Recent Tender Offer Developments: On the Edge or Deep In?

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I. INTRODUCTION

Recent developments in the field of tender offers have made it one of the most dynamic fields of corporation law today. Each new major takeover attempt seems to be an evolutionary step, the result of the innovation and creativity of the professionals involved. Rather than analyzing or criticizing the recent highly publicized battles, however, this Article addresses a subject of even greater importance: the implications of these developments for tender offer regulation in general, and a recent assessment of the regulatory framework provided in the Report of the SEC Advisory Committee on Tender Offers.[1]

On February 25, 1983, the Securities and Exchange Commission (SEC) established the Advisory Committee to review the effectiveness of current takeover laws in regulating newly devised acquisition practices.[2] In July of the same year the Committee issued its Report, which contained fifty recommendations for action by the SEC or Congress. A detailed analysis of each of the fifty recommendations is beyond the scope of this Article.[3] Instead, this Article examines the Committee's general approach to solving the problems of the current regulatory system, discusses a few of its more significant recommendations, and highlights some of the major problems left unresolved by the Committee. The author's aim is to bring into focus some of the fundamental questions left unanswered in the area of tender offer regulation—questions that must be answered if any change in takeover regulation is to achieve the Committee's desired goals.

II. FEDERAL REGULATION: A PATCHWORK QUILT

A casual browse through the federal regulatory scheme of tender offers reveals two curious characteristics. First, despite the recent emergence of the tender offer as the dominant means of acquisition, federal regulation in the tender offer area relates solely to disclosure issues and to the mechanics of purchasing the shares.[4] Since federal law provides no normative rules governing the role or obligation of directors

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1. SEC Advisory Committee on Tender Offers, Report of Recommendations (July 8, 1983), *reprinted in* FED. SEC. L. REP. (CCH) No. 1028 (extra ed.) (July 15, 1983) [hereinafter cited as Advisory Committee Report].

2. *See* SEC Release No. 34–19,528, 48 Fed. Reg. 9111 (1983).

3. *See generally* Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PENN. L. REV. 647 (1984).

4. *See* Williams Act, 15 U.S.C. § 78n(d)–(f) (1982); *see also Disclosure of Corporate Equity Ownership*, H.R. REP. No. 1711, 90th Cong., 2d Sess. 3–4 (1968); *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids*, S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967).

of either the bidder or the target during a takeover, it appears that state law was intended to fill the void.

The second curious characteristic is that federal regulation of tender offers consists of an odd joinder of a very simple governing statute[5] and a host of complex and sometimes conflicting rules promulgated under it.[6] The number and complexity of the SEC's rules are a direct result of the radical and unanticipated changes that have occurred in the tender offer area over the past decade. Fifteen years ago, when the basic regulatory framework was established, tender offers were conducted by corporate outsiders and were largely unregulated by the states. Since then, however, acquisition by tender offer has emerged as the preferred method in both hostile and negotiated transactions. This evolution has forced the SEC to assume a more active regulatory role.

The SEC had two regulatory methods from which to choose a response to this evolution. The SEC could have developed broad federal principles of fair conduct applicable to all aspects of the takeover process, or it could have adopted limited rules tailored to known transactions. The latter approach was chosen, probably because of a belief that aggressive constituents of SEC regulation would frustrate the spirit of any broad principles developed, and that state regulation of most aspects of acquisitions had been sufficient in the past and would continue to be so.

This choice and the resulting regulatory scheme are open to criticism for two reasons. First, the current regulatory scheme does not respond to the modern realities of tender offers. Fifteen years ago, federal regulation of the purchase stage and state regulation of all other matters may have been adequate because few people even knew what a tender offer was. Today, however, tender offers are the major acquisition technique. We should not continue to use this outdated approach to regulation. Multi-million and billion dollar transactions that crisscross the country and sometimes the globe should not be regulated in part by a federal disclosure statute and in part by laws of one of the fifty states.

The second criticism accepts the existence of this federal/state framework and instead focuses on the problems relating to the SEC's hole-plugging technique of regulation. Since, in the few areas the SEC does regulate, the Commission has rejected the path of regulation by broad guiding principles, the SEC has been forced to react to changes in tender offer practices instead of anticipating them.[7] This patchwork style of federal regulation, though admittedly effective in the short term, is inappropriate in the constantly changing field of modern takeovers. The inherently dynamic nature of the area, coupled with the endless creativity and ingenuity of bidders and targets, renders obsolete the SEC's responses to abuses almost before they are conceived.

A good illustration is provided by the SEC's reactions to the tender offer proration issue. In 1979 the SEC adopted an elaborate set of rules governing various

5. *See* Williams Act, 15 U.S.C. § 78n(d)-(f) (1982).

6. *See* 17 C.F.R. §§ 240.14d-240.14e (1984).

7. In this regard the author is also critical of himself. These rules were adopted during his tenure as Director of the SEC's Division of Corporation Finance, and he never called for a different approach. The thoughts presented here have evolved since then.

aspects of tender offers.[8] These rules were designed in part to establish uniform minimum time periods for tender offers so that shareholders would have an adequate response time, and in part to preempt certain state regulation.[9] The most significant changes provided in the 1979 rules were (1) to require tender offers to remain open for a period of twenty business days, (2) to allow shareholders to withdraw their shares during the first fifteen days, and (3) to require bidders formally to commence their offers within five days of having publicly announced the terms.

The 1979 changes, however, did not include a change conforming the rules governing proration to the new time periods. Under the proration rules, if a bidder made a partial offer that was oversubscribed, the bidder was required only to purchase on a pro rata basis the shares tendered during the first ten calendar days. After the ten calendar day period, the bidder could purchase on a first-come, first-served basis if the offer was not initially oversubscribed. Therefore, if shareholders did not immediately tender in response to a partial bid, they ran the risk of having only a smaller percentage or none of their shares purchased. Bidders took advantage of the different time periods by developing two-tier bids. The first tier was a tender offer in which the price per share was significantly higher than the price that was provided in the second tier merger which was to follow. If the shareholders did not tender within the first ten days of the offer (missing the opportunity to have all of their shares included in the proration pool), they would receive a lower average price per share. This mismatching of time periods created high front-end, low back-end transactions similar to "Saturday Night Specials," which were started on a Friday afternoon and completed seven days later, even though the first tier tender offer technically remained open for twenty business days. In response to the pressure placed on smaller shareholders by this practice, the SEC tinkered with the rules again in 1982 by adopting a provision that requires proration throughout the tender offer.[10] Although two-tier pricing is still permissible, the possibility that small shareholders will be excluded from the first, higher priced tier is lessened when the time for tender is effectively extended.

This series of SEC rule changes illustrates the Commission's reactive approach to tender offer regulation. Concerns raised by this approach, combined with the rapid change in the complexion of tender offer offenses and defenses, led to the appointment of the Advisory Committee.[11] Unfortunately, as is discussed below, the Committee continued this tinkering approach, eliminating some abuses while perpetuating the need for piecemeal regulation.

III. Advisory Committee: Good Idea, Bad Planning, Mixed Results

The SEC Advisory Committee was to review the effectiveness of the current regulatory scheme and to make recommendations for legislative and regulatory changes that would benefit shareholders of all corporations, not just those of target

8. *See* 44 Fed. Reg. 70,341 (1979) (codified at 17 C.F.R. §§ 240.14d-3 to .14d-4 (1984)).

9. *See id.*

10. *See* 47 Fed. Reg. 57,680 (1982) (codified at 17 C.F.R. § 240.14d-8 (1984)).

11. The Committee was established in accordance with the provisions of the Federal Advisory Committee Act, as amended. 5 U.S.C. App. §§ 1-15 (1982).

companies.[12] The Committee consisted of eighteen prominent merger and acquisition specialists drawn from the business community, academia, and the legal and accounting professions.[13] On July 15, 1983, the Committee issued its report that contained fifty recommendations for action.[14]

A. *Advisory Committee's Approach*

The Advisory Committee fulfilled its role in some areas and ducked it in other areas. On the positive side, the Committee made some very useful recommendations to help curb abuses in takeover tactics. The Committee's useful recommendations are discussed below.[15] However, the overall approach taken by the Committee is subject to some criticism. The major disappointment is that because the SEC was asking for advice, the Committee assumed it was to respond within the existing structure and framework of the governing federal statute, the Williams Act.[16] While the general public may have expected a broad policy analysis because of the controversy surrounding tender offers, the Committee viewed its task as helping the SEC improve the existing system.

The problem with the Committee's approach is that while the SEC may claim to be neutral in any particular contest, the Williams Act injects a certain target-shareholder bias into tender offer regulation. The Act was designed specifically to protect target company shareholders by ensuring that they would have certain information concerning a tender offer and a certain amount of time in which to act.[17] This regulatory scheme, by precluding bidders from acting as quickly and as furtively as they would like, displays a preference for the shareholders of a target over those of a bidder. This preference, in turn, decreases the speed and certainty with which bidders can make successful tender offers. And because time is money and uncertainty costs resources, the current regulatory approach discourages possible bidders and therefore reduces the number of takeovers.

Because it takes its lead from the Williams Act, the SEC properly focuses its regulatory attention in takeover matters on target rather than bidder shareholders. Moreover, because of its understanding of the Williams Act mandate, the SEC concentrates its efforts on protecting smaller, less sophisticated target shareholders

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12. *See* SEC Release No. 34–19,528, 48 Fed. Reg. 9111 (1983).

13. The members were Dean LeBaron, President of Batterymarch Financial Management, who was selected as Chair of the Committee; Jeffrey B. Bartell, Esq., of Quarles & Brady; Michael D. Dingman, President of the Signal Companies, Inc.; Frank H. Easterbrook, of the University of Chicago Law School; Joseph H. Flom, Esq., of Skadden, Arps, Slate, Meagher & Flom; the Honorable Arthur J. Goldberg; Robert F. Greenhill, Managing Director of Morgan Stanley & Co., Inc.; Ray J. Groves, Chair and Chief Executive of Ernst & Whinney; Alan R. Gruber, Chair and Chief Executive Officer of Orion Capital Corporation; Edward L. Hennessey, Jr., Chair of the Board of Allied Corporation; Gregg A. Jarrell, Senior Economist of Lexecon, Inc.; Robert P. Jensen, Chair and Chief Executive Officer of E. F. Hutton LBO, Inc.; Martin Lipton, Esq., of Wachtell, Lipton, Rosen & Katz; Robert E. Rubin, of Goldman, Sachs & Co.; Irwin Schneiderman, Esq., of Cahill, Gordon & Reindel; John W. Spurdle, Jr., Senior Vice President of Morgan Guaranty Trust Company of New York; Jeff C. Tarr, Managing Partner of Junction Partners; and Bruce Wasserstein, Managing Director of the First Boston Corporation.

14. Advisory Committee Report, *supra* note 1.

15. *See infra* notes 19–29 and accompanying text.

16. 15 U.S.C. § 78n(d)–(f) (1982).

17. *See* Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075 (5th Cir. 1970); H.R. REP. No. 1711, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2812.

rather than professionals, who are considered to be in a better position to control their exposure to risk. Not surprisingly, therefore, most of the SEC's rules in this area are aimed at providing these smaller target shareholders sufficient time to consider an offer and enabling them to obtain the highest possible price.[18] Such a scheme, however, lacks a guiding principle that can indicate when the SEC has sufficiently regulated tender offers. Furthermore, the Advisory Committee Report provides no indication or comment on how the proper regulatory balance should be struck. The problem is compounded by the SEC's apparent inability to regulate the conduct of directors of either the bidder or the target companies—it can protect only the target shareholders.

Because the Advisory Committee worked within the framework of the current system, its Report contains no real surprises and no suggestion for a fundamental reallocation of regulatory power. However, simply to state the result is to gloss over an increasingly important problem: there is no consensus regarding what directors should do when faced with a tender offer and what role target shareholders should play in authorizing or approving directors' responses.

B. *Advisory Committee's Specific Results*

Despite their shortcomings, the Advisory Committee's recommendations, at least in the context of tinkering, are comprehensive and sound. The most significant change recommended by the Committee calls for Congress and the SEC to adopt rules prohibiting the use of charter or bylaw provisions to erect blockades against changes in control.[19] In the alternative, the Committee suggested a rather ingenious approach: companies should be required to adopt supermajority provisions by the same vote percentage that is contained in the proposed supermajority provisions themselves. The Committee also advised that a regulation be imposed requiring these blocking provisions to be ratified by shareholder vote every three years.[20]

Another laudible recommendation was aimed at putting democracy back into the corporate governance system. The Committee recommended that certain matters relating to change of control be presented to the shareholders for nonbinding advisory vote. These matters would include supermajority provisions, disenfranchisement, standstill agreements, and change of control bail-out provisions (such as golden parachutes).[21] Thus, even though their vote would not be binding on the corporation, the shareholders would have an opportunity to vent their anger—or spout their praise.[22]

The Advisory Committee also proposed a list of specific recommendations in response to some of the abusive defensive maneuvers that have evolved. For instance, the Committee would prohibit target management from adopting change of

18. *See generally* 17 C.F.R. §§ 240.14d–240.14e (1984).
19. Advisory Committee Report, *supra* note 1, Recommendation 35, at 36.
20. *Id.*, Recommendation 36, at 36–37.
21. *Id.*, Recommendation 37, at 37.
22. *But cf.* Separate Statement of Frank H. Easterbrook and Gregg A. Jarrell, Advisory Committee Report, *supra* note 1, at 104: "Opinion polls are far less effective than real elections in eliciting the true position of the electorate."

control compensation agreements (for example, granting golden parachutes) if a tender offer for the company had commenced.[23] Also, to provide a check when target management negotiates special agreements aimed at courting a friendly bidder, the Advisory Committee suggested that any issuance of more than fifteen percent of a target company's stock during a tender offer must be approved by the shareholders.[24]

The Committee's most important proposal regarding open market purchases involves acquisitions of stock (other than from an issuer) that would give an acquiror more than twenty percent ownership of a company.[25] The proposal would require that qualifying acquisitions be done by a tender offer to all shareholders.[26] This recommendation was specifically designed to address so-called "creeping" tender offers.[27]

Finally, the Committee's recommendations would work to discourage "greenmail" schemes. A greenmail scheme exists when an investor buys a significant block of a company's stock on the open market and then announces a desire to be bought out by the company at a premium. If the target management balks, the greenmailer will threaten to mount a proxy fight or launch a tender offer to gain control of the company and liquidate it.[28] The Committee suggested that target companies be prohibited from repurchasing their own stock at a premium unless the stock has been held for at least two years or the target's shareholders have approved the repurchase.[29]

C. *Unanswered Questions*

Despite these significant steps forward, the Advisory Committee avoided serious issues in other areas. Most importantly, the Committee accepted without comment the notion that federal regulation should continue to govern disclosure issues and to regulate the conduct of the bidder, while state law should govern the legitimacy of the actions of the target company and its board.[30] It is not altogether clear, nor did the Committee explain, why such a bifurcated system with its inherent problems and inconsistencies should continue to exist after two decades of experience.

Because the Committee failed to scrutinize the wisdom of a bifurcated system, many of the Committee's recommendations only serve to stretch the system at both ends, leaving a dearth of reasoning at its core. On the one hand, for example, the

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23. Advisory Committee Report, *supra* note 1, Recommendation 38, at 40–41.

24. *Id.*, Recommendation 41, at 44.

25. *Id.*, Recommendation 14, at 23.

26. *Id.*

27. Creeping tender offers exploit the fact that no clear definition of "tender offer" exists in the regulatory scheme. Currently, bidders can acquire a significant interest in a target through open market purchases without being required to make disclosure until after the fact by filing a schedule 13D. Since these bidders technically are not making a tender offer, they are not prevented from buying shares in spite of an announced tender offer, and therefore they can purchase from selling shareholders on a first-come, first-served basis.

28. Although there has been litigation challenging the initial acquisition stage, see, e.g., Dan River, Inc. v. Icahn, 701 F.2d 278 (4th Cir. 1983), and the repurchase demand stage, see, e.g., Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977), each stage has usually survived attack.

29. Advisory Committee Report, *supra* note 1, Recommendation 43, at 46.

30. *See id.*, Recommendation 33, at 34.

Committee adopted without significant comment or analysis the state "business judgment" concept as the sole standard by which to appraise directors' conduct during the course of a takeover.[31] On the other hand, the Advisory Committee recommended that laws be passed to prohibit certain golden parachutes, shark repellants, issuances of a company's stock in the midst of a takeover,[32] counter tender offers as a response to any and all bids (the "Pac-Man defense"),[33] and repurchases of securities.[34] Each of these actions has been protected in the past under the state business judgment rule, which made each action unchallengeable if the directors acted in good faith and for any rational business purpose.[35] The business judgment rule itself has fostered the development of the various tactics the Committee now wants to eliminate as impermissible impediments to takeovers in general. The Committee provides no guidance as to why the line is drawn here. Further, no criteria is provided to judge how far directors of targets should be able to go in developing new techniques to tie up the target company.[36]

Also, although the Committee chose to address some of the problems spawned by the business judgment rule, it failed entirely to acknowledge what is perhaps one of the greatest ironies that characterizes this area. Because a target's response to a hostile takeover will pass legal muster if there is *any* rational business purpose for it, the invariable response of a target's board is a claim that the opening bid is inadequate. Yet conventional wisdom holds that many if not most shareholders would be willing to accept the bidder's premium above the market price despite the board's claims of inadequacy.

It is arguable that such a response by a board is necessary. Shareholders of major publicly held companies may be assumed to be powerless to act or negotiate and will therefore accept any premium offered because of a fear of missing out. But one could also argue that shareholders should be permitted to evaluate the board's analysis and recommendation and vote for themselves, particularly when actions taken by board members may in part be motivated by a reluctance to yield their positions to an uninvited bidder.

The heart of the problem is a lack of analysis by the Committee of the roles of directors and shareholders in an acquisition scheme. But even here the Committee is perhaps not entirely to blame. Without a clear consensus in the business and shareholder communities as to what the role of directors should be, it is difficult to draw regulatory lines that delineate when directors have gone too far. To its credit, the Advisory Committee seemed to agree with the general notion that shareholders' current checks on the board (their ability to vote and to sell their shares) are inadequate—hence the recommended "advisory vote."[37] But without an understand-

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31. *Id.*
32. *See supra* notes 19–20, 23–24 and accompanying text.
33. Advisory Committee Report, *supra* note 1, Recommendation 40, at 43.
34. *See supra* notes 28–29 and accompanying text.
35. *See infra* notes 43–62 and accompanying text.
36. *See, e.g.*, Greene & Junewicz, *Piecemeal Reform Suggested by Tender Offer Bill*, Legal Times, Aug. 20, 1984, at 11, 22, for a discussion of the strategy employed in Carter Hawley Hale's attempt to defeat a hostile tender offer.
37. *See supra* notes 21–22 and accompanying text.

ing of the role target shareholders should play in the tender offer process, even this recommendation may raise more questions than it answers.

IV. Current Scheme: Where, How, and Why

The lack of analysis concerning the proper role for directors and shareholders in a takeover bid, combined with the Committee's strong endorsement of the business judgment rule, will put increasing pressure on the courts to set new policy in this area. The courts, however, are ill-equipped to meet this demand, primarily because the courts' only analytical tool—the business judgment rule as construed under state law—was not designed to apply to a target board's decision to fight a tender offer.

Initially, federal law (in addition to state law) was thought to apply to a target's board reaction to a hostile tender offer.[38] The holdings of *Santa Fe Industries v. Green*[39] and its progeny,[40] however, drastically limit a plaintiff's ability to invoke federal antifraud provisions to challenge a board's decision. In *Santa Fe*, the United States Supreme Court held that minority shareholders did not state a claim under federal securities law by alleging that the terms of a proposed merger were inherently unfair. Although it is true that a few federal courts recently have tried to breathe a federal regulatory interest into the target's response,[41] these courts are a small minority and are likely to remain so.

It is clear, therefore, that the exclusive source of law under which the actions of directors are appraised is the law of the state of incorporation. This means that a target's decision to accept or reject an offer, make a counter bid, or throw the wealth of the company into an attempt to defeat the offer is evaluated solely under state law. State law also provides the gauge by which to test the validity of techniques used by the board to fend off hostile tender offers, such as golden parachute agreements and charter amendments.

The major problem encountered when state law is relied on, however, is that state statutes are silent in the context of hostile bids. Indeed, state statutes seem to reflect a legislative assumption that hostile bids never occur. As a result, the courts have had to devise the applicable standards for these cases. Most courts, after reviewing the existing case law, have selected the business judgment rule.[42]

A. *Business Judgment Rule*

The business judgment rule, although articulated in various ways in different jurisdictions, in general bestows a presumption of sound business judgment on the

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38. *See, e.g.*, Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1163 (S.D.N.Y. 1977); *see also* Royal Indus., Inc. v. Monogram Indus., Inc., [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976).

39. 430 U.S. 462 (1977).

40. *See, e.g.*, *In re* Sunshine Mining Co. Sec. Litig., 496 F. Supp. 9 (S.D.N.Y. 1979); Berman v. Gerber Prods. Co., 454 F. Supp. 1310 (W.D. Mich. 1978).

41. *See, e.g.*, Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1982); Goldberg v. Meridor, 567 F.2d 209, 215 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

42. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980).

board of directors. The board and managers are presumed to act in good faith, and their decision on a particular issue will not be disturbed if any rational business purpose can be found to support it.[43]

The rule was born and raised in the context of reviewing third party transactions structured and effected so as to maximize corporate profits. In this context the logic of the rule is compelling. Directors' decisions should be given great deference because directors require broad discretion when dealing in areas in which they have considerable expertise. Broad discretion encourages the development of competent leadership, and courts should not attempt to dabble in the daily problems involved with running a corporation.[44]

A second but related rule was developed to apply when corporate management had an interest in the outcome of its decision. In these cases, courts set aside the business judgment rule and look behind the board's claims to see if the board's decision was "intrinsically fair" to the corporation and its shareholders. Thus, the question arises: Why was the business judgment rule and not the intrinsic fairness test applied in takeovers?

The explanation is that the first courts to review a board's decision to fight a tender offer were being asked to decide, as a threshold matter, whether or not they should even attempt to second-guess the board's decision. At that time the legal arena had reached no consensus as to what should be the proper response of directors in a takeover situation. Without a consensus as to what was right, it was hard to judge whether the directors had acted improperly. The courts also realized that if they chose the path of second-guessing, it could lead to their having to impose tremendous damages on individual directors. Because the majority of directors often were not full-time employees and thus appeared to be disinterested, and because of the intense judicial reluctance to get involved, the courts uniformly chose an easier solution—the business judgment rule.

In *Treadway Companies, Inc. v. Care Corp.*,[45] for example, the Second Circuit was confronted with a case in which the directors were going to lose their jobs regardless of the outcome of the hostile bid.[46] Since the directors apparently did not possess conflicting interests in the outcome of the takeover, the court applied the business judgment rule to the board's decision to merge with a white knight.[47] Also, in *Panter v. Marshall Field & Co.*,[48] the Seventh Circuit refused to interfere with the directors' decision when the majority of the directors who voted to oppose a takeover

43. A succinct articulation of the rule was provided by the Delaware Supreme Court in Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971):

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

Id. at 720 (citation omitted).

44. *See generally* Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?* 37 Bus. Law. 27, 31–33 (1981).

45. 638 F.2d 357 (2d Cir. 1980).

46. *Id.* at 383.

47. *Id.* at 357.

48. 646 F.2d 271 (7th Cir.), *cert. denied,* 454 U.S. 1092 (1981).

attempt were arguably independent, outside directors, again without a conflict of interest.[49] Following these early cases, courts began to feel comfortable applying the business judgment rule, and the intrinsic fairness test was applied only in the traditional conflict-of-interest cases.

As the business judgment rule becomes more entrenched in takeover cases, management will continue to have unlimited discretion in deciding whether and how to fight. Furthermore, although there is no consensus on the proper role of target shareholders in the decisionmaking process,[50] the continued use of the business judgment rule is a decision in itself, a decision to relegate shareholders to a back-seat position.

B. *Impending Problems*

As courts apply the business judgment rule to takeover decisions, they will have to address a few fundamental problems. First, because the business judgment rule did not evolve in the context of modern takeovers, application of the rule in these cases raises some significant issues concerning the good faith requirement. The good faith element of the business judgment rule was originally included to ensure that the rule's "presumption of validity" would not apply to an officer or director who had engaged in self-dealing or who had a material personal interest in the outcome of the transaction.[51] It served as the flow valve that governed whether the business judgment rule or the intrinsic fairness standard would apply. Once a lack of good faith was shown, the decision was declared suspect and the burden shifted to the officer or director to show why the transaction was intrinsically fair to the corporation and its stockholders.

It is clear that when a director receives a commission in a corporate transaction[52] or even collaborates with the corporation in a profit-making transaction,[53] sufficient doubt is raised about the good faith element to require the director to prove the transaction's intrinsic fairness. It is not unreasonable to conclude that the decision to oppose a hostile takeover bid, which directly ensures that an outside director will continue to receive prestige and compensation as a member of the board, should receive the same legal treatment. However, decisions to oppose hostile takeover bids have not received such treatment. The courts began applying the business judgment rule without analysis in the easy cases and have continued to apply the rule as a shield, even though directors' continued association with the company is the unquestionable and intended result of a successful defensive strategy. These courts pay lip service to the intrinsic fairness test by agreeing to shift the burden to the director if

49. *Id.* at 294.

50. For an example of the lack of consensus, see Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lipton, *Takeover Bids in the Target's Boardroom; An Update After One Year*, 36 BUS. LAW. 1017 (1981).

51. *See* Thomas v. Kempner, 398 A.2d 320, 323–24 (Del. Ch. 1979); Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 115–16 (1979).

52. *See, e.g.*, Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Chasin v. Gluck, 282 A.2d 188 (Del. Ch. 1971).

53. *See, e.g.*, Burg v. Horn, 380 F.2d 897 (2d Cir. 1967); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939).

the plaintiff can prove that the director's "sole or primary purpose" underlying a defensive manuever was to retain control.[54] Only when the plaintiff has met this burden will the defendant be required to show that the transaction also had a valid corporate purpose.

It is thus fair to conclude, at least with respect to cases representing the legal mainstream on the business judgment rule (such as *Marshall Field*[55] and *Trueblood*[56]), that courts in effect have ignored the good faith element. The analysis has shifted almost exclusively to an inquiry of whether "any rational business purpose" existed for the decision. Yet merely to articulate the existence of "any rational business purpose" as a legal test raises suspicions about its adequacy.

The rational business purpose standard almost always can be met by a board's claim that the bidder's opening price is too low and that room must be left to negotiate a better deal.[57] If this "business purpose" will not suffice, shareholder groups with conflicting interests (for example, short-term versus long-term investors) will virtually assure that some business purpose is served.[58] The practical result is that a corporation, particularly one advised by knowledgable counsel, will rarely be unable to devise a sufficient business purpose for its conduct to pass legal muster.[59] Judge Cudahy pointed this out in his dissent in *Marshall Field.* He criticized the majority for adopting "an approach which would virtually immunize a target company's board of directors against liability to shareholders, provided a sufficiently prestigious (and expensive) array of legal and financial talent were retained to furnish *post hoc* rationales for fixed and immutable policies of resistance to takeover."[60]

More restrictive formulations of the rule provide only partial solutions to the problems presented by the good faith element. Some judges would interpret the rule to shift the burden of proof once a plaintiff shows that the desire to retain control was a motive in the particular business decision being challenged.[61] Judge Cudahy, again, is a good example. In espousing this middle standard, Judge Cudahy saw a bright line between decisions involving management of the business enterprise and decisions involving change of control. "The former involves corporate functioning in competitive business affairs in which judicial interference may be undesirable. The latter involves only the corporation-shareholder relationship, in which the courts may justifiably intervene to insist on equitable behavior."[62] Although a more restrictive formulation is more consistent with the original intent underlying the business judg-

54. Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980), *cert. denied,* 450 U.S. 999 (1981).

55. 646 F.2d 271 (7th Cir.), *cert. denied,* 454 U.S. 1092 (1981).

56. 629 F.2d 287 (3rd Cir. 1980), *cert. denied,* 450 U.S. 999 (1981).

57. *See supra* text accompanying notes 35–37.

58. *See, e.g.,* Swinney v. Keebler Co., 480 F.2d 573 (4th Cir. 1973); Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972).

59. 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).

60. 646 F.2d 271, 299 (7th Cir.) (Cudahy, J., dissenting), *cert. denied,* 454 U.S. 1092 (1981).

61. *See, e.g., id.* at 304 (Cudahy, J., dissenting); Johnson v. Trueblood, 629 F.2d 287, 301 (3d Cir. 1980) (Rosenn, J., dissenting), *cert. denied,* 450 U.S. 999 (1981).

62. 646 F.2d 271, 299–300 (7th Cir.) (Cudahy, J., dissenting) (citing Note, *Protection for Shareholder Interests in Recapitalizations of Publicly Held Corporations,* 58 COLUM. L. REV. 1030, 1066 (1958)), *cert. denied,* 454 U.S. 1092 (1981).

ment rule, it nevertheless raises its own difficulties by forcing courts to distill the subjective intentions of the directors and officers.

The problem could be that we just do not know enough about the decision-making process in the boardroom. This, coupled with a general lack of consensus on directors' and shareholders' roles, could explain many of the problems that plague the area.

V. RECENT JUDICIAL DEVELOPMENT: A FORESHADOWING?

Despite this tremendous hesitation by courts to look behind the actions of directors in cases involving tender offers, courts are becoming somewhat more suspicious when directors sit in judgment of each other. A recent series of cases appears to be a reaction to some of the problems caused by the wholesale application of the business judgment rule to decisions involving director self-interest.[63] These cases address the extent to which the business judgment rule applies to decisions of the board of directors to terminate derivative suits that the board has determined are not in the best interest of the corporation.

The issue is raised by the increasingly popular practice of designating special committees of disinterested directors to investigate allegations of wrongdoing by other directors.[64] After several years of avoiding the issue, the Supreme Court of Delaware rendered the landmark decision of *Zapata Corp. v. Maldonado*.[65] In *Zapata* the court recognized that under Delaware law, disinterested directors do in fact have authority to move to terminate any derivative action, even an action involving other directors as defendants. Of even greater interest and controversy, however, was the court's basic rejection of the business judgment rule as the appraisal mechanism for evaluating a committee's decison. The court interposed a new two-step test for reviewing a committee's decision. The first step includes a review of the traditional business judgment rule factors such as the independence and good faith of the directors.[66] The *Zapata* ruling places the burden of proof on the directors, however, rather than on the challengers.

If the directors meet the requirements of step one, the court may then exercise its own "independent business judgement" to decide whether it believes the action should be dismissed.[67] This two-step test seems to be a hybrid of the traditional business judgment rule and the "intrinsic fairness" test applied to self-dealing transactions.

If the courts can distinguish between board decisions involving management of a business enterprise and those involving evaluation of directors, they should also be able to distinguish decisions involving changes in control. Similarly, if courts are able to determine the reasonableness of directors' actions towards others, they should

63. *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); *see also* Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311 (S.D. Iowa 1981); Abella v. Universal Leaf Tobacco, 495 F. Supp. 713 (E.D. Va. 1980), *rev'd*, 546 F. Supp. 795 (E.D. Va. 1982) (Merhige, J., reversing his earlier decision on the motion to terminate).

64. *See generally* Block & Prussin, *supra* note 44, at 29–31, 45–52.

65. 430 A.2d 779 (Del. 1981).

66. *Id.* at 788–89.

67. *Id.*

be able to evaluate a board's decisions to pour the wealth of the company into a takeover fight.[68] They should, in short, take the dilemma by the horns and wrestle with it.

VI. Conclusion

The area of tender offer regulation is in need of a drastic reorganization. The bulk of regulation in this area is provided by a state law concept that grew up in an era when tender offers were rare and their abuses unknown. Today, tender offers have become the number one preferred acquisition technique. As the competition for attractive targets has increased, target management has developed innovative defensive techniques designed to defeat those bids. The practical result of applying the business judgment rule to evaluate the targets' actions is almost invariably a form of judicial abstention.

The confusion in this area is highlighted by the fact that, although courts are willing to trust directors when they vote to fight a tender offer and perpetuate their board positions, some courts hesitate to trust independent directors' judgments of other directors. It seems that the opportunity for abuse is at least as great in a decision to perpetuate one's own position as it is in a judgment of other directors' actions.

To make any progressive change in this area, some hard questions must first be answered. Without a clear understanding and a unified approach, any change is almost bound to miss the mark and only add to the current regulatory patchwork. A sufficient consensus needs to be reached about the steps a board should take when faced with a hostile bid and the extent to which shareholders should be involved in the process. Thought must be given to the type of restraints to be imposed on hostile raiders and why those restraints are better than others. Finally, it must be recognized that the courts have been applying rules of law developed in one context to the entirely distinct field of hostile tender offers without an adequate understanding of the sociology or dynamics of the corporate decisionmaking process.

The SEC Advisory Committee recognized some of these problems and advocated limited changes. Most of the suggestions were well considered. The recommendation that shareholders cast advisory votes on certain fundamental defensive actions of the board is a good attempt at increasing director responsibility. The Committee agreed with most shareholders that the currently available methods of voicing dissent—voting out directors or selling stock—are insufficient.

The Committee failed to address many other problems, however, and thus left the hard questions for another day. Until these questions are addressed, any change in the regulation of tender offers will only serve as a temporary patch on what is quickly becoming a leaky bucket.

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68. *See* Block & Prussin, *supra* note 44, at 63.

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