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TARGET MANAGERS AS NEGOTIATING AGENTS FOR TARGET SHAREHOLDERS IN TENDER OFFERS: A REPLY TO THE PASSIVITY THESIS

Dale A. Oesterle†

In 1981 Professors Easterbrook and Fischel advanced what is now known as the passivity thesis for tender offers.¹ They propose that the management of a corporation subject to a tender offer, the target, should be prohibited from resisting the offer in any fashion.² The authors view hostile takeovers as a significant means of displacing poor managers and argue that facilitating tender offers increases the incentive of all managers to perform in the best interests of their shareholders.³ The passivity thesis has found a sympathetic audi-

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¹ Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter cited as Easterbrook & Fischel I]. See also Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter cited as Easterbrook & Fischel II]; Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982-83) [hereinafter cited as Easterbrook & Fischel III]; Easterbrook & Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155 (1982).

² Professors Easterbrook and Fischel would, for example, preclude a target's management from manipulating the target's assets or capital structure to make the target less attractive to a potential acquirer, from contesting the legality of an offer under federal antitrust or securities law, from buying off bidders, and from seeking and favoring other bidders. For a list of popular takeover defenses, see Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities—An Update*, 40 BUS. LAW. 1403, 1414-26 (1985). Some specific tactics are discussed in this Article. See *infra* notes 38-40 (shark repellent amendments), 53-54 (antitrust obstacles), 56-58 (litigation), 125-30 (stock plans) and accompanying text.

³ Easterbrook & Fischel I, *supra* note 1, at 1174-82. There are two basic forms of managerial inefficiency: poor administrative decisions arising from ineptitude, excessive risk-aversion, or simply laziness; and a siphoning off of benefits belonging to shareholders. A bidder presumably will offer a premium over market price for control of an inefficiently managed company because the bidder expects to realize a profit by replacing the existing management with superior administrators. See Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965). If managers cannot obstruct tender offers, they can protect against a takeover only by maximizing the value of the company's stock, in short, by managing efficiently. See 1985 COUNCIL OF ECON. ADVISORS ANN. REP. 188-89. For a case study on how the threat of takeovers revitalized a lethargic industry, see *Raiders Sober the Oil Industry*, N.Y. Times, Jan. 11, 1985 at D1, col. 3.

ence. Many legal scholars have accepted the basic claim that most defensive tactics are undesirable, although some authors would preserve management's right to engage in some limited responses.⁴

Professors Easterbrook and Fischel justify the passivity thesis on two grounds. First, they harbor a deep suspicion of both the competence and the motives of corporate officers who defend against hostile tender offers. In a subsequent article they stated that "[i]n most cases resistance reflects either mismanagement (to the extent it pointlessly denies shareholders the opportunity to obtain a premium) or manager's self-protection (to the extent its point is to preserve managers' jobs or 'sell' their acquiescence in exchange for bonuses or promises of future employment)."⁵ In short, they believe that target managers who engage in defensive tactics rarely do so in the best interests of their shareholders. Second, Professors Easterbrook and Fischel argue that even if target managers defend against tender offers exclusively in the ostensible best interests of their shareholders (they seek, for example, to maximize the tender offer price for their shareholders by seeking higher bidders), there is a net reduction in shareholders wealth: "By raising the price, auctions reduce the number of acquisitions and thus the amount of monitoring. The decrease in monitoring results in higher agency costs of management and thus in lower returns on investment."⁶

The passivity rule attempts to address both problems. First, a blanket prohibition against defensive tactics assumes that only incompetent and selfish managers obstruct tender offers. Thus, the

⁴ Professors Bebchuk, Coffee, and Gilson, for example, favor allowing target management to seek competing bids. See Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030 (1982) [hereinafter cited as Bebchuk I]; Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 23-24 (1982-83) [hereinafter cited as Bebchuk II]; Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1151 (1984); Gilson, *Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982-83) [hereinafter cited as Gilson I]; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 868-75 (1980-81) [hereinafter cited as Gilson II]. Professor Carney argues for allowing target management to support shareholder amendments to the corporate charter. See Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, AM. B. FOUND. RESEARCH J. 341, 342 (1983). Professor Lowenstein, although skeptical about the value of takeovers, advocates limiting the scope of target management resistance to devices that provide shareholders more time to consider a tender offer. See Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 322-33 (1983). Dissenters to the passivity thesis include Harrington, *If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids*, 34 SYRACUSE L. REV. 977 (1983); Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980); Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978).

⁵ Easterbrook & Fischel III, *supra* note 1, at 1 (emphasis added).

⁶ *Id.* at 2.

rule eliminates the need for a case by case determination of whether target managers are acting in the best interests of their shareholders.⁷ Second, a blanket prohibition against defensive tactics, coupled with a repeal of the Williams Act,⁸ also increases the frequency of tender offers by reducing the price that bidders must pay to acquire control and by protecting the first bidder from subsequent bidders who “free ride” on the first bidder’s search costs.⁹ Thus, the rule enhances the incentive of outsiders to monitor the performance of corporate executives to the benefit of all shareholders.

This Article discusses separately each justification of the passivity thesis. In Part I it argues that Professors Easterbrook and Fischel do not give due regard to the role of loyal and conscientious target managers. Undoubtedly, self-interest motivates some target managers to resist a tender offer, and such resistance occurs at the expense of the target’s shareholders. But conscientious target managers do have a role in advancing their shareholders’ interests that their shareholders acting individually cannot pursue. Quite simply, target managers can act virtuously as bargaining agents for target shareholders.¹⁰ From this perspective the two factual predicates of Easterbrook and Fischel’s first argument—that there is a high frequency of target management misbehavior in responding to tender offers and that it is wasteful to determine on a case by case basis when such

⁷ Professors Easterbrook and Fischel believe that courts too often favor misbehaving target managers by applying the deferential business judgment rule and that the passivity rule “does not require courts to make business decisions.” A court need only determine whether managers were passive. Easterbrook & Fischel I, *supra* note 1, at 1198-99.

⁸ The Williams Act, 15 U.S.C. §§ 78g, 78l-n, 78s (1982). Professors Easterbrook and Fischel believe that the Williams Act allows a target’s management time to undertake a defensive strategy. Easterbrook & Fischel I, *supra* note 1, at 1162-63. See also Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978) (Williams Act operates to detriment of all shareholders). The Williams Act and rules promulgated thereunder by the Securities and Exchange Commission regulate tender offers and require disclosure by the offeror and the target management. For example, Rule 14e-1 of the SEC mandates that the tender offer must remain open for 20 business days, and if more shares are tendered than the offeror is willing to buy, the offeror must accept all shares tendered on a pro rata basis. 17 C.F.R. § 240.14e-1 (1985). See also Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 284-96 (1985) (discussing federal securities laws).

⁹ See *infra* text accompanying notes 81-86.

¹⁰ See, e.g., Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980). The authors argue that a board can (1) force the offeror to raise the premium, (2) force the offeror to engage in a negotiated acquisition on more favorable terms, or (3) attract other offerors. *Id.* at 109-10. Indeed, directors may have a fiduciary obligation to maximize the control premium for shareholders. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (managers violated their fiduciary duty by, among other things, agreeing not to solicit other offers and not to furnish information to other potential bidders).

misbehavior occurs—are open to serious question.¹¹

In Part II this Article considers the second argument of Professors Easterbrook and Fischel and concludes that, once target managers are limited to their proper role as bargaining agents, a claim that an absolute bar on defensive tactics by target managers would significantly increase total shareholder wealth is problematic. The rule will encourage shareholders and their managers to use alternate devices in order to gain collective negotiation leverage against bidders, and these devices are often much less efficient than a delegation of bargaining power to an agent. Indeed, this avoidance behavior may block tender offers that currently are successful. Thus, the Article concludes that a practical, and politically feasible, solution aimed at optimizing the wealth effects of hostile tender offers is an informed program of judicial supervision.

Finally, in Part III the Article suggests legal standards that courts could use to effectively police target managers. Although courts have exhibited an intuitive recognition of the role of target managers as bargaining agents, they have yet to develop a sophisticated case law that defines its implications. Indeed, courts searching currently for standards often reach unsound conclusions.¹² That courts' views have not matured does not mean that they cannot mature, however, and Part III contains guidelines for judicial analysis.

I

ARE MOST DEFENSIVE TACTICS CONTRARY TO THE SHAREHOLDERS' BEST INTERESTS?

A. Two-Tier Tender Offers: The Stampede Effect and the Need for a Collective Shareholder Response

Central to Professors Easterbrook and Fischel's argument for a blanket prohibition on all defensive tactics is their argument distinguishing resistance to a tender offer from other kinds of management decisions that affect directly a manager's personal wealth. Corporate managers, subject to court review,¹³ have long made decisions on executive compensation, on contracts with entities in which executives have an interest, and on refusals to merge or sell the company in direct negotiations (which may preserve executive

¹¹ This argument and its answer are versions of the Type I/Type II error analysis of legal rules developed in the Law and Economics school. See generally Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 35 J. LEGAL STUD. 257 (1974); Landes & Posner, *Legal Precedent: A Theoretical and Typical Analysis*, 19 J. LAW & ECON. 249 (1976).

¹² See, e.g., Carney, *Takeover Tussles: The Court's Tug-of-War with Corporate Boards*, 54 BUS. & SOC. REV. 64 (1985) (commenting on two recent cases from Delaware).

¹³ See *infra* text accompanying notes 94-100.

positions).¹⁴ Some nineteenth century courts imposed a blanket prohibition on transactions between a corporation and its executives, but later courts have recognized that this position is too confining.¹⁵ The prohibition prevents beneficial arrangements, and judicial supervision can adequately protect shareholders from managers who breach their duty of loyalty.¹⁶ This lesson, that blanket prohibitions disabling corporate managers are often counterproductive, continues to guide courts.

Why are target managers' responses to hostile tender offers so different? Professors Easterbrook and Fischel answer:

Conflicts transactions outside the realm of tender offers are not similarly interdicted because they typically involve corporate decisions that shareholders, as a practical matter, simply cannot make. But in deciding whether to accept or reject a tender offer, managers enjoy no particular comparative advantage over shareholders. The decision does not involve management of the corporation's affairs in any meaningful sense and thus can be made by shareholders even though they are not involved in those affairs to any significant degree.¹⁷

Shareholders cannot resolve conflicts transactions other than tender offers because "[t]hese types of decisions, regardless of the inevitable conflict of interest, must be made by management as agents for the firm; the shareholders themselves have neither the time, the expertise, nor the interest to become involved with running the corporation's affairs."¹⁸

On its face the distinction is appealing; target shareholders can judge just as well as target managers whether to sell or hold shares in light of market conditions. Indeed, reasonably diligent shareholders routinely make such decisions. Thus, whenever target managers block what otherwise would be a successful tender offer, they are standing in the way of shareholder wishes. Yet, the argument is not sound. Shareholders acting individually will accept a tender offer that acting collectively they would reject, and target management

¹⁴ State corporation codes require that a corporation's shareholders ratify the decision to merge or to sell a company. The decision not to merge or not to sell is not subject to such a requirement.

¹⁵ *E.g.*, Marsh, *Are Directors Trustees?*, 22 *BUS. LAW.* 35, 36-39 (1966) (discussing law on contracts between an officer and his corporation as of 1880).

¹⁶ There is considerable disagreement on how much judicial supervision is needed. See Buxbaum, *Conflict of Interest Statutes and the Need for Demand on Directors in Derivative Actions*, 68 *CALIF. L. REV.* 1122 (1980). Compare Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 *CORNELL L. REV.* — (1986), with Scott, *The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel & Bradley*, 71 *CORNELL L. REV.* — (1986).

¹⁷ Easterbrook & Fischel I, *supra* note 1, at 1198 (footnote omitted).

¹⁸ *Id.* at n.106.

can effect a collective shareholder response. Conscientious managers of a target company may be able to negotiate with the initial offeror and other potential bidders to extract gains for the shareholders that shareholders would not realize if they responded individually.¹⁹

The following two hypothetical cases illustrate the advantage of a collective shareholder response: In both cases Company *A* decides that it is willing to pay a fifty percent premium over market price for a controlling block of shares in Company *B*.²⁰ Once *A* controls *B*, *A* will use *B*'s assets to recoup its investment and make a small profit as well.²¹ In situation one, *A* discovers that a small fam-

¹⁹ In response to the argument that target managers may have access to information *not* reflected in the market price of the stock, advocates of the passivity thesis claim first, that this situation is rare, and second, that if they do have access, target managers can and will simply inform their shareholders of the concealed information. The frequency of such cases is probably overestimated, but they do occur; the second response is insufficient for two reasons. First, management may have access to valuable information that cannot be made publicly available without destroying its value. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 843-44, 850 n.12 (2d Cir. 1968) (en banc) (corporation discovers ore deposit on land it does not own and secrecy enables it to acquire mining right at minimal price). Professors Easterbrook and Fischel allow that such cases may constitute an exception to their theory. Easterbrook & Fischel I, *supra* note 1, at 1168 n.19. Second, there are substantial practical problems created by a requirement that target managers pass all tender offer information on to shareholders. See *infra* note 115.

²⁰ *A* may have several reasons to buy *B*. See *infra* note 72. The beneficial reasons include the displacement of poor managers and "synergy" gains. See generally Coffee, *supra* note 4, at 1166-67. Synergy gains are created if the target's assets have a unique value to the bidder. Because of the good fit, the value of the merged companies is greater than the value of the two companies as independent concerns. This hypothesis has critics, e.g., Lipton, *supra* note 4, at 1232-33; Lowenstein, *supra* note 4, at 249. The synergy gain is hard to calculate and is often a tar baby for potential bidders. See *Bus. WEEK*, June 3, 1985, at 88 (bidders often wildly overestimate gains in deciding to make tender offers).

²¹ The size of the premium that *A* is willing to pay for control depends not only on the size of gains from *A*'s better use of *B*'s assets, but also on how much of the gain *A*, as the new majority shareholder, can claim for itself. To maximize its share of the gains created by the new combination, *A* can either use its control of *B* to distribute the gains disproportionately between *A* and the other minority shareholders (some inequality is legally tolerated, but extreme inequality, known as "looting," is not), or *A* can eliminate *B*'s minority shareholders before the gains materialize. A common technique for accomplishing the latter approach is a merger in which the minority shareholders receive cash for their shares. Because such large cash outlays can cause liquidity problems, a second technique is to give the minority shareholders securities in *A* in exchange for their *B* shares (valued exclusive of the gains), thus diluting their claim to the gains once they are realized. The most extreme case would be one in which the minority shareholders received only debt instruments (bonds or notes) in *A* for their *B* common stock.

The success of a majority shareholder in excluding minority shareholders from a significant participation in the gains created by a tender offer depends crucially, therefore, on the inability of minority shareholders either to block these mergers or to seek court enforced appraisal rights that include a share of the gains from the merger. In *Weinberger v. UOP*, 457 A.2d 701, 713 (Del. 1983), the court created considerable uncertainty about the latter issue, however ("elements of future value . . . , which are

ily group owns fifty-one percent of *B*'s shares,²² and none of the family members holds an executive position in *B*.²³ *A* approaches the family, which appoints *X*, one of its members, to negotiate the sale. *A* initially offers a twenty percent premium.²⁴ *X*, on the other hand, has authorization from her family to sell only at a thirty percent premium. Seeking to maximize her family's gain, *X* does not counter with her bottom line position but instead offers to sell at a sixty percent premium.²⁵ Further bargaining leads to a sequence of concessions by both parties, and eventually *A* and *X* agree on a sale

known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered").

²² Assume that enough shares are outstanding to create a liquid market.

²³ This assumption avoids complications by making it less likely that courts will hold that a family member must apportion the control premium with the minority stockholders. Controlling shareholders generally have no duty to share a control premium with minority shareholders. *Compare* *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (largest shareholder in a corporation not accountable to minority shareholders for sale of stock) *with* *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.) (dominant shareholder accountable to minority shareholders for sale of control), *cert. denied*, 349 U.S. 952 (1955).

²⁴ For the sake of simplicity the example assumes a one-dimensional negotiation over the value of the stock. One-dimensional negotiations are usually competitive, that is, the parties do not reveal all relevant information about their interests (for example, their reservation prices) to one another in the bargaining. Of course, this negotiation could be multi-dimensional, including in the bargaining possibilities of future employment, payment terms, and the like. If so, a more cooperative process of bargaining may produce better results. *See generally* Menkel-Meadow, *Toward Another View of Legal Negotiation: The Structure of Problem Solving*, 31 U.C.L.A. L. REV. 754 (1984).

²⁵ The family may rationally insist on a minimum premium of 30% for three possible reasons. First, the family may benefit from an unequal division of the benefits of ownership in *B*. Through its control of *B*, the family may extract benefits that are unavailable to minority shareholders, such as placing family members on *B*'s payroll.

Second, the family may believe that another potential buyer will offer at least a 30% premium for control of *B* after the family informs the other buyer that *A* is an interested suitor. Indeed, *X*'s authorization to accept no less than a 30% premium may be the direct result of her calling other potential buyers and informing them of *A*'s bid. The timing qualification is crucial. If the other purchaser was a willing purchaser before *A* appeared, then the family would have sold to it before *A* appeared on the scene. *A*'s bid releases information to the market that is valuable to other potential buyers (so valuable that Easterbrook and Fischel fear a significant free-rider problem that might discourage first bidders from searching for targets, *see* Easterbrook & Fischel III, *supra* note 1) and encourages these buyers to consider entering the bidding. *See infra* text accompanying notes 81-86. More thought needs to be given to the kind of information that *A*'s bid provides other bidders. For example, does *A*'s bid signal to the market that *B* is poorly run, or does the bid simply impose a deadline constraint on the other bidders who already know *B* is poorly run and have been dragging their feet on making an initial offer?

Third, even if no other bidders are in the market, *X* may reasonably suspect that *A* is a special buyer, willing to offer a 30% premium. This is a classic bilateral monopoly: *A* has discovered a special value in *B* and *B* knows that it must sell to *A* to get above market returns. There is no unique solution to the bargaining. Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 316 (1974). This is especially true if *A* determines that *A* and *B* fit well together and this combination of the two will produce significant synergy gains. *See supra* note 20.

for a premium somewhere between thirty and fifty percent.²⁶

In case two, numerous shareholders own stock in *B*, and no group of shareholders has solidified into a controlling block. Again, the size of the premium *A* is willing to offer depends in part on *A*'s ability to maximize its share of the gains that it will create once it gains control of *B*'s assets. Case two is otherwise identical to case one.²⁷ *A* states to *B*'s board of directors that it is willing to purchase a controlling block of *B*'s stock at a premium over market price. As in situation one, *A* is willing to offer a fifty percent premium but initially offers only twenty percent. The board suspects that either *A* or a third party aware of *A*'s interest would pay more.²⁸ Consequently, the board counters *A*'s offer with a demand for a sixty percent premium hoping to maximize its shareholders' gain on the transaction. Unlike situation one, however, *A* can gain control of *B* without continuing to bargain with the board by appealing directly to the shareholders.

A makes a two-tier, front-end loaded bid. *A* begins, for example, a hostile tender offer for fifty-one percent of *B*'s stock by offering a twenty percent premium, and threatens to force out the remaining shareholders at a lower price in a takeout merger.²⁹ If

²⁶ The exact point of agreement will depend on the relative bargaining skill of the two parties—their coolness under deadline pressure, their concession patterns, their strategic disclosure of information, their sensitivity to cues on each other's reservation price, and so on. To induce concessions from *A*, *X* may find that threats to break off negotiations are necessary, buttressed perhaps by threats to find and sell to other potential buyers. *X* can, and indeed should, do all this as the faithful agent of her family. *A* can offer her a bribe to disadvantage her family in the bargaining (by revealing, for example, the extent of her authorization so that *A* can cut the deal at exactly the 30% premium), but *X* owes a duty of fidelity to her family and is under a legal obligation to decline.

In a one-dimensional negotiation, *X* will attempt to discover and change her opponent's true bottom line position while convincing her opponent that her bottom line position is higher than in fact it is. Thus, if *X* is able to discover that *A* will pay a 50% premium and convince *A* that her final authorization is for a 50% premium, she will have maximized her gain (unless, of course, she is able to increase *A*'s reservation price). *A* has similar goals. See generally White, *Machiavelli and the Bar: Ethical Limitations on Lying in Negotiation*, 1980 A.B.F. RES. 926.

²⁷ Case two is distinguished from case one in that in case one only the controlling family split the premium (and some argue the split should not be allowed), while in case two all the shareholders theoretically have an opportunity to claim the premium. The distinction is unimportant for the purposes of this Article, however.

²⁸ This analysis assumes that the board's primary motivation for demanding a premium over market value is not because the board or a controlling group of shareholders profits currently from an inappropriate division of *B*'s profits.

²⁹ This discussion assumes the legality of the two-tiered tender offer. In a two-tiered offer, the successful purchaser merges with the target, and the remaining target shareholders receive securities of the combined entity that are generally worth less than the tender offer price. See Dennis, *supra* note 8, at 319-31. Two-tier pricing has been attacked, so far unsuccessfully, as a manipulative device violative of the antifraud provisions of the federal securities laws, *Radol v. Thomas*, 534 F. Supp. 1302 (S.D. Ohio

the board must be passive³⁰ and the Williams Act is repealed, the stampede effect will cause *B*'s shareholders to tender as quickly as possible in an effort to secure the tender offer premium.³¹ Each shareholder must decide whether to sell without time to coordinate his response with fellow shareholders. Thus, if *A* structures the offer correctly,³² *B*'s shareholders will race to tender their stock because the tardy will lose the opportunity to share in the tender offer premium. Other potential bidders will lack time to participate in the bidding; they can only acquire *B*'s assets by paying the new owner, *A*, a higher price.

The coercive effect of a two-tiered tender offer increases as offerors are able to increase the disparity between the tender offer premium, which is certain, and the prospective value of stock in the target held subsequent to the completion of the offer, which is speculative. An offeror can use one of many threats to overcome the resistance of target shareholders who refuse to tender in the hope of participating in the gains from the new combination, e.g., a threat to

1982), and as violative of state law. See generally Mirois, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485 (1983).

Commentators have criticized these second-stage mergers (also known as takeout or freeze-out mergers). See, e.g., Brudney & Chirelstein, *supra* note 25; Brudney & Chirelstein, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072 (1983). The most prominent defenders of the practice are, expectedly, Professors Easterbrook and Fischel. They argue that unequal sharing of gains is a necessary incentive to buyers who could not otherwise afford to enter gain-creating transactions and to sellers who because of a free rider problem would not sell (enough shareholders will not sell in hopes of sharing in the gain created by the new combination that the tender offer will fail and none will benefit). See also Dennis, *supra* note 8, at 339-41. The argument has appeal, but its proponents have yet to discuss how far one can take it. If the "free rider" justifies takeout mergers at prices that do not include the effects of the merger, does it justify other acts by the new directors of the target that favor the new parent at the expense of residual original shareholders in the target? An extreme example is bifurcated dividends; should the old shareholders receive dividends no greater than those they would have received had there been no tender offer, while the bidder, now holding 51% of the target stock, receives more so it can appropriate the gains of the merger? Current law prohibits this result, of course, but does the logic of the free-rider argument justify it?

³⁰ Among other things, *B*'s board and its management cannot pursue negotiations with or contact any potential bidders.

³¹ The Delaware Supreme Court uses the term "stampede" in *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946, 955 (1985). Presumably, the term comes from the tendency of most herd animals (with the notable exception of the gnu) to run rather than collectively confront a predator. Once the herd starts to run, the prudent run with it because those who refuse to run or those who run too slowly are left to face the predator alone.

³² A simple offer, such as "starting immediately we will accept 50% of the outstanding shares on a first-come first-serve basis," should suffice. This type of offer, known as a Saturday Night Special, was legal prior to the passage of the Williams Act. Average cash tender offer premiums increased from 32% to 53% after the passage of the Williams Act. Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & Econ. 371, 373 (1980).

cash out the residual shareholders at a lower price or a threat to otherwise exclude them from the fruits of the combination (drawing down the value of their stock below the tender offer price) by manipulating the assets or capital structure of the target to favor the new parent.³³ What makes these threats so credible is that the offeror, accountable to its own shareholders, often must monopolize the profits created by the combination to get a favorable return on the huge sum it has spent to acquire the target.³⁴ Threats to disadvantage residual target shareholders may not be necessary, however; even a public rumor that falsely creates an overly pessimistic appraisal of the value of the new combination (and therefore the value of target shares held after the combination) may suffice.

The stampede effect is so strong that shareholders will choose to tender even though a majority suspect that another offeror may make a higher bid or suspect that *A*, if pushed, may offer a higher premium. Shareholders will accept a lower premium because of the risk that at least fifty-one percent of *B*'s other shareholders, acting individually, will tender their stock and the nontendering shareholders will receive less than the tender offer price.³⁵ Acting individu-

³³ The first threat, despite rumblings in the courts, is ostensibly legal if the value given residual target shareholders exceeds the premerger market price. See *supra* note 21. The second threat requires the parent and the new directors of the subsidiary to finesse the standards of fiduciary duty that ostensibly require the equal treatment of all shareholders.

³⁴ See *supra* note 21.

³⁵ This is sometimes loosely referred to as a "prisoner's dilemma," after a game devised by two psychologists. Brudney & Chirelstein, *supra* note 25, at 337; Carney, *supra* note 4, at 349-50; Lowenstein, *supra* note 4, at 307-09. In the game both players recognize they can both gain from mutual cooperation (each receives 3 units of value), but each player is also tempted to defect, earning, if the other player does not defect, a superior individual gain that exceeds the reward for mutual cooperation (5 units) and inflicting the worst outcome on the other player (0 units: "sucker's payoff"). If both players defect, however, both players receive a return which is lower than the reward for mutual cooperation (1 unit). In single decision games, each player typically distrusts the other, and both choose to defect with the effect that both receive the suboptimal return (1 unit). See generally R. AXELROD, *THE EVOLUTION OF COOPERATION* (1984); A. RAPOPORT & A. CHAMMAH, *PRISONER'S DILEMMA* (1965). In a tender offer the choice to cooperate is a choice to bargain collectively (holdout) so as to encourage the bidder to increase its offer or to encourage other bidders to make offers, and the choice to defect is the choice to tender immediately. The reward from mutual cooperation is the blended price (the weighted average of the price of shares tendered and of those exchanged in the follow-up merger) of the increased offer; the punishment for mutual defection is the blended price of the existing offer; the temptation to defect is a larger share of the tender offer premium as currently offered; and the sucker's payoff is the price given in the takeout merger.

The game does not describe accurately the situation of shareholders faced with a tender offer; their payoff matrix is more complex, primarily because the number of players is greater than two. Consider, for example, the returns for defecting if the pro rata rule of the Williams Act is in effect. See *supra* note 8. Shareholders tender hoping that at least, but no more than, the minimum number of shares requested are also offered, giving the shareholder his maximum share of the tender offer premium. Interestingly, a

ally, *B*'s shareholders cannot effectively resist *A*'s offer. In other words, shareholders who would vote to reject the offer will nevertheless tender. The stampede effect is unique to hostile tender offers; a shareholder who casts a negative vote and who is in the minority does not necessarily lose the opportunity to tender his stock once the offer begins. Voting on whether to accept a tender offer is, therefore, one mechanism for collective shareholder action.³⁶

Failure to unite in response to *A*'s offer may therefore result in *A*'s purchasing control of *B* for a twenty percent premium, nullifying the negotiating power held by even a conscientious and faithful board. The shareholders must bargain collectively if they are to vindicate their belief, or the belief of their board, that a higher price is available. Absent collective action, *B*'s shareholders lose the possibility of sharing in any negotiated premium over the initial twenty percent offer. They lose the power to enforce a bottom line position at a thirty percent premium or to bluff to a premium of up to fifty percent. Thus, the stampede effect diminishes the target shareholder's ability to bargain for a portion of the potential gain caused by the new combination of bidder-target. Academic commentators have often undervalued or even overlooked this effect in their writings,³⁷ but the business world has not.

person who defects may also hope that not enough others defect to make the tender offer successful, if he believes the bidder will pay more. Thus, shareholders who tender hope for an optimal mix of cooperation and defection by other shareholders.

³⁶ Arguably consistent with the position that offers to sell a company, if broken down to stock values, are decisions in which managers enjoy no particular advantage over shareholders is the claim that shareholders should be able to vote on hostile tender offers before an offer is activated. Some state statutes so provide. See *infra* note 43 and accompanying text. In other words, an assumption of misbehavior on the part of corporate managers in control transactions does not itself justify a prohibition of *all* defenses to hostile tender offers. Cf. *infra* note 39.

³⁷ See generally Coffee, *supra* note 4; Dennis, *supra* note 8; Gilson I & II, *supra* note 4.

Other authors have identified the stampede effect, but in searching for a link between the effect and inefficient transfers, they have consistently misassessed or narrowed its social costs. (In an inefficient transfer, gains to bidder and target shareholders are less than the losses incurred by all shareholders.) Professor Lowenstein, for example, argues that the stampede effect causes simple value-transfers from the target to the bidder by allowing the bidder to exploit temporary depressions in the target's stock price. Lowenstein, *supra* note 4, at 274, 291-94. Professor Carney identifies simple value-transfers in two-tiered tender offers that threaten a blended price that is lower than an anticipated post-tender offer market price for the stock of a target that has remained independent. (The blended price comes from the pro rata rule of the Williams Act and is the weighted average of the tender offer price and the takeover merger price.) Professor Coffee has fielded convincing rebuttals: he notes that Professor Lowenstein makes some questionable claims about stock prices, and Professor Carney, although finding an inefficient transfer, describes an unusual case. Coffee, *supra* note 4, at 1169-73. Yet, the stampede effect should not be ignored. The target shareholders will devise measures to resist it, and the relative efficiency of these devices is a part of the overall equation. See *infra* Part II.

B. Empowering Managers to be Negotiating Agents: The Optimal Mechanism Collective Shareholder Action?

Currently the business community is undergoing an intense period of experimentation, testing a variety of sophisticated techniques for defending against two-tiered tender offers. Many of the techniques represent illegitimate efforts by managers to protect their jobs, but many are legitimate, representing instead the efforts of shareholders and their managers to create mechanisms for a collective response. Shareholders who wish to avoid the stampede effect can take either of two basic approaches: they can delegate bargaining authority to a duly empowered agent, or they can create automatic blocking mechanisms that operate without the participation of an agent. The automatic mechanisms are inflexible, costly, or both, and the delegation of bargaining power to an agent creates agency costs (the risk of faithlessness). At present the trend is for shareholders to rely primarily on their directors as negotiating agents, and the methods of empowering them with negotiating authority are varied and complex. This section discusses first the popular automatic mechanisms and second the use of directors as negotiating agents.

There are several popular examples of automatic shields against the stampede effect.³⁸ Most of the devices are commonly implemented through amendments to corporate charters³⁹ and im-

³⁸ Much of the following discussion comes from an excellent treatment by Professor Carney. See Carney, *supra* note 4.

³⁹ Some commentators view these charter amendments as suspect because they are enacted at the instigation of management. The commentators point to management control over the proxy machinery and argue that management is able to get shareholders to vote contrary to their own interests. *E.g.*, Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 822-27 (1982). The argument has disturbing applications; it justifies ignoring shareholder votes on a wide variety of issues and, in its extreme form, justifies a uniform national corporate code that guarantees shareholders unwaivable rights. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). But see Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 269 n.20 (1967). Moreover, it seems contradictory to claim that the same shareholders who will vote against their own best interests at the behest of managers will choose wisely to sell their stock at the behest of bidders.

The answer to these well-worn arguments is best articulated by Professor Posner: companies that do not deal fairly with shareholders will have to pay more to attract investors, and this higher cost of capital will disadvantage the companies in their product markets. R. POSNER, *ECONOMIC ANALYSIS OF LAW* §§ 14.1-15.7 (2d ed. 1977). See also R. WINTER, *GOVERNMENT AND THE CORPORATION* 18-28 (1978). Thus, over time it is in the manager's interest to offer charter amendments that are honestly favored by their shareholders. Some managers, of course, may choose to manipulate rather than accommodate shareholders and, over time, the capital market will exact its penalty. See *infra* note 67.

Professor Gilson argues that shareholders vote with management without careful thought of the consequences because it is not worth the time for any single shareholder

pede the second-stage takeover merger. The shareholders enact super-majority provisions for mergers that follow a tender offer. The acquiring company must offer favorable terms (which usually means terms substantially equivalent to the tender offer price) in the second-stage merger to secure the necessary approval from enough of the minority shareholders to secure approval for the merger. A second example is a "fair price" amendment that prohibits any merger subsequent to a tender offer unless the price paid to minority shareholders is greater than or equal to the tender offer price.⁴⁰

Other automatic provisions come from federal and state legislation, presumably enacted at the behest of potential target companies. The legislation is arguably a substitute for provisions that target shareholders would themselves put in the articles of their corporations if they met and agreed on a mechanism for coordinating a response to a two-tiered tender offer. Thus, for example, one could justify the twenty business day minimum offering period provided under the Williams Act as a substitute for an agreement among all target shareholders not to tender for twenty days in response to any tender offer so as to give other bidders notice and time to make higher bids.⁴¹ One can argue similarly in justification for some of

to inform herself properly. Because no single shareholder can fully claim the gains of any individual research effort, each shareholder waits hoping to free ride on the efforts of others, and shareholder resistance to management proposals is systematically underfunded. Gilson, *supra*. Gilson overlooks, however, the incentive of the larger investors to monitor their investments, and if they disagree with management's treatment of shareholders, they can adversely affect the price of the stock. Thus, a large minority vote may give faithless managers only a temporary victory: the amendment may pass, but the vote indicates a substantial dissent that may translate into lower stock prices. It is no surprise, therefore, that large minority votes are often effective at changing corporate policies.

In this regard one study has found that the announcement of shark repellent amendments correlates with a rise in stock prices. Linn & McConnell, *An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361 (1983). See COUNCIL OF ECON. ADVISORS, *supra* note 3, at 208-09 ("As an initial matter, if a defensive tactic is explicitly adopted or sanctioned by the corporation's shareholders, it should not be considered abusive, regardless of the extent to which it might deter takeovers They have strong incentives to adopt whatever defensive measures they believe will maximize the value of the corporation's shares.") There is some contrary evidence based on a general survey of institutional investors; the investors opposed supermajority amendments and were split on the value of fair price amendments. Coffee, *supra* note 4, at 1181 n.101, 1189 n.126. The value of general survey information, however, is questionable in light of the importance of the specific target company's particular position to such decisions. The survey itself reflects this; the split on fair price amendments changed with the size of the target company. *Id.*

⁴⁰ Many fair price amendments are much more complicated and set the price through a formula based on prior market prices, tender offer prices, or even some form of price-earnings ratio related to earlier ratios.

⁴¹ Interestingly, this approach to the Williams Act implies that corporations should be able to opt out of the Act's protections. Several of the state statutory protections can be waived. *E.g.*, OHIO REV. CODE ANN. § 1701.831(a) (Page 1983); PA. STAT. ANN. tit.

the state statutory provisions.⁴² Ohio and Wisconsin statutes,⁴³ for example, require, among other things, a majority vote of the shareholders (excluding any shares held by a bidder) before any tender offer for over a defined number of shares can be executed. The provisions are a substitute for a collective agreement not to tender unless a majority of the target shareholders vote to do so.⁴⁴ This is not to say that either of these provisions is sound, but rather to say that each can be justified with an appropriate factual foundation.⁴⁵ The value of the legislative provisions is in saved transaction costs; a uniform rule avoids some of the need for individual corporate charter amendments on the matter.⁴⁶

15, § 1910a (Purdon 1984); 1983-85 WIS. LEGIS. SERV. 200, § 7 (West). If the Williams Act is too protective, corporations could choose to opt out in favor of less protective provisions. Indeed, there is a stronger argument for allowing corporations to opt out of the Williams Act than for allowing corporations to increase the protections of the Act (as they can now), for managers are more likely to act selfishly in the latter instance than the former.

⁴² Ideally, the federal government would defer entirely to the states on the matter of tender offer legislation; corporations could choose to incorporate in the state with legislation that provides them with the best tender offer regulations, and each state would be encouraged to develop legislation that best reflects shareholder interests. See COUNCIL OF ECONOMIC ADVISORS, *supra* note 3, at 215-16. But the states have shown a propensity to do more than model shareholder desires; they have a history of using takeover legislation to protect their tax base and local jobs. See Dennis, *supra* note 8, at 296-303; Note, *Second Generation State Takeover Legislation: Maryland Takes a New Tack*, 83 MICH. L. REV. 433 (1984).

⁴³ OHIO REV. CODE ANN. § 1701.831(e)(1) (Page 1983); 1983-85 WIS. LEGIS. SERV. 200, § 7 (West).

⁴⁴ The argument also provides an answer to the concerns of the majority of the Supreme Court in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), where five Justices held that the Illinois Business Take-Over Act was an unconstitutional burden on interstate commerce. The Justices noted the nationwide effect of the legislation (corporations with minimal contacts with Illinois were included) and were unable to find a strong target shareholder interest in the statute. They noted that the statute was designed to keep local businesses independent by obstructing tender offers. A statute that minimizes the extraterritorial effects and serves the interests of target shareholders in providing a collective response to tender offers might pass muster. Unfortunately, the language of some of the opinions that constitute the majority is very broad and may foreclose the argument.

Separate pluralities of the Court would have voided the Illinois act as a direct restraint on interstate commerce and as preempted by the Williams Act under the supremacy clause. Neither position can be satisfied by redrafting state takeover legislation; if either becomes acceptable to a majority of the Justices there will be a complete bar on state takeover acts. See *L.P. Acquisition Co. v. Tyson*, No. 85-1640 (6th Cir. Aug. 26, 1985) (Michigan Take-Over Offers Act preempted by Williams Act).

⁴⁵ Some states have also enacted "fair price" and "super-majority" provisions that are similar to the fair price charter and super majority voting amendments noted in the previous paragraph. *E.g.*, MD. CORPS. & ASSN'S. CODE ANN. §§ 3-601 to 3-603 (Supp. 1984). *Cf.* 15 PA. CONS. STAT. ANN. §§ 1408(B), 1409.1(C)(1)-(3), 1910 (Purdon 1984-85 Supp.) (restricts voting of "interested shareholders" in second stage mergers; disinterested shareholders have special redemption rights).

⁴⁶ Of course, if the legislation is out of step with shareholder preferences, it is wasteful. If the legislation provides inadequate protections, shareholders will continue

Automatic defenses are inflexible, however, and this is a substantial disadvantage. They discourage bidders that target shareholders may want to accommodate and leave no room for effective bargaining with those bidders that appear. The flexibility to entertain all offers and yet resist the insufficient ones can come only through the use of a bargaining agent. But how do shareholders empower such an agent? The most obvious method is through stock resale restrictions, contingent on the occurrence of a tender offer.

For example, the shareholders could agree to vest in the hands of an identified agent the exclusive right to tender stock in the event any tender offer is announced for more than a specified percentage of the stock, with the shareholders retaining the right to sell to anyone but the offeror during the period of the tender offer. The agent would then have the power to negotiate for the best price with the original bidder and to find other bidders to stimulate an auction. The right not to tender could also be vested exclusively in the agent or reserved to the shareholders enabling them to refuse to tender even though their agent recommends that they tender. In either case, however, the agent *must* agree to the price for the tender offer to proceed. The agent could be constrained, if desired, by some pre-established limits on his bargaining authority.⁴⁷ The major national stock exchanges do not favor resale transfer restrictions on securities, however, and stock subject to these company-wide contingent resale restrictions may not qualify to be traded on the exchanges.⁴⁸

Less direct mechanisms for coordination that do not involve resale restrictions are available. Indeed, many corporations have enacted them.⁴⁹ These mechanisms depend on an obstruction of the

to seek corporation by corporation solutions. If the legislation provides too much protection, shareholders will opt out, if possible. If they cannot opt out, overall stock prices will drop to reflect the legislation's inefficiency. This method of evaluating legislation on corporate governance is not new. See R. POSNER, *supra* note 39, § 14.3.

⁴⁷ Shareholders, worried about the loyalty of such agents, could theoretically agree to be bound by blanket prohibitions on tendering to certain kinds of offers, such as offers for less than a specified percentage of stock or for less than a specified premium over market value.

⁴⁸ The New York Stock Exchange does not expressly prohibit this kind of resale restriction, but it does disfavor several similar restrictions. The Exchange has an ongoing "concern" with tactics that discriminate against "anyone seeking to make a substantial investment" in a company. The Exchange also finds objectionable "right of first refusal" provisions, certain "call" provisions, and irrevocable proxies. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL 3-4 (1983). Because large publicly held companies depend on the liquidity of the exchanges to aid them in raising capital, exchange listing requirements are powerful standards. Coffee, *supra* note 4, at 1255-69 (suggesting use of exchange rules to control target management misbehavior).

⁴⁹ Coffee, *supra* note 4, at 1183.

second stage of the two-tiered tender offer—the takeout merger. The mechanism that best approximates the straight delegation of authority to negotiate the terms of a sale to an agent is a charter amendment imposing super-majority shareholder voting requirements (ninety to ninety-five percent) on mergers that can be waived by an incumbent board of directors. If the super-majority requirements are set high enough, a negotiated waiver is the only practical method of acquiring full ownership. This leaves the incumbent board with some flexibility to condition its waiver on a satisfactory price in either or both the terms of the tender offer or the terms of the second-stage merger.⁵⁰

Assume that shareholders have not gathered together beforehand to discuss and implement special options that consolidate their bargaining position, or they have met and decided to give their managers the broadest possible delegation of authority (“do what is best for us”). When confronted with a tender offer, how can generally empowered target managers act as bargaining agents? They are neither appointed to be the exclusive sales agent for a controlling block of shareholders, nor do they have the power to waive an automatic blocking provision such as a super-majority charter amendment. Instead, target managers must devise other techniques for stalling tender offers in order both to search for alternate buyers and to negotiate for the best price with the initial bidder. However, the tactics which they employ to stall a tender offer should be *reversible* so that managers can remove them once they reach an agreement with a bidder on appropriate tender offer terms. In this manner, tactics that have been universally condemned by commentators can, *if used properly*, be justified as advancing the best interests of the target shareholders.⁵¹ The crucial issues, therefore, are

⁵⁰ Presumably the passivity thesis would prohibit this tactic unless the agent with power to waive the requirement was not a controlling official of the target.

⁵¹ The only case to discuss a target management’s argument for creating a temporary block to a tender offer is *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984). The target company argued that a newly founded employee stock option plan (ESOP) was needed to consolidate voting control “to ‘buy’ time to explore financial alternatives to a Piezo takeover.” *Id.* at 267. The target managers had allocated target stock to the ESOP, in which the target managers were installed as trustees. Thus, the target managers controlled the ESOP’s decision to tender once a tender offer was announced. Giving a substantial block of stock to an ESOP, therefore, is a classic reversible defensive tactic. The court’s response was outrage.

We have never given the slightest indication that we would sanction a board decision to lock up voting power by any means, for as long as the directors deem necessary, prior to making the decisions that will determine a corporation’s destiny. Were we to countenance that, we would in effect be approving a wholesale wresting of corporate power from the hands of the shareholders, to whom it is entrusted by statute, and into the hands of the officers and directors.

Id. Of course, any effort by shareholders to collectively empower a negotiating agent is

whether a defensive tactic is reversible and how a tactic is used in any given case.⁵²

The target company's purchase of a third company that is a primary competitor of the bidder in one of the bidder's product markets is an example of a reversible tactic that managers may employ in the shareholders' best interests. The target company's purchase will block the tender offer because of the merger restrictions contained in antitrust legislation.⁵³ This tactic is reversible because the target management can sell the newly acquired business.⁵⁴ Thus, the tactic gives the target time to find a higher bidder or to negotiate for a higher price from the first bidder. However, if another bidder makes an offer and the tactic is used to discourage the initial bidder from making a counteroffer, its use becomes illegitimate because it favors one bidder over another.⁵⁵ Moreover, the tactic is often illegitimate if it is used to defeat a tender offer by a single bidder. If target management loses the sole bidder by demanding clearly unacceptable acquisition terms, it either has bargained poorly or has pursued its own interests at the expense of its shareholders.

Litigation by the target against the initial bidder is another reversible defense; the target can drop the lawsuit once the bargain is made. A recent study on target litigation by Gregg Jarrell demonstrates the value of this reversible defense.⁵⁶ By using litigation, the target hopes to stall a tender offer long enough to encourage new bidders or gain bargaining leverage against the current bidder. The target typically alleges securities and antitrust violations and other forms of fraud against the bidder (usually without good prospects of winning on the merits). Jarrell found that in over seventy-five percent of the cases, litigious targets significantly increased the take-over premium either by encouraging competitive bidding or by

necessarily a change of power. But this delegation of power is not itself evil; it is the use of the power that determines culpability. The holding undoubtedly was influenced heavily by facts indicating that the target managers resisted the bidder solely to perpetuate themselves in office. *Id.* at 266-67.

⁵² See *infra* part III.

⁵³ See, e.g., *Marathon Oil Co. v. Mobil Corp.*, 669 F.2d 378 (6th Cir. 1981) (affirming preliminary enjoinder of acquisition of Marathon Oil by Mobil because of "strong probability" that proposed acquisition violates antitrust laws), *cert. denied*, 455 U.S. 982 (1982).

⁵⁴ The tactic has two pitfalls: First, the target managers must not, reflecting their desperation, buy high and sell low. Second, the bidder may be able to avoid antitrust problems by promising to sell the new business immediately upon acquiring control. If courts accept such a promise as a complete defense to injunctive relief, the tactic fails.

⁵⁵ For a proposal on how courts should treat defensive tactics that favor one bidder, see *infra* notes 130-31 and accompanying text.

⁵⁶ Jarrell, *The Wealth Effects of Litigation By Targets: Do Interests Diverge In a Merger?*, 28 J.L. & ECON. 151 (1985). The defense may be infirm on other grounds, however, because it is arguably a misuse of judicial process. See RESTATEMENT (SECOND) OF TORTS § 682 (1972).

sweetening the offers from the only suitor.⁵⁷ Auctions therefore occurred more frequently for litigious than nonlitigious targets, and these auctions increased takeover premiums by an average of seventeen percent.⁵⁸ Jarrell also inferred that many targets who defeated takeovers by vigorous litigation, losing the entire takeover premium, did so unintentionally and that in such cases the targets took a gamble that may have been sensible under the circumstances.⁵⁹

C. The Risks of Relying on Target Managers as Negotiating Agents

The need for flexibility in responding to a tender offer and the high cost of obtaining contemporaneous directions from shareholders imply that the optimal choice for collective action consists of electing a generally empowered negotiating agent. The optimal system would seem to be one that ties agents' rewards exclusively to their success in the negotiation. For example, an agent who is not a member of the target's management team could be appointed as special outside director. This special director could have the delegated responsibility of negotiating for the highest tender offer price. The best way to empower such an agent with negotiating authority is to grant him the exclusive right to approve tender offers for shareholders, that is, the right to prohibit shareholders from tendering to an offeror. Compensation could be tied to stock price increases resulting from his acts in response to a tender offer.

This method of compensation would eliminate much of the conflict of interest that results when target managers respond to a tender offer. The special director, of course, may lose his job upon completion of a tender offer, but he realizes no gain by defeating a tender offer unless the post tender offer stock price exceeds the weighted average of the tender offer price and the anticipated second-stage merger price. Moreover, the special director's reputation as a negotiating agent, which could earn him opportunities to act in a similar capacity for other companies, depends on his success in negotiating the best price. Unfortunately, the creation of specially compensated and empowered directorships has never received serious consideration. Yet, it is the only system that courts should judge under the business judgment rule.⁶⁰

Without stock resale restrictions, the only way to empower directly a general negotiating agent is to grant target managers the authority to block or stall tender offers with a range of tactics based

⁵⁷ *Id.* at 174.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ See *infra* text accompanying notes 94-100.

on their ability to strategically manipulate corporate affairs. Of course, target managers who block or stall a tender offer may misbehave in order to keep their jobs or obtain other side-payments (such as bribes from one of the interested parties). Professors Easterbrook and Fischel, suspicious of the bona fide intentions of corporate managers, imply that corporate managers are largely incapable of acting as faithful bargaining agents in this setting. This belief infects other coordination devices as well. They argue that legal rules, such as the Williams Act, that are designed to aid shareholders just provide additional room for the maneuvers of self-serving managers.⁶¹ Moreover, they assert that provisions in corporate charters, which shareholders ratify ostensibly to coordinate their actions, originate from managers who seek to protect their own job interests through their control of the corporate proxy machinery.⁶² Thus, the only shareholder coordination mechanism that would pass muster under the passivity thesis is one that shareholders propose and ratify with no support or aid from the company's managers.⁶³

A shareholder-initiated coordination agreement will occur infrequently, if at all, because individual shareholder apathy is a rational response. No single shareholder can realize fully the gain that results from a coordination agreement. Each shareholder will therefore sit back and hope to free ride on the efforts of others. No shareholder will incur the costs that it would be rational for all shareholders collectively to expend. In addition, a shareholder would bear relatively large organizational costs in creating such an agreement, compared with the gain on that shareholder's stock that the agreement would generate. Because no generally available mechanism exists to prorate the costs outside of relying on management, shareholder coordination in publicly-held corporations will be systematically underfunded. Thus, target managers must often take the lead in organizing shareholders to prepare for a collective response.

The frequency of misbehavior by managers confronting the prospect of a hostile tender offer is an empirical question, and no convincing study analyzes a large number of tender offers to assess

⁶¹ See Easterbrook & Fischel I, *supra* note 1, at 1162-63, 1169-70; Easterbrook & Fischel III, *supra* note 1, at 16-17, 21; see also Easterbrook & Jarrell, *Do Targets Gain From Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 279 n.6 (1984). Cf. Brudney & Chirelstein, *supra* note 25, at 336-40 (recommending legislation aimed at eliminating undesirable effects of two-tiered tender offer).

⁶² Easterbrook & Fischel I, *supra* note 1, at 1201.

⁶³ The justifications for the passivity thesis, considered *infra* Part II, seem to require that even shareholder-initiated coordination mechanisms be prohibited. Although Professors Easterbrook and Fischel write as if the thesis acts solely on corporate managers, it also may apply to shareholder acts that disadvantage the first bidder or raise tender offer prices.

the effect of defensive tactics by target management.⁶⁴ Although some cases show that the intervention of target managers has enhanced the shareholders' gain,⁶⁵ other cases indicate that such intervention has reduced shareholders' gain.⁶⁶ Even in these latter cases, however, the target managers may have taken a justifiable gamble to increase the tender offer price. A straightforward application of the efficient capital market model suggests that firms run by managers who misbehave when confronted with tender offers will be penalized over time in the capital markets, and, therefore, that only firms run by managers who act properly in the face of a hostile tender offer will survive over time.⁶⁷

Whatever the frequency of target management misbehavior, a significant portion of such behavior results from the failure of the state courts and legislatures to define a proper role for target managers. This failure is correctable.⁶⁸ It is harsh to criticize target managers for engaging in acts that are declared legal, even though the acts are self-serving. In sum, Professors Easterbrook and Fischel have not made a convincing case for their passivity thesis as a bright line rule that errs on the side of excessive enforcement; target management misbehavior is neither so frequent nor so difficult to

⁶⁴ Many studies suggest that shareholders of the target gain substantially from successful tender offers, *see* Dennis, *supra* note 8, at 317-18 & n.175, but no thorough study of whether the defensive tactics of the target management increase or decrease the gain exists. The best data seem to be in Jarrell's study. *See supra* text accompanying notes 56-59.

The studies of firms whose managers completely defeated takeover bids offer ambiguous and conflicting information. *See, e.g.*, Easterbrook & Jarrell, *supra* note 61, at 281-82 (noting conflicting results in studies based on direct price comparisons of financial economists). *But see* Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, ABA INST. ON THE DYNAMICS OF CORPORATE CONTROL (Dec. 8, 1983) (citing study by Kidder, Peabody & Company finding that in over 50% of the cases, target shareholders benefited from the defeat of tender offer).

⁶⁵ *See, e.g.*, Coffee, *supra* note 4, at 1175 n.79 (noting several examples of competitive auctions stimulated by target management driving up the tender offer premium). *But see* Easterbrook & Fischel III, *supra* note 1, at 7 n.16 (questioning causal connection between management-stimulated auctions and increased premiums).

⁶⁶ Easterbrook & Jarrell, *supra* note 61, at 282-91.

⁶⁷ The model posits that the share price of a corporation reflects all public information on the prospects of that corporation. *See, e.g.*, Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 374-81 (1984); Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1315-19, 1330-54 (1981). If target management consistently misbehaves in anticipation of or during hostile tender offers, the share price of the firm presumably will drop to reflect the shareholder's lost opportunity to secure a tender offer premium. The drop in price will make raising additional capital more expensive for the firm. This result makes it more expensive for the firm to compete and expand. Moreover, if the price drops low enough, it may become worthwhile for an acquirer to spend the sum necessary to overcome the resistance of the target management.

⁶⁸ *See infra* part III. *But see* Coffee, *supra* note 4, at 1251 (asserting that failure of state courts and legislatures to define proper role for target managers is incorrectable).

penalize effectively that the judiciary, with a mature case law on the issue, cannot control it.

II

THE AGENCY COSTS JUSTIFICATION FOR THE PASSIVITY RULE

As noted earlier, the second justification that Professors Easterbrook and Fischel advance for the passivity thesis is an argument based on maximizing the ex ante position of shareholders by reducing agency costs.⁶⁹ Admitting for the sake of argument that target shareholders can and do benefit from some acts undertaken by their managers after a tender offer is announced, specifically their efforts to stimulate a competitive bidding market, they argue that this gain is largely unimportant to an investor's ex ante perspective, that is, his welfare considered at a time before the commencement of the offer. They claim that legal rules that increase the frequency of tender offers will lead to better management (or in the economists' terms reduce agency costs) because poor managers will more often lose their positions.⁷⁰ All managers who want to stay employed will have an enhanced incentive to maximize the value of their company, and thus the company's stock, which translates into an increase in the total ex ante wealth of all shareholders.

The second argument needs to be distinguished carefully from the first; otherwise, both positions tend to intermingle and provide false support for each other when neither can stand on its own. Mistakes or self-serving acts by target managers defending tender offers raise the price and discourage potential bidders, thus creating the ex ante effect of decreasing the monitoring efficacy of tender offers. Eliminating this misbehavior will increase the ex ante wealth of all shareholders; but this is apparently not enough. Professors Easterbrook and Fischel want to minimize the legitimate gains made by target shareholders from tender offers in order to entice a maximum number of potential offerors. Bargain prices lure more customers.

In theory, therefore, the passivity thesis prohibits a target's management from maximizing gains to their own shareholders ex post in order to benefit all shareholders ex ante. In essence, target managers who act to drive up tender offer prices to benefit their own shareholders impose costs on all shareholders (measured by the lost ex ante reduction in agency costs) who are external to the corporation. These external costs are similar in nature to the external costs imposed on the public by a corporate official who saves

⁶⁹ Easterbrook & Fischel I, *supra* note 1, at 1174-80.

⁷⁰ *Id.* at 1174.

costs for his shareholders by polluting the air or water. Although the external costs of pollution are easy to see, the external costs of defensive tactics by target managers are more obscure.

Apparent losses suffered by target shareholders who do not realize the maximum price for their stock are disregarded. According to the ex ante argument, these ex post losses are irrelevant to the ex ante calculation. Because these ex post losses of target shareholders will constitute corresponding ex post gains to bidders, the transfer of value effected by the passivity rule from target shareholders to bidders creates no net ex ante loss that offsets any part of the ex ante gains realized from reduced agency costs. A separate and more controversial claim is that there will be no discernible group who will be ex ante losers when the passivity rule takes effect.⁷¹

The ex ante argument on agency costs represents a significant addition to current thought on the role of target managers in tender offers, but the passivity rule may not provide the sizable ex ante gains that Professors Easterbrook and Fischel theorize. Professor Coffee and others have questioned whether the rule will encourage more inefficient than efficient mergers (or enough inefficient mergers with substantial costs so that losses from these takeovers exceed the gains from the additional efficient takeovers).⁷² More fundamentally in doubt, however, is whether the rule will stimulate a significant number of additional takeovers, however typed. Moreover,

⁷¹ Shareholders in companies that have a high probability of being future targets will bear the brunt of the losses created by the enactment of the rule unless they are diversified and also hold offsetting positions in companies that have a high probability of being future bidders. The potential ex post loss in the value of stock in potential targets translates into an ex ante loss to an identifiable group, offset by an ex ante gain realized by shareholders in potential bidders. At issue, therefore, is whether one can identify high probability targets and high probability bidders on the day the passivity rule takes effect. Compare *Bebchuk I*, *supra* note 4, at 1038; *Bebchuk II*, *supra* note 4, at 42-43 (yes) with *Easterbrook & Fischel III*, *supra* note 1, at 7-9 (no).

⁷² *Coffee*, *supra* note 4, at 1206-07. That hostile tender offers do in fact, or will once the passivity rule is adopted, displace inefficient management frequently enough to have a disciplinary effect is crucial to the argument. Several authors have noted that tender offers are often motivated by other interests. See, e.g., *Bebchuk I*, *supra* note 4, at 1030-34 (motive may be "synergistic gains," information that target stock is undervalued, or prospect of expanding size of enterprise); *Coffee*, *supra* note 4, at 1207 (noting that bidders pursue well-managed companies at least as often as they pursue mismanaged companies). Some data supports their observations. A management consultant firm found that of 58 major acquisition programs undertaken between 1972 and 1983, 28 were failures. *Do Mergers Really Work?*, *BUS. WEEK*, June 3, 1985, at 88. In most of the success stories, the management of the target stayed on to run the business. Moreover, the average return to bidders on tender offers is only some nine to eleven percent. See *COUNCIL OF ECON. ADVISORS*, *supra* note 3, at 197. This figure seems below what most managers would demand from other investments that have an equivalent high risk of failure. At issue, therefore, is what kind of tender offers a rule that favors bidders will encourage.

the rule may have costs that Professors Easterbrook and Fischel have omitted from their *ex ante* calculations.

A. The Incentive to Make a Tender Offer for Inefficiently Run Targets

1. *The Passivity Rule's Effect on the Tender Offer Price*

The argument that defensive tactics decrease shareholders *ex ante* wealth rests on two factual assumptions. First, even assuming that target manager misbehavior is stamped out, the acts of target managers who increase the tender offer price discourage a significant number of bidders who would otherwise bid for inefficiently run companies. Second, the passivity rule will disable target managers from increasing the tender offer price, thus significantly increasing the incentive of potential bidders to find inefficiently run targets in order to make a profit. The first factual assertion seems correct, although some commentators do take issue with aspects of it.⁷³ The second assertion, however, is problematic. At issue is the size of the effect that the passivity rule will have on tender offer prices and on bidders' incentives.

The passivity thesis disables shareholders from responding collectively to offers through target managers. Its purpose is to restrain artificially the price of target shareholders' stock by constraining the bargaining ability of target companies.⁷⁴ More direct restraints that are similar in effect to the passivity rule would be universally condemned as confiscatory; for example, once any potential acquiring company offers target shareholders a twenty percent premium over market price, the shareholders must sell. Indeed, the passivity rule has a confiscatory tone to it that has disturbing extensions.⁷⁵ In any event, the effect of this artificial con-

⁷³ Both Professors Gilson and Bebchuk have argued that allowing target managers to seek competitive bidders, for example, will not dampen the willingness of the first bidder because the first bidder can turn a quick profit even if its tender offer fails by tendering its shares to the winning bidder. Bebchuk I, *supra* note 4, at 1030, 1034-38; Gilson II, *supra* note 4, at 868-75. If the first bidder has acquired the shares at pre-tender offer prices, its profits can be substantial. Examples are not hard to find. In early 1984, Texas International Airlines, Inc. lost a bidding war for control of National Airlines but sold its National Airlines stock to the eventual winner, Pan American, for a profit of \$47 million.

⁷⁴ Professor Coffee terms the passivity rule a "zero takeover premium policy" because the rule enables bidders to mount successful tender offers at small premiums over the existing market price. Coffee, *supra* note 4, at 1164-65.

⁷⁵ In hypothetical case one in the previous section, *see supra* text accompanying notes 20-26, suppose that *X* has reason to legitimately suspect that *A* will pay more than a 20% premium for *B* because *A* is capable of using *B*'s assets to generate a considerable gain. Moreover, she suspects that if she tells other potential buyers about *A*'s interest, she can stimulate an auction to maximize her family's gain. Should we impose an arbitrary rule on *X* that prohibits her from bargaining to sell at anything significantly over

straint on bargaining is likely to be the proliferation of techniques designed to avoid the consequences of the rule.

The passivity rule operates on *ex post* behavior. An investor may not be able to predict which companies will become targets,⁷⁶ but once he becomes subject to a loss as a target shareholder, he will take steps to avoid it. Even a fully diversified investor may not be free from the pressure to gain an *ex post* dollar. He will encourage target managers to increase a tender offer premium if he does not own an offsetting position in the bidder. He does so hoping shareholders in other targets will not, for if all other targets act similarly to increase tender offer premiums, he loses *ex ante* on his other stocks; it is a classic prisoner's dilemma.⁷⁷ The passivity rule attempts to prohibit targets from maximizing their *ex post* position.

Yet there are three leaks in the rule that operate to restrict target managers once a tender offer is announced. First, an investor will encourage target managers to monitor investor activity and install defenses before a tender offer is announced, that is, once a tender offer appears likely. The definition of a tender offer announcement under the passivity rule will, of course, occupy courts. Second, if there are enough potential bidders that are largely identifiable in advance (companies like Mesa Petroleum develop an expertise in tender offers and mount a substantial percentage of current tender offers; repeat players are therefore common), and if, as is currently the case, most investors do not include stocks in these repeat players in their portfolios, most investors will encourage managers to install defenses even when the likelihood of a tender offer appears relatively remote. Third, investors will seek to empower negotiating agents that can operate for their collective interests after a tender offer is announced, by using agents that are not classified as target managers. Courts will be confronted with the question of whether all shareholder agents should be subject to the passivity

existing market prices? *A* has sunk costs in finding *B*, and those costs create social gains with the combination of *A* and *B*. If *X* is an excellent bargainer and *A* is a poor bargainer, or if *A* is simply outbid by the appearance of a new buyer (who free rides on *A*'s search), *A* may not recover those costs. To encourage *A*'s to buy *B*'s should we therefore establish rules which favor *A*'s in the bargaining?

⁷⁶ The market price of any stock will reflect all available information on the likelihood that a company will be a takeover target. Thus, unless an investor has inside, nonpublic information, he cannot rationally decide that a stock price is low in light of the potential of a tender offer. An investor must make his true investment decisions in the *ex ante* position, and his *ex post* position is a product of chance.

⁷⁷ See *supra* note 35. The cooperative outcome for all diversified investors who hold stock in a specific target is to not act to increase tender offer premiums so as to increase everyone's *ex ante* gain from reduced agency costs; defectors act to increase tender offer premiums hoping others will not. The inevitable result is the worse result: all investors who hold target stock increase tender offer premiums and incur the higher agency costs.

rule and, if so, with the definition of a shareholder agent in this context.

Such avoidance behavior will drive investors to use cruder and more costly defensive techniques. The substitutes for managerial discretion must operate automatically and may be less efficient because they may discourage offers that could lead to mutually beneficial negotiation between the bidder and target. More potential targets may turn to the use of shark repellent amendments or contingent share conversion rights plans.⁷⁸ If lawmakers seek to close these leaks in the rule, a prohibition of defensive acts by target managers after tender offers are announced will inevitably expand into a prohibition of all defensive acts by managers or shareholders. In the end courts will be mired in debates over, for example, whether management intended the creation of two classes of common stock to discourage takeovers or to further a legitimate business function.⁷⁹ If lawmakers leave the leaks, investors and target managers will continue to defend against tender offers, but by using more costly devices.

Even acts that fall clearly within the scope of the passivity rule, acts by managers after tenders offers have been announced, may pose troublesome issues for courts. Target managers will have an incentive to cheat on the rule by notifying other potential bidders after a tender offer is announced or by effecting some change in the corporate structure in the name of routine business. The methods of cheating can be subtle, and the courts will have to struggle with management's motives to determine whether the passivity rule has been violated.⁸⁰ For example, target managers could make strategic public disclosures of valuable information concerning corporate affairs in order to entice other bidders. The courts would then have to determine whether such disclosures served legitimate business purposes beyond blocking the existing tender offer.

Attempts to circumvent the passivity rule either by acts just outside its boundaries or by disguised violations are the inevitable response of citizens to government price restraints. In sum, the passivity rule will be largely ineffectual because target managers and shareholders will find ways to beat it.

⁷⁸ A common example is a convertible preferred stock dividend plan. *See infra* notes 125-30.

⁷⁹ *See* Lipton & Brownstein, *supra* note 64, at 1415-16 (discussing "super-voting" common stock).

⁸⁰ Professors Easterbrook and Fischel chide Professors Bebchuk and Gilson for allowing neutral auctioneering, arguing that disguised resistance is inevitable. Easterbrook & Fischel III, *supra* note 1, at 15 n.33.

2. *The Passivity Rule's Protection of First Bidders*

Increased protection of the first bidder lies at the core of the ex ante argument. If bidders who incur the costs of discovering inefficiently managed firms are consistently outbid by others who free ride on the first bidder's efforts, firms will underinvest in such searches, with the result that efficiency-gaining tender offers will not be pursued.⁸¹ The passivity thesis protects such bidders by enabling them to mount tender offers that are completed before other potential bidders can make competing bids.⁸² Proponents of the passivity rule argue that under these circumstances first bidders will usually prevail, allowing them to realize the maximum return on their search costs.

In practice, however, the kind of protection the passivity rule affords the first bidder may be less than complete. Reaching the shareholders of a widely-held corporation with a public tender offer requires some time, and if the benefits of free riding are significant, attentive competitors may find it worthwhile to respond quickly with higher bids. Indeed, a target's management may itself bid for the stock.⁸³

In some instances, the passivity rule may actually discourage the initial tender offer. This result may occur when a corporation tenders for a second corporation with the intention of selling its assets to a third. For example, suppose *A* is a widely-held company that tenders successfully for *B* with the hope of negotiating a sale of *B*'s assets to *C*. Upon learning of *A*'s tender offer, *C* could tender for *A* to obtain *B*'s assets, rather than negotiate with *A* for a resale because *A*'s shareholders can no better coordinate a response to *C*'s offer than *B*'s shareholders can coordinate a response to *A*'s offer. Because *C*'s tender for *A* largely eliminates *A*'s return on its tender for *B*, the managers and shareholders of *A* may have no greater in-

⁸¹ Professor Gilson downplays the free rider phenomenon, arguing that first bidders often profit handsomely by selling the stock they have acquired in the target to the winning bidder. Gilson I, *supra* note 4, at 53-62; Gilson II, *supra* note 4, at 870-71. In rebuttal, Professor Coffee notes that a substantial risk exists that first bidders will be unable to realize this quick turnaround profit because of the mechanics of the winning bidder's tender offer or because of the securities laws. Professor Coffee also notes that a recent study reveals that a bidder's own stock significantly declines in value after losing a bidding contest. Coffee, *supra* note 4, at 1177-78. Cf. *Unocal-Pickens Aftermath*, N.Y. Times, May 22, 1985, at D1, col. 3 (T. Boone Pickens, excluded from target's distribution of assets to shareholders, may lose \$20 million).

⁸² One study found that currently a first bidder loses in the face of competing bids in 76% of the cases. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141 (1983).

⁸³ Coffee, *supra* note 4, at 1195-98 (discussing leveraged buy-outs by management). Cf. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (target made exchange offer for its own shares).

centive to tender for *B* under the passivity rule than under current rules. Indeed, a tender offer by *A* may serve as a signal to the market that *A* should be a target for a tender offer by any company that believes it can better use *B*'s assets.⁸⁴ *A*, without participating in an auction, can never be sure it is the highest valued user of the assets of *B* and therefore can never be sure that a *C* is not lurking somewhere in the market.

Finally, even if the passivity rule does protect first bidders, it is a crude approximation of the ideal system. Other approximations may be more appropriate. The ideal system (assuming no transaction costs) for rewarding first bidders who gather or otherwise pay for valuable information identifying potential takeover targets would require a mandatory transfer payment to the first bidder from all subsequent bidders who use the information, regardless of which bidder wins the auction. All firms using the information would integrate its costs into their calculations of whether to bid and at what price. A rule requiring transfer payments would be impracticable, however, because of the problems of valuing the first bidder's information and of assessing whether the first bidder's research primarily motivated subsequent bidders to enter the market. For example, tender offers often come in waves in one industry, suggesting that some first bidders free ride off each other.

The passivity thesis, however, may not be the best alternative. Other schemes exist which do not carry the disadvantage of preventing the target shareholders from selling to the highest bidder. For example, all subsequent bidders in a tender offer auction could be required to make pro rata payments to the first bidder that approximate the first bidder's search costs. The payments depend on the difference between the initial bidder's first bid and its last bid.⁸⁵ If the bid is lost, any profits made on the sale of target stock bought in anticipation of the tender offer should be subtracted from this payment. This program needs a considerable degree of fine tuning to be workable and is probably politically infeasible, but it illustrates

⁸⁴ Companies like Mesa Petroleum that are career bidders typically have some of the most "bullet proof" takeover defenses.

⁸⁵ This rule approximates the optimal system by using the first bidder's bids to estimate its search costs. It assumes that a first bidder's initial bid is its bottom line price for making an appropriate rate of return on its total investment, which includes its sunk research costs. If the first bidder must meet competitive bidders, then the first bidder's highest bid in response will not include a return on its sunk costs. Ideally, therefore, the difference between a first bidder's first bid and its last bid will approximate an appropriate rate of return on its search costs.

The rule has numerous problems. First bidders under such a system will start low to maximize their payments. Moreover, the last bid of a losing first bidder may, because of the mechanics of the bidding, also be too low. For example, what does one do when the second bidder's first bid is too high for the first bidder to respond at all?

the range of alternatives to the passivity rule and sheds light on the nature of the rule itself.⁸⁶

B. The Costs of the Passivity Rule

The passivity rule has significant costs. Two types of costs were mentioned in Section A above, but the rule creates other significant costs as well. First, target managers and shareholders will use less efficient methods of collective activity to strengthen their bargaining position, and, second, the rule requires a series of control transactions to get target assets into the hands of the highest potential bidder in the market.⁸⁷ Third, the rule favors institutional and other large investors and makes it impractical for small investors to hold stock directly in companies that may be targets. Fourth, the rule, in decreasing the number of negotiated mergers, decreases the joint gains that negotiation itself can often create.

If the passivity rule is enacted and the Williams Act repealed, bidders will return to the "Saturday Night Special" and other short-lived offers with no pro rata acceptance contingency for oversubscriptions. Once such a tender offer is announced, small investors, who do not have enough at stake to justify constant market vigilance, will invariably lose the race to tender, making direct shareholding by small investors more risky. Small investors will thus be encouraged to invest in mutual funds or other intermediaries and the large publicly held companies will lose small stake holders. Even investments in financial intermediaries are not free from complications, however, as tender offers can be made for the intermediaries themselves as well, and large scale investors in the intermediaries will have an advantage. In sum, the stock market

⁸⁶ This overt transfer payment scheme offers several advantages over the passivity thesis. The target shareholders are not put under such extraordinary pressure to tender immediately. Indeed, a transfer payment system could retain most of the current slow-down provisions of the Williams Act. Target shareholders also would have the opportunity to sell to the highest bidder in the market, minimizing the number of transfers necessary to get the target company's assets to the most efficient user. In addition, bidders who otherwise would free ride on the first bidder's information can be assessed directly. Finally, target management continue in their customary role as agents acting to maximize the shareholders' gain. In sum, these advantages reduce feelings of exploitation that target shareholders and target managers experience as a result of Saturday Night Specials.

⁸⁷ Professors Bebchuk and Gilson have made this argument. Bebchuk I, *supra* note 4, at 1033; Gilson I, *supra* note 4, at 63. Professors Easterbrook and Fischel answer by saying, "We suspect that the costs of a drawn-out auction exceed the costs of an acquisition without auction, followed by retransfers, but we cannot be sure." Easterbrook & Fischel III, *supra* note I, at 14. They also argue that even after an auction, the winning bidder may have to sell parts of the target to maximize its value. *Id.* They base their position on hunches about transaction costs, and it seems counterintuitive. A series of tender offers in which each new buyer is anxious to replace the old managers seems significantly disruptive at each step; one management change seems far less expensive.

may lose small shareholders as the secondary markets become forbidding to all but the sophisticated and vigilant institutional or large scale investors.

The fourth, and perhaps most important, cost is the loss of joint gains often created through sophisticated negotiation. If bargaining parties cooperate by exchanging accurate information on their interests and by expanding the number of issues on the table, they can make trade-offs that maximize their joint welfare.⁸⁸ Tender offer payments can take a variety of forms, including cash, equity securities in the bidder, and debt instruments in either the bidder or the target. The target shareholders and the bidder could, with responsible bargaining, agree on packages that both prefer over a straight cash purchase. In short, encouraging parties to bargain cooperatively is inherently valuable. Disabling the target in the bargaining between targets and bidders frustrates this process. The bidder, without any negotiation, gets a bargain price from a short duration two-tiered tender offer and any serious effort to bargain comprehensively with the target managers to produce a better result takes time, putting the bargain price of the tender offer at risk.

III

TWO PROPOSALS

Professors Easterbrook and Fischel have demonstrated that our legal system should be sensitive to the position of first bidders; the issue is how to protect them. Two straightforward changes in existing legal rules would protect first bidders and strengthen significantly the salutary effect of hostile tender offers without a wholesale revision of the current system. First, Congress should amend section 13(d) of the Securities Exchange Act of 1934⁸⁹ to require a putative bidder to declare its intentions when acquiring more than ten percent of the equity securities of the target. Currently, the requirement is triggered at five percent.⁹⁰ This change better compensates

⁸⁸ See, e.g., Menkel-Meadow, *supra* note 24 (advocating nonadversarial negotiation as means to maximize interests of both parties).

⁸⁹ 15 U.S.C. § 78m(d)(1) (1982).

⁹⁰ *Id.* Congress would also need to amend § 16(b) of the Securities Exchange Act of 1934 to enable a losing first bidder to sell to the winning bidder without incurring § 16(b) liability. 15 U.S.C. § 78p(b) (1982). Under § 16(b) the holder of over 10% of the equity securities of a publicly-held company cannot buy and sell the company's securities within a six-month period; violators must turn all profits over to the company. The courts have created an exception for takeover mergers but remain reluctant to create an exception for negotiated sales with the winning bidder. See, e.g., *Texas Int'l Airlines v. National Airlines*, 714 F.2d 533, 538-39 (5th Cir. 1983) (refusing to uphold § 16(b) exception permitting beneficial owner of 10% of issuer's stock to trade as insider), *cert. denied*, 104 S. Ct. 1326 (1984). But see *Heublein v. General Cinema Corp.*, 722 F.2d 31 (2d Cir. 1983) (limiting application of § 16(b) when hostility, no exchange of informa-

first bidders when they lose. Second, state courts or legislatures should define and enforce standards of fiduciary misconduct for target management based on their role as negotiating agents for shareholders. This change largely eliminates a target's ability to block completely most tender offers and gives a first bidder a better chance at success.

A. Increasing the Five Percent Rule in Section 13(d) of the Williams Act

First bidders are not always discouraged by the possibility of being outbid by others because they often profit by tendering their shares in the target to the winning bidder. Rule 13(d), however, limits the profits of a first bidder by requiring any person who acquires more than five percent of a class of equity securities to disclose its position and its future intentions. A potential bidder must disclose its intentions to mount a tender offer once it acquires a five percent position in the target, and public disclosure has three effects: first, the market price rises in anticipation of the tender offer; second, bidders who want to free ride on the first bidder's research are notified; and third, the SEC is alerted that additional market purchases may represent a creeping tender offer.⁹¹ In sum, a first bidder's acquisition of a five percent interest in the target makes additional large-scale privately negotiated market purchases much more costly; any reasonably paced takeover attempt must proceed after such a disclosure via a tender offer.

Raising the rule 13(d) limit to ten percent will allow first bidders to purchase more stock in the target at pre-tender offer market prices. If a first bidder loses, it can reap the difference between pre- and post-tender offer prices. The first bidder, recognizing that it cannot match a higher bid, tenders its stock in the target and receives a pro rata portion of the tender offer premium.⁹² The first bidder, even if completely excluded from participation in the tender

tion, and involuntary conversion exist between buyer and holder of over 10% of issuer's shares) *cert. denied*, 104 S. Ct. 1416 (1984).

The proposal in the text may also require a revision of the pre-merger notification program in the Antitrust Improvements Act of 1976 to correspond with the notification provision in the Williams Act. 15 U.S.C. § 18(a) (1982).

⁹¹ See, e.g., *Wellman v. Dickinson*, 475 F. Supp. 783, 821-26 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d. Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

⁹² In a recent study the mean premium for the first step of two-tiered tender offers was 63.5%. SEC Release No. 34-21079, 16 SEC. REG. & L. REP. (BNA) 1129 (June 29, 1984).

Losing a tender offer has some risk, however, as Mesa Petroleum discovered in its bid for Unocal Corporation. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). In an effort to defeat Mesa's tender offer, Unocal Corporation made an exchange offer for its own shares but excluded the shares Mesa held. Applying the busi-

offer, may profit significantly when its stock is included in the second-stage takeover merger.⁹³ Since the company executing a second-stage takeover merger must typically pay the maximum pre-tender offer price, a losing bidder with substantial pre-tender offer purchases should not lose money and often gains significantly.

B. Refining the Standards of Conduct for Target Managers

The second recommended change is that courts should stop applying the business judgment doctrine or rule,⁹⁴ the primary purpose test,⁹⁵ or a combination of the two in evaluating a target management's conduct when responding to a hostile tender offer. The business judgment rule provides a safe harbor for directors or officers who make honest, informed business decisions which they reasonably believe will serve the best interests of their corporations.⁹⁶ Courts refuse to second-guess such decisions even if they eventually harm the company's financial position.⁹⁷ The deci-

ness judgment rule, the court vacated a preliminary injunction enjoining Unocal's exchange offer. *Id.* at 958-59.

The post-exchange offer price was lower than the price Mesa paid for the shares. Estimates of Mesa's losses run from \$20 to \$80 million, even though Unocal relented somewhat and allowed Mesa to exchange some of its shares. *N.Y. Times*, May 22, 1985, at D1, col. 3. The situation appears unique in that the winning bidder, the target itself, was unwilling to include Mesa because the target wanted to prefer its original shareholders whom the exchange offer protected. This factor separates the Unocal situation from most cases in which an outsider bidder gains control. In such cases, the new bidder wants to eliminate any large rival block of shareholders and, therefore, to include all shareholders in its tender offer. Even Unocal, in the end, gave concessions to Mesa in order to forestall future action after it had defeated Mesa's bid. *Id.*

⁹³ The mean premium offered for second-step takeover mergers is over 41%. SEC Release No. 34-21079, 16 SEC. REG. & L. REP. (BNA) 1129 (June 29, 1985).

⁹⁴ The doctrine protects board decisions; the rule shields individual directors from liability. Hincey, *Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 611-12 (1985).

⁹⁵ A second test for evaluating target managers' acts is the "primary purpose" test, which originated in *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964). In *Cheff*, the court held that the target management would be liable only if its "sole or primary motive" was to perpetuate itself in office. *Id.* at 556. Thus, the presence of a valid purpose exonerates management even if a defensive tactic collaterally enhances the managers' power. *E.g.*, *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (1960) (use of corporate funds by directors to purchase corporation's own stock held to further proper purpose of preserving corporation's business policies). In practice, however, the business judgment rule and the primary purpose test are very similar with the only difference being that under the primary purpose test the directors have the burden of proof. *Cheff v. Mathes*, 41 Del. Ch. at 503-04, 199 A.2d at 555. Recently, Delaware courts have simply mixed the tests without discussing their differences. *See, e.g.* *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985).

⁹⁶ *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (Tentative Draft No. 4 1985); *see also* Arshnt, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW 27 (1981).

⁹⁷ The business judgment rule is often stated as a "presumption" that directors and

sionmaker must be disinterested for the rule to apply.⁹⁸ In cases in which personal and company interests obviously conflict, courts disregard the business judgment rule and apply a more rigorous duty of loyalty standard.⁹⁹ If the conflict is not obvious, the complaining shareholder bears the burden of proving that an official of the company has a conflict of interest. If the shareholder carries the burden, the burden shifts to the implicated official to prove that the contested transaction was fair and reasonable.¹⁰⁰

Although target managers who fear for their jobs have a personal interest in the outcome of a hostile tender offer, most courts have applied the business judgment rule to insulate target managers who engaged in defensive tactics against a hostile tender offer.¹⁰¹ Instead of assuming that target managers inevitably have a personal stake in the outcome of a hostile tender offer and thus imposing the more rigorous duty of loyalty standard, most courts have initially saddled the complaining shareholders with the burden to show that the target managers had a personal interest in the outcome of the

officers have acted correctly. *See, e.g.,* *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

⁹⁸ *E.g.,* *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 265 (2d Cir. 1984) ("the business judgment rule governs only where the directors are not shown to have a self-interest in the transaction"); *Lewis v. S. L. & E. Inc.*, 629 F.2d 764, 769 (2d Cir. 1980) ("the business judgment rule presupposes that the directors have no conflict of interest").

⁹⁹ *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.08-5.12 (Tentative Draft No. 3 1984). Thus, the definition of "duty of loyalty matters" is crucial, and control contests are commonly excluded.

¹⁰⁰ *See, e.g.,* *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) ("Once a prima facie showing is made that directors have a self-interest in a particular corporate transaction, the burden shifts to them to demonstrate that the transaction is fair and serves the best interests of the corporation and its shareholders.").

¹⁰¹ *E.g.,* *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984) (use of "springing warrants"); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983) (sale of treasury stock and lock up option on treasury stock), *cert. denied*, 104 S. Ct. 550 (1983); *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (dismissing complaint for failure to plead that directors intended solely to keep themselves in control). A recent Delaware Supreme Court case, however, may indicate the beginnings of a withdrawal from a strict application of the traditional business judgment rule. In *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985), the court, noting "the omnipresent specter that a board may be acting primarily in its own interests," undertook a "threshold" examination of the grounds for a tender offer defense. *Id.* at 954. The directors had to show "reasonable grounds for believing that a danger to corporate policy and effectiveness existed." *Id.* at 955. Despite this language apparently limiting the application of the business judgment rule in a tender offer, the court stated that the directors "satisfy that burden by showing good faith and reasonable investigation," *id.*, which mimics the old standard and merely shifts the burden of proof. Later in the opinion, however, the Court did add a potential new substantive twist to the rule: "If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed." *Id.* at 955.

tender offer.¹⁰² In these cases the burden of showing specific personal gain has often proven insurmountable because some courts demand proof of self-interest beyond that related to continued employment.¹⁰³ In cases in which the courts do reach the fairness of a particular tender offer defense, courts commonly accept, often inappropriately, the managers' justifications.¹⁰⁴ Both phenomena arise primarily from the courts' lack of a mature conceptual basis for determining when the decisions of target managers have a proper corporate purpose.¹⁰⁵

Consider, for example, the paucity of analysis in *Norlin Corp. v.*

¹⁰² *E.g.*, *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980) (shareholders must show management's personal interest before burden shifts to management); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 702 (2d Cir. 1980) (same); *Horwitz v. Southwest Forest Indus., Inc.*, 604 F. Supp. 1130, 1135 (D. Nev. 1985). *But see Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946, 955 (Del. 1985) (directors must show "good faith and reasonable investigation" for business judgment doctrine to apply).

¹⁰³ In those jurisdictions that put the initial burden of proof on the plaintiffs, the cases are in total disarray on the very significant question of what plaintiffs must show to shift the burden of proof to the defendants. On the question of the effect of directors remaining on the board after the merger, compare *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 702 (2d Cir. 1980), with *Mobil Corp. v. Marathon Oil Co.*, 1981-82 FED. SEC. L. REP. (CCH) 98,375, at 92,284-85 (S.D. Ohio), *rev'd on other grounds*, 669 F.2d 366 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982). *See also Asarco Inc. v. Court*, 611 F. Supp. 468 (D.N.J. 1985) (3 of 12 directors were managers, other 9 held rights in new preferred stock designed to block offer; business judgment rule applies) (appeal pending).

¹⁰⁴ *E.g.*, *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 550 (1984); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1326 (1984); *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985). *But see Norling Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984) (discussed *supra* note 51).

¹⁰⁵ Courts troubled by a traditional application of the business judgment rule and yet unwilling to change occasionally turn to other provisions of state law to invalidate a defense. *See Minstar Acquiring Corp. v. AMF Inc.*, FED. SEC. L. REP. (CCH) ¶92,066 (S.D.N.Y. June 7, 1985) (Rights Plan was unauthorized stock reclassification and unreasonable restraint on alienability) (appeal pending); *Asarco v. Court*, 611 F. Supp. 468 (D.N.J. 1985) (poison pill preferred plan constituted illegal discrimination among shareholders) (appeal pending). *But cf. Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (discrimination in self-tender approved). The kind of analysis used by these courts, however, often has the same problem as the analysis in *Norlin*, *supra* note 51. A conclusory declaration that managers have usurped traditional shareholder powers is no answer when a delegation of negotiation power from shareholders to an agent may be in the shareholders' best interests. In some cases the managers misbehave, and in others they do not. At issue is what kinds of tactics are legitimate when target managers are acting properly as bargaining agents. Some are presumptively illegitimate because they establish dangerous precedent for board power in other contexts (board-created supermajority provisions, for example, e.g., *Televest v. Outdoor Sports Indus., Inc.*, C.A. No. 5798 (Del. Ch. March 8, 1978)), some are presumptively illegitimate because they signal board misbehavior (nonreversible poison pill preferred plans), and some are illegitimate only if used improperly in the context of a particular tender offer (reversible poison pill preferred plans).

Rooney, Pace Inc.,¹⁰⁶ the only significant case that has voided defensive tactics on the grounds that the directors violated the standards of fiduciary responsibility. The Second Circuit attempted to distinguish *Southeastern Public Service Co. v. Graniteville Co.*,¹⁰⁷ a case upholding a similar tactic. In both cases the target management created an Employee Stock Option Plan and Trust (ESOP)¹⁰⁸ and funded it with target stock to make it more difficult for a hostile bidder to obtain control. The district court in *Southeastern Public Service Co.* applied the business judgment rule, stating that opposition to a tender offer "which in the best judgment of management is detrimental to the corporation does not result in a breach of fiduciary duty."¹⁰⁹ The Second Circuit, after noting that the district court had correctly stated the law, distinguished the opinion because the directors self-interestedly used the ESOP to "retain control."¹¹⁰ The target management in *Southeastern Public Service Co.*, however, was also attempting to maintain control. The Second Circuit must have decided that the creation of an ESOP to stop tender offers is not always suspect, but it gave no guidance on why the facts before it supported relief, while the facts in *Southeastern Public Service Co.* did not. The Second Circuit, like so many other courts, simply hid behind a conclusory declaration of self-interest in deciding the case, although the declaration was an affirmative, rather than the more common negative finding. Courts seem conceptually rudderless when attempting to determine whether the target managers' decision to block a tender offer is ultimately fair to the shareholders.¹¹¹

Courts that have addressed the issue have understood intuitively that target managers do have a role to play in hostile tender offers, but their resort to the business judgment rule or its variants has severely hampered the development of a mature case law on the matter. A more sensible judicial approach would treat management decisions in response to hostile tender offers as courts now treat management decisions on a compensation question that affects all managing officials (i.e., establishing a benefits plan for all controlling officials or establishing an across the board pay increase).¹¹² In

¹⁰⁶ 744 F.2d 255 (2d Cir. 1984).

¹⁰⁷ No. 83-1028-8 (D.S.C. May 19, 1983).

¹⁰⁸ See 29 U.S.C. § 1107(d)(6) (1982); 26 U.S.C. § 401(a) (1982).

¹⁰⁹ No. 83-1028-8 (D.S.C. May 19, 1983).

¹¹⁰ *Norlin Corp.*, 744 F.2d at 267 n.13. Likewise, the court's strong language condemning "a wholesale wresting of corporate power," see *supra* note 51, does not square with its apparent support of the *Southeastern Public Service Co.* case.

¹¹¹ See *infra* notes 115-40 and accompanying text.

¹¹² Because all controlling officials, including directors, benefit from such programs, they cannot rely on authorization or ratification by disinterested directors. A similar problem arises when directors set their own compensation.

Some judges have identified the inherent conflict of interest affecting target manag-

such compensation decisions self-interest is assumed, and unless there is knowledgeable ratification by the shareholders, the officials have the burden of proving that the decision is fair to the corporation.¹¹³ In the event of shareholder ratification, the court will review the quality of the management disclosures and, if the disclosures are adequate, apply a waste of corporate assets standard to catch extreme cases.¹¹⁴ An identical general standard could be applied sensibly in the context of hostile tender offers. The standard of fairness in tender offers, however, would take its conceptual cues solely from the reasonableness of the target managers' acts in light of their role as a negotiating agent for the shareholders.

1. *Reactive Tactics That Defeat a Two-Tiered Tender Offer*

At the core of the proper definition of fiduciary in the context of tender offers is a definition of the proper role of target management as negotiating agents. Target management's acts designed to defeat a two-tiered tender offer and enable the company to remain independent should be inherently suspect. Only two conditions justify the intentional defeat of a two-tiered tender offer:¹¹⁵ a target's

ers, but they have argued for a simple shift in the burden of proof. See *Panter v. Marshall Field & Co.*, 646 F.2d 271, 299-301 (7th Cir.) (Cudelry, J., dissenting), *cert. denied*, 454 U.S. 1092 (1981); *Johnson v. Trueblood*, 629 F.2d 287, 300-01 (3d Cir. 1980) (Rosen, J., dissenting), *cert. denied*, 450 U.S. 999 (1981). See also *Crane v. Harsco Corp.*, 511 F. Supp. 294, 305 (D. Del. 1981). A shift of the burden of proof is not enough, however, and, not surprisingly, the judges were criticized for their inability to articulate a coherent rule for when the burden shifts. E.g., Veasey, *Further Reflections on Court Review of Judgements of Directors: Is the Judicial Process Under Control?*, 40 BUS. LAW. 1373, 1374 n.5 (1985).

In tender offers there can be no disinterested directors unless they are similar to those described *supra* text accompanying note 47. Typical outside directors also lose their positions with a change in control and are inevitably influenced by their future prospects with the target. They do have less to lose than target managers because salaries for outside directors are not as large, but their salaries give them a personal stake in the outcome.

¹¹³ See AMERICAN LAW INSTITUTE, *supra* note 99, § 5.09(a)(1)(c). A similar standard applies to transactions between the corporation and a controlling official when disinterested board of director approval is unavailable. See *id.* § 5.08(a)(2)(c).

¹¹⁴ Many courts will require proof of fairness even in the event of ratification by shareholders or disinterested board members. See Buxbaum, *supra* note 16.

¹¹⁵ Tender offers for 100% of the stock, used in junk bond financed bust-up takeovers, for example, do not create a stampede effect among target shareholders. Accordingly, target managers' efforts to defeat such a tender offer should be even more limited. Tactics designed to stall or block completely such offers can be justified only by the rare circumstances noted *supra* note 19. Ideally, in all other cases the target managers should be limited to providing shareholders with information on other bidders or on whether the only extant bidder will offer more if shareholders hold out. See Gilson II, *supra* note 4, at 861-62. However, those who must circulate opinions and impressions on financial transactions risk lawsuits brought by others who argue from hindsight that the disclosures were misleading or ill-informed. This risk may result in excess caution in the disclosure documents—documents that are so general or so qualified that they convey no information. Pragmatically, therefore, the best approach may be to let target managers

management may hold valuable nonpublic information which would decline considerably in value if publicly disclosed,¹¹⁶ and a target's management may know or have strong suspicions that a bidder will, after securing control through a partial tender offer, illegally loot the company to the disadvantage of the remaining minority shareholders.¹¹⁷ If target managers rely on either justification, courts should impose a heavy burden of persuasion.¹¹⁸ The best solution would institute a burden of proof that would require target management to demonstrate with clear and convincing evidence why acts designed to defeat a tender offer are in the best interests of the shareholders and a standard of proper purpose that limits the target management to proving one of the two conditions noted above in justification.¹¹⁹

bargain on behalf of target shareholders even in tender offers for all a target's stock, subject to standards similar to those outlined below.

¹¹⁶ See, e.g., *supra* note 19.

¹¹⁷ E.g., *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (N.Y. Sup. Ct. 1941) (sellers of controlling interest had duty to protect other shareholders from buyer's looting of corporate assets). Because minority shareholders have standing to sue looters, one can respectfully argue against including the second condition at all. *Accord* *Easterbrook & Fischel I*, *supra* note 1, at 1184-85 (arguing that desire to loot corporation is unlikely to motivate tender offer, and looters cannot often escape detection). A strict standard of justification, requiring that looting be a clear and substantial danger, would limit management's use of the defense as a makeweight while providing some protection for shareholders who are unaware of the danger. The definition of looting, however, should not necessarily include all cases in which a takeout merger is proposed at a price that is less than the tender offer premium. See *supra* note 29. One indication of looting, on the other hand, is a weighted average of the tender offer and second-stage merger prices that is lower than the pre-tender offer market price.

Interestingly, a simple disclosure to shareholders that an offeror is a looter may increase the stampede effect and facilitate the tender offer.

¹¹⁸ A target manager's conscious attempt to defeat a tender offer could be justified as an attempt to drive a potential acquirer into negotiating with target managers to execute a control change through a statutory merger. There is no compelling reason, however, for target managers to prefer a negotiated statutory merger over a negotiated tender offer.

¹¹⁹ The defensive tactics of Unocal Corporation, sanctioned by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985), would probably fail the standard. Unocal offered to pay its shareholders \$72 in senior debt securities if Mesa, a hostile bidder, acquired control of Unocal through a tender at \$54 a share. Incredibly, the Unocal board itself took advantage of the inability of its shareholders to engage in a collective response. The Unocal exchange offer tempted its own shareholders to hold their stock, because each hoped that enough other shareholders would tender at \$54 to Mesa so that Mesa would acquire control and the holdouts could participate in the exchange offer at \$72. The result, of course, was that no one tendered, and the Unocal shareholders lost both the tender offer price and the exchange offer price. If the Unocal shareholders could have acted collectively, they would have chosen a blended price of the tender offer and the exchange offer, tendering the minimum shares requested to Mesa and the remainder to Unocal and giving each shareholder an equal share of the total returns. Unocal eventually lifted the condition that Mesa acquire control. At this point, Unocal was offering its own shareholders a competing bid that, if accepted, recapitalized the company by replacing a large portion of the

On the other hand, acts by target managers that are designed solely to improve the tender offer price but that fail, resulting in the loss of the tender offer premium, can be justified as calculated gambles and should be evaluated under a more lenient standard. Target managers should bear the burden of demonstrating by a preponderance of the evidence that the gamble was reasonable. What will often distinguish these gambles from those acts intended to defeat completely tender offers is that target managers used reversible defenses.¹²⁰ When defensive tactics are reversible, management can use them to gain bargaining leverage and remove them once an appropriate compromise is reached. The tactics are not a complete bar to all future negotiation over the tender offer premium.

A threshold standard then for applying the more lenient standards of proof and justification is whether the defenses employed were reversible. This threshold standard is not conclusive, however, as a court may find that a company's refusal to remove a defense is motivated by a desire to block completely a tender offer rather than by a desire to gain temporary negotiating leverage. If so, the stricter standards of justification detailed above should apply.¹²¹ The application of the more lenient standards require a court to decide whether managers who employ a reversible defense to gain negotiating leverage have negotiated poorly and unreasonably. If managers delay long enough to lose the first, and perhaps only bidder, they must have sound reasons for doing so. There must be, for example, an imminent competing bid in the offing or strong evidence that justifies their mistaken belief that the initial bidder would give more.

Whenever the weighted average of the tender offer premium

company's equity with debt. The Unocal exchange offer defeated Mesa's bid, and the Delaware Supreme Court approved the tactic. *Id.* at 957.

The court held that the Unocal board was justified in defeating Mesa's bid because it was a two-tiered tender offer "designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." *Id.* at 956. The court's error was in not requiring the Unocal board to justify why Mesa's bid, substantially in excess of the current market price (which the Court never even mentioned in its opinion), was "inadequate." Two accounting firms hired by the board opined that \$60 per share was a reasonable price, but where were the other buyers who were willing to offer such a price? Studies that find a firm worth more than the market price of its stock are inherently suspect. *See supra* note 67. The court also relied on a questionable study that found that target shareholders benefit from defeated offers in a majority of cases. *See supra* note 64. The court, in essence, gave target managers the green light to block any two-tiered tender offer.

¹²⁰ *See supra* text accompanying notes 51-59.

¹²¹ A shareholder should be allowed to produce evidence that management intended to defeat the tender offer even though it employed reversible tactics. If target managers cannot prove by a preponderance of the evidence that they intended to negotiate with rather than block completely the hostile bidder, then the target managers must justify the blocking doctrine under the harsher standard.

and the anticipated second-stage merger price (or the value of the stock if there is no merger) exceeds the market price of the target stock,¹²² the target managers have not been able to find other higher bidders within a reasonable period, and the initial bidder credibly refuses to offer more, the target managers should be hard pressed to justify any further refusals. In short, the only safe course for managers responding to most tender offers is a successfully negotiated bargain with the highest bidder.

If defensive tactics designed solely for stalling a tender offer in order to provide bargaining leverage must eventually be neutralized once target management has secured the best price, the effect of these tactics on bidders depends on their sensitivity to time delays. Target management has leverage in the decision to delay; through delay the target can test the "give" in the bidder's price and find other buyers. Yet bidders who offer above market prices know that target managers should, at some point, agree to sell by withdrawing any artificially created block to a tender offer, and if bidders establish a credible time deadline for an attractive final offer, target managers may find it difficult to delay further. In sum, legal standards that encourage the proper use of reversible defensive tactics weaken the bargaining position of the target (compared to its current position), but they do not disable it.¹²³

The effect of the Williams Act is to make more difficult the target board's justification of its use of delaying tactics, for the Act itself, supplemented by SEC rules, creates a twenty day period in which the target can solicit subsequent buyers.¹²⁴ In most cases the target can entice subsequent bidders to appear within this period. The Act does not, however, aid the target in negotiating with the initial bidder if no other buyers can be found. In these cases the target may need a credible threat to stall the offer beyond the twenty day period in order to have significant bargaining leverage.

This proposal invalidates many of the poison pill stock plans currently in use. A target company typically creates a poison pill stock plan by issuing preferred stock to its shareholders, which they can, in the event of a tender offer, convert into a large quantity of

¹²² The argument that the market is undervaluing the stock should not be applicable unless the narrow conditions outlined *supra* note 19 exist. Moreover, any arguments based on a pessimistic appraisal of the second-stage merger price or of the value of non-tendered stock should be suspect, and the target managers should be pressed to sustain their burden of proof on the claims.

¹²³ Studies have shown that under current rules most of the gain created by a hostile tender offer accrues to the target shareholders. See Dennis, *supra* note 8, at 317 n.175; COUNCIL OF ECON. ADVISORS, *supra* note 3, at 197 (target shareholders gain 16 to 34%; bidder shareholders gain 2.3%, approximately a 9 to 11% return on the investment in the target).

¹²⁴ See *supra* note 8.

the bidder's common stock or redeem on generous terms.¹²⁵ If target management can negate the conversion or redemption features at its option, such plans may be legitimate reversible tactics, enabling target managers to negotiate on behalf of their shareholders. Target managers can negotiate for a higher price and withdraw the conversion or redemption feature when the deal is cut.¹²⁶ If management cannot negate the conversion or redemption features, the tactic is suspect, and courts should apply the more stringent standards applicable when management acts intentionally to defeat a tender offer.¹²⁷ Because some of the poison pill preferred stock currently issued cannot be easily detoxified, they are of questionable validity.¹²⁸

On the other hand, an example of a reversible share purchase rights plan is currently before the Delaware Supreme Court in *Moran v. Household International Inc.*¹²⁹ Under the *Household* plan, common shareholders are given rights to buy Household preferred stock if anyone makes a tender offer for over thirty percent of Household's common shares. The rights are out of the money, but if a tender offer succeeds and the buyer attempts a second-stage takeover merger, the buyer must exchange at a bargain price its own common stock for the rights. The exchange right, however, is not absolute. Prior to the tender offer, or before a bidder gains a twenty percent interest, Household's board can redeem the rights for a nominal price. Because the tactic is reversible, it is not inherently suspect. The critical issue is how Household's board uses its

¹²⁵ Fair price provisions are built into the redemption formula: on a specified change of control the preferred stock is redeemable at the highest price paid by the bidder in the last 12 months. The conversion feature gives preferred stockholders the right, in the event of a second-stage squeeze-out merger, to exchange for substitute preferred stock in the acquirer. The conversion rights "flip over," that is, the preferred stock of the acquirer can itself be converted into common stock of the acquirer, equal in value to the highest price paid by the acquirer in the last 12 months for target shares. A variation of the convertible preferred stock dividend plan is the share purchase rights plan. The target issues a dividend consisting of rights to purchase common stock that are contingent on a change in ownership. The rights flip over in the event of a merger when they entitle their holders to stock in the acquiring company at favorable terms.

¹²⁶ Once stock on stock rights are issued, a straight withdrawal of the conversion or redemption feature by the board is prohibited by state corporate laws, which categorize such action as a stock reclassification requiring a shareholder vote. On the other hand, withdrawing stock or stock rights dividends after declaration but before issuance poses no problem, and special redemption features may be built into the dividends that allow target managers to redeem them at minimal cost, even if issued. See *infra* note 129.

¹²⁷ See *supra* text accompanying note 119.

¹²⁸ The argument also applies to several other common defenses: "white squire" arrangements in which the target issues stock to a friendly holder, subject to a standstill agreement; "crown jewel" defenses in which the target sells, usually contingent on a change of control, its attractive assets; and most other "scorched earth" defenses.

¹²⁹ *Moran v. Household Int'l Inc.*, 490 A.2d 1059 (Del. 1985).

power.¹³⁰

2. *Tactics That Favor One Bidder Over Others or That Create an Auction*

The basic analysis detailed above also applies when target management acts to defeat one tender offeror by favoring another with a bargain price on assets (the crown jewel defense) or on stock (the lock-up or leg-up options).¹³¹ The problem is the most obvious whenever such a defense favors one bidder over another who is offering an equivalent or even lower price; target managers are most likely acting in their self-interest, receiving a bribe of some sort in the form of a pension plan or of guarantees of future employment from the favored bidder. But the defense is also inherently suspect even if the favored bidder offers a higher price. In such a case, a defense that permanently disadvantages the original bidders also signals misbehavior because the target managers are not content to let the hostile bidder put in a potentially higher bid; lock-up defenses effectively preclude the hostile bidder from making a counteroffer.¹³²

¹³⁰ See *Horwitz v. Southwest Forest Indus., Inc.*, 604 F. Supp. 1130 (D. Nev. 1985); *APL Corp. v. Johnson Controls, Inc.*, No. 85-C-990 (E.D.N.Y. Mar. 25, 1985) (preliminary injunctions refused to plaintiffs challenging similar rights plans). A misuse of the defense is evident in *Crown Zellerbach Corp. v. Goldsmith*, 609 F. Supp. 187 (S.D.N.Y. 1985). The target, from the outset, had no intention of redeeming the warrants; it used them as a complete and effective bar to the bidder's offer. See *supra* note 20.

A few of the poison pill stock (or stock rights or warrants) plans have a seductive feature: they guarantee to all shareholders who do not tender the tender offer price. The plans force the acquiring company who executes a second-stage takeover merger to pay tender offer prices and force an acquiring company who does not execute such a merger to redeem, at the shareholder's option, stock at the tender offer price. Unlike some plans that give target shareholders extreme bargains in the event of a tender offer or a second-stage merger, such plans merely guarantee that all shareholders can claim the tender offer premium. Thus, the plans eliminate the possibility of a front-end loaded tender offer, that is, a tender offer in which those shareholders who tender get more than those who do not. Target managers argue, therefore, that these plans are legitimate because, like fair price charter amendments, see *supra* note 40 and accompanying text, they do nothing more than eliminate the stampede effect. The argument is attractive but not convincing. Such plans, unless reversible, permanently close the door on potential offerors who want to buy only enough stock to control a publicly held company. The loss of any opportunity to entice and negotiate with these potential offerors is at substantial costs to target shareholders and should not be incurred absent a shareholder vote, which should be required for all automatic defenses.

¹³¹ The crown jewel option describes the sale of a prize division or asset to a preferred bidder (called a "white knight") contingent on the bidder's victory over the hostile bidder for control of the target. *E.g.*, *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982); *Whittaker v. Edjar*, 535 F. Supp. 933 (N.D. Ill. 1982). Lock-up and leg-up options are grants of a stock option to a white knight to preclude competition and to furnish an edge in the bidding contest. *E.g.*, *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983); *Marshall Field & Co. v. Ichan*, 537 F. Supp. 413 (S.D.N.Y. 1982).

¹³² Just before this Article went to press, the Delaware Chancery Court decided the

Accordingly, the courts should treat a defense that permanently disadvantages the bidder similarly to a defense that defeats a single tender offer, with two modifications. First, the first condition noted above for justifying the defeat of a tender offer (nonpublic valuable information) is not a credible reason for favoring one bidder over another.¹³³ The second condition, however, that the disfavored bidder will be a looter, can also justify permanently favoring one bidder over another. A second justification would be that the disfavored bidder is financially overextended and unwilling to make good on its promises, either in the tender offer itself or in the second-stage merger. Again these latter two situations are unlikely, and managers who rely on these justifications should be put to the heavy burden of proof noted above, the clear and convincing standard.

Thus, the use of defenses to stimulate an auction is legitimate only if, first, they disadvantage all existing bidders to give target managers time to find other bidders, and second, they are reversible so that once an auction is established, the bidding is unaffected by the tactic. Even so, if target managers hold off all existing bidders too long and lose them in an effort to create an auction, they should have to justify their gamble as reasonable under the circumstances.

3. *Target Managers Who Do Nothing*

A residual danger of target management self-dealing remains even if target managers neither defeat a sole tender offeror nor favor one bidder in an auction. A bidder may bribe a target's managers not to negotiate on behalf of the target shareholders. For example, if an initial bidder offers lucrative positions to the target's managers if the bidder gains control, the target managers' loyalty to their own shareholders is compromised. When target managers gain personally from a tender offer, other than in the form of stock appreciation in the target, their acts are inherently suspect. In such cases the target's managers must show with clear and convincing evidence that their actions served the shareholders' best interests. Only if the target's managers receive no benefits from the successful bidder should the standard of proof be relaxed in the face of complaints that they did not negotiate for better terms.¹³⁴

Revlon case on these grounds. *Revlon Loses a Takeover Ruling*, N.Y. Times, Oct. 24, 1985, at D1, col. 2.

¹³³ It is not an argument for favoring one of two bidders but only an argument for refusing to accept anything but a minimum price.

¹³⁴ Target managers with high severance agreements (golden parachutes) may also have an incentive to not interfere with a tender offer. Ideally, the severance plan should encourage target managers to bargain honestly without regard to their future employment. If the plan provides overgenerous payments unrelated to the price of the target's stock, managers may not bargain hard enough for the interests of target share-

Courts, however, can be too harsh in evaluating a manager's duty to negotiate when there is evidence of payments from the acquirer. In *Smith v. Van Gorkom*,¹³⁵ for example, the Delaware Supreme Court held that the managers of a company selling its assets violated their fiduciary duty by, among other things, agreeing with a potential purchaser *not* to solicit competing offers and not to furnish information to other potential bidders. Although the agreement ostensibly allowed the target some time to receive competitive offers and to accept them if they were later than the outstanding offer, the court concluded that the conditions on these rights were stifling.¹³⁶ Thus, the court held that the target managers had failed to test the market before accepting an outstanding offer price for the sale of control.¹³⁷

The basic reasoning is sound, but unfortunately clouded by the court's discussion of the target's market price as "historically depressed," "consistently undervalu[ing] the worth of . . . the stock," not indicative of "true value," and not reflecting the "inherent value of the company."¹³⁸ This language reflects a misunderstanding of stock prices and a confusion over the reasons for control premiums.¹³⁹ Justice McNeilly, in dissent, noted that other bidders were in fact showing sustained interest.¹⁴⁰ This evidence, absent evidence on the *reasons* for the withdrawal of these companies, implies that the price accepted was reasonable.

CONCLUSION

Some readers may dismiss this analysis as too lenient on target management, allowing them to continue to protect their own interests with a wide variety of defenses while portraying falsely a concern for the welfare of target shareholders. These readers, however, underestimate the scope of the proposed limitations.

Any irreversible defense that defeats a tender offer with the result that the target remains an independent company will create a

holders. Whether golden parachutes harm target shareholders or are a legitimate form of salary incentive, therefore, depends on the details of the agreement. See also Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909 (1985).

¹³⁵ 488 A.2d 858 (Del. 1985).

¹³⁶ *Id.* at 883. Interestingly, the majority opinion did not comment on whether other bidders were in fact contacted by the target managers in the case. In the dissent, however, Justice McNeilly argued that an investment banker was hired to find better offers, and the bankers prepared and mailed to over 150 companies a brochure on the target's history. Four companies showed interest but did not make offers. *Id.* at 896.

¹³⁷ *Id.* at 877-78.

¹³⁸ *Id.* at 875-76.

¹³⁹ See *supra* notes 20, 21, 67, and 119.

¹⁴⁰ 488 A.2d at 896 (McNeilly, J., dissenting).

substantial risk of personal liability.¹⁴¹ When target managers seek to defeat a tender offer, they must show with clear and convincing evidence either that they possessed valuable nonpublic information or that they reasonably believed the bidder would loot the corporation. If management inadvertently defeats a tender offer while negotiating a higher tender offer price, using a reversible defensive tactic, the management must show with a preponderance of the evidence that they made a reasonable bargaining gamble in holding out. Moreover, under the analysis, any defense that permanently favors one bidder over another creates a substantial risk of personal liability. Target managers who receive personal gains from a bidder must show with clear and convincing evidence that their actions in negotiating or not negotiating with the bidder were fair to target shareholders. Finally because most legitimate defensive tactics consist of arrangements that target managers can and in most cases will reverse, the power of such tactics in stopping tender offers is significantly curtailed.

The proposed standards of fiduciary responsibility will test the abilities of the courts. The beauty of the business judgment rule is that courts can avoid meddling in business decisions. But in conflict of interest situations courts must shoulder the burden of protecting the potential victims, and tender offers are such a case. The passivity rule appears to provide a quick fix with minimal court involvement, but the rule eventually would require courts to assess motive and effect under complicated circumstances that are not dissimilar from courts' responsibility under this proposal. Courts applying the passivity rule, for example, at minimum would have to determine whether management employed a given tactic for defensive purposes or whether they were motivated by routine business concerns, and the inquiries are likely to be more complex as avoidance behavior becomes more devious. The standards proposed in this Article are not open-ended; they build in benchmarks that should aid judges in determining whether generally empowered target managers are acting responsibly as bargaining agents.

¹⁴¹ The extent of a director's personal liability for acts undertaken in his capacity as a director has been the subject of debate. See generally Oesterle, *Limits on a Corporation's Protection of Its Directors and Officers from Personal Liability*, 1983 WIS. L. REV. 513.