

Michigan Law Review

Volume 86 | Issue 7

1988

The Promise of State Takeover Statutes

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Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1634 (1988).

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THE PROMISE OF STATE TAKEOVER STATUTES

*Richard A. Booth**

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INTRODUCTION

For more than a decade, the two-tier tender offer has baffled the courts, mystified the legislatures, and haunted the law reviews.¹ This puzzling spectre has tormented legal thinkers with a practical dilemma. On the one hand, such offers appear to be coercive,² and, perhaps worse, the threat of coercion has been cited as a justification (or excuse) for the most offensive defensive tactics, such as greenmail and poison pills.³ On the other hand, two-tier offers seem on the average to benefit shareholders who in spite of apparent coercion receive sig-

1. See Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 676-93 (1984); Comment, *The Front-End Loaded, Two-Tiered Tender Offer*, 78 NW. U. L. REV. 811 (1984) [hereinafter Comment, *The Two-Tiered Tender Offer*]; Comment, *Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique*, 131 U. PA. L. REV. 389 (1982) [hereinafter Comment, *Front-End Loaded Tender Offers*]. The issue appears to have been first identified in Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 330-40 (1974) [hereinafter Brudney & Chirelstein, *Fair Shares*], and analyzed further in Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter Brudney & Chirelstein, *A Restatement*].

2. See R. FERRARA, M. BROWN & J. HALL, TAKEOVERS: ATTACK AND SURVIVAL: A STRATEGIST'S MANUAL 123-29 (1987) [hereinafter FERRARA]; André, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865 (1987); Comment, *Front-End Loaded Tender Offers*, *supra* note 1, at 812; Brudney & Chirelstein, *Fair Shares*, *supra* note 1, at 336-37; Brudney & Chirelstein, *A Restatement*, *supra* note 1, at 1361-62; Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. BAR FOUND. RES. J. 341; Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 355-56 (1980). Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 18-20 (1987); see also Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911 (1987) [hereinafter Bebchuk, *The Pressure to Tender*]; Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985) [hereinafter Bebchuk, *Toward Undistorted Choice*] (arguing that all tender offers are somewhat coercive); Willis, *Your Money: Takeovers Pose a Tough Choice*, N.Y. Times, Mar. 26, 1988, at 18, col. 1 (natl. ed.). But see Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 151-52 (1987) (suggesting that coercion is not a complete explanation since some bids are rejected even when there is no resistance by management); Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp. v. Dynamics Corp. of America*, 101 HARV. L. REV. 96, 105 (1987) (arguing that it is artificial to characterize the attraction of selling one's shares at a premium as coercion).

3. See, e.g., *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250 (7th Cir. 1986), *revd. in part*, 107 S. Ct. 1637 (1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986); *Moran v. Household Intl., Inc.*, 500 A.2d 1346 (Del. 1985); Dawson, Pence & Stone, *Poison Pill Defensive Measures*, 42 BUS. LAW. 423 (1987); Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984); Comment, *Shareholder Rights Plans — Do They Render Shareholders Defenseless Against Their Own Management?*, 12 DEL. J. CORP. L. 991 (1987); Note, *The Hobbs Act and RICO: A Remedy for Greenmail?*, 66 TEXAS L. REV. 647 (1988); Grundfest, *Two-Tier Bids Are Now a Defensive Technique*, NATL. L.J., Nov. 9, 1987, at 26, col. 1; *Greenmail Blues*, Wall St. J., Dec. 12, 1986, at 28, col. 1 (editorial); cf. Gilson, *Drafting an Effective Greenmail Prohibition*, 88 COLUM. L. REV. 329 (1988).

nificant premiums in connection with such offers.⁴ Thus, though the worry persists, partial and two-tier offers remain wholly unregulated under the Williams Act, the general federal tender offer law, which, ironically, was meant to insure that every tender offer is a fair fight.⁵

The continued availability of coercive offers has been an important reason for widespread state takeover legislation.⁶ Despite the fact that in 1982 the Supreme Court in *Edgar v. MITE Corp.*⁷ held that an Illinois statute, which, among other things, required advance notice of tender offers and provided for a fairness review by a state official, was unconstitutional as an undue burden on interstate commerce, many states have adopted second-generation takeover statutes.⁸ The new

4. SEC, Office of the Chief Economist, *The Economics of Partial and Two-Tier Tender Offers*, 49 Fed. Reg. 26,755, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,637 (June 21, 1984); SEC, Office of the Chief Economist, *The Economics of Any-or-All, Partial and Two-Tier Tender Offers*, (Apr. 19, 1985).

5. Williams Act of 1968, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 781(i), 78m(d)-(e), 78n(d)-(f) (1982) (adding §§ 13(d)-(e), 14(d)-(f) to Securities Exchange Act of 1934)). See *Edgar v. MITE Corp.*, 457 U.S. 624 (1982) (holding Illinois takeover statute unconstitutional under dormant commerce clause; three Justices also of opinion that statute was preempted by the Williams Act in which Congress established a scheme that avoided favoring either bidders or target management). This is not necessarily to say that the Williams Act is flawed. Arguably the Act is purely procedural and designed to establish efficient bidding conventions and to reduce information costs and therefore should not be viewed as a cure-all for the problems of fairness or fiduciary duty that may arise in the course of a bid. See Langevoort, *supra* note 2, at 110-12; Comment, *The Two-Tiered Tender Offer*, *supra* note 1, at 818-20; Comment, Schreiber v. Burlington Northern, Inc.: *Misrepresentation as a Necessary Element of a Section 14(e) Cause of Action*, 12 DEL. J. CORP. L. 645 (1987); Note, *SEC Takeover Regulation Under the Williams Act*, 62 N.Y.U. L. REV. 580 (1987); see also Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977). But see *Basic, Inc. v. Levinson*, 108 S. Ct. 979 (1988) (suggesting that concept of manipulation may be broad enough to include misrepresentations affecting market price and holding that investor may justifiably rely on integrity of market mechanisms to assure fair pricing in connection with purchases and sales of securities). On the other hand, as I suggest in an article in preparation, the Williams Act may in fact cause many of the bargaining problems that arise in tender offers. R. Booth, *The Problem with Federal Tender Offer Law*. I agree, however, that the Williams Act performs a valuable informational function. See Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153 (1986). Even in this context, however, I would argue that the value of the Williams Act is overestimated. See also Borden & Weiner, *An Investment Decision Analysis of Cash Tender Offer Disclosure*, 23 N.Y.L. SCH. L. REV. 553 (1978); Brudney & Chirelstein, *Fair Shares*, *supra* note 1, at 330-40.

6. See *CTS Corp. v. Dynamics Corp. of America*, 107 S. Ct. 1637, 1651 (1987); Langevoort, *supra* note 2, at 105.

7. 457 U.S. 624 (1982).

8. As of year-end 1986, there were 22 states with some form of second-generation statute. See *CTS Decision Likely to Spur States to Enact Antitakeover Laws, IRRC Says*, 19 Sec. Reg. & L. Rep. (BNA), No. 24, at 868 (June 12, 1987); Romano, *supra* note 2, at 114-20; Garrity, *Addendum: Post-MITE State Takeover Statutes: Constitutional Issues and Recent Cases*, 42 BUS. LAW. 586 (1987). In the meantime, and largely as a result of the Supreme Court's April 21, 1987 decision in *CTS* upholding the Indiana Act, six more states have adopted new statutes, and three have revised existing statutes. See *North Carolina Legislature Responds to Attempted Takeover of Burlington*, 19 Sec. Reg. & L. Rep. (BNA) No. 23, at 829 (June 5, 1987); 19 Sec. Reg. & L. Rep. (BNA) No. 24, at 871 (June 12, 1987) (correction regarding North Carolina statute); *Massachusetts Adopts Broad Anti-Takeover Law*, 19 Sec. Reg. & L. Rep. (BNA) No. 30, at 1099

statutes have taken several forms, though all have sought to regulate hostile acquisitions by focusing on aspects of corporate governance that have traditionally been matters of state law.⁹

State takeover laws have been roundly criticized as economically inefficient protectionist legislation.¹⁰ The conventional wisdom is that

(July 24, 1987); *Arizona Antitakeover Bill Signed During Special Session*, 19 Sec. Reg. & L. Rep. (BNA) No. 31, at 1138 (July 31, 1987); "*Indiana-Style Takeover Law Now in Effect in Oregon*", 19 Sec. Reg. & L. Rep. (BNA) No. 35, at 1339 (Aug. 28, 1987); *Bill Modeled on Indiana Law Signed into Law by Missouri Governor*, 19 Sec. Reg. & L. Rep. (BNA) No. 33, at 1269 (Aug. 14, 1987) (revision of earlier law); *Wisconsin Governor Signs Two Antitakeover Measures*, 19 Sec. Reg. & L. Rep. (BNA) No. 38, at 1463 (Sept. 25, 1987) (revision of earlier law); *Delaware Governor Signs Law Restricting Hostile Takeovers*, 20 Sec. Reg. & L. Rep. (BNA) No. 5, at 188 (Feb. 5, 1988); *Idaho Governor Signs Anti-Takeover Law Modeled After Indiana, New York*, 20 Sec. Reg. & L. Rep. (BNA) No. 13, at 501 (Apr. 1, 1988); *Pennsylvania Enacts Law Against Hostile Takeovers*, 20 Sec. Reg. & L. Rep. (BNA) No. 13, at 502 (Apr. 1, 1988) (statute expressly permitting poison pills); see also *NASAA Adopts Model Control Share Act*, 20 Sec. Reg. & L. Rep. (BNA), No. 18, at 669, 708 (May 6, 1988). With the exception of the Wisconsin and Delaware acts, each new act and revision is modeled on the Indiana statute. By comparison, 37 states adopted first-generation takeover statutes prior to the decision in *MITE*. See Garrity, *supra*, at 586; Romano, *supra* note 2, at 113. See generally SEN. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987, S. Rep. No. 265, 100th Cong., 1st Sess. 48-56 (1987) [hereinafter SENATE TENDER OFFER REPORT]; *The Battle over Tender Offer Reform: From the States and the Courts to Congress*, 20 Sec. Reg. & L. Rep. (BNA), No. 2, at 60, 66-67 (Jan. 15, 1988).

The decision to adopt a new takeover statute in Delaware was particularly controversial. See Bandow, *Curbing Raiders Is Bad for Business*, N.Y. Times, Feb. 7, 1988, § 3 (Business) at 2, col. 3; Veasey, *A Statute Was Needed to Stop the Abuses*, N.Y. Times, Feb. 7, 1988, § 3 (Business) at 2, col. 3; *Debate Over a New Takeover Law*, N.Y. Times, Feb. 1, 1988, at 21, col. 3 (natl. ed.); *Delaware Moves Closer to Adopting Law to Deter Hostile Takeovers*, Wall St. J., Dec. 9, 1987, at 41, col. 3; *Will Delaware Fall?*, Wall St. J., Dec. 3, 1987, at 30, col. 1 (editorial); Black, *Why Delaware Is Wary of Anti-Takeover Law*, Wall St. J., July 10, 1987, at 18, col. 3; *Delaware Fails to Adopt Law on Takeovers*, Wall St. J., June 16, 1987, at 2, col. 2. For a description of the Delaware law, see Finkelstein, *The New Delaware Takeover Statute*, 21 REV. SEC. & COMM. REG. 47 (1988).

9. See *CTS Corp. v. Dynamics Corp. of Am.*, 107 S. Ct. 1637, 1651 (1987); Block, Barton & Roth, *State Takeover Statutes: The "Second Generation"*, 13 SEC. REG. L.J. 332, 340 (1986); Langevoort, *supra* note 2.

10. See Block, Barton & Roth, *supra* note 9; Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986); Danilow & Bentley, *State Takeover Statutes After MITE*, 20 REV. SEC. & COMM. REG. 13 (1987); Langevoort, *State Tender-Offer Legislation: Interests, Effects and Political Competency*, 62 CORNELL L. REV. 213 (1977); Pinto, *Takeover Statutes: The Dormant Commerce Clause and State Corporate Law*, 41 U. MIAMI L. REV. 473 (1987); Pozen, *The New Round of State Tender Offer Statutes*, 53 BROOKLYN L. REV. 89 (1987); Profusek & Gompf, *State Takeover Legislation After MITE: Standing Pat, Blue Sky, or Corporation Law Concepts?*, 7 CORP. L. REV. 3 (1984); Romano, *supra* note 2; Sargent, *Do the Second-Generation State Takeover Statutes Violate the Commerce Clause?*, 8 CORP. L. REV. 3 (1985); Warren, *Developments in State Takeover Regulation: MITE and Its Aftermath*, 40 BUS. LAW. 671 (1985); Note, *The Tender Offer Regulation Battle Continues: Should States Regulate Only Local Companies?*, 60 IND. L.J. 721 (1985); Note, *Second Generation State Takeover Legislation: Maryland Takes a New Tack*, 83 MICH. L. REV. 433 (1984); Note, *The Constitutionality of Second Generation Takeover Statutes*, 73 VA. L. REV. 203 (1987); Note, *Securities Law and the Constitution: State Tender Offer Statutes Reconsidered*, 88 YALE L.J. 510 (1979); *How Indiana Shielded a Firm and Changed the Takeover Business*, Wall St. J., July 1, 1987, at 1, col. 6; Hanks, *State Takeover Laws: The Second Generation*, NATL. L.J., Nov. 3, 1986, at 34, col. 1; see also Langevoort, *supra* note 2; Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563 (1983).

takeovers promote efficiency by threatening slack managers with removal. In the argot of legal economists, takeovers are said to reduce agency costs.¹¹ The disciplined manager is thus induced to make the enterprise as profitable as possible, assuring that corporate resources are put to their highest and best use. Consistent with this view, second-generation statutes were almost invariably struck down as unconstitutional. But to the presumable surprise of most courts and commentators who had spoken on the subject, the U.S. Supreme Court in *CTS Corp. v. Dynamics Corp. of America* upheld Indiana's second-generation statute.¹² It had been widely expected that the Court would overturn the Indiana act on the theory that a state statute which seeks to regulate the takeover process constitutes an impermissible burden on interstate commerce.¹³ It had become an article of faith, it seems, that the market for corporate control was wholly within the federal domain and that no thinly (or thickly) veiled effort by the states to help entrench local management could be tolerated.¹⁴

With the decision in *CTS*, it became clear that there is constitutional room for state law in the takeover field. And while state takeover statutes continue to be heavily criticized (together with the decision of the Supreme Court upholding the Indiana act), more and more states, including Delaware, rush to enact them.¹⁵ In the final

11. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169-74 (1981); Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984).

12. 107 S. Ct. 1637 (1987). For a recent survey of the cases holding such statutes unconstitutional, see Garrity, *supra* note 8, at 594-601.

13. See Cox, *The Constitutional "Dynamics" of the Internal Affairs Rule — A Comment on CTS Corporation*, 13 J. CORP. L. 317 (1988); Langevoort, *supra* note 2; Regan, *Siamese Essays: (I) CTS Corp. v. Dynamics Corp. of America and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation*, 85 MICH. L. REV. 1865 (1987). Despite the fact that the opinion of the MITE Court turned on the dormant commerce clause, it seems curious in retrospect that so many courts and commentators continued to focus on that argument, since the only real analysis was in the plurality opinion that the Illinois act in question was preempted because it conflicted with the Williams Act. 457 U.S. at 634-40. This seems all the more curious in that so many states crafted their second-generation statutes expressly to avoid preemption. This distinction was not, however, lost on Judge Posner who authored the reversed decision in *CTS. Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 263 (7th Cir. 1986), *revd. in part*, 107 S. Ct. 1637 (1987).

14. 794 F.2d at 261, 263-64 (Posner, J.), *revd. in part*, 107 S. Ct. 1637 (1987).

15. See Woodward, *How Much Indiana's Anti-Takeover Law Cost Shareholders*, Wall St. J., May 5, 1988, at 24, col. 3 (reporting study finding aggregate loss of \$2.65 billion or 6% of total value of Indiana companies); Bandow, *Curbing Raiders Is Bad for Business*, *supra* note 8; *Will Delaware Fall?*, *supra* note 8; *Expropriation at Home*, Wall St. J., Oct. 9, 1987, at 24, col. 1 (editorial); Simmons, *Shareholders Don't Need "Protection"*, Wall St. J., July 31, 1987, at 14, col. 3; Romano, *State Takeover Laws: Constitutional But Dumb*, Wall St. J., May 14, 1987, at 28, col. 4; *Life Tenure for Managers?*, Wall St. J., Apr. 23, 1987, at 32, col. 1 (editorial). *But see* Veasey, *A Statute Was Needed to Stop the Abuses*, *supra* note 8; Orr, *Shareholders Need a Knight Errant*, Wall St. J., May 27, 1987, at 30, col. 3; *see also* Labaton, *Business and the Law: States vs. U.S. on*

analysis, however, the Indiana Control Share Acquisition Chapter¹⁶ and other state takeover laws which, like the Indiana Act, seek to regulate the purchase of control shares — though they may have been prompted by protectionist motivations — are a remarkably intelligent approach to the problem of coercive tender offers.

The purpose of this article is, first, to describe the problems associated with two-tier tender offers and the closely related, and perhaps still more coercive, partial tender offer. Second, the article will address the natural question why such offers have not already been banned, suggesting a better view of what coercion means in the context of a tender offer. Third, the article will offer a management-oriented view of coercion, explaining the legitimate interests of managers (and other groups) in resisting takeovers, as well as how greenmail and poison pills, though subject to abuse, can be used quite properly to combat coercion. Fourth, the article will describe the variety of second-generation takeover statutes and consider how they attack the problem of coercion (in most cases with unacceptable costs). Fifth, the article will demonstrate how control share statutes such as the Indiana Act largely solve these problems quite efficiently and will offer a refinement of the Indiana Act which will eliminate the unnecessary bias it has for target management in its current form. And finally, the article will consider the prospects for survival of state regulation of the market for corporate control in light of mounting pressure for new federal legislation to preempt the field.

I. THE APPARENT PROBLEM OF COERCION

The problem of coercion can best be understood by first examining the two-tier tender offer, a simple device that has been around virtually since tender offers became a common and acceptable way to vie for control of target companies.¹⁷ The idea is straightforward: By offering more for the first, say, 51% of the shares of a target and less for the remaining shares if control is established, a bidder can induce more shares to be tendered early for a lower price than would be tendered if there were no risk in holding out. For example, suppose a

Takeovers, N.Y. Times, Sept. 28, 1987, at 30, col. 1 (natl. ed.). *But cf.* SEC, Office of the Chief Economist, *Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers* (May 18, 1987) (passage of Ohio law resulted in price decrease for covered companies of 1.68% to 3.24% not including Goodyear and 1.84% to 3.42% including Goodyear).

16. IND. CODE ANN. §§ 23-1-42-1 to -11 (West Supp. 1987). The chapter is referred to hereinafter as the Indiana Act or simply the Act.

17. See note 1 *supra*; see also SEC, *The Economics of Partial and Two-Tier Tender Offers*, *supra* note 4; SEC, *The Economics of Any-or-All, Partial and Two-Tier Tender Offers*, *supra* note 4.

bidder offers \$120 per share for the first 51% of a company which is currently trading for \$100 and announces that if the 51% are tendered the remaining 49% will be cashed out for \$100 per share. (The remaining shares can be forcibly purchased by the bidder causing a merger between the target company and another company controlled by the bidder in which the latter is the survivor with the target's shareholders paid in cash for their shares.¹⁸) A shareholder of the target would obviously be strongly tempted to tender in the first tier even if he or she thought the \$120 offered was too low (unless he or she had some reliable way of knowing that other shareholders would hold out¹⁹). The reason, of course, is that failure to tender in the first tier could result in being stuck with a mere \$100 in the second-tier cash out.

In this way, a two-tier offer puts considerable pressure on target shareholders. Worse still is a partial offer. In the preceding example, the offeror announced in advance its plans to cash out the remaining minority at the pre-offer market price. (A merger at any lower price would be unlikely to pass muster under state law.²⁰) But suppose the offeror says nothing about what it intends to do if control is achieved. The target shareholder who holds out faces the prospect of owning shares in a captive company. The chances are good that if the offer succeeds the remaining shares will trade at depressed prices, since future tender offers and their disciplinary effect on management²¹ are precluded, and since the new parent company may within fairly broad limits operate the target for its own benefit. If, for example, the target is rich in cash, the new parent could induce it to lend money to the parent on favorable terms. The possibilities are endless. Outright looting of the target's assets is, of course, illegal,²² but the target, which is now a captive company, will probably not command top dollar in any deal it makes with the parent.²³ Even if the parent scrupulously avoids taking undue advantage, the stock market will recognize

18. See Brudney & Chirelstein, *A Restatement, supra* note 1, at 1359-65.

19. See Carney, *Shareholder Coordination Costs, supra*, note 2; see also *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250 (7th Cir. 1986), *revd. in part*, 107 S. Ct. 1637 (1987); Leebron, *supra* note 5, at 186-91; SEC, *The Economics of Partial and Two-Tier Tender Offers, supra* note 4; SEC, *The Economics of Any-or-All, Partial and Two-Tier Tender Offers, supra* note 4; see also Bebchuk, *supra* note 2 (arguing that all tender offers are coercive to some extent since holdouts will be left with shares that may trade at a lower price in the market after the offer).

20. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

21. See note 11 *supra*.

22. See Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248, 263-68 (1985).

23. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); Bebchuk, *The Pressure to Tender, supra* note 2.

that advantage taking — or what might be called quasi-looting — is always possible, and stock of the target will inevitably trade at a lower price than it would if independent. After all, given the choice of two otherwise identical companies, why would an investor take the extra risk associated with the captive company?

At the extreme, shareholders in the aggregate may conceivably lose money from a partial bid. Suppose, as in the previous example, the bidder offered \$120 per share for the first 50% plus one of the shares, and after the bidder had gained control the remaining shares fell from the pre-offer \$100 to \$70. Half of the shareholders would have gained \$20 per share while half would have lost \$30 per share. Overall, target shareholders would have lost. Worse yet, the company would have been sold to apparently inferior managers. And perhaps worst of all, the economy as a whole would lose, since investors, mindful of the risk that they might be forced at some time in the future to tender at an inadequate price, will insist on higher returns to compensate for the returns lost from tender offers, raising the cost of capital for all companies.

The central point is that a partial bid may be even more coercive than the more blatant two-tier bid. In a two-tier bid, the holdout only risks missing out on the offered premium. In a partial bid, the holdout risks suffering a loss. Both kinds of bids, however, are coercive, and that means that in the end shareholders receive something less for the shares they tender in such bids than they would in a free and fair negotiation.

It is arguable that competition will neutralize whatever coercion might arise from the form of a bid. After all, if the bidder had discovered a way to keep more gain for itself than was necessary to make the deal profitable, another bidder would likely step in and offer more for the target, whether in the form of a higher bid per share or a less coercive offer, until the prospective returns from the takeover were reduced to a normal level. Indeed, statistics indicate that, on average, target shareholders enjoy most of the extraordinary gains that arise as a result of takeovers while bidders capture little gain in excess of an ordinary return.²⁴ But there may not always be other bidders present or ready to provide competition. The market for corporate control is, after all, a rarified environment with far fewer actors than the ordinary stock market. Moreover, although in the stock market mere observation of the behavior of other traders may provide enough information

24. See Leebron, *supra* note 5, at 174-79.

to justify an investment²⁵ since, under most conditions, stocks are efficiently priced and sufficiently liquid to guaranty against significant loss, a bidder's decision to seek control of a whole company is vitally dependent on what that bidder intends to do with it.²⁶

II. WHY COERCIVE OFFERS REMAIN LEGAL

The straightforward solution to the coercion problem would seem to be to prohibit partial and two-tier offers. Yet the courts have consistently refused to interpret the Williams Act to do so, while continually asserting that the essential policy behind the Act is to insure that every tender offer is a fair fight.²⁷ Even the SEC's Tender Offer Advisory Committee, which was assembled in part to study the problem of coercive offers, declined to recommend an outright ban on partial or two-tier offers.²⁸ Given the attention that has been paid to the coercion problem, it may seem curious that so little has been done as a matter of federal law to remedy the situation. Yet despite the problems created by partial and two-tier offers, there may indeed be serious problems with a rule prohibiting them.

A. Shareholders Seem To Benefit from Coercive Offers

Two related reasons are most frequently given for allowing coercive offers (or, more precisely, for not prohibiting them). It has been argued that a ban on partial and two-tier offers would eliminate many offers which are apparently beneficial to target shareholders. Recent studies by the SEC seem to confirm that target shareholders do in fact benefit from all kinds of tender offers. As might be expected, the greatest benefit comes from "any or all" offers in which shareholders receive an average premium of 59.6%, while average blended premiums are 54.5% in two-tier offers and 20.1% in partial tender offers.²⁹ Similarly, it has been argued that sometimes the bidder cannot afford

25. See Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 572-79 (1984) (discussing derivatively informed trading); Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863 (1987).

26. See Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630 (1985).

27. See note 5 *supra*; *Radol v. Thomas*, 772 F.2d 244 (6th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986); see also Comment, *The Two-Tiered Tender Offer*, *supra* note 1.

28. SEC Advisory Comm. on Tender Offers, Report of Recommendations (July 8, 1983) (recommendations 14, 16). See also Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs — Advance Notice of Possible Action, Exchange Act Release No. 21,079, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,637, at 86,917-18 (June 21, 1984) (expressing reservations of Committee about any further regulation of partial or two-tier offers).

29. SEC, *The Economics of Partial and Two-Tier Tender Offers*, *supra* note 4 (noting also that SEC rules regarding proration may have encouraged two-tier offers). See also Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485 (1983)

the higher premiums required to make a noncoercive bid or that the perceived gain from acquiring a target may be too small to justify the higher premium.³⁰ In other words, a rule against coercive bids may preclude some bidders from bidding and shareholders will be the worse off. Neither of these problems is as significant as it might seem.

Shareholders are not necessarily better off as a result of the gains they receive from partial and two-tier bids. The idea that they are better off stems from the notion that any premium is better than none.³¹ But that is not so. A simple example illustrates the point. Imagine a shareholder with a portfolio consisting of 100 shares of each of 300 different companies.³² During the course of a year, bids are made under current rules for twenty of those companies at premiums

(arguing that two-tier offers are designed to speed up tendering of shares and may have been encouraged by withdrawal rights that formerly extended beyond final proration date).

30. Although convincing a bank to finance a takeover can be difficult, the burgeoning junk bond market has provided a ready substitute source of financing and has enabled takeover bids that prior to 1983 could not have been mounted. See Coffee, *supra* note 10, at 2-4 & n.5; see Grundfest, *supra* note 3; SEC Office of the Chief Economist, *Noninvestment Grade Debt as a Source of Tender Offer Financing* (June 20, 1986) (junk bond financing for all tender offers rose from 0.3% in 1981-1984 to 13.6% during first half of 1985 and was predominant source of financing for hostile offers). In a further embellishment, the Fourth and Ninth Circuits have ruled that the Williams Act does not require a bidder to have firm financing before making a tender offer. *IU Intl. Corp. v. NX Acquisition Corp.*, 840 F.2d 220 (4th Cir. 1988); *Newmont Mining Corp. v. Pickens*, 831 F.2d 1448 (9th Cir. 1987). See *Williams Act Does Not Require Firm Financing to Mount Tender Offer*, 19 Sec. Reg. & L. Rep. (BNA) No. 45, at 1721 (Nov. 13, 1987). On the other hand, the most likely security for borrowing to finance a takeover is the value of the target's assets and prohibiting coercive bids might unduly encourage bust-up takeovers. See Lipton, *supra* note 2; Lipton, *Takeover Abuses Mortgage the Future*, Wall St. J., Apr. 5, 1985, at 16, col. 4. As Professor Coffee notes, the courts have suggested they may be more lenient toward defensive tactics designed to avert such takeovers. Coffee, *supra* note 10, at 4 & n.4 (citing *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 180-81 n.12 (Del. 1986); *Moran v. Household Intl., Inc.*, 500 A.2d 1346, 1349 n.4, 1356-57 (Del. 1985)).

31. Easterbrook & Fischel, *supra* note 11, at 1165-68, 1177-80. The idea that shareholders will happily sell their shares for any premium over the market price has often been expressed in judicial decisions. See, e.g., *Weinberger v. UOP, Inc.*, C.A. No. 5642 (Del. Ch. Jan. 30, 1985) (1985 Westlaw 11,546) (on remand to determine damages from freezeout merger in violation of fiduciary duty); *Armstrong v. Marathon Oil Co.*, 32 Ohio St. 3d 397, 513 N.E.2d 776 (1987) (market price before bid is best indication of fair value) (proceeding related to 1981 U.S. Steel bid for Marathon).

32. Three hundred is not an arbitrary figure. It appears that in practice it requires a portfolio of 200 to 300 shares to duplicate the performance of the S & P 500, which itself is widely regarded as the best indication of the market as a whole. See *Linked Deals in Stocks and Futures Contracts Roil Prices, Critics Say*, Wall St. J., Oct. 22, 1985, at 1, col. 6 (describing mechanics of program trading). Although it might be objected that not all shareholders hold portfolios of such size and diversity, a convincing argument can be made that they should — since such portfolios are readily available at nominal cost through mutual funds — and that tender offer rules ought to be constructed with such shareholders in mind. The argument, simply put, is that rational investors diversify because by doing so they can avoid some of the risk that attends investments in individual stocks without sacrificing any of the return. See J. LORIE, P. DODD & M. KIMPTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 23-24 (2d ed. 1985); Langbein & Posner, *Market Funds and Trust-Investment Law*, 1976 AM. BAR FOUND. RES. J. 1. But see Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976); Pozen, *Money Managers and Securities Research*, 51 N.Y.U. L. REV. 923

of \$20 over the market price, and all succeed. The shareholder receives a total premium of \$40,000. Now suppose that under a rule banning coercive offers successful bids are made for only ten of the companies but at premiums of \$50 per share over the market price. The shareholder receives total premiums of \$50,000 and is clearly better off.³³

Needless to say, the numbers are arbitrary. Different numbers might result in shareholders being better off under the current regime. The point is, however, that target shareholders are not necessarily worse off because some bids fail or are not made. The recent SEC studies actually support this idea if viewed from the right angle: the premium that target shareholders receive depends on the form of the bid. In short, shareholders do lose something from partial and two-tier bids even though they gain from all offers.

Moreover, there is no convincing reason why a bidder should not be able to finance the purchase of a target company at a price less than it would be worth under new management. If the perceived gain is at all demonstrable, the bidder can borrow to finance the takeover conventionally, by issuing junk bonds, or by simply making the offer contingent on arranging financing at a later date.³⁴ If the perceived gain is too small to justify a noncoercive offer, the offer probably should not be made anyway. That is, if the bidder cannot afford to pay what the shareholders would demand in a free and open negotiation, the offer, if made, should not succeed, since in the end shareholders must be presumed to be best able to judge what their stock is worth to them. Admittedly, in some circumstances a coercive offer may be the only way for a bidder to do a profitable takeover. Nevertheless, if the target company is acquired at a bargain price (from the point of view of the target shareholders), the gain to the bidder must come from a loss visited on the target shareholders. Indeed, the possibility that some bids generate ordinary returns for bidders but none for target shareholders in the aggregate is entirely consistent with the data.³⁵ More-

(1976) (both arguing that a much lower level of diversification may be defended depending on an investor's objectives).

There are other reasons for owning stock besides purely passive investment — for example, in order to control and manage the company or perhaps in order to cement a customer or supplier relationship. It is not necessarily irrational for such investors to fail to diversify. See Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257, 1282-88 (1985); see also text at note 26 *supra*.

33. See Booth, *Is There Any Valid Reason Why Target Managers Oppose Tender Offers?*, 14 SEC. REG. L.J. 43 (1986).

34. See note 30 *supra*.

35. See SEC, *The Economics of Any-or-All, Partial and Two-Tier Tender Offers*, *supra* note 4, tabs. 4a, 5 (seven offers in period 1981-1984 generated less than 0% premium [it's true!]; of all partial offers, 52% generated a premium of 20% or less, compared with an average 53.4% pre-

over, no competition would be expected to arise unless another bidder could conceive a more coercive offer which would leave the shareholders with an even greater loss. In other words, because of the availability of coercive bidding techniques, at least some companies are sold for less than they would be under a rule prohibiting such bids. As a result of those cases, equity capital is a bit more expensive than it should be. In short, the capital market is rendered less efficient than it might be.

It is conceivable, too, that the general availability of coercive bids may actually increase the incidence of takeovers. If investors fear a loss because of a potential for coercive bids and therefore insist on higher returns, the immediate result is lower market prices for stock. (As a stock's price falls, its return, held constant in dollar terms, naturally rises as a percentage of the stock's price, and it is the percentage return, of course, that concerns investors.) If for some reason bidders are more sensitive to decreases in stock prices than shareholders are concerned about the danger of coercive bids, coercive bids may keep stock prices somewhat depressed and takeover activity unduly encouraged.

Still, the idea that some bids which constitute a gain may be sacrificed in order to assure that remaining bids are made at a fair price smacks of throwing the proverbial baby out with the bathwater. There remains a nagging doubt about prohibiting partial bids. After all, there may well be bidders who for one reason or another can be trusted not to take advantage of the minority. The real question is, how many bids would be eliminated and how many would be sweetened by the proposed rule against coercive tender offers? And perhaps more important, which are which? Before addressing this question, however, there are other problems with prohibiting coercive bids that should be identified. As will be seen, they, too, ultimately point to a need to know when a bid that is coercive in form is likely to generate losses (or insufficient gains) for target shareholders.

B. *All Offers Are Arguably Coercive and Shareholders Thus Have a More Pressing Need for a Negotiating Agent*

A rule against bids which are overtly coercive would miss an arguably more important and pervasive form of coercion, namely, the coercion which arises because individual target shareholders perceive that it is futile to hold out no matter what the form of the offer.³⁶

mium for all offers); see also Leebron, *supra* note 5, at 194-97 (offering possible explanations for why bidding may not arise).

36. See Booth, *supra* note 33; Bebchuk, *The Pressure to Tender*, *supra* note 2; Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the*

Since shareholders are widely dispersed and lack economical methods of communicating with each other and coordinating their decisions to tender or hold out, each shareholder is more likely to tender, other things being equal, since by holding out a shareholder risks the possibility of missing the premium and being stuck with post-bid shares which are worth less than the offered cash or securities. Thus, even in the case of an offer for any or all of the target company's shares, investors may lose if target management remains passive and fails to negotiate or resist when there is good reason to believe either that the target is worth more than is being offered or simply that the bidder would pay more. After all, the bidder is motivated by the prospect of gain and will attempt to maximize that gain. While the any-or-all offer does not *threaten* the target shareholder into tendering for too low a price, neither does it insure that individual shareholders will know whether the price being offered is too low or that they will be able to do anything about negotiating for a higher price. Thus even in the case of the any-and-all offer, shareholders may prefer fewer offers with large premiums to many offers with small premiums.³⁷

On the other hand, the stock market might perform this negotiating function quite nicely even without managerial assistance. To be sure, evidence indicates that bidders capture little of the extraordinary returns that accompany takeovers.³⁸ The most likely explanation of this phenomenon is that arbitrageurs and other market professionals — who frequently amass a majority of target stock during the pendency of an offer — are indeed in a position to negotiate effectively.³⁹ But even if market professionals are effective substitute negotiators who induce bidders to pay top dollar for their targets, they can be expected typically to keep the additional gains for which they negotiate. Ordinary investors would still likely favor some level of manage-

Passivity Thesis, 71 CORNELL L. REV. 53 (1985). The shareholders' basic need for a negotiating agent provides a solid policy rationale not only for *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), which arguably stands for the proposition that the board of directors of a target company has a duty to bargain for the shareholders, but a policy rationale for Securities Exchange Act Rule 14e-2, 17 C.F.R. § 240.14e-2 (1987) as well, which requires a target company to respond to a tender offer. See Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117 (1986) [hereinafter Oesterle, *The Negotiation Model*]; see also Easterbrook & Fischel, *supra* note 11, at 1177-80. The duty of target management to act as a negotiating agent, and in particular not to halt the bidding process before the best price has been achieved has been affirmed in recent cases. See *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

37. See text at note 33 *supra*.

38. See Leebron, *supra* note 5, at 174-79.

39. See Romano, *supra* note 2, at 130-31, 145-48; Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 409-10 (1983).

ment negotiating or resistance, because the ordinary investor can keep more of the gain by holding out rather than selling out to the arbitrageurs. In short, although arbitrageurs perform a valuable function, they may be replaceable by a cheaper bargaining mechanism.

The idea that shareholders depend on management to negotiate the highest possible premium suggests that shareholders also depend on management to defend against coercive offers by inducing bidders to employ a type of bid that offers a greater return for shareholders. Such tactics are, however, often strenuously opposed by shareholders, who argue that they are really designed to entrench management.⁴⁰ The market bears out this reaction to some extent: There tends to be a negative effect (albeit mild) on the stock price of a company which adopts defenses, the magnitude of which depends on the precise defense adopted.⁴¹

The most obvious explanation for shareholder opposition to defensive maneuvers is that shareholders really do prefer more tender offers, at any premium, to fewer. Shareholder reaction to defensive tactics may be seen as proof that shareholders perceive a net benefit from tender offers of all kinds. The problem with this explanation is that it fails to account for the fact that the form of a tender offer appears to have a significant effect on the premium offered and paid. This discrepancy indicates that at the very least shareholders should care about the form of a bid and should welcome any good faith effort on the part of management to negotiate on their behalf. The fact that they do not calls for explanation.

Discrepant premiums indicate that there is something amiss in the market. In theory, there is no reason to expect premiums to vary according to the form of a bid.⁴² No matter what the form, the share-

40. See Easterbrook & Fischel, *supra* note 11; Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982); see also Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); see also *Holder Resolutions Against Poison Pills Win More Support at Annual Meetings*, Wall St. J., May 13, 1988, at 6, col. 1; *Poison Pill Challenge Loses*, N.Y. Times, Apr. 15, 1987, at 23, col. 3 (natl. ed.). For a detailed description of one such fight, see *Santa Fe Southern's Annual Meeting Features "Landmark" Poison Pill Vote*, Wall St. J., May 24, 1988, at 10, col. 1; *Santa Fe Southern Holders Vote to Kill Poison Pill, Against Management Wishes*, Wall St. J., May 25, 1988, at 3, col. 2; *Santa Fe Southern Faces Thorny Issue of Whether to Accept Vote on Poison Pill*, Wall St. J., May 26, 1988, at 10, col. 1. See generally P.L.I., SHAREOWNER ACTIVISM: THE EMERGING ROLE OF INSTITUTIONAL INVESTORS (1987) [hereinafter SHAREOWNER ACTIVISM]. But see Carney, *supra* note 2; Carney, *Two-Tier Tender Offers and Shark Repellents*, 4 MIDLAND CORP. FIN. J. 49 (1986) [hereinafter Carney, *Two-Tier Tender Offers*].

41. SEC, Office of the Chief Economist, *Shark Repellents: The Role and Impact of Antitakeover Charter Amendments*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,714 (Sept. 7, 1984).

42. See Leebron, *supra* note 5, at 175-77 (noting anomaly that greater target shareholder gains are associated with tender offers than with mergers); Gilson, *Evaluating Dual Class Com-*

holder ends up with something that is readily measured in cash. In an any-or-all bid, tendering shareholders receive cash or other securities or some combination, while holdouts keep the stock they had. In a partial bid, the shareholder receives some cash and is left with some stock which can be sold for cash. The end result can quite easily be translated into cash. So why would the two results differ? That is, why would the shareholder be influenced to accept a lesser overall price simply because the bidder has chosen to employ a coercive bid? The usual answer is coercion itself, but that is not a wholly satisfactory explanation once it is understood *by shareholders* that the form of the bid affects overall returns. Why, after all, would even the first shareholder willingly accept an offer which it is known will turn out to be inferior? And, by the same token, why would a bidder ever fail to use a two-tier or partial bid if shareholders are willing to accept such offers?

An alternative explanation seems more likely, namely, that some shareholders do in fact receive higher premiums than others and that the blended premium paid in a coercive offer is in reality the second tier of an offer which began with private purchases prior to the public offer at the advertised first-tier price or an even higher price. This explanation could account for a systematic difference in premiums offered from one sort of offer to another, as well as for bidders' ability to succeed at lower premiums in two-tier and partial offers. If shareholders realize that a disproportionate share of the available aggregate premium has been paid to earlier tenderers, they may settle for a smaller premium, not because they are happy with it, but because they believe that a higher premium cannot be negotiated. Similarly, shareholders may oppose defensive tactics designed to avert partial and two-tier offers because such maneuvers may have the same effect. In other words, shareholders may recognize that a partial or two-tier offer is the best that can be expected under particular circumstances. This possibility suggests still another reason why coercive offers have not been banned.

C. The Open Market Alternative to Regulated Tender Offers Makes Banning Coercive Offers Futile

Probably the most serious objection to a rule prohibiting coercive offers is that a bidder could easily avoid the rule by purchasing stock

mon Stock: The Relevance of Substitutes, 73 VA. L. REV. 807 (1987) (arguing that since dual-class capitalization and management buyouts result in public shareholders receiving similar post-transaction investments, explanation for discrepant returns must be found somewhere other than in form of transaction).

on the open market or privately from larger shareholders (unless of course the rule were combined with a seemingly unacceptable additional rule that required all large purchases to be made by tender offer). Thus a rule against partial or two-tier bids would accomplish little and might do considerable harm since it would induce more bids designed to circumvent the Williams Act which might also deny many public shareholders the opportunity to tender.

Professor Romano has offered a related explanation for why institutional investors frequently oppose charter amendments designed to discourage partial and two-tier bids. As she points out, it is well known that many tender offers begin with open market or private purchases designed to establish a beachhead from which to launch a public offer.⁴³ Any shareholder who can expect regularly to be able to sell all of his or her shares at the first-tier premium without risking the possibility that only some shares will be accepted pro rata at the first-tier price (the usual treatment faced by smaller public shareholders) will naturally oppose any effort to curtail such offers. Indeed, if the first-tier price tends to be higher than the average premium offered in an any-or-all offer, such a shareholder will clearly prefer two-tier offers. Moreover, such a shareholder may even take steps to discourage the payment of too high premiums to other shareholders because of the recognition that there is only a finite amount of premium money to go around and that some of that which would go to relatively weakly positioned target shareholders can easily be diverted without jeopardizing the success of the offer.⁴⁴

Professors Easterbrook and Fischel have made a similar point in connection with shareholder voting. As they note, the standard one-share-one-vote model, which, at least until the recent past, had been followed by virtually all exchange-traded companies, serves in most situations to minimize agency costs by eliminating the ability of any one group of shareholders to make or force management decisions which serve their particular constituency to the detriment of other shareholders.⁴⁵ Though their main point in this regard is that distributing hold-up potential or veto power too broadly creates difficulties in negotiation or conflict resolution generally, it seems a necessary corol-

43. See Freund & Easton, *The Three-Piece Suit: An Alternative Approach to Negotiated Corporate Acquisitions*, 34 BUS. LAW. 1679 (1979); Tobin & Maiwurm, *Beachhead Acquisitions: Creating Waves in the Marketplace and Uncertainty in the Regulatory Framework*, 38 BUS. LAW. 419 (1983); see also André, *Unconventional Offers Under the Williams Act: The Case for Judicial Restraint*, 11 J. CORP. LAW 499 (1986).

44. See Grundfest, *supra* note 3.

45. Easterbrook & Fischel, *supra* note 39; see also Leebron, *supra* note 5.

lary that anyone who has hold-up power, as a large holder of target shares might, is likely to use it.

This account of coercion may at first seem overly ornate. Yet given the bad name which partial and two-tier offers have had from the beginning, it seems difficult to believe that a bidder would ever employ a two-tier bid which effectively holds itself out as inferior.⁴⁶ It would seem more sensible, if only for purposes of public relations, to average the two premiums and offer a single price for the remainder of the shares.

There are at least two possible explanations for the survival of coercive bids. One is that the form of the bid is a method of advertising the strength of the bidder's position to target shareholders. It would be far easier, of course, for the bidder simply to state the effective or blended premium offered in the form of an any-or-all bid. But as previously noted, shareholders naturally suspect that any bidder is willing to pay more, that is, that the initial offer may be a "low ball" bid which will allow the bidder to capture more of the gains than necessary to go ahead with the deal. However, by electing to structure the bid as a two-tier or partial offer, the bidder sends a signal that the price being offered, though lower than normal, is the best bid that is likely to be made, or that some of the aggregate premium being offered has already been diverted to early sellers. Thus the use of a "coercive" bid may be seen as a perverse form of bonding: The bidder chooses to employ a bid that on its face ought to be less appealing to shareholders, thus convincingly conveying the message that the offer is not likely to be raised by the bidder or bettered by another.

The data lend support to this explanation. The fact that bidders on average make only ordinary returns means that excess returns must be directed elsewhere.⁴⁷ If excess returns appear to be smaller in coercive bids, it must be because some part of the excess has been siphoned off. Perhaps more to the point, if bidders only make ordinary returns, they are likely to be much more reluctant to assume additional risk. The risk a bidder takes is not easily diversified. Although a shareholder can indulge a hunch and wait for a better bid even if by doing so some

46. This, together with the ready availability of junk bond financing (see note 30 *supra*) may explain to some extent the less frequent use of two-tier offers by third-party bidders recently, but the fact that such bids are known to be inferior to other bids remains inconsistent with their use and success in connection with defensive buyout bids and dual class recapitalizations by management. See Grundfest, *supra* note 3; Gilson, *supra* note 42. One possible explanation, however, is that shareholders expect lower premiums in management buyouts because the bid need not be high enough to satisfy management itself (or overcome any defenses since none will arise). See generally Booth, *supra* note 26.

47. See note 24 *supra*.

bids are lost altogether, a bidder can ill afford such luxuries: The bidder requires considerable up front investment to locate a target and mount a bid.⁴⁸ Yet employing an apparently coercive two-tier bid, which in effect announces that the price to be paid is inferior to the price that would be offered by an any-and-all bidder, would seem to be an unnecessary risk (assuming that anyone who makes a tender offer has a genuine interest in seeing it succeed).⁴⁹ There must be some benefit associated with using such an offer. The benefit is most likely that shareholders are for some reason more inclined to accept it. Thus, there is even greater reason to believe a two-tier offer is an indication of an earlier bribe and that a coercive offer somehow conveys information about the adequacy of the price being offered.

The disproportionate use of two-tier bids in such circumstances may also be explained as an effort to portray the offer as fairer than it really is. Conceivably, an offer that did not throw a bone to the public shareholders by soliciting some publicly held shares at prices as high as those paid to true first-tier offerees might be enjoined under state law on a theory akin to that of *Pelzman v. Feldmann*, namely, that it is illegal for controlling shareholders to sell control at a premium without sharing the premium with the public shareholders.⁵⁰ The fit is not exact, of course, since first-tier offerees are by definition not controlling shareholders. Nevertheless, one could fairly characterize a private first-tier offer as a bribe to a select few shareholders who are in a position to make or break an offer.

The foregoing explanations may seem somewhat Byzantine, but they are not out of proportion with the phenomenon they seek to explain, namely, that shareholders accept bids that are effectively advertised as inferior. There is a surprising amount of evidence, albeit anecdotal, that these explanations are at least partially correct. In one notable case, a target company which had initially opposed a tender

48. T. COPELAND & J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 609-10 (2d ed. 1983); Easterbrook & Fischel, *supra* note 11, at 1178-79; Berg, *Talking Deals: Premium's Size in Takeovers*, N.Y. Times, Nov. 26, 1987, at 30, col. 1 (natl. ed.). The trade-off between protecting the bidder's interest in information about an attractive target and maximizing the price paid to target shareholders is discussed at length in a trilogy of articles. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982). Cf. Leebron, *supra* note 5, at 194-97 (discussing possible reasons why auction might not arise).

49. This is not always the case. Sometimes, perhaps often, an initial bidder is primarily interested in greenmail or inducing the target to find a white knight to whom the bidder's shares may then be tendered at a profit. See Stewart & Herzberg, *Cutting Corners: Secret Dealing Helped Paul Bilzerian Make Takeover Bids Work*, Wall St. J., May 19, 1988, at 1, col. 6. Yet even in such cases the form of the bid ought to affect its credibility.

50. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

offer, acquiesced when it became apparent that the offer would succeed.⁵¹ Bidder and target thereupon agreed that the original offer would be cancelled and that a new offer on similar terms would be made, thereby allowing additional shareholders of the target to tender their shares. The effect, however, was to reduce the proportion of shares purchased from shareholders who had tendered earlier. The Supreme Court ruled that such a tactic did not constitute manipulation under the Williams Act and that the shareholders were not entitled to relief. The relevant point for present purposes is that the tendering public shareholders received a smaller premium because of increased proration owing to intervening sales by a presumably more powerful and better organized shareholder group.

In a slightly different vein, the SEC has recently seen fit to adopt a rule that requires tender offers to be made to all shareholders.⁵² Admittedly, the impetus for the rule was the perception that a target could unfairly defend itself by making a tender offer for its own shares excluding those of the hostile bidder (as occurred in the battle for Unocal⁵³). Nevertheless, it is difficult to believe that the advantages of making a higher offer to some shareholders rather than a lower offer to all shareholders were not noticed earlier. Furthermore, the SEC has recently proposed a rule against "street sweeps," or the purchase of large blocks of shares from market professionals during or shortly after a tender offer.⁵⁴ Here too, the primary concern is unequal treatment. The worry is that public shareholders are not afforded the same opportunity to sell their shares that market professionals enjoy.

There is no reason to assume that favored treatment of certain stockholder groups does not also occur before a bid. There are ample data indicating that markets rise for days before a bid is publicly announced.⁵⁵ The simplest explanation for the typically observed pre-

51. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985).

52. Exchange Act Rule 14d-10, 17 C.F.R. § 240.14d-10 (1987).

53. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). The rule has been criticized as beyond the SEC's authority. See FERRARA, *supra* note 2, at 79-83; Comment, *Creeping Federalization of Corporate Law: Unocal Corp. v. Mesa Petroleum Co. and the All-Holders Rule Under the Federal Securities Laws*, 12 DEL. J. CORP. L. 563 (1987); see also note 5 *supra*.

54. See *Acquisitions of Substantial Amounts of Securities and Related Activities Undertaken During and Following a Tender Offer for Those Securities*, Exchange Act Release No. 24,976, (Oct. 1, 1987) [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84, 160.

55. See *Carney*, *supra* note 25, at 891-93; Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981); SEC, Office of the Chief Economist, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?* (Feb. 24, 1987) (legitimate speculation explains much of pre-announcement run-up); see also *The SEC's Fight with Itself*, Wall St. J., Mar. 19, 1987, at 34, col. 1 (editorial); *Unusual Stock Moves Continue to Raise Questions About Leaks*, Wall St. J., Feb. 6, 1987, at 23, col. 4.

bid run-up is, of course, insider trading. It is likely, however, that the bidder's pre-announcement purchases in the open market are noticed by professional traders — if for no other reason than the increase in volume that they generate — and that the bid is thus anticipated by many traders who know nothing in particular about it (much as Vincent Chiarella, the now famous (and acquitted) financial printer divined the encoded targets in the tender offer forms he helped print⁵⁶). Indeed Professors Gilson and Kraakman have named this process “derivatively informed trading.”⁵⁷

Sometimes, perhaps more often than not, takeover bids are conceived and promoted by investment bankers who have no interest in assuming managerial control of the target company. That is, shares are frequently amassed in anticipation of finding someone to bid. It has been suggested that this trend developed because the merger and acquisition departments of investment banks had grown too large to depend solely on deals proposed by others.⁵⁸ There is nothing particularly surprising, or necessarily sinister, about investment banks seeking to generate more of what has become a very profitable business. The point is that one would expect a good deal of activity to occur before a bid is publicly announced. And since maximizing profit depends on reselling as many acquired shares as possible at the highest possible price, one would expect a professional takeover intermediary, be it an investment bank or arbitrageur, to seek to sell its shares outside a two-tier offer or wholly in the front end. Indeed, if public shareholders are averse to proration, it stands to reason that professional traders will do all they can to avoid it.

There is thus every reason to think that institutional investors, who have been quite vociferous in their opposition to shark repellent amendments and other measures designed to reduce the incidence of partial and two-tier bids,⁵⁹ have taken steps to capture a disproportionate share of first-tier bids. Their efforts to seek and obtain reduced brokerage commissions while the rates were still supposedly fixed and their efforts to share in underwriting discounts in connection with new issues despite industry rules that required all public sales of securities to be at the same price are notorious and have led to legislation and rulemaking designed to confine such favored treatment to so-called

56. *Chiarella v. United States*, 445 U.S. 222 (1980).

57. Gilson & Kraakman, *supra* note 25, at 572-79.

58. See *Investment Bankers Feed a Merger Boom And Pick Up Fat Fees*, Wall St. J., Apr. 2, 1986, at 1, col. 6.

59. See note 40 *supra*.

“soft dollar” discounts.⁶⁰ Why should things be different when it comes to tender offers?

To sum up, shareholders may not benefit from all tender offers; in fact, the true problem of coercion seems likely to infect all offers as well as those that are coercive in form. While competition will likely mitigate or eliminate the effects of coercion in many cases, the fact remains that premiums are demonstrably lower in coercive bids. The upshot would seem to be that partial and two-tier offers are not so much the cause of coercion as they are an expression of the fact that premium money has been siphoned off by early tenderers. In short, there seems to be nothing to the threat of a coercive bid other than the well advertised possibility of a smaller gain. Even if one is disinclined to believe such a story, one can see that banning partial or two-tier offers would have little effect but to induce bidders to direct their pre-offer efforts and larger premiums to more substantial shareholders. The proposed SEC rule governing street sweeps, it bears noting, suffers from the same defects, suggesting perhaps that all sales of significant blocks of shares should be regulated as tender offers. Yet, federal regulation of private sales is difficult to imagine given the firmly entrenched philosophy of disclosure and the equally strong revulsion for substantive (or merit) regulation. The implication thus would seem to be that the tender offer process cannot be controlled by rules like the Williams Act. Indeed, the Williams Act may well cause some of these problems.⁶¹ What shareholders need instead is some sort of collective

60. See Steele & Lawton, *Soft Dollar Practices*, 19 REV. SEC. & COMM. REG. 207 (1986); see also *Pension Funds Feud with Money Managers Over Brokers' Rebates*, Wall St. J., Oct. 4, 1984, at 1, col. 6. Similarly it appears that some investors are routinely favored over others in connection with the allocation of attractive new issues of securities. See *The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures*, Exchange Act Release No. 9671, 2 Fed. Sec. L. Rep. (CCH) ¶ 4506B (July 26, 1972); Miller & Monroe, *Trading at Time of Stock Offerings Raises Questions of Manipulation*, Wall St. J., Apr. 1, 1987, at 31, col. 4. Coincidentally, similar practices have recently come under fire in connection with the distribution of junk bonds to finance takeovers and buyouts. Smith, *How Drexel Wields its Power in Market for High-Yield Bonds*, Wall St. J., May 26, 1988, at 1, col. 6; Nash, *"Junk Bond" Policy Shift at Drexel*, N.Y. Times, May 5, 1988, at 29, col. 3 (natl. ed.); Subcommittee Members, *Drexel Clash on Drexel Officials' Trading Junk Bonds*, 20 Sec. Reg. & L. Rep. (BNA) No. 17, at 636 (Apr. 29, 1988); Milken Pleads Fifth to Questions on Drexel Officials' Personal Bond Deals, 20 Sec. Reg. & L. Rep. (BNA) No. 17, at 640 (Apr. 29, 1988).

Ironically, but not surprisingly, existing and proposed definitions of insider trading on the basis of nonpublic market information about planned tender offers exclude sales to the bidder itself. Sec. Exch. Act Rule 14e-3, 17 C.F.R. § 240.14e-3 (1987); *SEC Submits Draft Legislative History to Accompany Insider Trading Proposal*, 20 Sec. Reg. & L. Rep. (BNA) No. 7, at 252, 279 (text) (Feb. 19, 1988). See also Banoun & Beier, *Warehousing and Parking*, 21 Rev. Sec. & Comm. Reg. 39 (1988).

61. See Concept Release on Takeovers and Contests for Corporate Control: Advance Notice of Possible Commission Actions, Exchange Act Release No. 23,486, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,018, at 88,201 (July 31, 1986) [hereinafter SEC Concept Release]; *Expropriation at Home*, Wall St. J., Oct. 9, 1987, at 18, col. 1 (editorial); R. Booth, *supra* note 5.

bargaining mechanism that allows them to extract some of the premium from true first-tier offerees.⁶² As will be seen, the Indiana Control Share Acquisition Chapter is exactly that.

D. *A Ban on Coercive Offers Would Protect Larger Companies Which Benefit Most from the Discipline of Takeover Threats*

Fairness to shareholders aside, a rule against partial bids might unduly favor the incumbent management of larger companies. Even if a bidder ought to be able to borrow to finance the acquisition of a company that will be worth more after the takeover, it will be more difficult to put together the financing for larger deals.⁶³ Moreover, bigger targets and their shareholders are likely to be less susceptible to coercion. Coercion, after all, depends on the bidder's ability to pay a larger premium to early tenderers and to recoup the excess premium from holdouts either by operating the acquired company as a captive or by cashing out the remaining minority at a price which is depressed because of the threat of captive operation. Bigger companies are, other things equal, less susceptible to such threats. Bigger, more mature and established businesses are more likely, essentially, to run themselves. The bigger the business, the more likely it is to be internally diversified and thus resistant to operational changes that can reduce its value.⁶⁴ Bigger companies are more actively traded and thus more efficiently priced. Similarly, bigger targets are less likely to increase or decrease dramatically in value for any reason, be it technological breakthrough or operation as a captive subsidiary.

Admittedly, the motivation for many takeovers seems to be precisely that the target is overly diversified. Otherwise, the so-called bust-up takeover would not have gained the prominence that it has.⁶⁵

62. See SEC Advisory Comm. on Tender Offers, *supra* note 28. Professor Carney and Professor Coffee have offered a slightly different explanation for why some shareholders may be more eager to tender and others more worried about coercion: Some shareholders are less diversified than others and thus more concerned with the fortunes of particular companies. See Carney, *Two-Tier Tender Offers*, *supra* note 40, at 51-53; Coffee, *supra* note 10, at 67-81. Baysinger & Butler, *supra* note 32, have also argued that the established relations some shareholders have with target companies lead them to support takeover defenses. See also Booth, *supra* note 26 (fact that management has undiversified investment may generate genuine difference of opinion as to value of company and potential for real gain from going private). However, no one has as yet offered a very convincing explanation of why an investor (purely as an investor) would prefer to be less than fully diversified. See Coffee, *supra* note 10, at 67-68. *But see* note 32 *supra*.

63. SEC, *The Economics of Partial and Two-Tier Tender Offers*, *supra* note 4, at 86,923-24. *But see* note 30 *supra*.

64. See Fama & Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983).

65. See Lipton, *supra* note 2; Lipton, *Greenmail, Bust-Up Takeovers — A Discussion Memorandum*, N.Y.L.J., Sept. 7, 1984, at 1, col. 4.

In short, despite the earlier teachings of the business schools, diversification may not always lead to higher value when real assets rather than financial assets are involved.⁶⁶ It is sometimes also argued that stocks of diversified companies are systematically undervalued because, since it is relatively cheap to diversify a portfolio of stocks, any effort to diversify across lines of business at the firm level is more costly and denies the investor the option to structure his or her portfolio as he or she pleases. Additionally, analysts who follow diversified companies, it is argued, tend to specialize in the industry from which the company grew and have less appreciation for the value of other lines of business.⁶⁷ But the most likely explanation for why bidders prefer diversified companies is that the managers who carried out the diversification were motivated more by empire building than by profitability.⁶⁸

The idea that a diversified company may be more resistant to takeover, then, requires explanation. Diversification comes in many forms. Diversification across lines of business seems to have led to the takeover of many companies.⁶⁹ However, a business may also be diversified simply by virtue of bigness which may, for example, allow the business to self-insure against some risks, thus raising profitability.⁷⁰ But there is more to diversification than economies of scale. For example, a business may be diversified by having a wide range of customers who themselves may be in a variety of businesses, rendering the supplier business less susceptible to volatility in its return. These sorts of diversification are clearly value-enhancing in that they reduce costs,

66. See Coffee, *supra* note 10; Wayne, *Management Gospel Gone Wrong*, N.Y. Times, May 30, 1982, § 3 (Business), at 1, col. 2. The Supreme Court itself in *CTS* expressly recognized growing doubts about the value of diversification of real assets: "[T]here is no reason to assume that the type of conglomerate corporation that may result from repetitive takeovers necessarily will result in [sic] more effective management or otherwise be beneficial to shareholders." 107 S. Ct. at 1651 n.13 (emphasis in original). In the context of *CTS*, this statement must be interpreted as supportive of more restrictions on takeovers. It is, however, an equally good argument for a less restrictive regime with respect to those companies that are or are more likely to be overly diversified. Thus it seems all the more clear that what is needed is a flexible regulatory scheme which respects the different attributes of different companies.

67. See Brooks, *Some Concerns Find that the Push to Diversify Was a Costly Mistake*, Wall St. J., Oct. 2, 1984, at 33, col. 4.

68. Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238 (1979). As I sketch elsewhere, finance theory suggests that some companies may be systematically undervalued in the market in the sense that they generate more return for less risk than the market will recognize for purposes of portfolio construction and management. For such companies — and there are presumably few if any of them — empire building may be acceptable at least in terms of market effects. See Booth, *Junk Bonds, the Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553.

69. See note 66 *supra*.

70. See Fama & Jensen, *supra* note 64.

in the case of economies of scale, and the fluctuation or volatility of returns, in the case of customer diversity. Thus, other things being equal, these companies will find their stock valued higher in the market.⁷¹ In short, firms are better at some kinds of diversification and markets are better at others. Of course, the very fact that a smaller company tends to be less diversified may mean there is more to be gained by diversifying it, and thus more reason for its takeover and less reason for nonchalance in connection with its management's self-defense. But aside from the fact that takeovers appear to be more motivated by the opposite problem of too much diversification, there is no reason whatever to think that the management of a smaller, developing company fails to appreciate the value of diversification or will fail to pursue it with alacrity. And given that diversification across lines of business has apparently prompted many takeovers, there is every reason to suspect the ability and motive of the bidder in the same connection.

Professor Gilson has recently argued in a somewhat different context that a company's choice of particular takeover defenses may be dictated by its stage of development.⁷² He notes that mature companies are more likely to go private — an advance or preemptive defense — while growing companies are more likely to issue nonvoting stock or to undergo a recapitalization that reduces the voting rights of public shareholders while preserving the option of raising additional equity capital.⁷³ As Gilson points out, the two transactions are quite equivalent in the sense that outside shareholders end up with an investment, whatever it may be called, that amounts to nonvoting common stock.⁷⁴

Gilson surmises that the differing preferences are the result of differing agency costs present in the two types of firms. In the mature firm with few growth prospects and little need for new capital, management may be tempted to slack off and extract high salaries and benefits. Management need not please its shareholders except in order to avoid a takeover. In a company with growth potential, however, management appreciates the value of a dollar (as the saying goes). In such a company, management's interests are likely to coincide with that of the shareholders. Not only is there every reason to keep the shareholders happy and the stock's price up in order to raise needed

71. On the relationship between risk and return, see generally J. LORIE, P. DODD & M. KIMPTON, *supra* note 32, at 13-24.

72. Gilson, *supra* note 42.

73. *Id.* at 823-32.

74. *Id.* at 811-15.

new capital at the lowest possible price, there are also good reasons to work hard and to keep salaries and perquisites to a minimum if such forgone consumption can, in effect, be reinvested in the company itself at presumably attractive returns, to be withdrawn later as deferred compensation.⁷⁵ The preference of mature companies and their shareholders for management buyouts and of growth companies and their shareholders for dual-class capitalization can thus be understood as a direct result of differing agency costs. The shareholders in the growth company are unconcerned about management's agenda and are relatively happy to trade in their voting stock for nonvoting stock, while the shareholders in the mature company require a firmer commitment, either in the form of junk bonds or cash, because they have reason to suspect management's enthusiasm.⁷⁶

The differences that Professor Gilson has outlined apply equally well to takeover defenses generally: If managers of growing companies have few conflicts of interest with their shareholders, they are much more justified in resisting a takeover. Moreover, the takeover is more likely to depend on coercive techniques, since the offered premium is less likely to be justified by slack management under the current regime. At the very least, there is reason to believe that the problem of coercion is not the same for every potential target company. Indeed, for larger companies it may be no problem at all.

III. DEFENSIVE RESPONSES TO COERCION

While it is somewhat artificial to describe as coercion a shareholder's inclination to sell out for less than the maximum premium, it is not an unreasonable characterization, given that nothing really matters to an investor other than risk and return. Most investors understand fairly well that the market cannot be beaten without inside information.⁷⁷ Thus, when a bidder offers a premium, there is no good reason not to take it, and there is certainly no good reason to wait for the smaller back-end premium if the bid is likely to succeed in shifting control. In other words, that target shareholders might benefit from some sort of mechanism which allows them to recapture the extra part of the aggregate premium that true first-tier offerees receive is no reason *not* to take an inferior bid, provided there are reasons to believe the inferior bid is the best that can be expected.

Standing alone, the possibility that shareholders might reap too lit-

75. *Id.* at 815-32.

76. *Id.* at 823-27.

77. See J. LORIE, P. DODD & M. KIMPTON, *supra* note 32, at 65-77; Bebchuk, *The Pressure to Tender*, *supra* note 2.

tle from takeovers (and that the capital markets are rendered marginally inefficient) is not a particularly convincing reason for additional regulation or substantial reform. But reduced returns for shareholders are not the only cost of coercion. In some cases, part of the motivation for a takeover can come from the ability of a bidder to cancel or renegotiate contracts with managers, employees, or other groups, or to undertake strategies that transfer wealth away from senior creditors. As Professor Coffee has argued, legitimate claims against the corporation may be compromised for the benefit of shareholders. His argument is not simply that communities, for example, may be hurt by business dislocations and consequent unemployment and loss of tax basis — though those are certainly real costs which are usually ignored in the academic debate over the wisdom of takeovers. Rather, Professor Coffee's focus is on managers who may be forced out without compensation in the event of a successful takeover. He argues that managers depend on deferred compensation, which they have, in effect, accepted as a sort of bond insuring their best efforts on behalf of the shareholders. Thus, a hostile takeover may be an opportunity for shareholders to renege on their end of the deferred compensation deal: The bidder effectively bribes the target shareholders to sell out management and pays the bribe from part of the savings generated by cancelling deferred claims.⁷⁸

Viewed as a financial claim on the firm, the manager's interest may be likened to a large, undiversified (and undiversifiable) investment. Since the manager cannot diversify (in most cases he or she will not be wealthy enough to invest in several different ventures to the extent of his or her implicit investment in the firm in question), the potential target manager (and all companies are potential targets) is forced to bear more risk than the shareholders, who can easily diversify, and is legitimately motivated to take extraordinary steps to reduce that risk, as by adopting takeover defenses. As Coffee points out, similar arguments can be made for other constituencies such as employees and bondholders.⁷⁹ Presumably each of these groups has a legitimate in-

78. See Coffee, *supra* note 10, at 23-24.

79. See *id.* at 16-24; McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988); Murdoch, Sartin & Zadek, *Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles*, 43 BUS. LAW. 1 (1987); Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27 (1987); Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491 (1987); Booth, Book Review, 57 U. CIN. L. REV. (forthcoming) (reviewing FERRARA, *supra* note 2); Much & O'Dea, *LBOs and the Risk of Fraudulent Conveyance*, Natl. L.J., Nov. 3, 1987, at 36, col. 1. A recent study by Commissioner Grundfest of the SEC apparently indicates, however, that tenders offers do not in fact reduce the wealth of securities holders other than stockholders. See *Grundfest Says Study Shows Takeovers Sharply Increase Shareholder Wealth*, 19 SEC. REG. & L. REP. (BNA) No. 39, at 1487 (Oct. 2, 1987).

terest in preserving its stake in the company. For example, a manager who has agreed to assume a position with the target company and has agreed to defer a portion of his or her compensation as a way of bonding performance, has every legitimate interest in preventing the company from breaching the deal. Although it is arguable that target managers' efforts to thwart takeover of the company constitute self-dealing and thus violate their fiduciary duties to maximize shareholder wealth and forgo self-aggrandizement, managers also have a contract with the company on which the company has a duty to perform. Presumably, management's job is to see that *this* contract, like other contracts, is fulfilled. On the other hand, it can also be argued that it should be up to management to anticipate such risks and negotiate for contractual protections.

Aside from management's legitimate self-interest in avoiding takeover in some circumstances, management does not and should not reason in the same way a passive (and diversified) investor reasons in reacting to a takeover attempt. Whether one focuses on the manager's desire to keep her job in the present or to keep it long enough to enjoy whatever deferred compensation may be expected, both of which are legitimate goals within limits, management's stake in the company is a nondiversified investment and is not valued the way a passive investor in financial instruments would value it. Management's concern is not with how its investment performs after being averaged with a collection of other investments. Rather, management's goal is to maximize the value of the real assets under its charge. And shareholders expect management to do just that, notwithstanding the fact that the investment is ordinarily *priced* in the market by the interaction of investors who only care about its value as part of a portfolio.⁸⁰ Even if it is somewhat artificial to say that a shareholder can be coerced by a premium that is too small, *management* certainly can be coerced by a bidder who offers a small premium to target shareholders who are effectively compelled to accept it. Thus, as matters currently stand — at least under federal law — partial and two-tier bids remain legal and target management must protect itself, the shareholders, and the company against coercive bids as well as take an active role in negotiating, by means of defensive tactics or otherwise, the highest price possible.

Early takeover defenses were simple and innocuous by today's

80. See Coffee, *supra* note 10, at 68-73. Regarding the importance of diversification as a matter of investment strategy, see J. LORIE, P. DODD & M. KIMPTON, *supra* note 32, at 132-43. As for the idea that management (or other constituencies for that matter) may place a different value on an enterprise because they hold a nondiversified investment in it (usually necessarily), see Booth, *supra* note 26; Carney, *Two-Tier Tender Offers*, *supra* note 40; Gilson, *supra* note 42.

standards. Many companies adopted charter amendments which required any second-step merger be consummated at a fair price or at the same price paid in the front-end tender offer, or which required a supermajority vote to approve a merger, or both.⁸¹ Such charter amendments were reasonably effective against two-tier offers. But they were arguably redundant where state law provided for careful judicial scrutiny of the terms of second-step mergers or allowed the remaining shareholders to vote on the adequacy of the offer.⁸² And none of this did anything to discourage partial offers. If a bidder was content to gain control and to postpone any merger indefinitely, these defenses and protections were neutralized. And indeed, for that reason they may have encouraged partial bids. There are, however, at least two tactics — both severely criticized — which are quite effective against partial bids.

A. *Greenmail*

The first tactic, which predates even the Williams Act, is greenmail, or the repurchase by a target company — typically at a premium — of the target stock acquired by a bidder or potential bidder.⁸³ The potential abusiveness of greenmail is easy to see. Not only are remaining target shareholders denied the opportunity to tender at a profit in the offer that is averted, but target management typically uses corporate funds — shareholder wealth — to buy off the bidder.⁸⁴ Target shareholders thus appear to lose twice. Partial bids, however, offer at least a theoretical justification for greenmail. Greenmail may serve the interests of holdout shareholders if they stand to lose more by a transfer of control than the premium they must pay the bidder to desist. The fact that greenmail can be beneficial to shareholders is consistent with empirical evidence. Although often the price of the target's stock declines after a repurchase to a level below that prevailing before the greenmailer began buying, on the average the decline in price is remarkably slight, and in many cases the stock continues to trade at prices higher than before the greenmailer began purchasing.⁸⁵

81. See SEC, *Shark Repellents: The Role and Impact of Antitakeover Charter Amendments*, *supra* note 41.

82. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); Booth, *The New Law of Freeze-Out Mergers*, 49 MO. L. REV. 517 (1984).

83. See *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964).

84. See FERRARA, *supra* note 2, at 413-23; Lipton, *supra* note 2; Gilson, *supra* note 3; Macey & McChesney, *supra* note 3; Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 (1985).

85. See Macey & McChesney, *supra* note 3, at 43-48. *But see* SEC, Office of the Chief Economist, *The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices, [1984-85 Transfer*

The fact that greenmail may serve a legitimate end is, however, nothing to celebrate. It means that target management is largely free to use the device whenever a colorable case for potential coercion can be made out. And that means that management is largely free to use greenmail to preserve its control regardless of detriment to shareholder wealth. It is thus impossible to generalize about the benefits or harms of greenmail. The one thing that does seem certain is that as long as partial and two-tier tender offers are legal, greenmail *can* be beneficial from a shareholder point of view. Quite clearly, however, it would be preferable to regulate tender offers directly in a way that would eliminate the abuses — both offensive and defensive — that arise from partial and two-tier bids, rather than scrutinize on a case-by-case basis the responses devised by (or for) target managers.

B. *Poison Pills*

A more recent but equally criticized defensive tactic is the evil-sounding poison pill.⁸⁶ With a typical poison pill, the target distributes to shareholders a dividend of warrants which gives each shareholder the right, in the event a hostile bidder acquires a fixed percentage of the target's stock, to buy additional shares of the company at a discount, possibly even below the market price prevailing before a bid is announced.⁸⁷ A bidder who acquires 50% of a company which has distributed rights for the purchase of, say, five discounted shares for each share held, would find that the remaining shares together with the triggered rights now constitute a 300% interest relative to the bidder's stake, reducing what appeared to be an acquired 50% voting position to approximately 14%. Faced with such a poison pill, the bidder would need to acquire something between 85% and 90% of the target's stock (together with the warrants attributable to it) to be assured that the holdouts would not be able to retain control of the company. In effect, a poison pill operates like a supermajority voting requirement, except that it works not only in

Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,713 (Sept. 11, 1984); Forman, *Greenmail Isn't Always Blackmail*, Wall St. J., May 7, 1987, at 30, col. 3.

86. See FERRARA, *supra* note 2, at 337-74; Dawson, Pence & Stone, *supra* note 3; Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, *supra* note 3; SEC, Office of the Chief Economist, A Study on the Economics of Poison Pills, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,971 (Mar. 5, 1986). It has been suggested that the Supreme Court's decision upholding the Indiana takeover law may actually have encouraged a new form of poison pill. See Labaton, *Business and the Law: More Potency for Poison Pills*, N.Y. Times, July 20, 1987, at 22, col. 1 (natl. ed.). On the other hand, the availability of pre-packaged state takeover laws may encourage the courts to strike down customized defenses. See text at note 225 *infra*.

87. See *Gearhart Indus., Inc. v. Smith Intl., Inc.*, 741 F.2d 707 (5th Cir. 1984).

connection with a merger but also in the ordinary exercise of other control devices, such as voting for directors.

While one might object to a poison pill simply because it is designed to thwart takeovers, the typical poison pill does not block a takeover if the bidder is willing to buy a large enough percentage of target shares. Few if any investors would exercise their warrants if the bidder appeared likely to succeed. To do so would simply result in holding a larger minority interest under the bidder's control. Thus, the successful bidder is not likely to find that after paying for, say, 90% of the target there remains another 60% to freeze out (that is, the original 10% together with the additional "50%" of the stock that the 10% holdouts could have purchased in the example given). And even if the bidder did find that the holdouts had all exercised their rights, there would always remain the option simply to cancel the second-step merger. Thus, from the target shareholder's point of view, exercising one's warrants in connection with a bid that is likely to succeed is equivalent to opting into the neglected end of a partial tender offer.⁸⁸

The more serious objection would seem to be that the typical poison pill allows holdout shareholders to buy additional shares at bargain basement prices.⁸⁹ Such a tactic might at first seem every bit as objectionable as the target's selling off valuable assets. On reflection, however, it seems apparent that the poison pill simply allows the target to fight fire with fire. Partial and two-tier bids derive their coercive power from the threatened transfer of wealth from holdouts to tenderers. The poison pill may be a way of transferring the same wealth back to the holdouts — thus assuring equal treatment of all shareholders — by the simple expedient of giving the holdouts more stock.

The fact that shares are being sold or distributed for less than the price bid in the wake of the tender offer is not necessarily objectionable in circumstances where the holdouts may end up with shares worth even less than before the offer. (The same argument may also justify the sale of large blocks of stock to friendly bidders who intervene in a hostile takeover or fear that competition may arise as a result of their own first bid.⁹⁰) Admittedly, allowing sales of stock at apparently bar-

88. This risk may lower the percentage of stock a bidder must acquire in order to avoid the effects of a poison pill, since in close cases a potential holdout would probably decline to invest more in the target company.

89. See *Gearhart*, 741 F.2d 707 (5th Cir. 1984); Oesterle, *The Negotiation Model*, *supra* note 36, at 131-32.

90. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). FERRARA, *supra* note 2, at 466-85; Johnson & Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315 (1987); Lamb & Turezyn, *Revlon and Hanson Trust: Unlocking the Lock-Ups*, 12

gain prices in the context of a hostile takeover — whether in connection with a poison pill or otherwise — creates an opportunity for abuse by target managers who are willing to defend at any cost to the company and shareholders. And it may be that managers who choose to employ poison pills and other defensive sales of stock should bear the burden in court of demonstrating that the price received is fair.⁹¹ The central point remains that the mere fact stock is being sold for less than the tender offer price is not conclusive when it occurs in response to a partial or two-tier offer.

There is, however, a genuine difficulty with poison pills which has gone largely unrecognized: They allow target managers virtually full discretion to set the percentage ownership necessary for takeover. A poison pill which requires too high a percentage of shareholders to tender effectively requires the bidder to pay too much for the company. In the end, there will be fewer than the optimal number of tender offers, a lower level of investment by investors denied this aspect of return, and a higher cost of capital for business. On the other hand, investors may on balance lose less as a result of this feature of poison pills than they do when partial and two-tier bids are freely employed. In either event, it would be preferable for target managers to exercise some restraint in setting the terms of poison pills to avoid requiring a percentage offer that is too high. The problem, of course, is that it is probably impossible when adopting a poison pill to know just how much harm potential holdouts are likely to suffer in a bid that has not yet been made. Thus poison pills, like greenmail, are no doubt used to entrench management.

In the end, this aspect of balancing in the poison pill defense makes it potentially desirable. The poison pill is not an absolute bar to takeover. Rather it allows the target company to decide what percentage of stock ownership by the bidder is adequate to offset the likely harm to holdouts. Thus the initially surprising judicial response to poison pills — that they are legal as long as they are appropriate to the perceived threat⁹² seems quite sensible. Still, poison pills do have costs,

DEL. J. CORP. L. 497 (1987); Nachbar, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. The Requirement of a Level Playing Field in Contested Mergers, and its Effect on Lock-Ups and Other Bidding Deterrents*, 12 DEL. J. CORP. L. 473 (1987); Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068 (1983).

91. See *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986); *Unocal Corp. v. Mesa Petroleum, Inc.*, 493 A.2d 946 (Del. 1985); Oesterle, *The Negotiation Model*, *supra* note 36.

92. See *Moran v. Household Int'l., Inc.*, 500 A.2d 1346 (Del. 1985). *But see Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 258-59 (7th Cir. 1986) (opinion by Posner, J., arguing that threshold less than majority was by definition too low), *revd. in part*, 107 S. Ct. 1637 (1987).

as documented in another recent SEC study.⁹³ For one, they leave no room for good-faith partial offers. They may even chill the prospect of eminently fair two-step equal price offers, since in practice all target shareholders must exercise whatever rights they receive — if any exercise their rights — in order to avoid the effects of dilution in the value of pre-bid shares.

IV. STATE TAKEOVER LEGISLATION

Up to now, federal law has failed completely to deal with any of these problems. The Williams Act's antifraud and manipulation provision does not reach partial or two-tier bids or the defensive tactics that arise in response to such bids.⁹⁴ Several proposals for reform are being debated at present, and it is once again suggested that federal corporation law may be on the way in response to the perceived shortcomings of state law and stock exchange regulation.⁹⁵ But any reform at the federal level will probably follow the traditional disclosure theme and eschew any direct interference with the state law of corporations.⁹⁶ Such disclosure-based reforms seem bound to fail. The problems with tender offers have little to do with information and disclosure. They have instead to do with the distribution of gains. Dis-

93. SEC, A Study on the Economics of Poison Pills, *supra* note 86.

94. See *Radol v. Thomas*, 772 F.2d 244 (6th Cir. 1985); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984). But see *Pryor v. U.S. Steel Corp.*, 794 F.2d 52 (2d Cir.), *cert. denied*, 107 S. Ct. 445 (1986) (bidder's extension of Williams Act proration deadline held actionable); *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981) (two-tier offer held manipulative).

95. See Buxbaum, *The Threatened Constitutionalization of the Internal Affairs Doctrine in Corporation Law*, 75 CALIF. L. REV. 29 (1987); Karmel, *Will Takeover Abuses Lead to Federal Corporation Law?*, N.Y.L.J., Feb. 19, 1987, at 1, col. 1. In December, the Tender Offer Disclosure and Fairness Act of 1987 was introduced in the Senate. S. 1323, 100th Cong., 1st Sess., Dec. 17, 1987. See SENATE TENDER OFFER REPORT, *supra* note 8. The bill would, among other things, reduce the 10-day window under § 13(d) to 5 days (and prohibit additional purchases prior to filing), would require a waiting period of 60 days in the case of a bidder who first discloses a passive investment intent and then decides to make a bid for control, would increase penalties for failure to disclose, would allow the SEC to seek civil penalties of up to 50% of the value of the stock at issue, would limit greenmail by allowing the paying company to recover any premium over 3%, would require more extensive registration of arbitrageurs, would give the SEC authority to promulgate regulations regarding Chinese Walls between various departments of brokerage houses and investment banks and would increase penalties for insider trading and obstruction of insider trading investigations. See also *SEC to Impose Voting Rights Rule, Abandons Effort for Industry Agreement*, 19 Sec. Reg. & L. Rep. (BNA) No. 23, at 812 (June 5, 1987); SEC Concept Release, *supra* note 61; note 53 *supra*.

96. See SENATE TENDER OFFER REPORT, *supra* note 8, at 51-54 (rejecting both preemption of state takeover laws and imposition of federal one-share-one-vote rule); *The Battle Over Tender Offer Reform: From the States and the Courts to Congress*, 20 Sec. Reg. & L. Rep. (BNA) No. 2, at 60 (Jan. 15, 1988); *Proxmire Urges SEC to Postpone Action on Shareholder Voting Rights Proposal*, 20 Sec. Reg. & L. Rep. (BNA) No. 18, at 674 (May 6, 1988); *SEC to Delay Final Action on Disenfranchisement Proposal*, 19 Sec. Reg. & L. Rep. (BNA) No. 45, at 1719 (Nov. 13, 1987); *Senate Panel Approves Takeover Bill, Is Neutral on State Antitakeover Laws*, 19 Sec. Reg. & L. Rep. (BNA) No. 39, at 1479 (Oct. 2, 1987).

closure-based federal law as interpreted by the Supreme Court simply does not address fairness.⁹⁷

It is (or once was) arguable that the value of disclosure depends on the existence of a reasonable opportunity to negotiate or a fair market mechanism. To circumvent an open negotiation or auction, for example, by forcing a shareholder to sell in a going private merger with full disclosure but at an unfair price is arguably the equivalent of fraud.⁹⁸ The argument applies, with appropriate changes, in the tender offer context. Indeed, it is particularly strong in connection with tender offers since the Williams Act not only mandates disclosure but also sets ground rules by which the auction is to be conducted. Thus, even though it is well established that federal antifraud law applies only if some failure to disclose is shown, the Williams Act arguably reaches issues of fairness and in particular issues of fairness arising from the form of a tender offer.

The Supreme Court has, however, foreclosed any such line of development in the law. And it seems highly unlikely that any congressional fine-tuning of either disclosure rules or ground rules can give the federal courts the authority to fashion creative remedies for the problems of coercion.⁹⁹ It is also far from clear that it would be desirable to rework the Williams Act ground rules in any fundamental way. It is at least arguable that the Williams Act causes many of the apparent problems requiring further regulation. For example, but for the Williams Act, tender offer arbitrage might not have grown to the proportions it has.¹⁰⁰ It is also suggested that the Williams Act has had the effect of raising premiums paid to shareholders,¹⁰¹ which, though

97. See *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977). But see *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978).

98. See *Green v. Santa Fe Indus.*, 533 F.2d 1283 (2d Cir. 1976), rev'd., 430 U.S. 462 (1977). Regarding two-tier offers in particular, the advantage enjoyed by larger shareholders, see Romano, *supra* note 2, at 129-30, 170-80, might also be thought of as inside information — not necessarily as to anything in particular about the value of the target company but simply as to the fact that whenever a takeover arises the chances are good that news will reach the larger shareholder first. See *id.* at 177-78. But see Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979).

99. See *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); note 5, *supra*. For other examples of cases in which the Williams Act has been narrowly interpreted, see *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985); *Radol v. Thomas*, 772 F.2d 244 (6th Cir. 1985); *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985). Cf. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672 (1987).

100. See R. Booth, *supra* note 5.

101. See Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1980); T. COPELAND & J. WESTON, *supra* note 48, at 605-10.

good news for shareholders in the short run, may mean that more tender offers have resulted in the breakup of the target company. Moreover, each new reform of the rules has a tendency to create another problem. For example, the SEC's adoption of rules extending withdrawal rights and eliminating proration pools may have induced more two-tier bids.¹⁰² And the currently contemplated rule against street sweeps, that is, the purchase of large blocks of shares from arbitrageurs after cancellation of a tender offer,¹⁰³ is likely to discourage statutory tender offers and encourage tactics designed to concentrate shares that may be swept up. Finally, and perhaps most important, federal reform seems doomed to fail since the most potent weapons on both sides — freezeouts, poison pills, and greenmail — arise directly from powers firmly entrenched in state law. Thus state law would seem to be a more promising source of reform.

A. *The Motives Behind State Legislation*

Although there are several different models of second-generation statutes, they have been criticized as a group for a variety of reasons. Professor Coffee has argued that state takeover statutes are flawed by the "pretense that they are intended only to 'protect' shareholders."¹⁰⁴ As he sees it, target shareholders enjoy the biggest part of the gains from takeovers and those gains may even be at the expense of other constituencies of the corporation. Thus, in his view, statutes which restrict takeovers are *designed* to protect shareholders, but are actually *intended* to protect other interests, such as those of middle managers, employees, creditors, and the community as a whole, from what might be characterized as overreaching by shareholders anxious to sell out for a quick profit.¹⁰⁵ In Coffee's view, then, state takeover statutes are a response to the needs of managers and others who are unable to adopt adequate defenses without legislative help. His position is that state takeover statutes may be properly motivated but are flawed because they seek to address the legitimate concerns of other constituencies by regulating the takeover process as between shareholders and bidders.¹⁰⁶

While these arguments have merit, they do not dispose of the need

102. See Mirvis, *supra* note 29, at 485.

103. See note 54 *supra*. Blanc, *Commission Proposes to Outlaw Market Sweeps*, Natl. L.J., Nov. 9, 1987, at 28, col. 1.

104. Coffee, *supra* note 10, at 108.

105. See *id.* at 31-35. Anyone who has worked for a major law firm should understand the fragility of the nexus and thus the aptness of the web metaphor, especially if one has the opportunity as did I to witness its almost spontaneous disintegration.

106. *Id.* at 104-08.

to insure a fair outcome *as between shareholders and bidders* in takeover contests. The fact that shareholders in the aggregate may be overcompensated deserves attention. Perhaps some wholly new form of regulation designed to slow or even reverse the transfer of wealth to common stockholders should be enacted (though one would assume private contracting could take care of this problem in fairly short order). There is, however, no reason not to perfect the mechanism by which takeover contests are decided as between rival managers. Moreover, the problems managers face in protecting their investment in the target arise at least in part because shareholders are coerced (or tempted) by inadequate offers. Thus, perfecting the auction process by which corporate control is bought and sold addresses at least part of the problem faced by management and is preferable to no solution at all. Finally, it is desirable, other things being equal, to assure that shareholders are fully compensated in connection with any takeover, rather than leaving too much of the gain on the table for bidders to appropriate. After all, it is bidders who initiate takeovers, and the more of the gain they can appropriate, the more they will appropriate.

It is also argued that the true motivation for state takeover statutes is the prospect of gain to the enacting state at the expense of other states. Since takeover statutes are generally thought to raise the cost of acquisitions, a state with a larger proportion of potential target companies might enact a statute to force higher bids for its companies, which would tend either to keep domestic corporations independent or raise disproportionately the premiums enjoyed by the state's residents.¹⁰⁷ The obvious problem with this argument is that a takeover statute is just as likely to backfire by rendering protected companies sufficiently less attractive as targets that investors in those companies will lose a disproportionate number of lucrative opportunities to tender their shares. Indeed, companies which find their stock slumping because of such a statute might well move to a jurisdiction without one. The argument cannot be totally discounted, since shortsightedness may be endemic in the legislative process.¹⁰⁸ Nonetheless, even if true, such motivations are no cause for worry if the market is efficient in factoring untoward protections into market prices. Many commentators have taken the externality argument quite seriously, however.¹⁰⁹

107. See Romano, *supra* note 2, at 138-41.

108. *Id.* at 135-36.

109. See *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250 (7th Cir. 1986), *revd. in part*, 107 S. Ct. 1637 (1987); Block, Barton & Roth, *supra* note 9; Coffee, *supra* note 10, at 93-103; see also Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 268, 287-89 (1977). Indeed, the focus of the Supreme Court's recent decision in *CTS* as well as the earlier decision in *MITE* was on whether state takeover statutes unduly burdened

Finally, Professor Romano has argued that state takeover statutes may be adopted at the behest of potential target corporations which are reluctant to propose the defenses embodied in the statutes to their own shareholders. In some cases, when there is a perceived need for immediate action, the potential target may find that the state legislature can react more quickly, surely, or cheaply (believe it or not), since a high-profile special shareholders meeting is typically required for quick action by the company. The potential target may also worry that proposing a defensive charter amendment is inconsistent with political positions the company has taken in the past. Professor Romano offers the very believable example of the Aetna Life Insurance Company, concerned that it might soon be the subject of a hostile bid, pressing the Connecticut legislature to adopt a takeover statute, in part because the company, as a major institutional investor, had gone on record against the adoption of defenses by companies in which it invests. Simply put, target management may fear embarrassment or may even figure, sometimes correctly, that the shareholders simply will not approve the amendment.¹¹⁰ Ultimately, Professor Romano herself is not completely convinced that this process implies that takeover statutes are a sly way for potential target companies to gain defenses which reduce shareholder wealth by overprotecting management.¹¹¹ As she recognizes, and as has been sketched here already, takeover defenses may make sense for some companies depending on size and ownership and may be abusive for others.¹¹² The basic question is whether and how a statute responds to the varying needs of varying companies.

B. *The Varieties of State Statutes*

The new statutes have taken five distinct forms.¹¹³ For the most part, they address matters — such as shareholder voting and organic changes — that have traditionally been governed by state law.¹¹⁴ Unlike the first-generation statutes, the new statutes generally apply only to firms incorporated in the enacting state which also have a signifi-

interstate commerce. There was little else for the Court to review and it may well be that much of the commentary which focused on the externality question did so not because it was especially convincing but because the Supreme Court was expected to agree with the multitude of lower courts that had struck down second-generation statutes. *See* note 13 *supra*.

110. Romano, *supra* note 2, at 129-31.

111. *See id.* at 145-48.

112. *Id.* at 170-87. *See also* Carney, *Two-Tier Tender Offers*, *supra* note 40.

113. *See* Block, Barton & Roth, *supra* note 9; *see also* Garrity, *supra* note 8 (noting a possible sixth type in the Wisconsin scaled voting statute).

114. Block, Barton & Roth, *supra* note 9, at 340.

cant presence in the state or a relatively large proportion of shareholders resident in the state.¹¹⁵

Many states have adopted more than one of the new style statutes, sometimes with differing standards as to what companies are covered, creating a bewildering array of combinations and permutations. For example, Indiana itself has adopted both a control share statute (requiring a shareholder vote to enfranchise any bidder who acquires more than 20% of a target's shares) with an appraisal remedy for dissenters¹¹⁶ and a fair price statute (requiring that the price in a second-step merger be the highest price paid for previously acquired shares) with a five-year merger prohibition (banning any combination between a target company and an interested shareholder for five years).¹¹⁷ The fair price and five-year rules apply automatically only to companies registered under the federal Securities and Exchange Act of 1934 (which generally means companies with \$5 million or more in assets and 500 or more shareholders),¹¹⁸ while the control share statute applies to companies with one hundred or more shareholders and with headquarters or significant assets in Indiana or 10% or 10,000 of its shareholders resident there.¹¹⁹ Under both statutes, companies that are covered may opt out while companies that are not covered may opt in.¹²⁰ All this means that companies with more than 100 but less than 500 shareholders, for example, are covered only by the control share statute. As for larger companies, there are presumably only a very few which meet all the criteria for coverage. Nevertheless, it may be difficult — absent voluntary disclosure by the company or a new rule by the SEC — for an investor to know with certainty which companies are subject to which statutes. Notwithstanding the confusion, but mindful of the fact that more than one statute may operate as to any particular company, the individual statutes are relatively simple and have distinctive advantages and disadvantages. They are identified here with the state in which they first appeared.

115. See Sargent, *supra* note 10, at 16-22.

116. IND. CODE ANN. §§ 23-1-42-1 to -11 (West Supp. 1987).

117. IND. CODE ANN. §§ 23-1-43-1 to -24 (West Supp. 1987).

118. IND. CODE ANN. § 23-1-43-20 (West Supp. 1987). See Exchange Act Rule 12g-1, 17 C.F.R. § 240.12g-1 (1987).

119. IND. CODE ANN. § 23-1-42-4 (West Supp. 1987). These requirements suggest that the Indiana statute and others like it may apply for the most part to companies with disproportionate numbers of undiversified shareholders, who for that very reason have more to lose from a takeover at an inadequate price.

120. IND. CODE ANN. § 23-1-42-5; § 23-1-43-22 (West Supp. 1987).

1. Disclosure Statutes

Minnesota has adopted a statute that is similar to the statute struck down in *Edgar v. MITE Corp.* in that it sets up a state-level disclosure process akin to that of the Williams Act.¹²¹ The Minnesota legislature took pains, however, to avoid the constitutional infirmities which led to preemption of the Illinois Act in *MITE*. Thus, the new Minnesota statute does not provide for any pre-offer notification.¹²² Moreover, it permits only the Minnesota Commissioner of Commerce and not the target company to call a fairness hearing and does not allow the Commissioner to pass on the merits of the offer.¹²³ The new statute does not delay the tender offer process beyond the federal timetable.¹²⁴ Finally, it applies only if 20% or more of the target company's shareholders are residents of Minnesota, and it provides for the suspension of the offer only as to Minnesota residents.¹²⁵

The obvious criticism of the Minnesota disclosure statute is that it adds little if anything to the Williams Act, except the possible uncertainty of politically motivated administrative review, and it puts Minnesota shareholders at a potential disadvantage in the case of heavily subscribed offers. Indeed, a savvy bidder might well use the Minnesota statute to achieve a takeover at a lower aggregate price. For example, by declining to comply with the Minnesota statute and having the bid enjoined as to Minnesota residents, the bidder is able, in effect, to restrict the offer to the residents of other states, and might therefore be able to offer a greater premium (though it is conceivable that the SEC's all holders rule would operate in such a case to prevent the bid from proceeding as to any target shareholders¹²⁶).

On the other hand, state-level disclosure is not without merit. It is entirely likely that hostile takeovers generate measurable social costs, such as unemployment, that fall disproportionately on particular geo-

121. See Block, Barton & Roth, *supra* note 9, at 340-44. The statute has been held constitutional on its face by the Eighth Circuit. *Cardiff Acquisitions, Inc. v. Hatch*, 751 F.2d 906 (8th Cir. 1984). Minnesota has also adopted a control share statute similar to the Indiana statute. See Block, Barton & Roth, *supra* note 9, at 349-52. That statute was struck down in *Cardiff* primarily because it applied even if none of the target shareholders were Minnesota residents. Connecticut, Oklahoma, and Wisconsin have also adopted modified first-generation statutes. See Romano, *supra* note 2, at 114 n.10. It should be noted, too, that Delaware still has on the books a relatively weak first-generation statute which has never been overturned. DEL. CODE ANN. tit. 8, § 203 (1987).

122. See Block, Barton & Roth, *supra* note 9, at 343.

123. See *id.*

124. See *id.*

125. See *id.*

126. Exchange Act Rule 14d-10, 17 C.F.R. 240.14d-10 (1987).

graphic areas, even if on balance they generate economic gains.¹²⁷ The problem, however, is that such information is of very little interest to most target shareholders as shareholders.¹²⁸ It is highly unlikely that an *investor* will or even ought to base the decision to tender on social considerations.¹²⁹ Such information might, on the other hand, legitimately affect the thinking of a target company's board of directors with respect to whether resistance is appropriate. Indeed, Pennsylvania has amended its corporation code to authorize boards in the discharge of their duties to consider "the effects of any action upon employees, upon suppliers and customers of the corporation and upon communities in which offices or other establishments of the corporation are located, and all other pertinent factors."¹³⁰ Nevertheless, even if state-level disclosure is an effective way of addressing the problem of social cost in the context of takeovers, and even if a state can constitutionally do anything to impede a takeover simply because it hurts its economy (which is highly doubtful¹³¹), state-level disclosure has nothing to do with coercion of target shareholders. Coercion is clearly a more pressing problem. Coercion allows bidders to buy companies more cheaply than they otherwise could and enables them to foist on society the social costs that attend takeovers while keeping for themselves more of the gain.¹³²

2. Fair Price Statutes

The most common sort of statute is based on the Maryland model, which focuses on cash-out mergers, the usual second step of a two-tier offer.¹³³ The Maryland statute requires, among other things, an 80% vote of all shareholders and a two-thirds vote of all remaining shareholders other than the bidder to approve a cash-out merger.¹³⁴ The bidder can avoid the vote by offering the highest price paid any other

127. See Coffee, *supra* note 10, at 71-73, 104-09.

128. *Id.*, at 107-09.

129. Cf. *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919) (board directors may not divert, for humanitarian purposes, corporate assets owed to shareholders as dividends).

130. 42 PA. CONS. STAT. ANN. § 8363 (Purdon Supp. 1987). Ohio has adopted a similar statute. Ohio Rev. Code Ann. § 1701.59 (Anderson 1985 & Supp. 1987). See generally Oesterle, *The Negotiation Model*, *supra* note 36, at 138-42.

131. See generally Langevoort, *supra* note 2.

132. See text at notes 17-26 *supra*.

133. MD. CORPS. & ASSNS. CODE ANN. §§ 3-601, 8.301(14) (Supp. 1984). Connecticut, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Michigan, Mississippi, New Jersey, New York, North Carolina, Pennsylvania, Virginia, Washington, and Wisconsin have adopted similar statutes. See note 8, *supra*.

134. MD. CORPS. & ASSNS. CODE ANN. § 3-602 (1985).

shareholder to the remaining minority.¹³⁵ As has been noted, that often means that the price paid in the second step will actually be higher than the average price for shares purchased earlier.¹³⁶

The Maryland statute has been popular in part because it is less restrictive: It applies only to the second step of a takeover — and thus was believed to have the best chance of surviving constitutional attack — and is the sort of statute preferred by some shareholders because it addresses the coercion problem.¹³⁷ In any event, it tracks closely the kind of provision that corporations have most frequently adopted for themselves.¹³⁸ As Professor Romano points out, that suggests that such a statute may reduce costs by eliminating the need for individual companies to comply with the formalities of amending their certificates.¹³⁹ But as she argues, the fact that relatively few companies have actually adopted such provisions casts doubt on this explanation, unless the failure to adopt is explained by a fear of substantial opposition or negative trading reaction by shareholders.¹⁴⁰

The Maryland statute and others like it have merit because they eliminate two-tier offers by inducing bidders to do the second step at roughly the same price as the first. While all bids are arguably coercive, some commentators maintain that when the bidder announces in advance that if a majority of target shares are tendered the remainder will be cashed out at the same price, there is no coercion: A target shareholder is free to hold out without risk of missing the premium if the offer succeeds.¹⁴¹ Such bids are thus positively desirable since they succeed only if the bidder in fact perceives that the target can be more efficiently operated under the new management. Moreover, the Maryland statute has the very real advantage of allowing the shareholders to approve a second-tier offer at a lower price if, because of changed circumstances, that becomes attractive.

Still, the statute is inefficient to the extent that it actually requires a higher price to be paid in the second step.¹⁴² Moreover, since the supermajority vote effectively allows any significant minority to veto the second-step merger, there may be cases in which holdouts block a

135. MD. CORPS. & ASSNS. CODE ANN. § 3-603(b) (1985).

136. See text at note 43 *supra*.

137. Romano, *supra* note 2, at 117-20.

138. *Id.*

139. *Id.* at 120.

140. *Id.* at 129-31.

141. See Brudney & Chirelstein, *A Restatement*, *supra* note 1, at 1361-62. But see Bebchuk, *supra* note 2, at 1740-42 (arguing that there is coercion even in such offers).

142. See Booth, *supra* note 26.

merger which shareholders in the aggregate would have approved.¹⁴³ There may even be cases in which opportunistic shareholders veto the merger in hopes of receiving a bribe in a subsequent offer.¹⁴⁴ The primary problem, however, is that there is nothing in the Maryland statute to prevent an abusive partial bid or to allow shareholders the option to decide when a partial bid should be entertained. Bidders remain free under such a regime to purchase a bare controlling interest and to leave the remaining shareholders to stew in their juice. As the SEC studies found, such offers are the least beneficial to target shareholders and, it seems fair to conclude, are therefore the cheapest way for bidders to gain control of their targets.¹⁴⁵ Thus, the Maryland statute may ultimately induce more undesirable partial offers although it will undoubtedly discourage some partial offers in which the bidder harbors an undisclosed plan sooner or later to merge the target with another company.

3. Business Combination Statutes

The New York statute (together with the newly adopted Delaware statute) also focuses on second-step mergers, but New York's statute goes well beyond the Maryland model by prohibiting business combinations with an interested shareholder for a period of five years (which is nearly forever in the context of corporate takeovers) unless approved by target shareholders before the bidder acquires 20% of the target's shares.¹⁴⁶ "Business combination" is very broadly defined and comprehends virtually every kind of organic change or asset disposition imaginable.¹⁴⁷ Thus, the New York statute in essence prohibits "bust-up" takeovers, in which the plan is to sell off large parts of the target once control is gained.¹⁴⁸

The New York statute is subject to the same criticism as the Maryland statute: it does not directly address partial offers. What is worse,

143. See Easterbrook & Fischel, *supra* note 39.

144. See *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985) (when it became apparent that tender offer would succeed target management struck deal with bidder allowing management to tender its own shares); see also text at notes 42-62 *supra*.

145. SEC, *The Economics of Partial and Two-Tier Tender Offers*, *supra* note 4; SEC, *The Economics of Any-or-All, Partial and Two-Tier Tender Offers*, *supra* note 4.

146. N.Y. BUS. CORP. LAW § 912 (McKinney 1986). Regarding the new Delaware statute, Arizona, Indiana, Kentucky, Minnesota, Missouri, New Jersey, Washington and Wisconsin have adopted similar statutes. See note 8 *supra*.

147. N.Y. BUS. CORP. LAW § 912(a)(5) (McKinney 1986).

148. See note 30 *supra*. The Delaware bill is a good deal less restrictive than its New York counterpart. It applies only to bidders who acquire between 15% and 85% of a target's shares. In such circumstances, a merger within three years must be approved by a two-thirds vote of disinterested shareholders. The Delaware statute is to be codified at Del. Code Ann., tit. 8, § 203. For the complete text, see 20 Sec. Reg. & L. Rep. (BNA) No. 5, at 209 (Feb. 5, 1988).

however, the New York statute prohibits some bids which clearly are noncoercive and beneficial. Again, two-tier bids are a problem because the bidder announces in advance that, once control passes, remaining shareholders will be cashed out at a price lower than that offered in the front-end tender offer. The effect is to induce some shareholders to tender for less than they would otherwise be inclined to accept. But if the bidder announces in advance that if the tender offer succeeds in attracting a majority of target shares the remainder will be cashed out at the same price, there is no such coercion.¹⁴⁹

The New York statute prohibits such *two-step* bids together with coercive *two-tier* bids. Moreover, the New York statute also prohibits innocuous clean-up mergers following a successful bid for all the shares of a target. In short, the New York statute simply prohibits hostile takeovers which are motivated by a bidder's plans to change significantly the business of the target, since the statute requires that a hostile acquiror maintain the acquired company largely in its pre-existing form. Yet the most important positive effect of hostile takeovers is that they are a means of redeploying assets, which are not being put to their highest and best use, by replacing inefficient managers or by threatening them into making changes.¹⁵⁰ On balance, then, the New York statute is a reprehensible protectionist law.

New York also adopted a statute prohibiting greenmail unless approved by shareholder vote.¹⁵¹ Unlike the five-year merger ban, this statute makes some sense, although it is clearly of limited impact since greenmail is only one of many defenses a target company can deploy. It may also prove to be counterproductive in that target shareholders, although sometimes served by greenmail, may be reluctant to vote for it. Management is in a far better position to know whether another more attractive bid is likely. But management will not often be in a position to disclose anything very convincing that will justify greenmail. Either the expected better bid will be inchoate and greenmail will buy some time, or the alternate bid will be sufficiently well defined that greenmail will be unnecessary. Thus it seems doubtful that greenmail statutes represent much of an improvement.

4. *Appraisal Statutes*

Pennsylvania has adopted still another kind of statute, which gives remaining shareholders what amounts to an appraisal right after a bid-

149. See text at note 141 *supra*.

150. See Coffee, *supra* note 11; Easterbrook & Fischel, *supra* note 11; Gilson, *supra* note 42. But see Leebron, *supra* note 5 (outlining several other possible reasons for takeovers).

151. N.Y. BUS. CORP. LAW § 513(e) (McKinney 1986). See generally Gilson, *supra* note 3.

der acquires a 30% stake in the target company.¹⁵² A holdout shareholder may demand a cash payment for her shares equal to the judicially determined fair value on the day before the bidder reaches 30% ownership.¹⁵³ The Pennsylvania statute is in some ways preferable to the Maryland model since it addresses the plight of the minority shareholder after a partial bid. Nevertheless, the appraisal remedy — for which Pennsylvania seems to have an inexplicable penchant¹⁵⁴ is far from an ideal way to handle the problem. As with the Minnesota disclosure statute, the appraisal remedy requires outside intervention, in this connection to decide the true value of target stock in a situation in which the value is, by definition, indeterminate. The bidder and the target shareholders are, after all, engaged in what amounts to a negotiation. The bidder thinks that the company is worth some price higher than the market indicated before the bid. The target shareholders realize that the bidder expects to gain from the deal, but they do not know by how much. In the end, the gain will be split somehow between the shareholders who will receive a premium and the bidder who will own the company and its enhanced prospects. Any price between the pre-bid market price and the bidder's privately estimated value of the target could be said to be a fair price under such conditions. To set up a judge or any other official as an arbiter of fairness is not only futile, it is downright misleading insofar as it suggests there is a determinable fair price for which the target may be sold.¹⁵⁵

In short, appraisal is a second-best method of valuation (at best) which can do no more than substitute an unknown rule of valuation for a reasonably well understood, even if not altogether fair, bidding process. While the mystique of litigation and judicial decision may have some marginal benefit in reassuring a populace nervous about the effects of takeovers, it also injects into the implicit negotiation between buyer and seller the unnecessary and therefore costly risk attending an

152. PA. STAT. ANN. tit. 15, § 1910 (Purdon Supp. 1987). Maine and Utah are the only other states that have adopted similar statutes. ME. REV. STAT. ANN. tit. 13A, § 910 (1987 Supp.); UTAH CODE ANN. § 16-10-76.5 (1987). See note 8, *supra*.

153. Romano, *supra* note 2, at 116-17 & n.19.

154. See *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958); see also Garrity, *supra* note 8, at 590 (noting that appraisal rights have been recognized "particularly" in Pennsylvania). It may be that Maine followed the Pennsylvania statute because it too placed particular faith in the appraisal remedy. See *In re Valuation of Common Stock of Libby, McNeill & Libby*, 406 A.2d 54, 58 (Me. 1979). In the vein suggested by Professor Romano, a state's political tradition or institutional memory may strongly influence its choice of whether to enact a takeover statute and what sort of statute to enact. Cf. Booth, *Self-Regulation in a Democratic Society*, 50 J. AIR L. & COM. 491, 500 (1985).

155. Booth, *supra* note 26; Leebron, *supra* note 5. For a striking example of how unsympathetic a court may be to the plight of the holdout shareholder, see *Armstrong v. Marathon Oil Co.*, 32 Ohio St. 3d 397, 513 N.E.2d 776 (1987).

individual judge's opinion. Specifically, the Pennsylvania statute is likely to generate all sorts of litigation as to the fair value of target stock. Bidders will no doubt argue that the market price on the day before control passes is too high because it reflects their buying activity, while target shareholders will argue that the stock is worth even more than the market indicates because tendering shareholders were coerced by the threat of being left behind (ironically) with nothing but an appraisal remedy. While recognizing the right of the remaining minority to be cashed out is perhaps a step in the right direction since it allows the problems of the minority to be litigated, creating such a right hardly provides a quick and clear answer and on balance probably costs more in the way of increased risk and unduly discouraged bids than it is worth in avoiding coercive bids.

5. Control Share Statutes

The Indiana Control Share Acquisitions Chapter,¹⁵⁶ which is based on the more restrictive Ohio Control Share Acquisition Statute,¹⁵⁷ prohibits the acquiror of 20% or more of the shares of a covered company from voting those shares unless a majority of the other shareholders (other than management shareholders) votes to restore the acquiror's voting rights.¹⁵⁸ The Indiana Act requires a similar vote in the event of additional acquisitions raising the acquiror's interest to over one third and one half, respectively, of the total voting power of the corporation.¹⁵⁹ (It is unclear whether shares for which a vote has already been approved must again be reenfranchised upon crossing the next threshold.) The acquiror can demand that a vote be held within fifty days of filing an acquiring person statement with the corporation.¹⁶⁰ If the acquiror does not prevail in the vote, the corporation may redeem the acquiror's shares at fair market value, but redemption is not required.¹⁶¹ In the event a bidder prevails in the vote

156. IND. CODE ANN. §§ 23-1-42-1 to -11 (West Supp. 1987).

157. See Block, Barton & Roth, *supra* note 9, at 345. The Ohio Act may be found at OHIO REV. CODE ANN. § 1701.831 (Anderson 1985). The Ohio Act differs from the Indiana Act in several important ways. For example, the Ohio Act appears to require advance shareholder approval for the bidder even to purchase shares which lift its ownership over the one-fifth, one-third, and one-half levels. Thus the Ohio law would seem to discourage bona fide investment transactions and might even catch in its net a brokerage firm which handled a disproportionate amount of the trading in an Ohio company.

158. IND. CODE ANN. § 23-1-42-9 (West Supp. 1987). In addition to Indiana and Ohio, control share statutes have been adopted in Arizona, Florida, Hawaii, Idaho, Louisiana, Massachusetts, Minnesota, Missouri, Nevada, North Carolina, Oklahoma, Oregon, Utah and Wisconsin. See note 8 *supra*.

159. IND. CODE ANN. §§ 23-1-42-1, -9 (West Supp. 1987).

160. IND. CODE ANN. § 23-1-42-7 (West Supp. 1987).

161. IND. CODE ANN. § 23-1-42-10(b) (West Supp. 1987). This provision could be read to

after acquiring a majority of shares, dissenting shareholders have the right to be cashed out at the highest price per share paid by the bidder in the control share acquisition.¹⁶² Finally, the Act applies only to companies incorporated in Indiana with headquarters or significant assets there and 10% or 10,000 shareholders resident in Indiana and which do not amend their charters to opt out of the Act's coverage.¹⁶³

The Indiana Act obviously solves the coercion problem since it renders the bidder's shares sterile once a threshold is crossed. Thus, no matter how many shares the bidder amasses, the remaining shareholders cannot be forced to sell in a cash-out merger unless they agree to allow the bidder to exercise his or her votes. And presumably the shareholders will not agree unless the bidder makes known in advance whether she intends to force a merger and, if so, at what price. It ought to be noted that the Indiana Act sterilizes the bidder's shares for *all* purposes and prevents the bidder, or indeed any 20% shareholder, from assuming working control of the company even by voting acquired shares in a regular annual meeting. In this sense, the Indiana

impose fairly broad restrictions on repurchases of stock from potential bidders, that is, greenmail. What the statute does, at a minimum, is give the target corporation an option to repurchase at fair market value the shares of a bidder who has failed to prevail in a shareholder vote or has failed to file an acquiring person's statement. The question is, however, whether this provision can be read to provide an exclusive standard for share repurchases generally or from potential bidders. For example, suppose a bidder acquires 20% and succeeds in a shareholder vote. Can the target company repurchase those shares — assuming of course that the owner agrees — for a price in excess of market value? Arguably, when a vote has already been held, a repurchase, if any, should be at the statutorily specified price which the corporation could have paid if the vote had simply turned out differently, though practically speaking, the value of shares with votes is vastly different from the value of shares without votes.

If management repurchases the shares with its own money (rather than the corporation's as is typical in a greenmail case), management too will be precluded from voting the shares unless enfranchised by a shareholder vote. Ironically, this means that the remaining nonmanagement shareholders will find themselves with relatively more voting power and with shares that are more valuable from the point of view of potential subsequent bidders. This result seems somewhat unfair in that the defensive repurchase of shares is probably one of the least manipulative tactics management could employ. Management is, after all, putting its money where its mouth is — saying, in effect, “we really do believe the offer is inadequate” — and competing directly with the bidder for shareholders who wish to sell out. See Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986).

Finally, the Act does not specify precisely when fair market value is to be measured. Thus, in the case of a failed bid, the target company may be able to wait until market prices have fallen (if they do) before exercising this “option.” This provision may then operate as something of a penalty against bidders who fail and may in fact constitute a disincentive for making bids for companies subject to the Act.

162. IND. CODE ANN. § 23-1-42-11 (West Supp. 1987).

163. IND. CODE ANN. § 23-1-42-4(a)(3) to -5. Prior to August 1, 1987, the Act applied only if the board of directors adopted a resolution to opt into its coverage. IND. CODE ANN. § 23-1-42-3(b). It should be noted also that the Act does not apply to corporations with fewer than one hundred shareholders, a curious provision in light of the fact that the smaller a corporation is the more susceptible it is to coercive tender offers. IND. CODE ANN. § 23-1-42-4(a)(1) (West Supp. 1987).

Act is very much like a statutory poison pill.¹⁶⁴

The timing of the shareholder vote under the Indiana Act received much of the Supreme Court's attention in the *CTS* decision. In holding the Indiana Act unconstitutional, the Seventh Circuit followed, in part, the reasoning of the plurality in *MITE* that the Illinois statute there held unconstitutional among other things, imposed an unreasonable delay in the tender offer process, which was in conflict with the timetable prescribed by Congress in the Williams Act.¹⁶⁵ The Supreme Court in *CTS*, however, distinguished *MITE* on the grounds that the Illinois Act had allowed an indefinite delay for a state official to conduct hearings and make findings on the fairness of the offer (either on her own initiative or that of target management). The Court held that the Indiana Act, unlike the unconstitutional Illinois Act, does not interfere generally with the federally imposed scheme or specifically with the federal timetable. The Indiana Act leaves it to the shareholders voting collectively to decide whether an offer will go forward (rather than conferring that power on a state official or management and thus upsetting the delicate balance established by Congress) and the fifty-day delay under the Indiana Act falls within the sixty days allowed under federal law to complete a tender offer (though the court failed to mention that tender offers *may* be completed in as few as twenty days).¹⁶⁶ The Court also rejected the notion that the Indiana Act will discourage bidders from commencing offers, noting that an offer may be conditioned on obtaining shareholder approval.¹⁶⁷

Thus, the Court's opinion should not be read as validating every variety of second-generation statute. The Indiana Act as upheld relates to the voting rights of bidders, and voting rights, as the Court noted, have historically been subject to wide variations governed by state law and charter provisions.¹⁶⁸ Other statutes which impose substantive terms on second-step mergers or directly restrict the sale of shares to bidders may still be struck down as an undue restraint on

164. See text at notes 86-93 *supra*.

165. 15 U.S.C. § 78n(d)(5) (1982); *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 263 (7th Cir. 1986), *revd. in part*, 107 S. Ct. 1637 (1987).

166. 107 S. Ct. at 1646-47.

167. 107 S. Ct. at 1647.

168. 107 S. Ct. at 1647-52. It seems ironic in retrospect that state takeover statutes were held to be unconstitutional as an undue burden on interstate commerce while privately adopted shark repellents were left unaffected. See Leebron, *supra* note 5. However, the same irony is evident in the Williams Act's provision of tender offer ground rules which can be avoided by the simple expedient of cancelling an outstanding offer and starting a new one as in *Schreiber*, *supra* note 95. See notes 94 & 99 *supra*. The explanation, of course, is that state takeover statutes constitute state action, while shark repellents do not. Still, if one thinks of corporation law as a standard form contract — provided by the state simply because it is cheaper than individual negotiating, then perhaps takeover statutes are only superficially state action.

commerce derogating from the shareholder's right to make up her own mind about whether to sell her shares.¹⁶⁹ Although the Supreme Court gave short shrift to the burden on commerce argument, the Court did note that the Indiana Act provides a way — consistent with the scheme set up by the Williams Act — for shareholders *collectively* to decide whether to sell or hold.¹⁷⁰ In short, it looks as if the Court took pains to preserve shareholder choice. And one might even go so far as to say that the Court thereby endorsed the burden on commerce argument.

V. THE MERITS OF CONTROL SHARE STATUTES

The Indiana Act is far from perfect as it stands, if for no other reason, because the Indiana Code also includes provisions similar to the Maryland, New York, and Pennsylvania statutes. In theory, however, the control share vote could stand alone. And when considered alone, it is a remarkably intelligent approach to the problem of fairness in tender offers. First, the shareholder vote eliminates overtly coercive offers as well as implicitly coercive offers which are merely inadequate. The seemingly large assumption, of course, is that shareholders will actually vote intelligently. Despite the traditional wisdom that shareholders do not care about voting, however, there are very good reasons to trust the process. Second, the Act also discourages private pre-offer purchases and thus the possibility of bribes or side payments that reduce the premium available for other shareholders. Third, the Indiana Act does not preclude partial and two-tier offers which for idiosyncratic reasons may be attractive to shareholders. Fourth, the Act also

169. Indeed, cases decided since *CTS* are about evenly divided on the constitutionality of other state statutes. See *Batus, Inc. v. McKay*, No. CV-N-118-HDM (1988 Westlaw 41, 395) (D. Nev. Mar. 30, 1988) (striking down Nevada law that prohibited tender offers of more than 60 days duration); *BNS Inc. v. Koppers Co.*, 683 F. Supp 458 (D. Del. 1988) (upholding Delaware business combination law); *RP Acquisition Corp. v. Staley Continental, Inc.*, No. 88-190-JRR (1988 Westlaw 46,468) (D. Del., May 9, 1988) (same over SEC objection in amicus brief); *Hyde Park Partners L.P. v. Connolly*, 839 F.2d 837 (1st Cir. 1988) (Massachusetts law penalizing bidder who fails to disclose control intent before acquiring 5% of target stock by banning takeover attempt for one year enjoined as not likely to pass constitutional muster); *RTE Corp. v. Mark IV Indus., Inc.*, No. 88-C-378 (E.D. Wis., May 4, 1988) (striking down Wisconsin three-year 10% business combination statute as preempted by Williams Act); *Veere, Inc. v. Firestone Tire & Rubber Co.*, C88-571A (1988 Westlaw 42, 739) (N.D. Ohio, Mar. 16, 1988) (upholding Ohio statute); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022 (W.D. Okla. 1987) (Oklahoma control share law applying to out-of-state corporations with substantial nexus to state unconstitutional). See also *SEC Says New York Takeover Law Violates Commerce, Supremacy Clauses*, 20 Sec. Reg. & L. Rep. (BNA) No. 10, at 379 (Mar. 11, 1988) (management authority to limit post-bid transactions distinguishes New York law from Indiana law which merely provided for shareholder approval of bid). The court declined to decide the constitutional question since the plaintiff had failed to show irreparable harm entitling it to an injunction. *Salant Acquisition Corp. v. Manhattan Indus., Inc.*, 682 F.Supp. 199 (S.D.N.Y. 1988).

170. *CTS*, 107 S. Ct. at 1645-46, 1651.

addresses the long-standing problem of private sales of control, since it applies to all sales of control shares including those of currently controlling shareholders. Fifth, and perhaps most significant, the Indiana Act may with minor modifications provide a self-executing mechanism that tends to assure that companies which need defenses against coercive offers can have them cheaply, discourages companies that do not need protections from adopting defenses, and gives the market a relatively easy-to-read label indicating which is which.

A. *The Beauty of Shareholder Voting*

Generally speaking, shareholder voting makes good sense in a takeover situation.¹⁷¹ Whether a particular shareholder is inclined to sell out or hold out, putting the issue to a vote relieves any pressure to sell for fear of being relegated to the minority. The shareholder can vote according to whether she believes the offer being made — whether it is simply to allow the acquiror to be a fully enfranchised shareholder with whatever risks attend the bidder's status as such or whether it is to cash out all remaining shareholders — is sufficiently attractive. If one votes with the losing side, little is lost, as it is if one declines to tender believing the offered price is too low. In short, the shareholder vote has the beauty of allowing shareholders to indicate their desire to sell or hold out without having to risk a significant loss that goes with tendering the wrong way. Moreover, the control share vote is self-executing: It requires the intervention of no outside agency and does not purport to set up any hard and fast rules about what is fair.

One genuine worry, of course, is that shareholders simply do not care about their vote or will vote however management instructs. That once may have been true, but these days it is difficult to believe that a shareholder with any significant stake in a target company will fail to cast a serious vote on the question whether the company should be sold at whatever premium the bidder offers. Given that institutional investors control a majority of disinterested shares in many if not most companies and, as previously noted, that arbitrageurs frequently amass as much as a majority of the target stock in takeover situations, it seems likely that a relatively few individuals — who may even be in touch with each other and thus capable of concerted action

171. See Booth, *supra* note 26; see also Easterbrook & Fischel, *supra* note 39, at 415-18. Indeed Professor Bebchuk has proposed a scheme of tender offer regulation which is similar in effect to the Indiana statute but which involves simultaneous tendering and voting as to whether the offer should proceed. His rationale for collapsing the two steps is simply that it would be cheaper. See Bebchuk, *Toward Undistorted Choice*, *supra* note 2; Bebchuk, *The Pressure to Tender*, *supra* note 2.

— are in a position effectively to decide the outcome of the vote.¹⁷² Even if they are not, the vote may provide a focal point for grassroots organizing that would not likely arise if shareholders are forced to choose between tendering, selling in the open market, or holding out for a higher bid. At the very least, management and bidder will present their best cases to the shareholders without the coercion and strategic behavior that necessarily attends a tender offer.

Recent reports indicate that institutions are taking an ever more active part in fundamental decisions, such as the deployment of advance takeover defenses.¹⁷³ While this may sound conspiratorial, it is, as the Supreme Court recognized in *CTS*, a benefit for shareholders to be able to coordinate their decisions whether to sell. It is precisely shareholders' *inability* to coordinate their response in a straightforward tender offer that gives the bidder its biggest advantage: Since target shareholders fear that if they hold out others will tender, all are inclined to tender.¹⁷⁴

Professors Easterbrook and Fischel have pointed out that the very survival of shareholder voting argues that it is a valuable institution, and they surmise that its value lies in reducing agency costs by giving shareholders a potential veto over transactions which do not advance their interests as residual claimants on the wealth of the firm.¹⁷⁵ Conveniently, the explanation is consistent with the observation that there are very few shareholder votes of consequence. Nevertheless, it seems quite likely that management either consults with larger shareholders in advance or simply does not propose transactions that are not likely to be approved. Thus, there is little reason to expect many contested votes and little reason to worry that the institution of shareholder voting appears on the surface to be a rubber stamp. Moreover, whether shareholders care about voting or actually bother to exercise their vote is very much beside the point, for the vote will induce the bidder to offer a fair price in the first place. While there are obvious problems in proving their theory, Easterbrook and Fischel point to several phenomena that support the view that voting has value even though shareholders tend to ignore it.¹⁷⁶ As they note, institutional investors have vigorously opposed many shark repellent charter amendments, such as provisions requiring a supermajority vote in connection with mergers.

172. See *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985).

173. See Romano, *supra* note 2, at 129-31; note 40, *supra*.

174. See Bechuk, *supra* note 2.

175. Easterbrook & Fischel, *supra* note 39, at 401-06.

176. *Id.* at 406-08.

Easterbrook and Fischel do profess some mystification at why managers submit issues to a shareholder vote when they are not required to do so.¹⁷⁷ They speculate that one reason may be that legal rules encourage managers to do so. That is, failure to seek ratification may mean a penalty in the form of damages or expensive litigation and delay. However, a more powerful reason would seem to be that if voting does in fact reduce agency costs in the cases in which it is required by law, it probably also reduces agency costs when management chooses to use it voluntarily.¹⁷⁸ Indeed, shareholder ratification is one of the best recent examples of how corporate norms seem to follow what the parties would agree to do if able to negotiate: Delaware, the jurisdiction arguably most in tune with what shareholders and management really want from each other, has in recent years given shareholder votes enhanced legal effect. Perhaps the most notable example is in connection with freeze-out mergers, where the Delaware Supreme Court has established a presumption of fairness if the deal is approved by a fully informed vote of the noninterested shareholders, a procedure which is nowhere to be found in statutory law.¹⁷⁹

It is admittedly somewhat off the mark to talk of agency costs in connection with a freezeout or management buyout where management and shareholders are better described as adversaries than as agent and principal. It is probably more precise to think of voting as a bonding mechanism by which management proves that there are no significant objections, and risks added liability to demonstrate that full disclosure has been made. For example, in a transaction such as a management buyout, the shareholder vote can reassure public shareholders that they are receiving an appropriate premium in a transaction that often cannot be put to a market test because of management's controlling interest. Moreover, shareholder voting can operate as a negotiating mechanism between shareholders and management. The fact that a vote is valuable to someone else is sufficient to make it valuable to the shareholder.¹⁸⁰ Since a vote is clearly valuable to the bidder or management who can use it to control the company (even though the vote is no good to the shareholder for such purposes), the shareholder will insist on getting top dollar for it. Even though a shareholder may hold a fully diversified portfolio and may care very little about the ups and downs of particular companies represented in

177. *Id.* at 417-18.

178. *Cf.* Coffee, *supra* note 10, at 25-28 (discussing voluntary measures undertaken by managers to reduce agency costs).

179. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

180. *See* Booth, *supra* note 26.

it, the shareholder will not ignore the opportunity to realize an additional gain where there is nothing to be lost by treating the decision to accept or reject an offer as outside the logic of diversification. That is, the shareholder will approach the voting decision very much as management would.

In short, shareholder voting, though much maligned, is a more trustworthy institution than it is generally given credit for being. While there remains some concern that a shareholder who has no ability to affect the outcome of a vote will simply vote in favor of the first reasonable bid, there is reason to believe each vote will be actively courted (albeit in proportion to the size of the block) and that much, if not all, of the coercion (or temptation) to tender will be obviated.

B. *Elimination of Side Payments*

In a logical extension of their argument for the value of shareholder voting, Easterbrook and Fischel defend the presumption that each share carries one vote. By the same token, they criticize cumulative voting on the ground that any distribution of voting rights which differs from financial rights will create additional agency or negotiating costs since shareholders with greater voting rights will have hold-up power and, in effect, will insist on some extra payment (or bribe) to vote consistently with the aggregate interests of the residual financial claimants.¹⁸¹ They quite rightly point out that the overly broad distribution of hold-up power, as under cumulative voting, may generate the perception among individual voters that their votes are worth more when aggregated than the total benefit to be gained from the transaction in question, making negotiation difficult if not impossible.¹⁸²

The argument proves more than Easterbrook and Fischel conclude. Obviously, institutional investors are among the largest and best organized shareholder groups. Often they themselves have hold-up power and will thus regard their shares as worth more than those that do not possess such control. In other words, they will *use* the power they have, and even if they do not, management or a potential bidder will anticipate that they will. Yet, as Easterbrook and Fischel note, the potential for inconsistent and illogical decisionmaking increases where there are, in effect, two masters being served.¹⁸³ The

181. See Easterbrook & Fischel, *supra* note 39, at 408-10. See also SEC, *supra* note 41, at 87,182 (recognizing possibility that shareholders vote for shark repellent charter amendments because they expect to be paid for doing so).

182. See Easterbrook & Fischel, *supra* note 39, at 408-10.

183. *Id.* at 405-06.

clear implication is that the hold-up power of institutional investors should be neutralized to the extent possible.

The Indiana Act does just that. Under the Indiana Act a bidder who acquires a 20% position cannot vote. There is thus little or no incentive to bribe early tenderers. The control share vote renders all votes equal. It eliminates the hold-up power that larger or well organized shareholder groups can exercise in connection with a transfer of control and thus their ability to negotiate for a bribe. In short, the Act obviates quasi-coercion. Since bidders will likely have access to any number of sources for early shares, the first 20% will ordinarily be available for a minimal premium, and whatever additional amount would have been paid for the privilege of voting the shares will be redistributed to (or at least available for) remaining shareholders.¹⁸⁴

Arguably, the Indiana Act does leave some room for a larger shareholder to insist on a bribe in connection with the control share vote. What, after all, is to keep a larger shareholder from striking a private deal with a bidder to vote in favor of enfranchising the bidder in exchange for the bidder's later buying the shares at a larger premium than is offered to the remaining shareholders (assuming there is any offer made to the remainder at all)?

There are several answers. In the first place, such a deal would likely be viewed as illegal vote selling.¹⁸⁵ Second, even if legal, the deal would need to be disclosed if ever reduced to an enforceable form.¹⁸⁶ And disclosure would likely galvanize any opposition to the bid or, more likely, would lead to lawsuits. Third, and probably most important, such a deal would likely render the subject shares nonvotable under the Act itself, which sterilizes interested shares, that is, shares as to which an acquiring person may "exercise or direct the exercise of the voting power of the issuing public corporation in the election of directors."¹⁸⁷

There is, of course, a danger of unspoken agreements and engineered coincidences. Conceivably, regular players in the takeover

184. See Leebron, *supra* note 5.

185. See *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982); *Chew v. Inverness Mgt. Corp.*, 352 A.2d 426 (Del. Ch. 1976); see also Easterbrook & Fischel, *supra* note 39, at 410-11 (discussing reasons for prohibition against vote buying); Note, *The Standstill Agreement: A Case of Illegal Vote Selling and a Breach of Fiduciary Duty*, 93 YALE L.J. 1093 (1984).

186. See Exchange Act Schedule 13D, Item 6 (Contracts, Arrangements, Understandings or Relationships with Respect to Securities of the Issuer), 17 C.F.R. § 240.13d-101-6 (1987).

187. IND. CODE ANN. § 23-1-42-1 (West Supp. 1987). One might quibble, of course, with the "election of directors" language. That is, it could be argued that a proxy given solely for purposes of a control share vote does not fall literally within this definition of interested shares. Section 23-1-42-2(a), however, makes it quite clear that acquiring the right to vote is itself a control share acquisition.

game might share their gains with block sellers as payment for future favors. One solution might be to set up a presumption that shares bought within, say, a year were bought as part of a deal.¹⁸⁸ The problem, of course, is that any such presumption naturally becomes a standard of minimum behavior, is relied on for its very precision, and because of the reliance it engenders is especially resistant to change. It is thus far from clear that the Indiana Act will succeed in eliminating all favored treatment of better organized shareholder groups. Some shareholders will likely always have hold-up power and the ability to command a higher premium in ways that are difficult to predict. For example, large yes-voters may be given the option to remain shareholders in an attractive successor corporation.

There are, however, good reasons for allowing some shareholders to capture larger benefits. Unless there is a particular shareholder or group that is a real threat, there may be no genuine incentive for management to please any of the shareholders.¹⁸⁹ As matters currently stand, small shareholders get a free ride on the larger shareholders' monitoring of corporate management. Unless the larger shareholder can command (or capture) extra return in excess of a pro rata benefit for monitoring, there may be insufficient incentive to perform the service. Indeed, it is unreasonable not to pay the monitoring shareholder something extra for valuable services rendered. Since the benefit inures to the shareholders, it *should* come out of their pockets. Thus, it may be that some level of disproportionate treatment is beneficial for all concerned.

In short, there is some danger that the Indiana Act may have done the job of equalizing shares too well. In the grand scheme of things, however, it seems likely that slightly lower incentives to monitor are a small price to pay for eliminating the distortions of takeover by bribery. It is even more likely that larger shareholders will find ways to increase their own return to compensate for monitoring. The important point, however, is that the Indiana Act appears to eliminate disproportionate — indeed virtually unchecked — compensation for larger shareholder-monitors in the absence of such a statute.

188. Compare IND. CODE ANN. § 23-1-42-2(b) (West Supp. 1987) (shares acquired within 90 days or pursuant to plan of control share acquisition are control shares).

189. See Coffee, *supra* note 10, at 16-24; Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982). Compare Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) (unequal treatment of shareholders may sometimes be necessary to accomplishing mutually beneficial transaction), with Bebchuk, *supra* note 2, at 1780-88 (unequal treatment is unfair), and Easterbrook & Fischel, *supra* note 39, at 409-10 (unequal voting power creates distortions in shareholders' valuation of their shares). See also Gilson, *supra* note 42.

C. *Preservation of Attractive Partial Bids*

Perhaps the most appealing feature of the Indiana Act is that it does not necessarily preclude all two-tier or partial bids. The problem with such bids is that shareholders in the aggregate may end up worse off after a shift of control even though tenderers as a subgroup are better off. Losses to holdouts may exceed gains to sellers. But it is also possible for holdouts to enjoy some gain even though sellers enjoy more. Suppose, for example, that following a successful \$150 per share bid for a bare majority of a target trading at \$100, the remaining target shares trade for \$120. Though the holdout may regret not tendering, and though there may be some unfairness in leaving the smaller gain with the shareholders who valued the company more highly, clearly even the holdout is better off. Suppose now that a cash-out merger at \$130 is proposed. Again, although the holdout may rue the day he or she failed to tender, he or she has every reason to vote for the merger.

There is no good reason to prohibit such deals absolutely. While there may be a certain residual coercion felt by potential holdouts, takeover battles are conducted in the real world where things take time, circumstances change, and new information comes to light. A bidder who in good faith believes a target to be worth \$150 per share may discover upon gaining control that in fact the company was really only worth \$130 at the time of the bid, or that the market as a whole has fallen in the interim so that \$130 is now an equivalent price.¹⁹⁰

It is, of course, possible for a bidder to obtain one fifth, one third, or a majority of the shares of the target, to be enfranchised by shareholder vote on the representation that the shares will be held for investment only, and then, claiming some change of circumstances, to cash out the remaining shareholders at a loss. Similarly, the bidder might assume control of the target having convinced the shareholders that it has superior management skills or a more promising business strategy than old management and then proceed to run the company as a captive subsidiary, making it just profitable enough in its dealings with the parent to avoid the charge of looting. These are not serious concerns. Presumably the courts can deal with those few cases in which bidders misrepresent their intentions. Moreover, it seems unlikely that shareholders will readily approve vesting control in a bidder who does not offer substantial assurances against taking such advantages. For example, the bidder might offer the remaining shareholders an option to compel the bidder to repurchase minority shares at some

190. See Berg, *supra* note 48.

fixed price at some point in the future, thereby reducing or perhaps even eliminating the risk that the price of minority shares will fall (even for external reasons such as a general decline in the stock market).

In any event, partial and two-tier bids may sometimes be approved, as well they should, since the bidder may really offer superior management or plans. In short, there is no reason to require a bidder who faces considerable risk in the first place to assume still more risk by enshrining the initial bid as a floor for any future merger. That will only make it more expensive than necessary for bidders to do takeovers. And potential target shareholders will in the end be the ones to suffer lower overall returns from inefficient management and too few attempted takeovers.

Although one of the most desirable features of the Indiana Act is that it leaves open the possibility of a fair partial or two-tier offer, Indiana unfortunately also adopted a fair price statute.¹⁹¹ No doubt the Indiana General Assembly reckoned that a belt and suspenders approach was safest, but in this instance the fair price statute serves only to obviate the desirable flexibility of the control share statute, which allows shareholders to accept a bid they find attractive even if it is lower than the front-end bid. Little if any shareholder protection is gained, since the control share statute offers as much assurance against coercion in the event of a two-tier bid as the fair price statute. Still more unfortunate is that Indiana also opted for a New York style five-year merger ban, which eliminates the possibility of an equal price merger unless the merger is planned and approved before the bidder ever gains a 10% stake in the target.¹⁹² Both provisions should be repealed as soon as possible.¹⁹³

191. IND. CODE ANN. § 23-1-43-19 (West Supp. 1987).

192. IND. CODE ANN. § 23-1-43-19 (West Supp. 1987).

193. The Indiana Act also confers dissenters' rights on remaining shareholders after the *approval* of a control share acquisition of a majority or more of the shares, IND. CODE ANN. § 23-1-44-8(4) (West Supp. 1987). This seems curious in that giving holdout shareholders the right to vote on whether a purchaser can vote would seem to be ample protection. Moreover, it seems quite unfair, at least at first blush, to expose a bidder to the risk — over and above the risk of losing the vote — that any substantial number of shareholders will seek to be cashed out. On the other hand, shareholders have traditionally had the right to dissent when they have the right to vote. And more important, acquisition of a majority of outstanding shares with the right to vote means that the company has effectively been sold to new management, just as if by merger.

The impact of dissenters' rights in the context of a control share acquisition will probably be slight notwithstanding the fact that fairness of price is defined as the highest price paid to acquire control shares. In the first place, only shareholders who vote against enfranchising the bidder are eligible to dissent, and their numbers are by definition limited when the bidder has been approved, particularly if, as under the current statute the previously controlling shareholders are not able to vote. Second, many shareholders who vote against a bidder who nevertheless prevails will likely decline to pursue their dissenters' rights since they will recognize that most other shareholders perceived the shift in control as attractive. And even if a potential dissenter is not

D. Regulation of Inside Sales of Control

The Indiana Act appears to apply not only to takeover bids launched by outsiders but also to sales of control by existing controlling shareholders. For example, the Act apparently would have governed the sale of control in *Perlman v. Feldman*¹⁹⁴ (which, indeed, involved an Indiana corporation). This was presumably no mere oversight on the part of the Indiana General Assembly, since a sale of control by a controlling shareholder is essentially equivalent to a partial bid by an outsider. That is, the purchaser in such a case may be motivated to pay a premium to the seller, either because the purchaser intends to loot the company and is bribing the seller for the privilege, or because the purchaser thinks she can make the company worth more and can buy control at the lowest cost by dealing with the current controlling shareholder. In either event, the Indiana Act appears now to give the nonselling shareholders the right to vote on whether the sale may go through.

In this regard, the Act is a mixed blessing. On the one hand, it seems only fair to apply sale of control standards uniformly to all buyers including friendly ones. On the other hand, it is not clear that shareholders can easily be convinced of the good intentions of a potential buyer (any more than the wisdom of greenmail¹⁹⁵). Presumably, friendly buyers will need to offer the same assurances as will hostile buyers. That means, of course, that friendly sales will become somewhat more expensive and thus less frequent. This feature of the Act may thus backfire in the same way as the New York greenmail statute.¹⁹⁶

Whether shareholder review of inside sales of control is good or bad depends on whether such sales are more often motivated by the opportunity to loot or by the buyers' better ideas. If the former, the Indiana Act is a marginal improvement. Unfortunately, it will not likely ever be known whether this is a positive aspect of the act, since its effects as measured by, say, the stock prices of Indiana companies

persuaded by the consensus, the market price of target stock will presumably remain enhanced following a successful vote, meaning that the potential dissenter will virtually always choose to sell his or her shares in the open market rather than await the outcome of a lengthy and unpredictable appraisal proceeding. On the other hand, the Indiana Act defines fair value as a price not less than the highest price per share paid in the control share acquisition. Thus, although appraisal cannot ordinarily result in an award which reflects any gain from the offending transaction, the Indiana Act does create some potential incentives to dissent.

194. 219 F.2d 173 (2d Cir. 1955), cert. denied, 349 U.S. 952 (1955).

195. See text at note 151 *supra*.

196. See Levmore, Book Review, 65 TEXAS L. REV. 1061 (1987) (reviewing D. BAYNE, THE PHILOSOPHY OF CORPORATE CONTROL: A TREATISE ON THE LAW OF FIDUCIARY DUTY); Hamilton, *supra* note 22.

will no doubt be overshadowed by other effects of the Act, except perhaps in the rare case of a publicly held company which is majority owned by a single individual or group and which does not opt out. Only in such a case will it be possible to isolate the effect of the Indiana Act on the threat of an insider's sale of control as perceived by minority shareholders.¹⁹⁷

E. *Identifying Targets Susceptible to Coercion*

Although the Indiana Act leaves open the possibility that holdout shareholders may approve partial and two-tier bids even when they are paid less than those who tender or sell in the first step, the Act (like a poison pill) also creates the danger of forcing bidders to offer higher premiums than they otherwise would, thus reducing the number of takeovers proposed, and in turn reducing management efficiency. Such a result seems somewhat more likely than the converse approval of a lower second tier: In the absence of a control share statute, a bidder need only offer enough to satisfy half plus one of the target shareholders, whereas with a simple control share statute providing for a single vote when the bidder acquires, say, a majority of target shares, the bidder must also satisfy a majority of the remaining half minus one of the shareholders (or a total of three quarters of the shareholders as measured before the bidder began purchasing) in order to be enfranchised. The bidder can, of course, risk buying a bare majority and trying to convince the holdouts of the wisdom of conferring voting rights. But the risk of losing the vote may outweigh the cost of offering enough in the first place to satisfy the three quarters whose consent must eventually be had.

It is possible that, because of this disincentive to bid for companies covered by the control share statute, the price that must be offered to early tenderers will be depressed enough to allow a *higher* back-end merger price. What seems more likely, however, is that the remaining shareholders will insist on a higher payment in exchange for their approval. The bidder may, of course, be able to avoid much of the risk by conditioning a bid on receiving shareholder approval. Still, the requirement of a vote upon acquisition of a majority of shares has the same adverse potential as was observed in connection with the Maryland fair price statute.¹⁹⁸ It seems to encourage holdout shareholders to insist on at least equal or perhaps better treatment than early sellers,

197. See generally Weiss & White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551 (1987).

198. See text at notes 142-44 *supra*.

even though, but for the bargaining power conferred by the statute itself, shareholders would sometimes approve partial or two-tier bids.

The operation of the Indiana Act is more complex than the single vote, 50% trigger control share statute described. The Indiana Act requires a bidder to estimate at three different ownership levels how many shareholders must be won over. The principle, however, is the same. By sterilizing the bidder's shares, the holdouts' shares are made more valuable than they otherwise would be and tender offers are probably unduly discouraged. For example, assume the bidder buys 20% of the target. Ignoring the possibility of any management shares being sterilized — and in some cases there may be relatively few — the vote required to reenfranchise the bidder is 40% plus one. That means that any proposed cashout must satisfy just over 60% of the shareholders as measured before the bidder began purchasing (that is, the 20% who sold out plus the 40% who voted in favor of the bidder). The bidder is thus forced to pay more for the target than the shareholders would have demanded in a perfectly uncoerced negotiation. Similarly, if the bidder purchases one third of the shares, the statute effectively requires two-thirds approval. And if the bidder purchases 50% of the shares, the holders of 75% of all target shares must be satisfied that the shift in control is wise.

It seems likely, at least in the situation described, where management itself controls few shares, that the Indiana Act increases the price a bidder must pay to effect a takeover. And ultimately, that is the reason most courts and commentators have been highly critical of state takeover legislation.¹⁹⁹ (It bears noting, however, that the same criticism has been leveled at the Williams Act,²⁰⁰ though it can also be argued that on balance the Williams Act lowers the price of takeover.²⁰¹) Nevertheless, the fact that the Indiana Act makes it more expensive (or apparently so) for a hostile bidder to gain control does not lead inexorably to the conclusion that the Act is bad for business. Inasmuch as the Indiana Act is similar to a statutory poison pill, it may well be appropriate for a company which is susceptible to a coercive bid. If there is a peculiar danger that a potential target company may be subject to a bid in which no competition will arise, or in which holdout shareholders will lose more as a result of looting (or quasi-

199. See text at notes 107-09 *supra*; Jarrell & Bradley, *supra* note 101.

200. Jarrell & Bradley, *supra* note 101. *But see* Leebron, *supra* note 5, at 181-82 (noting that expectation of bargaining parties affects willingness to accept particular price and suggesting that increases in tender offer premiums over time may thus be natural).

201. See R. Booth, *supra* note 5 (Williams Act rules — especially the highest price rule — eliminate much of the reason for a shareholder to hold out); Leebron, *supra* note 5, at 174-77 (bidders gain more in tender offers than in negotiated mergers).

looting) than tenderers will gain, then the effective 75% control requirement of the Indiana Act may make sense.

The fact that the Act applies to all covered Indiana companies, however, raises the central question whether on balance the Act will prevent truly coercive bids and attendant losses, or rather will protect larger companies for which a partial or two-tier bid does not visit losses on holdouts and is not coercive. Again, it seems likely that bigger targets are less susceptible to coercion. Bigger companies are more actively traded and more efficiently priced. They are less likely to increase or decrease dramatically in value for any reason, be it a technological breakthrough or operation as a captive subsidiary. At the very least, there is reason to believe that the problem of coercion is not the same for every potential target company, and for some very large companies coercion may be no problem at all. For such companies, the Indiana Act serves only to entrench incumbent management, even though for smaller companies the Act may perform a valuable function.²⁰²

1. *Opting Out*

Since the Indiana Act allows covered companies to opt out²⁰³ if their shareholders prefer exposure to coercive bids, it is arguable that the stocks of companies which inappropriately choose protection might be disfavored in the market. That is, it may be argued that in the end, the forces of the marketplace will induce companies to do the right thing. And if it turns out that protection against partial and two-tier bids makes sense for some companies but not for others, then the Indiana Act has the considerable advantage of catering to both. There is reason to worry, however, that the market is not *that* efficient. Poison pills, which are similar to a privately adopted control share statute, are devised and adopted one company at a time. The market can be expected to discipline strictly any company which adopts a pill that is overprotective (and perhaps any company that adopts a pill at all). Because the Indiana Act applies to all Indiana corporations which do not opt out, however, it is much less risky for any one company, in effect, to try out a poison pill.

The same would be true, though probably less markedly, if the Indiana Act were of the opt-in variety. The reason, ironically, is the same one that makes partial and two-tier offers coercive. The company that dares to adopt a poison pill not knowing whether others will

202. See text at notes 63-76 *supra*.

203. IND. CODE ANN. § 23-1-42-5 (West Supp. 1987).

follow may indeed find that others do not follow. If so, the lonely leader may become the focus of adverse shareholder reaction and may suffer devastating discounting in the market, making it an even more likely target. However, if every company adopts measures that shareholders dislike, there may be no significant market reaction, unless there is a reasonably close substitute investment to which investors may turn at relatively little cost. And even if the statute is of the opt-in variety, it may provide enough coordination for many companies to risk adopting it, possibly on the argument that others are likely to opt in, so that most all will opt in.

It may appear, then, that takeover statutes are abusive because they are a way for target companies to circumvent a vote of their own shareholders and perhaps even market discipline (at least in the sense of not being singled out for discounting).²⁰⁴ On the other hand, as previously noted, there may be occasions when larger or better coordinated shareholders will be able to veto shark repellent amendments and will be motivated to do so because they expect to be paid a disproportionate amount (a bribe) for their shares if a tender offer arises. If so, such companies, or more precisely their noninstitutional shareholders, may benefit from a control share statute precisely because it can be adopted without a shareholder vote.

Professor Romano has suggested that the central problem may be how to tell which companies have the sort of shareholder population for which a takeover statute makes sense and what kind of company is predominant in each jurisdiction.²⁰⁵ Presumably, a state in which most of the publicly traded companies are susceptible to a coercive takeover ought to adopt an opt-out statute (and vice versa), thereby achieving a maximum reduction in the transaction costs of negotiating corporate charters.²⁰⁶ Professor Romano found no convincing evidence of a correlation between the kind of shareholder population within a state's corporations and the state's adoption of a takeover statute (or the speed with which the statute is adopted). Neither did she find any evidence that the market value of companies incorporated in states which adopt takeover statutes either rises or falls (though this

204. It has been argued by some that managers are (quite naturally and to some extent rightly) more concerned about protecting their jobs and deferred compensation arrangements than they are about keeping the price of the company's stock high. *See, e.g., Coffee, supra* note 10, at 16-24. If so, market discipline other than the threat of takeover may make little difference to such managers and a takeover statute would likely be viewed as a particularly attractive device. *See also Gilson, supra* note 42.

205. *See Romano, supra* note 2, at 180-87.

206. *Id.* *See also* R. POSNER, *ECONOMIC ANALYSIS OF LAW* 369-72 (3d ed. 1986) (function of corporation code is to provide standard form contract between shareholders and management).

inquiry was complicated by the difficulty of determining exactly when the market will react).²⁰⁷

The worry that companies which ought not adopt takeover defenses will be able to take advantage of the statute is probably overstated however. First, even though investors who could block a decision to opt in will not necessarily be able to force the company to opt out,²⁰⁸ management will have an incentive to opt out if it is appropriate, since by doing so it will stand out from the crowd in a positive way in the eyes of investors and will likely be rewarded with cheaper capital. Opting out will not only expose the company to the threat of takeover and the discipline that goes with it, it will also signal to investors management's high level of confidence in the job it is doing. Second, and more important (though somewhat at odds with the first point), it is unclear that a control share statute is much of a deterrent against the takeover of a larger company with more diverse shareholders. Presumably, the smaller company can be controlled by acquiring large blocks of shares from a relatively few shareholders and is therefore most susceptible to a coercive offer or one which directs a bigger premium to key shareholders. Moreover, larger companies can in many cases be controlled with a smaller percentage of shares than are required to trigger the control share statute. Shareholders in a large target company are less likely to have opinions of the target's value which differ as much as they do in a smaller company which is more susceptible to dramatic changes of fortune and whose stock is less heavily traded. Finally, larger companies are much less susceptible to advantage-taking or quasi-looting by a prospective parent, which can drive down the price of shares after control has passed. In short, it is probably not that damaging to shareholder wealth for a company which should *not* be subject to a control share provision to be covered while the converse is potentially quite destructive.

Thus again, it may be difficult to tell whether the Indiana Act is something that on balance is good for the capital markets, particularly if most states adopt such provisions. For the moment, however, there

207. Romano, *supra* note 2, at 181-86. See also SEC (Office of the Chief Economist), *Institutional Ownership, Tender Offers, and Long-Term Investments* (Apr. 19, 1985) (finding no statistical evidence that takeover activity or institutional ownership leads managers to focus on short term results). But see Gordon, *Ties That Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 75 CALIF. L. REV. (forthcoming 1987) (reporting relatively small institutional ownership in companies proposing dual class recapitalization). There is every indication, however, that managers pay attention to the composition of the shareholder population particularly in connection with the threat of takeover. See FERRARA, *supra* note 2, at 189-91; SHAREHOLDER ACTIVISM, *supra* note 40; *The Trench Warriors*, N.Y. Times, May 29, 1988, § 3 (Business), at 1, col. 2.

208. See Romano, *supra* note 2, at 186-87.

remains a reasonably wide variety of second-generation takeover statutes from which to choose and presumably companies which choose to be incorporated in the states which offer the optimal kind of statute will be rewarded with cheaper capital.²⁰⁹

2. *Sterilization and the Fair Vote*

There is further reason to believe that the Indiana Act is less protective of management in certain circumstances than may at first appear. Consider again the situation in which a bidder has acquired a 20% stake in the target company. If management — which cannot vote its shares on a control share question under the Indiana Act — also controls 20% of the company's shares, the bidder need only woo a majority of the 60% which neither it nor management owns. That 30% plus one in addition to the 20% which the bidder has already bought adds up to a bare majority of the shares as measured before the bidder began buying. In such a case, the Indiana Act produces an eminently fair result — but only accidentally, that is, only because bidder and management happen to own the same number of shares. Needless to say, in larger companies, in which management controls relatively little stock, sterilization works a real disadvantage on the bidder. Not only is the bidder precluded from voting, but the bidder has already bought the shares most likely to be voted in favor of the bidder's enfranchisement. Of course, management too is precluded from voting its shares, which are presumably the ones most likely to vote against the bidder. Yet, where management owns fewer shares than the bidder, the bidder is put at a distinct disadvantage, because more of the votes likely to be cast in its favor have been sterilized. It seems backwards, to say the least, to make it more difficult for a bidder to proceed the more shares it acquires. On the other hand, in a corporation large enough to have a management with relatively few votes of its own, it seems likely that a bidder who acquires just under 20% of

209. In other words, it would seem preferable to eschew at least for the moment any temptation to preempt state takeover laws by imposing a uniform federal scheme, as has been proposed in a number of bills in Congress. See notes 94-96, *supra*; *House Staff Is Drafting Compromise on Preempting State Control Share Laws*, 19 Sec. Reg. & L. Rep. (BNA) No. 38, at 1443 (Sept. 25, 1987); *Senate Panel Approves Takeover Bill, Is Neutral on State Antitakeover Laws*, 19 Sec. Reg. & L. Rep. (BNA) No. 39, at 1479 (Oct. 2, 1987); Leebron, *supra* note 5 (fixed rules create inefficiencies; state law has traditionally been more flexible; Williams Act was passed against backdrop of state law); Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEXAS L. REV. 469 (1987); see also Romano, *supra* note 2, at 181 (reaction of stock market is best evidence of value of takeover statute). *But see* Weiss & White, *supra* note 197. It bears noting that Delaware declined — somewhat to the surprise of observers — to adopt a statute similar to the Indiana Act. See *Delaware Bar Committee Decides to Study Control Share Law Further*, 19 Sec. Reg. & L. Rep. (BNA) No. 24, at 868 (June 12, 1987); 19 Sec. Reg. & L. Rep. (BNA) No. 25, at 922 (June 19, 1987) (reporting explanatory letter from bar committee to Delaware Secretary of State).

the stock will be able to exert a good deal of influence and perhaps even actual control over the company. Thus, as previously noted, the Indiana statute may not in practice prevent shifts in control at very large companies, but rather will have its greatest impact on smaller companies, which are by definition less efficiently priced and more susceptible to coercive bids.

Nevertheless, where management and bidder have roughly equal stakes in the company, the vote is an elegant solution to the problem of coercion. This suggests a possible improvement in the Indiana statute. Rather than requiring a vote upon the acquisition of arbitrary percentages, as under the current statute, it might be more sensible to hold a single vote when the bidder acquires the *same* percentage of the target's stock as is controlled by pre-bid management, thus insuring what happened by accident in the example given. With the trigger percentage so determined, a vote of the disinterested shareholders would reflect the true median view of nonmanagement shareholders regarding the desirability of a continued battle for control.

It is open to question, of course, whether the median view of disinterested shareholders as to the value of the company is in fact the optimum standard by which to determine whether a takeover should proceed.²¹⁰ Intuitively, a majority vote would seem to have merit, since where the bid price is approved by the median voter, at worst half the target shareholders will be overcompensated and half will be undercompensated. Moreover, assuming that a graph of the values perceived by the shareholders is a relatively straight and continuous line, the amount of overcompensation roughly equals the amount of undercompensation suffered by various shareholders. Well-diversified shareholders would be perfectly happy with such an outcome since they would sometimes receive more and other times less but on the average would get a fair price for their stock.²¹¹

A simple majority vote will not, however, reflect whether those who vote in favor of the merger perceive the gain to be greater than the loss perceived by those who vote against the merger. It is possible, after all, that the range of values perceived by the shareholder population (or by discrete groups) is not a smoothly sloping line but rather increases (or decreases) in jumps from one shareholder or group to the next. If for example, a minimal majority of the shareholders is barely satisfied by the offered price, while the remaining shareholders perceive the value of the company to be considerably higher, the lost gain

210. See Romano, *supra* note 2, at 189 n.142.

211. See Booth, *supra* note 26.

for the holdouts could far exceed the realized gain to those voting in favor of the bid.

At first blush, this problem would seem to be serious if institutional investors are more often than not inclined to accept bids as is often said. On the other hand, it may be that the reason for their opposition to takeover defenses, as has been argued, is that institutional investors often enjoy the opportunity to sell earlier or at an effectively higher price than other target shareholders. If that is the primary reason why institutional investors are willing to settle for smaller premiums, then it is no reason to question the efficacy of a majority vote under a control share statute. Since the vote will determine whether there will be any further sales to the bidder, institutional investors will ordinarily be denied any preference over other target shareholders and will have no peculiar incentive to vote in favor of the bid. There may be other as yet unidentified reasons why institutional investors or other groups of investors are more or less inclined to tender. At this juncture, however, there is no particular reason to think that a majority vote is not the optimum standard.²¹²

Admittedly, it may be difficult, for purposes of enforcing a one-vote control share statute, to determine which shares should be regarded as under management control. (Similarly, and as noted previously, problems may arise in determining precisely which shares are controlled by the bidder.) The easy answer is that the same problem attends the Indiana Act as it currently stands (not to mention federal law). Under the current statute, management has every incentive to minimize the number of shares that are deemed to be under its control. And it seems fair to assume that there will be a good deal of litigation over whether shareholders friendly to target management are in fact controlled by management.

A modified statute requiring a single vote upon a bidder's acquisition of the same percentage as management would discourage such controversies. Under such a statute, management would be faced with conflicting incentives. On the one hand, management would still be tempted to understate its control in order to count the votes of friendly shareholders. On the other hand, management would also be tempted to overstate its control in order to postpone the vote, clear the market of shares most likely to vote in favor of the bid, and shift additional risks onto the bidder, who is forced to acquire a larger percentage of target stock without the benefit of knowing whether the bid can pro-

212. See Easterbrook & Fischel, *supra* note 39, at 409-10; Bebchuk, *supra* note 2; Leebron, *supra* note 5; Brudney & Chirelstein, *A Restatement*, *supra* note 2.

ceed. It seems likely then that on balance target managers would be inclined to state their control percentage accurately in order to avoid the possibility of a vote that is either too early or too late. It might even be advisable to require each covered company to state publicly in advance exactly what it considers its control percentage to be and to update the number as circumstances change.²¹³

Holding a single vote upon the bidder's acquisition of the control percentage differs from the law as it now stands. The current statute contemplates as many as three separate votes as the bidder crosses each statutory threshold. (Again, it is unclear whether the bidder must be reenfranchised as to all of her shares at each vote or simply as to newly acquired shares.) While this scheme is understandable because, among other reasons, control may often be exercised with less than a majority of the stock, it nevertheless seems wasteful in the extreme to allow target shareholders three chances to decide and management as many as three chances to thwart a single takeover. No doubt the reason for requiring three votes was that different companies can be controlled with different percentages of shares. If, however, there is a reliable and relatively inexpensive way of determining, company by company, the percentage necessary for control, the sensible approach would be to hold a single vote at the time the bidder reaches that percentage of stock ownership. And what better evidence could there be of the percentage needed to control a company than the percentage management itself controls?

It seems unlikely, in any event, that a second or third vote would ever turn out differently from the first. More important, however, the idea is to achieve an efficiently functioning takeover mechanism which takes shareholder preferences into account in an optimal way. The idea is not to assure that no shareholder will be dissatisfied with the outcome of any particular control contest, but rather that on the average shareholders — as well as bidders and target managers — are fairly treated. It is no argument in favor of multiple votes to say that shareholders have an inalienable interest in holding onto their shares and that only after *repeated* expressions of approval by the ever smaller majority of remaining disinterested shareholders can a bidder have full access to ownership rights.²¹⁴

213. For example, the SEC might require such disclosure annually in 10K reports and require any changes to be reported in an 8K. See Exchange Act Rules 13a-1, 13a-11, 17 C.F.R. § 240.13a-1, 13a-11 (1987). This might be particularly helpful in light of the fact that relatively few companies meet all the criteria for coverage under many second-generation statutes. See text at notes 108-20 *supra*.

214. Compare *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977) (recognizing shareholder

VI. THE PROSPECTS FOR FUTURE PREEMPTION

Although the Supreme Court in *CTS* gave little credence to the till-then widely accepted notion that most second-generation statutes were an undue burden on the free flow of securities and thus unconstitutional under the dormant commerce clause, the Court might view other sorts of statutes less charitably,²¹⁵ or regulatory developments might raise new questions about the Indiana Act and similar statutes. Though Congress has for now declined to pass legislation designed to preempt state takeover laws,²¹⁶ there remains a serious threat that SEC or stock exchange rules touching on shareholder voting rights may be modified in such a way as to conflict with the operation of control share statutes (or worse).

The SEC has recently announced that it proposes to curtail the use of devices which confer superior voting rights on some shareholders.²¹⁷ The proposed rule grew out of controversy surrounding the New York Stock Exchange's proposal to dilute its long-standing policy requiring equal voting rights for all shareholders.²¹⁸ A growing number of NYSE-traded companies, fearful of exposing themselves to takeovers, undertook to recapitalize by exchanging financially attractive nonvoting stock for voting stock and began using nonvoting stock to acquire other companies.²¹⁹ The NYSE, worried about losing business to other exchanges more hospitable to takeover defenses, suspended its rule rather than delist the offenders and sought either to abolish the rule or to induce (or force, with the help of the SEC's authority) the other exchanges to adopt similar rules.²²⁰ The SEC has now proposed to settle the controversy itself by adopting a rule to govern all exchanges. The contemplated rule will likely allow listed companies to issue new stock with lesser voting rights in connection with acquisitions but will curtail recapitalizations in which existing voting

interest in the form of investment), with *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (overruling *Singer*).

215. See note 169 *supra*.

216. See notes 95-96 *supra*.

217. See Voting Rights Listing Standards — Proposed Disenfranchisement Rule, Exchange Act Release No. 24,623 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,183 (June 24, 1987).

218. See Gilson, *supra* note 42; Gordon, *supra* note 207; Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986); Note, *Dual Class Recapitalization and Shareholder Voting Rights*, 87 COLUM. L. REV. 106 (1987).

219. See Karmel, *Is One Share, One Vote Archaic?*, N.Y.L.J., Feb. 26, 1985, at 1, col. 1. It should be noted that dual class recapitalizations are often carried out using what amounts to a coercive exchange offer that shareholders cannot well refuse. See Gilson, *supra* note 42; see also Grundfest, *supra* note 3.

220. See Karmel, *supra* note 219.

rights are significantly diluted presumably even contingently as they are when a poison pill is deployed.²²¹

Aside from the fact that the SEC's action infringes an area of regulation traditionally left to the exchanges,²²² the new rule would also seem to call into question the validity of statutes such as the Indiana Act which temporarily nullify the voting rights of bidders. It could be argued, after all, that SEC-imposed rules which limit the ability of target companies to dilute or eliminate voting rights are preemptive of state statutes which effectively suspend voting rights in many of the same situations.²²³

The SEC's proposed action is clearly a victory for the NYSE, which feared losing listings because of its stricter rule. But it is far from clear that the rule, if adopted, will have much effect on the threat of takeover faced by the typical NYSE company. Again, two-tier offers are far more of a threat to smaller companies which are less actively traded and which, because of their smaller size, are more susceptible to dramatic price swings or more likely to become captive subsidiaries. Shareholders in such companies are not only likely to differ more in their opinions of what constitutes an adequate offer, but they also justifiably fear the consequences of a partial bid and are thus more likely to tender early for what they perceive to be a less attractive offer than are shareholders in a large NYSE-listed company. Other things equal, the proposed rule is likely to disserve smaller companies and to eradicate whatever positive attraction alternative exchanges may have had.²²⁴ If, in the end, the effect of the new rule is simply to force companies to use the available state statute rather than customized poison pills, it is probably all for the good.²²⁵ On the other hand, if the SEC's rule is interpreted as preempting state takeover statutes, it will probably do more harm than good, since it will force all companies regardless of size, shareholder characteristics, control percentage, or likely consequences of takeover into a mold which is essentially designed for NYSE-listed companies.

221. See Voting Rights Listing Standards, *supra* note 217; see also note 96 *supra*.

222. See note 53 *supra*.

223. See SENATE TENDER OFFER REPORT, *supra* note 8, at 53-54; see also SEC Concept Release, *supra* note 61 (raising possibility of rule requiring shareholder approval of poison pills).

224. As I argue elsewhere, exchanges perform a unique standardizing function similar to that of state law. See R. Booth, *supra* note 5. In effect, the exchange on which a stock is traded can operate as a cheaply readable label describing, among other things, the sort of takeover defenses the company may employ. Moreover, the exchange can act as a coordinating agent to reduce the risk a company might face by adopting nonstandard rules. But to the extent the rules of the various exchanges are homogenized — as they must necessarily be if the SEC adopts a uniform rule for all — they lose much of their value. Cf. Macey & Miller, *supra* note 209.

225. See Leebron, *supra* note 5, at 216-19; note 86, *supra*.

CONCLUSION

Despite their nearly universal condemnation, control share statutes appear to be a promising solution to several pressing problems associated with so-called coercive tender offers. But, as has been argued here, existing control share statutes should be reworked to eliminate their biases in favor of target management. The ideal control share statute would provide for a single vote as of the bidder's acquisition of shares equal in number to management-controlled shares. The other varieties of state takeover statutes that have been adopted alone or in combination with control share statutes are, for the most part, nothing more than misguided attempts to achieve the same sort of bargaining balance which is effectively established by control share statutes. They should be repealed. Finally, there should be little need for anything more than a pure disclosure statute at the federal level once a well-crafted control share statute becomes readily available.²²⁶

226. See *Leebron*, *supra* note 5, at 221-22.