fischel passivity rule, both of which rely upon judicial inquiry into the subjective *intent* of target management, the British rule is prophylactic, focusing on the prevention of certain *effects* determined to be undesirable—that is, the frustration of bona fide offers. And unlike an absolute prohibition, the British rule permits certain defensive tactics if approved in advance by a majority of shareholders.

The role of shareholder approval in that system is interesting and unique. Clearly, the approval by shareholders of particular defensive tactics, even those that might frustrate a bid, brings egalitarianism to takeover battles and ensures that at least those shareholders voting in favor of the tactics consent to and assume the risk of any untoward effects.

Such approval also raises, however, the troubling possibility that a majority of the shareholders may vote to adopt tactics that harm the financial interests of the minority or at least are inconsistent with their desires. This problem may actually be transitory: shareholders that disagree with the majority vote may sell their shares in the market, where the shares will presumably be repurchased by investors who approve of the majority vote or at least are willing to fight to change it.

4. Mandatory Shareholder Approval

A modification of the British rule would bar defensive tactics subject to the exception that shareholders could vote to approve the use of any tactic or to adopt any behavioral rule for management ranging from passivity to uncompromising resistance. If adopted, periodic reapproval of such provisions could be required, recognizing that the composition of the shareholder body changes over time. One criticism of this modification (and the British system as well) is that management may wield significant influence over the outcome of the vote because it

³⁶³ See CITY CODE, *supra* note 147 (General Principle 38).

³⁶⁴ See *supra* notes 267-76 and accompanying text.

³⁶⁵ See CITY CODE, *supra* note 147 (General Principle 38).

³⁶⁶ See *id.*

controls the proxy solicitation process.³⁶⁷ This problem is compounded by the fact that the Commission has been reluctant to allow shareholders to use Rule 14a-8 as a way of getting their own proposals (which often favor takeovers) on the ballot.³⁶⁸

Another criticism of the approach is that it may deprive the board of the ability to bargain meaningfully for shareholders. Any company adopting a no-resistance policy is likely to get lower-priced bids than it would otherwise. That problem may be eliminated, however, if shareholders empower their board to take only defensive maneuvers reasonably calculated to increase the consideration received by shareholders. This type of limitation on the board makes assessing defensive conduct less difficult: one at least knows that shareholders wanted the directors to react if they could increase the price, but did not necessarily want the directors to have the discretion to remain independent at all costs.

Any system requiring shareholder approval of defensive strategies, including compensation devices like golden parachutes, has several advantages. First, a rule based on shareholder approval accords with the economic reality of tender offers. The shareholders are the real target of the bid and they should logically determine the nature of management's response, as the New York Stock Exchange suggested on one occasion.³⁶⁹ Second, a system based on shareholder approval gives courts clear rules to apply in determining whether directors have acted properly. Management also would know the precise extent of its discretion when faced with a tender offer: shareholders would specify the tactics permitted and the corporate constituencies that they wish to protect. These prospective guidelines for directors may reduce dependence on the judiciary for developing standards of conduct. Finally, this approach would prohibit board approval of executive compensation agreements triggered by changes in control.³⁷⁰ Such agreements, which fall under broad definitions of defensive tactics, would be permitted only if each agreement specifically wins shareholder approval.

One major problem with this model is that shareholder approval of defensive tactics would be nearly impossible to obtain once a tender offer is underway, because the time period for completing the offer is so

³⁶⁷ See E. ARANOW & H. EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL*, 541-568 (2d ed. 1968); Berle, *supra* note 56, at 1213.

³⁶⁸ See R. HAMILTON, *supra* note 16, at 579-82.

³⁶⁹ See *Kaplan v. Goldsamt*, 380 A.2d 556 (Del. Ch. 1977), where the New York Stock Exchange took the position that management should obtain shareholder approval for a proposed repurchase of a sizeable, though noncontrolling, block from a dissident shareholder. *Id.* at 561. The board did so but noted that it "did not feel that legally this was necessary." *Id.*

³⁷⁰ See *infra* note 385.

short. Thus advance authorization by shareholders may be the only realistic alternative, and that authorization would have to be fairly general because the precise nature of a potential bid will not be known. If, as a result, directors simply submit the business judgment rule to shareholders, their approval would have little, if any, impact on corporate defense tactics.

Given the real disagreement about how directors should respond to tender offers, requiring shareholder approval before defenses can be undertaken lends legitimacy to such defenses when they are pursued. This approval may be criticized as impractical or unrealistic. Still, the legitimacy of director action is tied to shareholder approval, and we should work to find ways to express that approval other than simple election to office.

D. SEC Advisory Committee Recommendations

Although the climate was right for the Advisory Committee to advocate an aggressive federal role in takeover defense regulation the Committee simply tinkered with the basic structure of the present regulatory system. The abusive defensive tactics developed in recent years were addressed by specific recommendations. There was no more general statement about what the obligations of directors are or should be and no call for any fundamental reallocation of responsibility from state law to federal law for reviewing the propriety of corporate decision-making in change of control situations.

The most striking aspect of the Committee's work in this area was its complete endorsement of the business judgment rule.³⁷¹ As our discussion has illustrated,³⁷² the business judgment rule, as currently applied in the change of control context, provides for no substantial review of defensive actions by a target company's management. Although the Committee acknowledged that the principal issue was whether a new regime of federal corporate law should be created,³⁷³ the Committee provided no reasons to justify its confidence in the continued application of the business judgment rule, as defined by state law. It merely recommended retention of the rule as the "principal governor of [corporate decisionmaking,] including decisions that alter the likelihood of a takeover."³⁷⁴ This may be the fundamental weakness of the report, par-

³⁷¹ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 34 (Recommendation 33).

³⁷² See *supra* notes 317-47 and accompanying text.

³⁷³ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 34-35.

³⁷⁴ See *id.* at 34 (Recommendation 33).

ticularly in light of the insufficient analysis provided by the Committee.

The most significant change recommended by the Committee is that Congress and the Commission adopt regulations that prohibit the use of charter or bylaw provisions that place high barriers to changes in control.³⁷⁵ In the interim, the Committee recommended that companies be required to adopt supermajority provisions by the same vote percentage contained in the provisions.³⁷⁶ Furthermore, the Committee proposed a requirement that such provisions be ratified by shareholder vote every three years.³⁷⁷

The final step in the Advisory Committee's hybrid approach to the problem of defensive tactics was designed to increase shareholder democracy. The Committee recommended that certain matters relating to changes of control be submitted to the company's shareholders for non-binding advisory votes.³⁷⁸ The matters include supermajority provisions (to the extent not otherwise prohibited or restricted), disenfranchisement, standstill agreements, and change of control compensation.³⁷⁹ The results of the votes would have no legal effect on the company's board of directors, and the Advisory Committee provided no guidance about what effect the advisory votes would have on the operation of the business judgment rule. Two Committee dissenters expressed their dissatisfaction with the nonbinding nature of the votes by commenting cogently that "[o]pinion polls are far less effective than real elections in eliciting the true position of the electorate."³⁸⁰ Given the questionable value of advisory votes, they suggested that the costs of requiring advisory votes would outweigh the gains.³⁸¹

The main problem with the shareholder advisory vote is that it presumably leaves the business judgment rule, with all its disadvantages, in place. Moreover, it may result in directors paying increased attention to the expressed views of large shareholders. To the extent that large shareholders already control the board, the advisory votes

³⁷⁵ See *id.* at 36 (Recommendation 35).

³⁷⁶ See *id.* at 36-37 (Recommendation 36).

³⁷⁷ See *id.*

³⁷⁸ See *id.* at 37-39 (Recommendation 37). The shareholder advisory vote was probably included because many observers have sensed that there has been significant shareholder dissatisfaction with the reaction of directors to hostile bids. These directors are purportedly acting on behalf of shareholders who may want to sell their shares, yet the directors do not consult shareholders about whether to pursue strategies that may frustrate the bid (and their opportunity to tender). Moreover, the simple vote to elect a director to oversee the business of the corporation does not necessarily convey, in the mind of the shareholder, such unlimited discretion to block changes of control.

³⁷⁹ See *id.*

³⁸⁰ See *id.* at 104 (Separate Statement of Frank H. Easterbrook and Gregg A. Jarrell).

³⁸¹ *Id.* at 104-05.

could merely become a sounding board for entrenched management, rather than a meaningful opportunity for smaller shareholders to influence corporate conduct. Accordingly, it is not surprising that several commentators have criticized binding, let alone advisory, shareholder votes as a meaningful protection for shareholders.³⁸²

On the other hand, advisory votes would increase the information available to directors about shareholders' wishes. Increased awareness of shareholder attitudes would improve management decisionmaking for "it would be a poor director who did not consider the views of stockholders a relevant consideration."³⁸³ In this respect, the measure advocated by the Advisory Committee would improve the status quo.

A series of Advisory Committee recommendations respond directly to potentially abusive defensive maneuvers. First, the Committee acknowledged the argument that golden parachutes and other change of control compensation agreements might make corporate management more responsive to shareholder interests in the context of a takeover attempt by insulating them from fears of job insecurity.³⁸⁴ Thus, in spite of widespread public disenchantment with the practice,³⁸⁵ the Committee did not bar golden parachutes entirely. Instead, it proposed that target management be precluded from adopting change-of-control compensation agreements after a tender offer for the company had commenced.³⁸⁶ The company would also be required to disclose the terms of such compensation packages and submit any package to an advisory vote of the shareholders.³⁸⁷

The Advisory Committee also deferred to arguments in favor of allowing target management to negotiate special options or agreements intended to induce a friendly bidder to compete with a hostile tender offeror. The Advisory Committee found that such arrangements are sometimes necessary to attract a second bidder and thus promote competition.³⁸⁸ As a result, the Committee's recommendation regarding this practice was directed toward curbing abuses by requiring stockholder approval for issuance of more than fifteen percent of a target company's stock during a tender offer.³⁸⁹ This was not a particularly radical pro-

³⁸² Brudney & Chirelstein, *supra* note 5, at 299-300 & n.2 (collecting authorities).

³⁸³ Berle, *supra* note 56, at 1223.

³⁸⁴ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 39.

³⁸⁵ See Knight, *Golden Parachutes Reward Corporate Failure*, Wash. Post, Sept. 13, 1982, at 1, col. 1.

³⁸⁶ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 40-41 (Recommendation 38).

³⁸⁷ See *id.*

³⁸⁸ See *id.* at 44.

³⁸⁹ See *id.* (Recommendation 41).

posal, however, because the New York Stock Exchange already has a rule requiring shareholder approval for the issuance of more than 18.5% of a listed company's shares.³⁹⁰

The counter tender offer, or "Pac-Man" defense, would still be generally available under the Advisory Committee's recommendations even though the practice was criticized as destructive and wasteful in light of the Martin-Marietta/Bendix fiasco.³⁹¹ The only situation in which the Committee recommended prohibiting the use of the defense was during the pendency of a cash tender offer for 100% of the target company because there would be no shareholders left for the target's management to protect.³⁹²

The Committee failed to offer any new proposals for regulating a target company's sales of significant assets ("scorched-earth defense"), even when undertaken during a tender offer. Rather, the Committee again ratified the business judgment rule as the primary device for policing abuses of this type of takeover defense.³⁹³

Finally, the Advisory Committee was particularly troubled by the greenmail practice.³⁹⁴ As a result, it recommended prohibiting a target company from repurchasing its stock at a premium unless the stock was held for at least two years or unless the target's directors secured prior approval of its shareholders.³⁹⁵

The Committee's approach to regulation of defensive tactics seems internally inconsistent. The Committee fully endorsed the business judgment rule, while, at the same time, it prescribed specific federal remedies for abusive defenses that have developed and been unassailable to date because of the protection that target management receives under that rule. While perhaps solving today's problems, the Committee's approach appears to be fundamentally incapable of controlling abuses that may develop along with inevitable, new defensive tactics. The approach only tinkers with the current system, and such tinkering may not be sufficient for a system that appears more fundamentally flawed. The Committee's endorsement of the business judgment rule without any supporting analysis more likely indicates a reluctance to alter the allocation of regulatory responsibilities that currently exists between state and federal government than a real intent to affirm any

³⁹⁰ See NEW YORK STOCK EXCHANGE COMPANY MANUAL A-284 (1983).

³⁹¹ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 42-43 (Recommendation 40).

³⁹² See *id.* at 43 (Recommendation 40).

³⁹³ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 45 (Recommendation 42).

³⁹⁴ See *id.* at 46.

³⁹⁵ See *id.* at 46 (Recommendation 43).

strengths in the business judgment rule.

In its House testimony, the Commission accepted some and rejected other recommendations, yet no logical thread is discernible. For example, the Commission would prohibit, absent shareholder approval, company stock sales in excess of five percent during a tender offer or proxy contest and also intends to propose legislation to bar defensive issuer tender offers.³⁹⁶ On the other hand, the Commission believes that counter tender offers and "Crown Jewel" asset sales, even amid a hostile tender offer, should be permitted unless they violate the business judgment rule. While it accepted the role of the business judgment rule, it would revise its application in the change of control context, because "shareholders would be better served if the courts gave greater recognition to potential conflicts of interest between management and shareholders."³⁹⁷

The Commission endorsed the recommendations with respect to "greenmail" and golden parachutes.³⁹⁸ But it refused to endorse, because of the resulting broad intrusion into state law, the Committee's recommendation for advisory votes and for legislation prohibiting the use of charter and bylaw provisions that erect high barriers to change of control.³⁹⁹

In sum, the Commission seemed to be torn between a desire to avoid intruding into classic areas of state law and a desire to subject certain strategies to further federal regulation. The Commission deference for state law may be excessive, especially if its price is further toleration of egregious defensive tactics. As an aside, it is interesting to note that the Commission's highly regarded war on insider trading is based almost entirely on the "federalizing" of state concepts of fraud and fiduciary duty.

E. *Authors' Recommendations*

The current regulatory system fails to provide the clear guidelines necessary to promote responsible decisionmaking and to deter misconduct by management in defending against tender offers. Due to the inherent self-interest of target management in the context of a hostile takeover bid, more shareholder protection than that provided by the present formulation of the business judgment rule is needed.

We contend that proper regulation of defensive tactics requires

³⁹⁶ Shad Statement, *supra* note 117, at 30-31.

³⁹⁷ *Id.* at 11; *see also id.* at 31.

³⁹⁸ *Id.* at 31 (greenmail); *id.* at 28-29 (golden parachutes).

³⁹⁹ *Id.* at 27 (advisory notes); *id.* at 23 (charter and bylaw provisions).

that the rules differentiate between full bids and partial bids. As noted in Part II, partial bids present unique concerns for shareholder welfare, including the possibility of looting and overreaching. Those possibilities are presented by virtually any partial bid and may justify defensive strategies that are not justified when the bid is for all outstanding shares. These special concerns are obviously absent when the bid is for all outstanding shares, because there is no profit in looting a corporation of which one is the sole owner.

We therefore propose dual regulation of defense tactics that responds to the special problems of partial bids, provides a framework for meaningful scrutiny of the tactics, and permits shareholders to determine the board's response. This is tentative, as must any proposal be which suggests major changes in the current system, and is proposed to stimulate discussion.

When faced with a full tender offer, the board's primary response should be either to recommend acceptance of the offer or to attempt to find another bidder willing to offer a higher price for *all* outstanding shares. In negotiating with other bidders, the board may not sell, or grant options to buy, particular corporate assets, unless it makes similar arrangements available to the original bidder in an effort to induce that bidder to raise its price.

The board should not otherwise be permitted to engage in any action that could frustrate the initial bidder without express shareholder approval.

When faced with a partial tender offer, the directors may (1) try to find a bidder willing to buy all of the shares of the company, or a greater percentage than the original bidder is offering to buy, or (2) take measures calculated to frustrate the initial bid (including the partial liquidation of the company or the sale of particular assets). Any effort to frustrate the bid can be undertaken only if it (1) is intended to meet a business purpose approved by the shareholders in advance, and (2) is reasonably related to the achievement of that purpose.

The directors should then have the burden of proving that the shareholders approved the purpose underlying their action and that the action was reasonably related to the achievement of that purpose.

This proposal is superior to the present system for several reasons. First, and most importantly, it reestablishes the shareholders as the primary decisionmakers when a tender offer is made for their shares. It differentiates between decisions regarding the proper management of the business, which would continue to be scrutinized according to the business judgment rule, and the fundamentally different decision to transfer control of the enterprise, which should remain the province of

shareholders.

Second, the proposal gives directors clear rules to follow and establishes that their primary purpose is to maximize returns for shareholders. Third, it subjects the actions of directors to a standard of review that courts may easily apply. Finally, it promotes an auction market for the shares (and assets) of the corporation which should lead to purchase by those willing to pay the most for them.

Finally, it is important that Congress act to solve the greenmail problem by prohibiting the repurchase by issuers of stock at premium prices absent express shareholder approval. It is hard to understand why a two-year holding period, such as the Advisory Committee recommends, should purify the transaction such that it becomes proper to dispense with shareholder approval. The benefits of shareholder approval are more rigorous oversight of the price that management is willing to pay and deterrence of this greenmail because shareholders may be reluctant to approve the repurchase unless they are allowed to participate. The costs to the issuer are those associated with preparing proxy materials.

Issuers should still be permitted to buy shares in the marketplace periodically to reacquire shares for options or because the shares are, in the judgment of management, underpriced. Thus, the shareholder approval requirement should probably be invoked for positions of a certain size sold to the company in a negotiated transaction.

V. IMPACT OF ACQUISITIONS ON CONSTITUENCIES OTHER THAN THE TARGET'S SHAREHOLDERS

Recent mergers and acquisitions have spawned considerable public concern over the impact of acquisitions on the shareholders of the bidder, the national and local economies, and the employees and creditors of acquired companies.⁴⁰⁰ The current regulatory system, comprised of antitrust law, federal securities law, and state corporate law, does not respond to those interests.⁴⁰¹ This lack of responsiveness stems from no lack of diligence in enforcing existing laws, but rather from the fact that the existing regulatory system was not designed with these concerns in mind. This section first discusses the relevance of those constit-

⁴⁰⁰ See, e.g., *Proposed Purchase of Marathon Oil Co. by Mobil Oil Corp.: Joint Hearings Before Senate Comm. on Commerce, Science, and Transportation and House Comm. on Energy and Commerce*, 97th Cong., 1st Sess. (1981); Behr, *Takeovers: A Need for Controls?*, Wash. Post, Jan. 5, 1984, at D9, col. 1; Cohn, *supra* note 344, at 507.

⁴⁰¹ E.g., *Conoco, Inc. v. Seagram Co., Ltd.*, 517 F. Supp. 1299, 1304 (S.D.N.Y. 1981).

uencies, and then considers alternatives for protecting them assuming that Congress determines to do so.

A. *Neglected Constituencies*

1. Shareholders of the Acquiring Company .

Tender offers precipitate cataclysmic changes in the shareholder composition of the target company; the very commencement of the offer provokes a sharp increase in market purchases and sales as professional investors quickly amass large holdings to tender to the original bidder, or perhaps to a competing bidder. And the shareholder population changes once again when the bidder purchases tendered shares. In contrast, the shareholders of the offeror remain relatively constant before, during and after the bid.

State law permits the offer to be financed, commenced and consummated without the approval of the bidder's shareholders. Yet the decision to acquire another company may have enormous economic consequences for them. The market value of their shares may be markedly reduced as the result of debt incurred to finance the acquisition.⁴⁰² The bid will divert corporate resources from other possible uses;⁴⁰³ furthermore, the acquisition of a company in another industry may dramatically change the character of the bidder's business operations, with a corresponding cut in operating efficiency.⁴⁰⁴ The most surprising recent concern, voiced by academic economists, is that "there is little or no evidence that the primary objectives sought in mergers—greater economies of scale and productivity, increased profitability and improved stock performance—are being attained to any significant degree."⁴⁰⁵

2. Employees and Suppliers of the Target Company

The directors of the target of the bid unquestionably have a fiduciary duty to act in the best interest of shareholders. Far less clear is their responsibility and authority to protect the interests of employees and suppliers who may have a significant economic stake in the resulting business combination. Whether directors should have the legal authority to oppose a bid on the grounds that it is not in the best interests

⁴⁰² Martin-Marietta borrowed nearly \$1 billion to finance its bid for Bendix.

⁴⁰³ Speech by Harold M. Williams, "Tender Offers and Corporate Directors," reprinted in [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445, at 82,877 (Jan. 17, 1980).

⁴⁰⁴ Murray, *Do Mergers Make Sense?*, Dun's Business Month, Oct. 1982, at 88-90 (discussing recent acquisition of Conoco, Inc. by E.I. de Nemours Dupont).

⁴⁰⁵ *Id.* at 88.

of employees in nonexecutive positions is the subject of debate.⁴⁰⁶

This interest may warrant explicit government recognition. Indeed, the City Code on Take-Overs and Mergers, which regulates the conduct of tender offers in the United Kingdom, specifically instructs the directors of a company faced with a bid to consider the interests of employees and creditors, along with those of shareholders, in determining the company's reaction to a bid.⁴⁰⁷

3. Economic and Social Interests of the Affected Community

Mergers and acquisitions also affect the welfare of the community in which the target company conducts its operations. The business combination may result in antitrust problems which require the divestiture of plants. Melding the acquired corporation with the acquiror may result in the transfer or dismissal of key employees. These events directly impact the local community by decreasing (or increasing) tax revenue or affecting unemployment compensation payments. These events indirectly affect the local community in ways more subtle but no less significant. Employee transfers may diminish the revenues of local businesses that supplied goods and services for the subject company's employees. Justice Powell, in his concurring opinion in *Edgar v. MITE Corp.*,⁴⁰⁸ noted that when corporate headquarters are relocated as the result of an acquisition, "the state and locality from which the transfer is made inevitably suffer significantly."⁴⁰⁹

Courts have determined that these interests may warrant legal protection in the takeover context⁴¹⁰ as well as in other, more general contexts.⁴¹¹

⁴⁰⁶ Compare Lipton, *supra* note 275, at 105-06 (defending responsibility to employees) with Easterbrook & Fischel, *supra* note 159, at 1190-92 (rejecting any obligations to employees and other nonshareholder groups).

⁴⁰⁷ See CITY CODE, *supra* note 147, at 15 (General Principle 11).

⁴⁰⁸ 457 U.S. 624, 646 (1982) (Powell, J., concurring).

⁴⁰⁹ *Id.* Justice Powell explained: "Management personnel—many of whom have provided community leadership—may move to the new corporate headquarters. Contributions to cultural, charitable, and educational life—both in terms of leadership and financial support—also tend to diminish when there is a move of corporate headquarters." *Id.* See also Gelfond & Sebastian, *supra* note 342, at 458.

⁴¹⁰ See, e.g., *Herald Co. v. Seawell*, 472 F.2d 1081 (10th Cir. 1972). In *Herald*, the court expressly held that directors—at least directors of certain kinds of corporations such as newspapers—have an obligation to "employees, and to the public," in addition to their duty to stockholders. Thus the directors in that case were justified in averting a takeover which they believed would have "an adverse impact on the character and quality" of the newspaper, and would lead to "poor relations with employees." *Id.* at 1092.

⁴¹¹ See, e.g., *American Rolling Mill Co. v. Comm'r*, 41 F.2d 314 (6th Cir. 1930); *Armstrong Cork Co. v. H.A. Meldrum Co.*, 285 F. 58 (W.D.N.Y. 1922) (both cases holding that it is within legitimate business purpose of corporations to make contribu-

B. *Protection of Non-investor Constituencies*

Reevaluation of tender offer regulation should include discussion of whether new regulations should specifically protect in any way those constituencies now recognized by federal case law. Even if one believes these constituencies should be recognized, there is still the important question of how they should be protected. Current formulations of the business judgment rule might permit, but certainly do not require, target company directors to consider the interests of employees, local economies, and others in planning defensive action. Possible consideration is certainly not a surrogate for participation. Similarly, adoption of the proposal requiring shareholder participation in decisions to commence or resist a takeover bid will not necessarily help because shareholders may not consider those interests.

The most important proposal in this area calls for federal legislation that would, if enacted, charge a federal governmental agency with protecting these constituencies in mergers and acquisitions. On July 13, 1983, Representatives Rodino and Seiberling introduced H.R. 3561⁴¹² that would establish a public interest test, to be administered by the Department of Justice or the Federal Trade Commission, for acquisitions resulting in a company having more than \$5 billion in assets and more than 25,000 employees. In determining "whether it is unlikely that any acquisition would serve the public interest," and thus whether judicial relief is necessary, the Assistant Attorney General (in charge of the Antitrust Division) or the Federal Trade Commission "may consider the views of any person, including parties to the transaction, their employees, their customers and interested agencies of Federal, State, and local governments."⁴¹³ Matters for consideration expressly include the effect of the acquisition on the effective management of corporate assets, the offering of new goods or services,⁴¹⁴ whether the acquisition

tions and establish programs for the benefit of employees and the community in which the corporation operates); Blumberg, *Corporate Responsibility and the Social Crisis*, 50 B.U.L. REV. 157 (1970); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1160 (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").

⁴¹² H.R. 3561, 98th Cong., 1st Sess. (1983). This bill, if adopted, would add a new section 7B to the Clayton Act, 15 U.S.C. § 18 (1982).

⁴¹³ § 7B(d)(2), H.R. 3561, 98th Cong., 1st Sess. (1983).

⁴¹⁴ This factor likely springs from concern over the size of tender offer premiums. The size of recent tender offer premiums, sometimes amounting to 50% to 100% of past stock prices, is difficult to explain on the basis of resource efficiency or modern economic thinking. In 1980, the then Chairman of the Securities and Exchange Commission noted: "These are resources that do not flow back as new capacity, improvements in productivity, innovation, new products or new jobs. Rather, . . . at best these dollars

would unduly disrupt management or employees, and, in light of probable benefits, result in excessive fees or other transaction costs.

H.R. 3561 is a response to the growing national concern over the troubling impact of recent successful tender offers on the shareholders of bidders, the employees and creditors of target companies, and the health of local economies. Although such legislation has far to go before adoption, it signals the discomfort of legislators with current regulation and with the highly publicized acquisition battles in which it is difficult to discern whose interests are being served.

C. SEC Advisory Committee Recommendations

The Advisory Committee on Tender Offers provided no substantial analysis and made no recommendations concerning the additional constituencies affected by acquisition.

D. Authors' Recommendations

Despite the lack of Committee consideration, legislators considering proposals springing from the Committee's deliberations are certainly likely to focus on non-investor constituencies. The adoption of legislation to protect these groups could, in fact, have effects on the conduct of mergers and acquisitions that far surpass those of the proposals discussed in the other sections of this Article.

If protection of new corporate constituencies is needed, it is not

remain in the secondary market." Speech by Harold M. Williams, Tender Offers and Corporate Directors, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445, at 82,877 (Jan. 17, 1980). The efficient market hypothesis holds that the current market price reflects all available public information about the company. See generally Easterbrook & Fischel, *supra* note 159, at 1166 n.15 (collecting authorities).

These findings raise serious unresolved questions about the appropriateness of premiums that vastly exceed current market value. The application of these economic theories and findings to other legal areas has spurred a reassessment of past practices and has led to the proposal of new legal rules to govern the behavior of brokers and dealers, see, e.g., Langbein & Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RESEARCH J. 1 (discussing the extent to which a trustee may invest a trust's corpus in a market fund without violating the legal standards that govern the investment of trust assets); Pozen, *Money Managers and Securities Research*, 51 N.Y.U. L. REV. 923, 928-53 (1976) (discussing the application of portfolio theory to limit purchases of investment research by money managers), trust managers, new disclosure systems for investors, see, e.g., Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293 (1975) (suggesting the application of portfolio theory to securities disclosure), and pension plan beneficiaries, see, e.g., Junewicz, *Portfolio Theory and Pension Plan Disclosure*, 53 N.Y.U. L. REV. 1153, 1221-33 (1978); Note, *Fiduciary Standards and the Prudent Man Rule under the Employment Retirement Income Security Act of 1974*, 88 HARV. L. REV. 960, 966-69 (1975). Perhaps these economic findings may suggest a rationale for the legal evaluation of tender offer premiums as well.

clear why bargaining with the corporation, perhaps with shareholder approval, isn't the answer. If, however, legislation is deemed necessary, H.R. 3561 seems inadequate. First, it provides no standards that managers may follow in planning acquisitions or that regulators may follow in evaluating them. Also, the proposal is only applied retrospectively and therefore creates possibilities for delays in business transactions. Second, the bill would require government officials somehow to decide if the beneficial effects of a merger on one constituency outweigh the detrimental effects on another. That decision would clearly become politicized to the overall detriment of the economy.

CONCLUSION

This Article has focused on the ever-changing landscape of tender offer practice. Each new regulation, while adopted to stop a specific abuse, becomes the subject of intense scrutiny by tender offer lawyers and investment bankers constantly in search of strategies that will yield a competitive edge in the next deal. This process has resulted in enormous changes in the mergers and acquisition marketplace that require a thorough review of the current federal and state regulatory system.

This Article concludes that the following regulatory reforms merit serious consideration in efforts to make current regulation of mergers and acquisitions more responsive to marketplace realities. The Advisory Committee recommended that its proposals be implemented as a package, by Commission rulemaking and new legislation. The Committee warned against implementing its proposals on a piecemeal or selective basis because the compromise it achieved resulted from the balance reflected by the package as a whole.

In our judgment, however, Congress should hold broad hearings on the issues discussed in this Article and acquisitions in general, not just on the Committee's recommendations. Congress should consider legislation giving the Commission plenary rulemaking power in the tender offer area comparable in scope to its authority under section 14(a). This Article has suggested the following comprehensive set of reforms that ought to be considered either by Congress or the Commission (if it gets new rulemaking authority), in determining how best to regulate the acquisition of corporate control:

1. Congress and the Commission should change the structure of the Williams Act and implement the Commission's 1980 legislative proposal⁴¹⁵ or the proposal of the Advisory Committee,⁴¹⁶ which re-

⁴¹⁵ See *supra* notes 88-93 and accompanying text.

⁴¹⁶ See ADVISORY COMMITTEE REPORT, *supra* note 32, at 23 (Recommendation 14).

quires that stock accumulations in excess of a certain percentage be done by means of a tender offer.

2. Congress and the Commission should consider the role of the partial bid. At a minimum, the use of two-tier tender offers that do not offer substantially equivalent consideration in each tier should be prohibited. This measure would eliminate the coercion of two-tier offers yet preserve the economic advantages of such offers.

3. The rationale for uniform regulatory treatment of negotiated and hostile deals should be reconsidered. Disclosure should be similar and not depend on the form of the transaction. Presuming that directors will act to protect subject company shareholders, it is difficult to see the reason for the same minimum time periods and disclosure requirements in negotiated transactions as exist in hostile transactions. Negotiated transactions seem far more efficient and productive than hostile transactions, which are often fraught with litigation and waste.

4. Courts will be reluctant to interfere with decisions taken by directors so long as they feel bound to apply a rule of law which affords directors such wide discretion. The wisdom of such a rule is unassailable in the context of a decision relating to conducting the company's business. But its applicability is questionable in the context of a change of control since the director's common law fiduciary duty does not embody the mandate to frustrate tender offers. Therefore, mechanisms should be considered for securing shareholder approval of the conduct to be pursued by directors. Given the current time periods applicable to bids, such approval is only realistic if secured in advance.

The range of responses of directors to a hostile tender offer should vary depending on whether the tender offer is made for all the shares or only for part of the outstanding shares. The directors' principal option in response to the former should be to find a third party willing to pay a higher price for all the outstanding shares. The board may pursue other interests, for example, corporate independence, only with the express, specific approval of a majority of shareholders.

Partial offers present special concerns, and directors should have greater latitude in responding to them. In response to partial offers, directors should be permitted to find a third party willing to pay a higher price, and to take action calculated to frustrate the bid, provided that such action pursues a business purpose approved by the shareholders in advance and is reasonably related to the achievement of that objective. The directors should have the burden of proving that the shareholders have approved the purpose underlying the action and that the action was reasonably related to the achievement of that purpose.

5. Current federal regulation is designed to protect shareholders

faced with a takeover bid. Left largely unprotected are noninvestor constituencies: employees, creditors, and local economies. Consideration should be given to these interests in the development of future regulation.

The traditional approach of government regulation in recent times has been to respond to abuses by the adoption of highly specific rules of conduct. In the tender offer field this approach has led to an enormous complexity of regulation, and has resulted in today's rules developed in response to yesterday's transactions being ineffective or irrelevant in controlling tomorrow's variations. The replacement of this approach with a philosophy of generalism that favors the control of conduct through normative rules of behavior and which specifies with some certainty the roles of directors and shareholders would diminish the dependence of the current system on lawyers and litigation.