
The Legitimacy of Takeover Defense in the '90s

Robert A. Ragazzo

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THE LEGITIMACY OF TAKEOVER DEFENSE IN THE '90s

*Robert A. Ragazzo**

TABLE OF CONTENTS

INTRODUCTION		690
I. THE LEGAL BACKGROUND		692
A. <i>The Unocal Standard</i>		692
B. <i>The Delaware Chancery Court's Interpretation of Unocal</i>		696
C. <i>The Delaware Supreme Court's Interpretation of Unocal</i>		698
1. <i>Moran v. Household International, Inc.</i>		698
2. <i>Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.</i>		699
3. <i>Paramount Communications v. Time Inc.</i>		701
D. <i>Conclusion</i>		704
II. AN ECONOMIC ANALYSIS OF DEFENSIVE TACTICS		704
A. <i>The Efficient Markets Hypothesis</i>		704
1. <i>Valuing Investments</i>		704
2. <i>Three Forms of EMH</i>		705
B. <i>Defensive Tactics Assuming the Validity of EMH</i>		707
1. <i>Negotiation</i>		707
2. <i>Auctions</i>		709
C. <i>Defensive Tactics as a Challenge to EMH</i>		710
1. <i>Evidence on the Weak Form of EMH</i>		710
2. <i>Evidence on the Semi-Strong Form of EMH</i>		711
3. <i>Evidence on the Strong Form of EMH</i>		714
D. <i>Evidence on the Impact of Successful Takeover Defense</i>		715
E. <i>Conclusion</i>		717
III. SHAREHOLDER CHOICE		718

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A.	<i>Partial Offers</i>	719
1.	<i>The Two-Tiered Offer</i>	719
2.	<i>The Pure Partial Offer</i>	721
B.	<i>All-Cash, All-Shares Offers</i>	722
1.	<i>No Second-Step Merger Announced</i>	722
2.	<i>Second-Step Merger at the Tender Offer Price</i>	723
C.	<i>Solutions to the Problem of Tender Offer Coercion</i>	725
IV.	THE ROLE OF THE TARGET COMPANY'S BOARD	726
A.	<i>The Duties of Target Company Directors</i>	727
B.	<i>The Target Company's Board as the Best Decision-Maker</i>	729
V.	CHECKING THE BOARD'S DISCRETION	731
A.	<i>Shareholder Action</i>	731
B.	<i>Judicial Review</i>	735
	CONCLUSION	738

INTRODUCTION

The validity of preclusive defensive tactics is the most important unresolved issue in the mergers and acquisitions field. In a typical scenario, a bidder makes an all-cash, all-shares tender offer¹ at a substantial premium to the market price of target company stock² and conditions its offer on obtaining enough stock to force a second-step merger with the target company.³ If the target company's board finds the offer price inadequate and resolves to fight the offer,⁴ it adopts or implements defensive tactics that preclude the offer as a

1. An all-cash, all-shares tender offer is an offer to buy 100% of target company shares for cash.

2. Takeover premiums averaged 50% over the market in the 1980s. See Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 601 (1989); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 892 (1988); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1235 & n.1 (1990).

3. State law typically requires a 51% shareholder vote, see, e.g., CAL. CORP. CODE § 1201(a) (West Supp. 1990); DEL. CODE ANN. tit. 8, § 251(c) (1991), or a 67% vote, see, e.g., N.Y. BUS. CORP. LAW § 903(a)(2) (McKinney 1986), to effect a merger. Corporations are empowered to adopt charter provisions increasing the vote necessary to effect a merger. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(4) (1991). Most offerors desire to effect a second-step merger after acquiring control of a target company. Conditioning the offer on the ability to effect a second-step merger gives the offeror access to the target company assets as collateral and helps the offeror obtain financing. Offerors also prefer to eliminate minority shareholders so that every corporate decision made by the offeror is not open to legal challenge on the ground of unfair self-dealing. See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 499, 508 (7th Cir.) (Easterbrook, J.), cert. denied, 493 U.S. 955 (1989).

4. This Article is limited to the legitimacy of the takeover defense in response to inadequate offers. Other grounds recognized by the courts as the basis for tender offer defense include: "nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities offered in the exchange." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

practical matter.⁵ The bidder's ability to proceed with the offer often hinges on litigation challenging the preclusive defensive tactics.

Proponents of the efficient markets hypothesis ("EMH") assert that preclusive defensive tactics should be prohibited.⁶ According to EMH, the stock market is the best indicator of any stock's value.⁷ If EMH is accurate, the target company's board and shareholders do not have to judge the financial adequacy of a premium offer because the market has already made that judgment. The bidder is able to offer a premium because target company assets are more valuable in its hands.⁸ According to this line of argument, preclusive defensive tactics are impermissible because every premium offer is socially beneficial.⁹

The Delaware courts have rejected the EMH view.¹⁰ As a result, under current law, some target constituency must pass on the economic merits of a tender offer. Some Delaware cases have suggested that target company shareholders must make this economic choice and that preclusive defensive tactics are inappropriate.¹¹ Other Delaware cases have suggested that the target company's board should play the primary role in assessing the merits of tender offers.¹² This Article argues that target directors should have access to preclu-

5. Any mechanism that will defeat the particular offer will suffice. A popular defensive tactic is the poison pill rights plan. In its most common form, the target company's board issues one right for every outstanding share of common stock. Until an acquiring person crosses a certain ownership threshold, typically about 20%, the rights trade with the common stock. Once the acquiring person crosses the designated threshold, rights certificates are issued enabling target stockholders to buy one common share of the target company per right for a price that is higher than the current value of the stock. If the acquiring person effects a second-step merger between it and the target, target stockholders obtain the right to purchase shares of the acquiring company at half-price. This type of poison pill is known as a flip-over rights plan. *See, e.g., Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1348-49 (Del. 1985). Some poison pills, called flip-in plans, allow target stockholders, other than the bidder, to purchase target company shares at half-price once the bidder crosses the ownership threshold. *See, e.g., Grand Metro. Pub. Co. v. Pillsbury Co.*, 558 A.2d 1049, 1051 n.2 (Del. Ch. 1988); *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 791-92 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). The flip-over and flip-in provisions of the poison pill constitute a substantial financial disincentive to hostile offers. However, before an acquiring person crosses the designated ownership threshold, the poison pill may be redeemed by the target company's board at a nominal price. The redemption provision allows negotiated offers to proceed. *See Moran*, 500 A.2d at 1349.

6. *See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-82 (1981); Alan Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165, 165, 195 (1988); *cf. Amanda*, 877 F.2d at 500-02 (Easterbrook, J.) (arguing that defensive mechanisms injure target shareholders).

7. *See* discussion *infra* part II.A.2.

8. *See* discussion *infra* part II.A.2.

9. *See* discussion *infra* part II.A.2.

10. *See infra* text accompanying notes 28, 81.

11. *See* discussion *infra* part I.B. (discussing the Delaware Court of Chancery's interpretation of *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)).

12. *See* discussion *infra* part I.C. (discussing the Delaware Supreme Court's interpretation of *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)).

sive defensive tactics and that their actions should be subject to rigorous judicial review.

Part I of this Article surveys the legal background in the takeover defense: a difficult question. Part II argues that, for reasons consistent with and contrary to EMH, the existence of a premium does not eliminate the need to judge the merits of an offer. Preclusive defensive tactics may be appropriate in individual cases to force the bidder to raise its price, to conduct an auction, or to safeguard the independence of the target company. Part III demonstrates that target company shareholders are not the appropriate body to make the tender offer decision because the tender offer process virtually forces them to accept every premium tender offer. The courts and commentators have assumed that an all-cash, all-shares offer that promises a second-step merger at the tender offer price is noncoercive. Part III will demonstrate that this view is erroneous. Part IV concludes that, even if shareholders could exercise free choice when responding to tender offers, the target company's board should still play the primary decision-making role because state corporation law makes the board responsible for evaluating offers to sell the company and because the board is better situated than shareholders to make tender offer decisions. Part V suggests that the corporate election machinery and judicial review are adequate safeguards against the danger that directors will further their own interests at the expense of shareholders when adopting defensive tactics.

I. THE LEGAL BACKGROUND

A. *The Unocal Standard*

In the first wave of takeover litigation, the courts held that board action in opposition to a takeover bid was protected by the business judgment rule.¹³ Pursuant to this standard, a party challenging directorial action must demon-

13. See *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293-94 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Buffalo Forge Co. v. Ogden Corp.*, 555 F. Supp. 892, 904 (W.D.N.Y.), *aff'd*, 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 634 (D. Md. 1982); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 951 (N.D. Ill. 1982). *But see* *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 233-34 (9th Cir. 1975). Some courts applied a seemingly different test and refused to uphold defensive tactics unless the target company's board could prove that the board's primary purpose in adopting such tactics was to further shareholder interests rather than the board's. See *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 n.47 (2d Cir. 1980); *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964); *Bennett v. Propp*, 187 A.2d 405, 408 (Del. 1962). However, directors were able to articulate valid, nonselfish business purposes for their actions, and the courts generally accepted such articulations without much probing of whether these legitimate purposes were primary. See, e.g., *Cheff*, 199 A.2d at 555-56 (approving defensive maneuvers upon a finding that the board acted reasonably without determining the board's primary motivation). As a result, the primary purpose test proved indistinguishable from the business judgment rule. See *Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006, 1023 n.26 (S.D.N.Y. 1984); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 829 (1981); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1969-70 (1984).

strate fraud, bad faith, or gross overreaching.¹⁴ The board will prevail whenever it can articulate a rational, unselfish business purpose for its action.¹⁵ Thus, the business judgment rule is a formidable standard for any plaintiff to overcome.¹⁶

The chief alternative to the business judgment rule is the intrinsic fairness test. This standard applies whenever directors have a direct financial stake in action taken by the board.¹⁷ Where the intrinsic fairness test applies, the directors must prove the substantive fairness of the transaction by an objective standard.¹⁸ The courts rejected the intrinsic fairness test in the takeover defense context for several reasons. First, directors do not have a direct financial stake in the success or failure of a tender offer.¹⁹ Second, it is the responsibility of the target company's board, rather than the courts, to make substantive business decisions.²⁰ Finally, the courts have noted that application of the intrinsic fairness test would invalidate most defensive tactics.²¹

Nevertheless, target company directors face a conflict of interest when adopting defensive tactics that have the effect, if not the goal, of perpetuating the directors' authority.²² The business judgment rule, like the intrinsic fairness test, is usually outcome determinative.²³ In *Unocal Corp. v. Mesa Petro-*

14. See, e.g., *Panter*, 646 F.2d at 293; *Warshaw v. Calhoun*, 221 A.2d 487, 492-93 (Del. 1966).

15. See *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

16. See, e.g., EARNEST L. FOLK, *THE DELAWARE GENERAL CORPORATION LAW* 75-81 (1972).

17. See ROBERT C. CLARK, *CORPORATE LAW* 138, 166-71 (1986). A typical example is a contract between directors and the corporation. See, e.g., *Cohen v. Ayers*, 596 F.2d 733, 739-40 (7th Cir. 1979).

18. E.g., DEL. CODE ANN. tit. 8, § 144(a)(3) (1991); N.Y. BUS. CORP. LAW § 713(b) (McKinney 1986); Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655 (1992); Andrew G.T. Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674, 676 (1979). Intrinsic fairness is often difficult for directors to prove. See, e.g., *Lewis v. S.L. & E., Inc.*, 629 F.2d 764 (2d Cir. 1980) (invalidating contract between interlocking corporations); *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (invalidating freezeout merger transaction); *Sinclair Oil*, 280 A.2d at 722-23 (invalidating refusal by controlling shareholder to comply with contractual obligations); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 121 N.E. 378 (N.Y. 1918) (invalidating contract between interlocking corporations).

19. See *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 790 n.1 (Del. Ch. 1988).

20. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (noting that takeover defense "decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment").

21. See, e.g., *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986); see Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 247-48 (1989).

22. See *Unocal*, 493 A.2d at 954 (noting that, in the takeover defense context, there is an "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders"); *Easterbrook & Fischel*, *supra* note 6, at 1175.

23. See *Anderson, Clayton*, 519 A.2d at 111; see also Gilson & Kraakman, *supra* note 21, at 247-48 (asserting that use of the business judgement rule would effectively insulate target company defensive measures from judicial scrutiny).

leum Co.,²⁴ the Delaware Supreme Court recognized that the traditional standard for judicial review of takeover defense was too lenient, and created an intermediate standard of review.²⁵ To have defensive tactics upheld under *Unocal*, the target company's board must prove that it has "reasonable grounds for believing that a danger to corporate policy and effectiveness exist[s]" and that such tactics are "reasonable in relation to the threat posed."²⁶

The result in *Unocal* does little to elucidate the requirements of this new test. In *Unocal*, an entity controlled by T. Boone Pickens owned 13% of Unocal and offered \$54 per share in cash for an additional 37%. If the tender offer succeeded, Pickens announced he intended to acquire the remaining 50% of Unocal for securities that he valued at \$54 per share. Unocal's investment banker opined that Unocal was worth at least \$60 per share on a liquidation basis. The Unocal board rejected Pickens' offer as inadequate and commenced a self-tender offer. In the event Pickens consummated his 37% tender offer, the board resolved to purchase Unocal's remaining shares in exchange for \$72 per share in Unocal debt securities. Shares owned by Pickens were not eligible for the self-tender.²⁷

In addressing the first prong of its new test, the Delaware Supreme Court rejected the EMH view²⁸ and held that an inadequate offer price is a threat warranting defensive action.²⁹ However, the court never examined whether the Unocal board had sustained its burden of proving that it had reasonable grounds to believe that Pickens' \$54 offer, which represented a substantial pre-

24. 493 A.2d 946 (Del. 1985).

25. *Id.* at 954-55; see also Gilson & Kraakman, *supra* note 21, at 249-51 (noting that academic and political pressures likely contributed to the formulation in *Unocal* of the intermediate standard of review for defensive measures used by target companies in response to tender offers). The direction taken by *Unocal* was suggested by Judge Cudahy's prescient dissent in *Panter v. Marshall Field & Co.*, 646 F.2d 271, 299 (7th Cir.) (Cudahy, J., dissenting), *cert. denied*, 454 U.S. 1092 (1981).

26. *Unocal*, 493 A.2d at 955. If the board makes this showing, a plaintiff must then show that the board violated the business judgment rule to prevail. *Id.* at 958; *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985). Although the Delaware Supreme Court has purported to add this third prong to the *Unocal* test, it is of little practical relevance. If the target company's board proves that it reasonably perceived a threat and that it acted reasonably in response to that threat, there is little likelihood that a plaintiff will be able to show that the board's conduct violated the business judgment rule.

27. *Unocal*, 493 A.2d at 949-51.

28. See *id.* at 955 n.10. Similarly, in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court held directors liable in damages for accepting a merger proposal that represented a 45% premium over market. The court held that the existence of such a premium did not absolve the directors of their duty to investigate the intrinsic value of the company. *Id.* at 875-78. Although *Van Gorkom* is nominally a duty of care case, its clear implications are that market price is not necessarily the best indicator of a company's worth and that, if the directors find that a company is worth more than both the market and offer prices, the directors have a duty not to facilitate the offer. In *Unocal*, the court extended *Van Gorkom* from the merger to the tender offer context. Neither *Van Gorkom* nor *Unocal* contains any systematic analysis of the validity of EMH.

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

mium to the previously prevailing market price, was inadequate.³⁰ The court did not scrutinize the Unocal board's bases for believing that the company was worth more than \$54 per share. Although the court noted that the target's investment banker opined that Unocal was worth at least \$60 per share on a liquidation basis,³¹ the court did not evaluate whether this opinion was justified or whether liquidation was a potential option.

The court also did not apply the second prong of the new test in a rigorous fashion. Whether the Unocal board's defensive action was reasonable in response to the threat posed by Pickens' offer constituted a substantial question. The self-tender was a show-stopper—a death blow to Pickens' offer. Assuming Unocal was not worth \$72 per share,³² the self-tender represented an overpayment to all of Unocal's shareholders except Pickens.³³ In effect, it represented a substantial redistribution of income from Pickens to the rest of Unocal's shareholders. The latter would be allowed to raid the Unocal treasury at Pickens' expense.³⁴ Pickens, of course, was unwilling to proceed under this scenario.³⁵

The court did not explain why this show-stopping defense was a reasonable response to an inadequate offer. Perhaps it was designed to force Pickens to negotiate with the Unocal board to generate an adequate price. Perhaps the Unocal board had a business plan that would have generated value superior to Pickens' offer. However, the court did not rely on any proof of this type.

The court also viewed the Pickens offer as a threat because it was two-tiered (i.e., the court believed the \$54 worth of securities offered in the second step of the takeover attempt were worth less than the tender offer consideration of \$54 in cash). Although a two-tiered offer represents a substantial threat to

30. Unocal's stock traded at approximately \$35 per share prior to Pickens' accumulation of such stock. Pickens' \$54 offer, therefore, represented a 53% premium. See Fred R. Bleakley, *Unocal's Partnership Plan*, N.Y. TIMES, Apr. 23, 1985, at D4.

31. *Unocal*, 493 A.2d at 950.

32. The Unocal board does not seem to have offered any proof that the company was worth \$72 per share.

33. If the company was worth \$72 per share, the self-tender price would merely have represented a fair exchange for the remaining minority interest. In that event, Pickens would have purchased the initial 50% of Unocal at a substantial bargain and would have had no objection to proceeding with the transaction.

34. Pickens had to be excluded from the self-tender because if all of Unocal's shareholders were permitted to raid the corporate treasury by selling their shares back to the corporation for an excessive price, there would have been no restraining influence on Pickens. Without the exclusion, the self-tender would have been equivalent to a dividend declared equally to all shareholders, who would have owned the same proportionate share in a smaller company as a consequence. Thus, if Unocal was worth \$60 per share (in which case Pickens' offer would have been inadequate but the price of the self-tender would not have been justified), Pickens would have been willing to buy half the company at the bargain price of \$54 per share and then sell back whatever percentage of his shares the self-tender allowed at the same premium as the other shareholders.

35. Pickens withdrew his offer on the next business day after the Delaware Supreme Court upheld the Unocal board's exclusionary self-tender. Fred R. Bleakley, *Pickens To End Bid for Unocal*, N.Y. TIMES, May 21, 1985, at D1.

shareholder choice,³⁶ the court did not cite or examine any proof showing that the securities to be offered by Pickens in the second step were worth less than \$54 per Unocal share. Moreover, it is hard to justify the proportionality of the show-stopping self-tender as a response to the two-tiered threat. If the board had given the minority remaining after the first tier the right to receive \$54 per share in cash, the two-tiered threat would have been completely removed. Instead, the board offered \$72 per share to minority shareholders, thereby essentially precluding the Pickens offer.³⁷ Thus, the opinion suggests that any two-tiered offer can be precluded without regard to price.

The *Unocal* court's acceptance at face value of the justifications offered by the target company's board is reminiscent of the traditional business judgment rule.³⁸ However, the new *Unocal* test purports to shift the burden of proof to the target company's board and contains objective-proof language similar to that of the intrinsic fairness test.³⁹ Whether the *Unocal* test would allow target company directors carte blanche in responding to takeover bids, tie their hands, or accomplish something in between would be determined in future cases.

B. *The Delaware Chancery Court's Interpretation of Unocal*

The Delaware Court of Chancery has, until very recently, used *Unocal* as a vehicle for promoting shareholder choice and limiting the scope of the board's power to oppose takeover bids. In *City Capital Assocs. v. Interco Inc.*,⁴⁰ the bidder ultimately offered \$74 per share in cash for 100% of Interco's stock and promised a second-step merger at the tender offer price. The Interco board, upon the advice of its investment banker, found the offer inadequate, refused to redeem the company's flip-in poison pill rights plan,⁴¹ and adopted a

36. See discussion *infra* part III.A.1.

37. The court also cited greenmail as a threat posed by the Pickens offer. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985). Greenmail can be defined as a repurchase of securities at a premium from a substantial shareholder for the purpose of preventing that shareholder from mounting a takeover attempt. *E.g.*, *Polk v. Good*, 507 A.2d 531, 537 & n.3 (Del. 1986); *Unocal*, 493 A.2d at 956 n.13; Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis*, 98 HARV. L. REV. 1045, 1045 n.3 (1985). Although Pickens had a justified reputation as a greenmailer, *id.* at 1046 n.8 (noting that Pickens' Mesa Partners entity had recently made a greenmail profit of \$89 million from Phillips Petroleum), it is hard to understand why this threat justified the board's self-tender. Greenmail cannot be unilaterally imposed on a target company. The *Unocal* board simply could have refused to pay greenmail. If the board was concerned that greenmail might be necessary to prevent Pickens from visiting harms on the corporation or its shareholders, the board should have identified these threats and relied on them to justify its defense rather than on the threat of greenmail.

38. See Gilson & Kraakman, *supra* note 21, at 252.

39. See *supra* text accompanying notes 13-26. See generally Gilson & Kraakman, *supra* note 21, at 252-60 (analyzing whether the *Unocal* intermediate standard of review is primarily a rhetorical instruction with minimal substance or a sincere inquiry into the legality of defensive actions implemented by target companies).

40. 551 A.2d 787 (Del. Ch. 1988).

41. See *supra* note 5 (describing the flip-in poison pill rights plan).

restructuring. The restructuring involved the payment of a \$66 per share cash dividend. The company's investment bankers valued the company's post-restructuring shares at \$10 per share, giving the restructuring a total estimated value of \$76 per share.⁴²

The chancery court was willing to accept that: Interco's board "acted prudently to inform itself of the value of the Company"; "[t]he board believes in good faith that the [bidder's] offer is for a price that is 'inadequate,'" and "[t]he board of Interco believes in good faith that the restructuring has a value of 'at least' \$76 per share."⁴³ Nevertheless, applying *Unocal*, the court enjoined the Interco board's refusal to redeem its poison pill.⁴⁴

Applying the first prong of the *Unocal* test, the *Interco* court agreed that an inadequate offer qualified as a "threat."⁴⁵ The court, however, had a strict view of what action was reasonable in response to the threat of inadequacy. The *Interco* court believed that, because the bidder made an all-cash, all-shares offer and promised a second-step merger at the tender offer price, its offer was not coercive.⁴⁶ The court thought that Interco's shareholders were entitled to exercise the free choice that the offer provided. In the court's view, the only reasonable use of the poison pill in response to an inadequate offer was to generate a higher third-party offer, either through negotiation or an auction, or to create an alternative transaction for shareholders to consider. Preclusive defensive tactics were an unreasonable response.⁴⁷ Once the board had generated the best alternatives, it was required to redeem the poison pill and allow third-party offers to proceed.⁴⁸

42. *Interco*, 551 A.2d at 791-94.

43. *Id.* at 795.

44. *Id.* at 800. Curiously, the court declined to enjoin the restructuring, despite the fact that it also was adopted without shareholder approval and would have precluded the offer. *Id.* at 800-03.

45. *Id.* at 797-98.

46. *Id.* at 790. As will be demonstrated, the chancery court's view is erroneous. See discussion *infra* part III.B.2.

47. *Interco*, 551 A.2d at 798.

48. *Interco* was foreshadowed by the chancery court's prior decisions. In *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986), a bidder made an all-cash, all-shares tender offer and promised a second-step merger at the tender offer price. The target company's board responded with a self-tender for 65% of its stock that promised equivalent value. The court held that the self-tender was an unreasonable *Unocal* response because it precluded the bidder's offer. Shareholders were entitled to choose between the competing transactions. *Id.* at 112-16. *Anderson, Clayton* arguably is limited by the fact that the bidder's offer was concededly adequate. The target company's investment banker was unwilling to provide an opinion to the contrary. *Id.* at 108-10.

In *Robert M. Bass Group, Inc. v. Evans (Macmillan I)*, 552 A.2d 1227 (Del. Ch. 1988), a bidder offered \$64 per share in cash for 100% of Macmillan, Inc., and promised a second-step merger at the tender offer price. In response, the Macmillan board adopted a restructuring that one of its investment bankers opined was worth \$63-\$68 per share. The bidder then raised its offer to \$73 per share. The court reaffirmed *Anderson, Clayton* and held that the restructuring response was disproportionate to any threat posed by the offer because, *inter alia*, it did not allow shareholders to choose between the alternative transactions. See *id.* at 1242. *Macmillan I* represented an extension of *Anderson, Clayton* because Macmillan's investment bankers did opine, and the

Interco was strongly endorsed in *Grand Metropolitan Public Ltd. v. Pillsbury Co.*⁴⁹ In that case, the bidder sought to acquire the entire equity interest in Pillsbury for \$63 per share. The Pillsbury board found the offer inadequate, refused to redeem the company's flip-in poison pill plan,⁵⁰ and announced that it would spin off its Burger King subsidiary and sell certain other assets. The chancery court required redemption of the poison pill and enjoined the Burger King spin-off.⁵¹ The court held that, where the only *Unocal* "threat" posed by the offer was its alleged inadequacy, using the poison pill to preclude shareholder choice was a "Draconian" response that would not be countenanced.⁵²

C. *The Delaware Supreme Court's Interpretation of Unocal*

In contrast to the chancery court, the Delaware Supreme Court has developed a body of *Unocal* precedent suggesting that target company directors enjoy wide latitude in responding to hostile takeover bids and that the board may preclude inadequate offers without giving shareholders any choice. The chancery court was able to develop a seemingly inconsistent line of authority because tender offer events overtook the parties before the chancery court cases could be appealed, and none of the supreme court precedents constitutes a square holding.

1. *Moran v. Household International, Inc.*

In *Moran v. Household International, Inc.*,⁵³ the Delaware Supreme Court considered the validity of a flip-over poison pill rights plan.⁵⁴ After holding

target company's board did find, that the bidder's offer was inadequate. *Id.* at 1237-38. The chancery court was, however, notably unimpressed by the bankers' opinions. *See id.* at 1240-41. Moreover, the *Macmillan I* court would have allowed preclusive defense tactics if the board's alternative transaction had been at a demonstrably higher value than the tender offer price. *Id.* at 1242. *Interco* does not make this concession.

49. 558 A.2d 1049 (Del. Ch. 1988).

50. *See supra* note 5 (describing the flip-in poison pill rights plan).

51. *Pillsbury*, 558 A.2d at 1050-52, 1057, 1061.

52. *Id.* at 1058-60. In dictum, the chancery court in *TW Services, Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. Mar. 2, 1989), sought to limit the reach of *Macmillan I*, *Interco*, *Pillsbury*, and *Anderson, Clayton*. The court noted that in each of these cases, the target company board had created a sale-type alternative to a hostile offer in addition to refusing to redeem its poison pill. The court viewed these cases as holding only that shareholders must be allowed to choose between tender offers and sale-type alternatives. It took the position that pure preclusion, in the absence of an alternative transaction, was an open question. *Id.* at 92,181. However, the opinions in the other cases did not purport to be limited in this way. There has been speculation that the chancery court reversed its course because the Delaware Supreme Court was dissatisfied with *Interco*, which the supreme court never had the opportunity to consider on appeal. *See Perry Kalajian, The Poison Pill and the Controversial World of Corporate Mergers and Acquisitions: A Critical Assessment*, 29 HOUS. L. REV. (forthcoming 1992) (manuscript on file with *The Houston Law Review*); William Meyers, *Showdown in Delaware: The Battle To Shape Takeover Law*, INSTITUTIONAL INVESTOR, Feb. 1989, at 64, 75.

53. 500 A.2d 1346 (Del. 1985).

54. *See supra* note 5 (describing the flip-over poison pill rights plan).

that the poison pill was authorized by Delaware's corporation statute,⁵⁵ the court examined its validity under *Unocal*. Applying the first prong of *Unocal*, the court held that two-tiered and bust-up⁵⁶ offers were threats that a board could take steps to oppose. Since the poison pill helps to prevent such offers, it passed muster under the second prong of *Unocal*.⁵⁷

The court also rejected the argument that the poison pill was a disproportionate response under *Unocal* because it deprived the shareholders of their right of choice with respect to tender offers.⁵⁸ The court noted that the poison pill was not necessarily lethal to all offers.⁵⁹ The court's conclusion regarding this point is hard to fathom. The poison pill is lethal to most offers.⁶⁰ In any event, if shareholder choice is desirable, mechanisms that substantially impede it should be as objectionable as those that prevent it entirely. In actuality, the court believed that shareholder choice was not required by Delaware law. The court noted that many defensive mechanisms that precluded shareholder choice had been upheld and saw no reason to distinguish with respect to the poison pill.⁶¹

The *Moran* court seemingly gave no independent effect to *Unocal's* second prong and suggested that once a cognizable threat appears any defensive action is justified.⁶² The poison pill does more than equalize the prices of the tiers in a two-tiered tender offer; it precludes the offer completely. The poison pill also has the potential to preclude single-tier offers that do not threaten a bust-up of the target company.⁶³ However, the scope of *Moran* is arguably limited by the fact that the case dealt with the decision of a board to adopt a poison pill plan, rather than a decision to implement a previously existing plan to preclude a particular offer. The *Moran* court noted that, in deciding whether to redeem the poison pill in response to an offer, the board's conduct would be judged under *Unocal*.⁶⁴ Thus, the court may simply have postponed application of the *Unocal* test.

2. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.

Shortly after *Unocal* and *Moran*, the Delaware Supreme Court seemingly gave its imprimatur to preclusive defensive tactics in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁶⁵ Anticipating a hostile bid by Pantry Pride,

55. *Moran*, 500 A.2d at 1351-53.

56. A bust-up offer is one in which the bidder intends to sell assets of the target company to help pay off the acquisition debt. Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 11 & n.40 (1987).

57. *Moran*, 500 A.2d at 1356-57.

58. *Id.*

59. *Id.* at 1356.

60. See *supra* note 5 (describing the mechanics and effect of the poison pill rights plan).

61. *Moran*, 500 A.2d at 1354.

62. See *id.* at 1354-57.

63. See *supra* note 5 (describing the mechanics and effect of the poison pill rights plan).

64. *Moran*, 500 A.2d at 1354.

65. 506 A.2d 173 (Del. 1986).

Inc., the Revlon board adopted a back-end rights plan that gave all of Revlon shareholders except Pantry Pride the right to exchange their shares for notes with a face value of \$65 if Pantry Pride acquired more than 20% of Revlon's shares but did not acquire all Revlon's shares for at least \$65 per share in cash. Pantry Pride informally offered \$45 per common share in cash for 100% of Revlon. It later commenced a \$47.50 tender offer and conditioned its offer on redemption or nullification of the rights plan. Pantry Pride raised its offering price to \$50 and then \$53 per share. The Revlon board enlisted Forstmann Little & Co. ("Forstmann") as a white knight and generated a bidding contest. Pantry Pride, which ultimately raised its offer price to \$58 per share, successfully challenged certain preferential treatment given to Forstmann.⁶⁶

Once the Revlon board decided to create an auction, the continued independence of Revlon ceased to be an issue, and it became clear that the board would be required to redeem the back-end rights plan for the highest bidder. Nevertheless, the Delaware Supreme Court went out of its way to address the validity of using the rights plan to preclude Pantry Pride's offer prior to the inception of the auction. Applying *Unocal*, the court noted that the rights plan was a reasonable response to Pantry Pride's original offer, which the board reasonably viewed as "grossly inadequate" and which portended a bust-up of Revlon.⁶⁷ The court never examined whether Revlon was worth \$65 per share (the back-end price) and seemed unconcerned that the rights plan would have precluded any offer below \$65 per share.

Revlon suggests that the target company's board would have been justified in using the rights plan to preclude Pantry Pride's offer without regard to its shareholders' wishes as long as the board had reasonable grounds to believe that the Pantry Pride offer was inadequate.⁶⁸ However, because the rights plan issue was rendered moot, the court's statements regarding preclusive defensive tactics are dicta. As a consequence, this aspect of *Revlon* has largely been ignored by later cases.⁶⁹

66. *Id.* at 182-85.

67. *Id.* at 180-81.

68. See Michael W. Schwartz, *Chancery Court Ignores Del. Supreme Court Precedents*, N.Y. L.J., June 5, 1989, at 45.

69. The Delaware Supreme Court strengthened the powers of target company directors in two subsequent cases. In *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987), an entity controlled by T. Boone Pickens offered \$105 per share in cash for 42% of Newmont and proposed to acquire any remaining shares in a second-step transaction for the same consideration as the tender offer. Because, inter alia, the Newmont board viewed the offer as inadequate, it engaged in a complicated restructuring designed to thwart the Pickens offer by enabling Consolidated Gold Fields to purchase 49.7% of Newmont and control 40% of the Newmont board. As part of this scheme, Gold Fields agreed to restrictions on the transferability of its shares and agreed to support the board's nominees for the 60% of the board it did not control. The supreme court upheld the Newmont board's actions under *Unocal*, in part as a response to the coercive nature of Pickens' partial offer. However, the court also noted that the board was entitled to pursue the continued independence of Newmont as a goal and responded appropriately in the face of what the board considered to be an inadequate offer. *Id.* at 1342-45. The court approved the board's conduct despite the fact that the board effectively precluded both Pickens' offer and any

3. Paramount Communications v. Time Inc.

The preceding chancery and supreme court cases set the stage for *Paramount Communications v. Time Inc.*⁷⁰ Time had been seeking a merger partner for some years to expand into the film industry. Time settled on Warner Brothers as the best merger candidate. After long negotiations, Time and Warner agreed to a merger, pursuant to which Time was willing to pay Warner's shareholders a 12% premium to allow Time to be the surviving company. Time believed that preserving its corporate culture was crucial to its integrity and continued success. After the merger agreement was announced, Time's stock, which had been trading in the \$103-\$113 range, traded as high as \$122 per share.⁷¹

Paramount then offered \$175 per share in cash for 100% of Time's stock. Time's board, on the advice of its investment banker, found the \$175 offer to be inadequate. The Time board believed that the Paramount offer, although offering more value in the short-term than the merger with Warner, was not adequate to capture the intrinsic value of Time plus a fair control premium. The company's investment banker opined that one Time share would be worth \$150 after the merger and would trade between \$208 and \$402 within four years of the merger.⁷² Time's board also recast the form of the acquisition. Instead of a merger, which would have required the consent of Time's shareholders, Time proposed to acquire Warner pursuant to a cash tender offer. Time raised the premium it was willing to pay Warner's shareholders to 56%. Paramount then raised its tender offer price to \$200 per share, which the Time board also rejected as inadequate.⁷³

The chancery court viewed the original merger agreement, which was concluded before Paramount surfaced as a bidder, as valid under the traditional business judgment rule. However, recasting the transaction as a tender offer to deprive Time shareholders of a vote the Time board feared it might lose was a defensive tactic that triggered *Unocal* review.⁷⁴ The chancery court phrased the essential questions as (1) whether the Time board was entitled to take the

other hostile offers. Schwartz, *supra* note 68, at 47.

In *Mills Acquisition Co. v. Macmillan, Inc. (Macmillan II)*, 559 A.2d 1261 (Del. 1989), which was primarily concerned with the board's duties when conducting an auction, the Delaware Supreme Court noted that target company directors must do more than merely refrain from breaching the duties of care and loyalty. They also have a duty "to affirmatively protect and defend those interests entrusted to them." *Id.* at 1280. This language suggests that the board may not stand silently by and allow an inadequate offer to proceed. See *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1146 (Del. 1990) (noting "the injunction of *Unocal* that the duties of care and loyalty prevent a board from being a passive instrumentality in the face of a perceived threat to corporate control"); Schwartz, *supra* note 68, at 47 n.17.

70. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1990).

71. *Id.* at 93,266-71.

72. *Id.* at 93,271-73.

73. *Id.* at 93,273-75.

74. *Id.* at 93,282.

position that the merger agreement, although promising less value in the short-term, was a more valuable long-term alternative, and (2) whether the Time board was entitled, without allowing a shareholder vote, to decide that question by itself.⁷⁶

The chancery court held that Time's directors were entitled to view Paramount's offer as a *Unocal* "threat." The court rejected, without any systematic analysis, the EMH view that the Paramount offer should be viewed as superior to the Warner combination because it was higher than the market price of Time's stock that resulted from the announcement of the merger and was also higher than the price the company's investment banker predicted its stock would reach immediately after the merger.⁷⁶ Although one would have expected the court to then examine in detail whether the Time board was reasonable in believing that the combination with Warner was more valuable than Paramount's offer, the court sanctioned the Time board's conduct on the ground that the Warner combination was a good-faith business decision predating the Paramount offer.⁷⁷ This focus on subjective good faith seems contrary to *Unocal*'s objective standard of review and the court's own ruling that *Unocal*, rather than the traditional business judgement rule, applied once the board took defensive action in response to the Paramount offer.

The court held that recasting the form of the merger transaction, which effectively precluded the Paramount offer,⁷⁸ was a reasonable response under the second prong of *Unocal* because it protected the combination with Warner.⁷⁹ Since the primary threat presented by the offer was that it would prevent the combination with Warner, this holding seems tautological. The court believed that the denial of shareholder choice was not a problem because shareholders have no statutory right to vote on whether a company should proceed with a tender offer.⁸⁰ This view in effect sanctions all preclusive defensive tactics, such as the poison pill, that can be adopted without a shareholder vote.

The Delaware Supreme Court affirmed. It agreed with the chancery court

75. *Id.* at 93,276-78.

76. The court did cite two examples in which the predictions of a target company board that the company would ultimately be worth more than a pending tender offer came to pass. *Id.* at 93,277. However, if the stock market price is the best predictor of a company's value, then half of all takeover targets should do better in the future than their current market prices and half should do worse. The fact that two target companies improved on their market prices and exceeded an offeror's price is largely irrelevant.

77. *Id.* at 93,282-83.

78. Paramount conditioned its tender offer on abandonment of the combination with Warner. *Id.* at 93,271.

79. *Id.* at 93,283-84.

80. *Id.* at 93,281-82. The chancery court limited its prior precedents pertaining to shareholder choice in tender offers through its dictum in *TW Services, Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. Mar. 2, 1989). *See supra* note 52. The court viewed the Warner combination as a way of continuing Time's business rather than as a sale-type alternative to Paramount's offer. *Paramount*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,282-83.

that the Time board's conduct was subject to *Unocal* scrutiny. However, although the supreme court reaffirmed its position that a board need not defer to the stock market on the issue of value,⁸¹ the court rejected the view that, to pass *Unocal* muster, Time's board was required to produce evidence that the Warner combination was more valuable than the Paramount offer. The court noted that, in addition to potential financial inadequacy, the Paramount offer represented a threat to the Time board's strategic business plan. In the court's view, the Time board was entitled to take steps to protect this plan without regard to comparative values.⁸² The court emphasized that, since the Time board acted in good faith after a detailed investigation, its judgment should not be second-guessed by the courts. Applying *Unocal's* second prong, the court held that, since preserving the Warner deal was a legitimate purpose, precluding the Paramount offer was permissible. The court noted that shareholders had no right to choose with respect to Paramount's offer because tender offer decisions, like all other corporate decisions, were initially within the board's purview.⁸³

On its face, *Paramount* suggests that the *Unocal* standard is indistinguishable from the traditional business judgment rule.⁸⁴ Target company directors can seemingly prevail whenever they seek to protect a business plan adopted in good faith after reasonable investigation. A bidder cannot force the board even to consider whether a present sale at the offer price would generate a higher value for shareholders. However, just as the chancery court's precedents, which endorsed shareholder choice in sweeping language, came to be restricted by their facts, *Paramount* may be a more limited precedent than its language suggests. *Paramount* involved a preexisting strategic combination of many years' planning rather than an attempt simply to preclude a takeover bid to guarantee the independence of a target company. The Delaware Supreme Court's decision in *Paramount* may be viewed as holding only that a board need not abandon a preexisting deal, and may take the steps necessary to protect such a deal, once a tender offer is made.⁸⁵

81. *Paramount Communications v. Time Inc.*, 571 A.2d, 1140, 1150 n.12 (Del. 1990); see *supra* note 28 and accompanying text (citing the Delaware courts' apparent rejection of the EMH theory in the context of tender offers).

82. *Paramount*, 571 A.2d at 1151-53.

83. *Id.* at 1154-55. Specifically referring to *Interco*, the supreme court noted that, to the extent certain chancery court opinions granted the shareholders a right to choose in the tender offer context, "we hereby reject such approach as not in keeping with a proper *Unocal* analysis." *Id.* at 1153.

84. See Marc I. Steinberg, *Nightmare on Main Street: The Paramount Picture Horror Show*, 16 DEL. J. CORP. L. 1, 19 (1991). The Delaware Supreme Court recently emphasized the similarities between the *Unocal* standard and the business judgment rule. See *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1145 n.29 (Del. 1990).

85. Lisa A. Duda, Comment, *Paramount Communications, Inc. v. Time Inc.: A Decision of Paramount Significance?*, 16 DEL. J. CORP. L. 141, 184 (1991). Much of the supreme court's language lends itself to this limitation. The supreme court noted that it "purposely detailed the evidence of the Time Board's deliberative approach, beginning in 1983-84, to expand itself" and that "Time's decision in 1988 to combine with Warner was made only after what could be fairly

D. Conclusion

The courts have squarely rejected the EMH view and held that market price is not dispositive of target company value. Without any systematic analysis, the courts have taken the position that a premium tender offer can be inadequate and, using the language of *Unocal*, a "threat" to the target company and its shareholders. On the issue of which target constituency should make the economic choice posed by tender offers, the courts have come down squarely on the side of the target company's board. Although the rigor of judicial review remains to be established by later cases, the courts have suggested that judicial review of preclusive defensive tactics will be deferential.

II. AN ECONOMIC ANALYSIS OF DEFENSIVE TACTICS

This part argues that, even if EMH is accurate, preclusive defensive tactics may still be justified in individual cases to enable the target company's board to negotiate with the original bidder or to conduct an auction.⁸⁶ This part also argues that a rigorous analysis supports the courts' decision to take proof on whether a premium offer captures the intrinsic value of the target company as a going concern.

A. The Efficient Markets Hypothesis

1. Valuing Investments

The first step in valuing a company is to estimate the returns the company will pay out in the future. The estimated returns must be discounted to account for the time value of money, since the returns will be earned in the future, and for the risk or variation in the expected returns.⁸⁷ A corollary principle is that investors expect to be compensated for taking risk. Risk is divided by economists into that which is peculiar to individual companies (alpha risk) and that which varies in conjunction with the market as a whole (beta risk). Economists hypothesize that alpha risk can be eliminated by diversifying one's investment portfolio. Because alpha risk can be eliminated through diversifica-

characterized as an exhaustive appraisal of Time's future as a corporation." *Paramount*, 571 A.2d at 1151-52. The supreme court emphasized that "Time's responsive action to Paramount's tender offer was not aimed at 'cramming down' on its shareholders a management-sponsored alternative, but rather had as its goal the carrying forward of a pre-existing transaction in an altered form." *Id.* at 1154-55.

86. If a target company board opposes a takeover bid as inadequate, it can have three theories on why the offer price does not adequately reflect target company value: (a) the target company is more valuable as an independent entity; (b) the board can negotiate a higher price from the original offeror; or (c) the board can sell the company for a higher price after an auction. Gilson & Kraakman, *supra* note 21, at 260. Only the first of these justifications is antithetical to EMH. See discussion *infra* part II.B.

87. See THOMAS E. COPELAND & J. FRED WESTON, *FINANCIAL THEORY AND CORPORATE POLICY* 77-108, 841-43 (3d ed. 1988); RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 68-124 (1986).

tion, economists predict that the market will not compensate an investor for bearing it. Beta risk, by contrast, is a fact of investing life. It cannot be eliminated, and the market must compensate investors for bearing it.⁸⁸

Compensation in accordance with beta risk is usually expressed as a function of the Capital Asset Pricing Model ("CAPM"), which postulates that the expected return of an investment portfolio (ERP) is equal to the risk-free rate of return (RF) plus the beta (BP) of the portfolio multiplied by the difference between the expected rate of return on the market portfolio (ERM) and the risk-free rate of return. In symbols, $ERP = RF + BP(ERM - RF)$.⁸⁹ CAPM predicts that a portfolio's expected rate of return varies linearly with the portfolio's beta and, since the other symbols represent observable constants, varies only with the portfolio's beta.⁹⁰

2. Three Forms of EMH

If capital markets are efficient, it is impossible to make a profit speculating in securities because the current market price is the best predictor of future market prices. Capital markets will be efficient if the following criteria are met: all investors are rational utility maximizers; market trading involves no transaction costs; the securities markets are perfectly competitive; and information is costlessly and instantaneously available to all investors.⁹¹

There are three forms of EMH: weak, semi-strong, and strong. According to the weak form, the market price of a security reflects all information regarding the past trading prices of that security. According to the semi-strong form, the market price of a security reflects all publicly available information about that security. The strong form posits that the market price of a security reflects all information about that security whether or not the information is public.⁹²

If EMH is correct, takeovers should be motivated by factors that make the assets of the target company more valuable in the hands of the bidder. As a

88. See, e.g., COPELAND & WESTON, *supra* note 87, at 193-239; GILSON, *supra* note 87, at 125-55.

89. GILSON, *supra* note 87, at 138. Thus, if the risk-free rate of return is 5% and the expected return on the market portfolio is 14%, CAPM predicts that a company with a beta of two (i.e., a company whose returns are twice as volatile as the market as a whole) will have an expected return of 23%.

90. Studies have tended to verify the first but not the second of these predictions. See Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 782 (1985). However, Professors Fama and French of the University of Chicago Business School recently disclosed the results of a study that challenges the core of CAPM. Fama and French analyzed the performance of thousands of stock over a fifty-year period and concluded that little, if any, correlation exists between a company's beta and the return on its stock. According to Fama and French, "long-term returns depend not on beta, but on company size and price-to-book ratios." Eric N. Berg, *A Study Shakes Confidence in the Volatile-Stock Theory*, N.Y. TIMES, Feb. 18, 1992, at C1, C6 (nat'l ed.).

91. See, e.g., COPELAND & WESTON, *supra* note 87, at 331; GILSON, *supra* note 87, at 156.

92. See, e.g., RICHARD BREALY & STEWART MYERS, *PRINCIPLES OF CORPORATE FINANCE* 262 (1981).

result, the bidder is able to pay a premium over the existing market price.⁹³ The two most common explanations for the value-enhancing nature of takeover bids are that the bidder will be able to manage the target's assets more efficiently or that the combination will create synergies not available to the target company as an independent entity.⁹⁴ According to this paradigm, takeover defense represents a social cost that prevents the market for corporate control from acting as a check on inefficient or disloyal management.⁹⁵ Takeover defense also prevents assets from being transferred to their most valuable uses.⁹⁶

93. Of course, bidders may simply be incorrect in thinking that a takeover will result in increased value. Studies show that successful acquisitions are either neutral from the perspective of the bidder's shareholders or result in a small loss in value. See Black, *supra* note 2, at 602-04; John C. Coffee, *The Uncertain Case for Takeover Reform: An Essay on Shareholders, Stakeholders and Bust-Ups*, 1988 Wis. L. REV. 435, 442-43; George W. Dent, Jr., *Unprofitable Mergers: Toward a Market-Based Legal Response*, 80 Nw. U. L. REV. 777, 778-79 (1986); Lipton, *supra* note 56, at 26 & n.115; Stout, *supra* note 2, at 1262.

One commentator has suggested that the takeover premium reflects the elasticity in the supply curve for securities. According to this theory, the market price represents the worth of a single share of stock to that shareholder most willing to sell. To the extent that a bidder wishes to purchase a controlling interest, the bidder must be willing to pay a price that reflects the value placed on the stock by more optimistic shareholders. According to this theory, the premium does not necessarily reflect social gain. Rather, it merely reflects the value placed on the stock by the last shareholder whose sale is necessary to give the bidder a controlling interest. *Id.* at 1259-75.

94. See, e.g., GILSON, *supra* note 87, at 371-445; *id.* at 34-56 (Supp. 1990). But see Edward S. Herman & Louis Lowenstein, *The Efficiency Effects of Hostile Takeovers*, in KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 211, 211-40 (John C. Coffee et al. eds., 1988) (arguing, based on accounting data, that during the time period from 1981-83 targets were on average more profitable than bidders, and bidders saw their profitability decline post-acquisition).

If EMH is correct, premium takeover bids should not be made if the bidder cannot enhance the value of the target company. For example, diversification at the company level should not motivate takeover bids because diversification in an efficient market is better practiced at the shareholder portfolio level. See, e.g., GILSON, *supra* note 87, at 341-70. Similarly, whether the purchase method of accounting will apply to the takeover should not affect the transaction because accounting methodology does not affect the actual value of the target company and an efficient market should recognize this fact. See, e.g., *id.* at 257-340; *id.* at 31-33 (Supp. 1990). Nevertheless, such factors matter to sophisticated participants in the business world. AT&T recently changed the form of its \$7.4 billion acquisition of NCR to qualify for the purchase method of accounting for the transaction. Allison L. Cowan, *A.T. & T. Alters Merger To Win Audit Ruling*, N.Y. TIMES, July 4, 1991, at D22.

Certain motivations for takeovers reflect gains to the bidder but not social gains. Bidders may seek a controlling stake to redistribute value from minority shareholders to themselves or from other corporate constituencies, such as bondholders or employees, to themselves. Bidders may seek to augment their market power in a particular field. They may be influenced by tax considerations. The commentators have been skeptical of such motives. See, e.g., GILSON, *supra* note 87, at 445-98; *id.* at 58-59, 72-120 (Supp. 1990).

95. E.g., Easterbrook & Fischel, *supra* note 6, at 1174-80.

96. E.g., *Amanda Acquisitions Corp. v. Universal Foods Corp.*, 877 F.2d 496, 500 (7th Cir.) (Easterbrook, J.), *cert. denied*, 493 U.S. 955 (1989).

B. *Defensive Tactics Assuming the Validity of EMH*

This section assumes that EMH is accurate, that the market price of a target company's stock is determinative of value, and that premium takeover bids are value-enhancing. Defensive tactics may still contribute value to target company shareholders in individual cases.

1. *Negotiation*

Assume that the actual value and market price of a corporation's stock is \$100 per share. A bidder offers \$105 per share for the entire company. The bidder is able to offer a premium because synergies will result from the combination. Should the bidder's offer be accepted?

The hypothetical does not give enough facts to formulate an answer. It may be that synergies envisioned by the bidder make the target company's stock worth \$200 per share in the bidder's hands. In this event, the bidder has appropriated 95% of the synergy gains, which is unfair to the target company's shareholders. The target company's shareholders would prefer the bidder's offer to remaining independent. However, their first choice would be to negotiate with the bidder to ensure a fairer division of the synergy gains.

If the target company were owned by a single shareholder, that shareholder could do the bargaining himself. However, because shareholdings are dispersed and concerted action is expensive, shareholders in most public companies must rely on the board to serve as bargaining agent.⁹⁷ Defensive tactics such as the poison pill force the bidder to negotiate with the target company's board. If all parties bargain in good faith, the most rational outcome would be a sale of the target company for approximately \$150 per share.⁹⁸

There is, however, a danger that the target company's board may refuse to negotiate in good faith. The directors may use defensive tactics for the purpose of maintaining target company independence, and their own positions, rather than to obtain negotiating leverage. This result would cost the target company's shareholders money and prevent the target company's assets from being shifted to their most valuable use. As a consequence, one commentator who has argued that tender offer results should approximate those that would be obtained if target companies were owned by individual shareholders has also argued that the target company's board should not have access to preclusive defensive tactics for negotiating purposes.⁹⁹

This position involves unjustifiable overkill. If the choice were between a per

97. For two articles supporting the use of the target company board as a negotiating agent, see David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Dale A. Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53 (1985).

98. This analysis assumes that there are no other bidders for the target company and that no other target companies are substitutes from the bidder's perspective.

99. See Lucian A. Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197, 215-16 (1988).

se rule allowing preclusive defensive tactics and a per se rule proscribing such tactics, we would weigh the benefits and costs to target company shareholders resulting from negotiation and impose the appropriate rule. This balance is an empirical question. The evidence does not currently support a per se ban on preclusive defensive tactics.¹⁰⁰

However, there is an intermediate position. We can examine case by case whether target company directors were justified in resisting particular offers. Since the benefits of giving target company directors the power to negotiate are potentially large, case-by-case litigation appears superior to a per se rule against preclusive defensive tactics.¹⁰¹ If the problem is that the *Unocal* standard of review is too lenient as currently applied, the best solution is to improve the standard of review.¹⁰²

The courts have suggested that target company directors may use defensive tactics to further negotiation but should abandon such tactics once negotiations have concluded and allow the shareholders to consider the best available third-party offer.¹⁰³ As will be demonstrated, this procedure is inappropriate because shareholders do not have a fair opportunity to choose to accept or reject a tender offer.¹⁰⁴ In addition, if the rule were that defensive tactics had to be withdrawn after the conclusion of negotiations, bidders would have no incentive to negotiate. Using defensive tactics to further negotiation is effective only if the board has the ability convincingly to threaten preclusion. To hold otherwise would be equivalent to giving labor unions the right to bargain but

100. See discussion *infra* part II.D.

101. Negotiation need not involve communication with the bidder by the target company's board. Employing preclusive defensive tactics is a form of negotiation that has often caused bidders to raise their prices. *E.g.*, *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1147-49 (Del. 1990) (resistance by target company caused bidder to raise its offer from \$175 per share to \$200 per share); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1339 (Del. 1987) (resistance by target company caused bidder to raise its offer from \$95 per share to \$105 per share); *Revlon, Inc., v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173, 176-77 (Del. 1986) (poison pill rights plan caused bidder to raise its offer from \$42 per share to \$53 per share prior to commencement of an auction); *Grand Metro. Pub. Co. v. Pillsbury Co.*, 558 A.2d 1049, 1052 & n.4 (Del. Ch. 1988) (poison pill caused bidder to raise its offer from \$60 per share to \$63 per share); *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 792-94 (Del. Ch. 1988) (poison pill caused bidder to raise its offer from \$64 per share to \$74 per share); *Robert M. Bass Group, Inc. v. Evans (Macmillan I)*, 552 A.2d 1227, 1234-37 (Del. Ch. 1988) (resistance by target company caused bidder to raise its offer from \$64 per share to \$73 per share); see also *Sutton Holding Corp. v. DeSoto, Inc.*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,964, at 95,398-99 (Del. Ch. Feb. 5, 1990) (finding that target directors failed to meet their *Unocal* burden, but refusing to enjoin poison pill to allow target directors to force the bidder to improve on its initial offer); Schwartz, *supra* note 6, at 172-74 (noting that target company shareholders often benefit from the takeover process to the extent that the bidder is forced to bid against itself). Whether the boards in these cases ultimately accepted the bidder's highest offer is irrelevant. The cases demonstrate that negotiation is a tool of great potential value to target shareholders. It is the function of judicial review to decide whether the target company's board has acted reasonably in rejecting the bidder's highest offer.

102. See discussion *infra* part V.B.

103. See, *e.g.*, *Revlon*, 506 A.2d at 180-81; *Interco*, 551 A.2d at 798.

104. See discussion *infra* part III.

not to strike.

2. Auctions

In some cases, the target company's best strategy is to conduct an auction. An auction may generate the highest possible price for target company shareholders and force bidders to give target company shareholders their fair share of any gains flowing from the acquisition. If the bidding is competitive and the target company offers unique value to the bidders, an auction may even succeed in capturing the lion's share of acquisition gains for the target company's shareholders. The courts have upheld the use of defensive tactics to give the target company's board time to conduct a proper auction.¹⁰⁵

Some commentators have suggested that facilitating an auction is the only legitimate use of preclusive defensive tactics.¹⁰⁶ However, the auction alterna-

105. See, e.g., *CRTF Corp. v. Federated Dep't Stores*, 683 F. Supp. 422, 439 (S.D.N.Y. 1988); *BNS, Inc. v. Koppers Co.*, 683 F. Supp. 458, 475-76 (D. Del. 1988); *Doskocil Cos. v. Griggy*, C.A. No. 10,095 (Del. Ch. Oct. 7, 1988); *Nomad Acquisition Corp. v. Damon Corp.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040 (Del. Ch. Sept. 16, 1988); *Facet Enters. v. Prospect Group, Inc.*, C.A. No. 9746 (Del. Ch. Apr. 15, 1988).

106. Gilson, *supra* note 13, at 868-75; Louis Lowenstein, *Toward an Auction Market for Corporate Control and the Demise of the Business Judgment Rule*, 63 S. CAL. L. REV. 65, 69 (1989). Other commentators oppose this limited position and argue for a total ban on defensive tactics. These commentators argue that the gains to target company shareholders resulting from negotiations or auctions decrease the benefits to initial bidders. Some bidders will, therefore, be unwilling to incur the search costs necessary to identify value-enhancing takeovers, and fewer such takeovers will occur. See Easterbrook & Fischel, *supra* note 6, at 1175-80; Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229, 229-30 (1986). Although the cost of deterred offers is a difficult empirical question, an intuitive analysis suggests that the cost is not substantial. If negotiations and auctions are allowed, many initial bidders will still succeed at a price that covers search costs. If the initial bidder loses out to a higher bidder, it typically will have purchased approximately 5% of the target company shares, the threshold for certain federal disclosure requirements, prior to launching its bid and will make a substantial profit by selling these shares to the victorious bidder. See Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1034-38 (1985) [hereinafter Bebchuk, *The Case for Facilitating Competing Tender Offers*]; Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 52-62 (1982).

Opponents of negotiations and auctions also argue that gains to target company's shareholders are irrelevant because they merely represent a redistribution of value from the bidder's shareholders to the target company's shareholders. Shareholders with diversified portfolios, these commentators argue, do not care *ex ante* about the distribution of gains from value-enhancing takeover bids. They care only about the total volume of such bids. See Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 8-9 (1982). However, some empirical evidence suggests that individual investors tend to hold portfolios that are not diversified. See MARSHALL E. BLUME & IRWIN FRIEND, *THE CHANGING ROLE OF THE INDIVIDUAL INVESTOR* 46-50, 117-20 (1978). Although the market may not compensate them for the extra risk they have taken, the traditional legal view has been that directors owe a fiduciary duty to their own shareholders, not to the market as a whole. See Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 29 (1982); John C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1216-21 (1984); *cf.* OHIO REV. CODE ANN. § 1701.59(E)(2) (Anderson Supp. 1990) (empowering, but not requiring,

tive does not eliminate the need for preclusive defensive tactics as an aid to negotiation. After an initial bid is made, there is no guarantee that an auction will develop.¹⁰⁷ Other bidders may not be able to realize the same acquisition gains as the original bidder. If the initial bidder is the most efficient acquiror, other potential bidders, realizing that they cannot win at a price that is appropriate for them, may refuse to bid. In addition, the initial bidder has a substantial timing advantage over other bidders. New bidders may not be able to do research or obtain financing quickly enough to compete with the initial bidder.¹⁰⁸

There is also no guarantee that, if an auction develops, the winning bid will be at an appropriate price. Assume that a bidder offers \$120 per share for a corporation whose stock is selling at \$100 per share and that a combination with the bidder will create synergies of \$40 per share. A second bidder, who can realize synergies of \$100 per share, bids \$125 per share and wins the auction. Just as the target company's board would not have accepted \$125 per share from the second bidder if it had made the only bid, it should not accept \$125 per share simply because an auction has occurred. In either case, the target company's board should hold out for something close to \$150 per share.

C. *Defensive Tactics as a Challenge to EMH*

More controversial is the use of preclusive defensive tactics to preserve the independence of the target company. Critics of defensive tactics that further independence rely on the market as the dispositive measure of value.¹⁰⁹ The empirical evidence does not justify their faith in the market.

1. *Evidence on the Weak Form of EMH*

The empirical evidence supports the weak form of EMH. The market ought to exhibit a strong tendency toward weak-form efficiency because information about past stock prices is widely available at low cost.¹¹⁰ Studies of the weak form of EMH have tended to show that trading strategies based on past stock prices have not been profitable.¹¹¹ However, the validity of the weak form of

directors to consider the interests of a variety of nonshareholder interests, including the national economy).

107. See David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 194-95 (1986) ("Since the vast majority of tender offers are not competitive, there is usually no auction at all.").

108. See Bebchuk, *The Case for Facilitating Competing Tender Offers*, *supra* note 106, at 1036.

109. See, e.g., Easterbrook & Fischel, *supra* note 6, at 1165-68; Schwartz, *supra* note 6, at 188-89.

110. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 568-69 (1984).

111. See COPELAND & WESTON, *supra* note 87, at 391-92; KENNETH D. GARBADE, *SECURITIES MARKETS* 241-49 (1982); JAMES H. LORIE & MARY T. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 75-83 (1973); Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 389-96 (1970); Gilson & Kraakman, *supra* note

EMH is of little relevance. It is undisputed that bidders and target companies rely on more information than past prices to arrive at values.

2. Evidence on the Semi-Strong Form of EMH

There is reason to question the semi-strong form of EMH. Public companies are required to make available to investors a large amount of financial information. However, much of that material is filed with the Securities and Exchange Commission and is not provided directly to investors. Although not readily accessible to the man on the street, sophisticated market professionals, who control a large percentage of trading activity, have low-cost access to such information. Their trading might cause the market price to reflect most publicly available information very quickly.¹¹²

The systematic evidence on the semi-strong form of EMH is mixed. Researchers have tested the semi-strong form by examining whether sophisticated investors can devise profitable trading strategies based on the public announcement of material information. Many tests confirm that sophisticated investors cannot earn significant profits by racing public announcements to market.¹¹³ Researchers have also examined whether sophisticated investors, such as mutual fund managers, can make trading profits based on their superior analysis of public information. Much empirical evidence suggests that sophisticated investors cannot obtain significant profits through analysis of public information.¹¹⁴

However, the evidence is not uniform. Some tests of the market's ability to absorb public information contradict the semi-strong form of EMH.¹¹⁵ More-

110, at 555 n.25; Gordon & Kornhauser, *supra* note 90, at 772-75.

112. See Gilson & Kraakman, *supra* note 110, at 569-72.

113. See COPELAND & WESTON, *supra* note 87, at 361-83, 392; GARBADE, *supra* note 111, at 249-59; Fama, *supra* note 111, at 383, 404-09; Gilson & Kraakman, *supra* note 110, at 555 n.26; Gordon & Kornhauser, *supra* note 90, at 834-37.

114. See COPELAND & WESTON, *supra* note 87, at 383-90, 392; Gordon & Kornhauser, *supra* note 90, at 838-41; Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 389, 415 (1968) (concluding that mutual fund managers do not outperform the market as a whole by an amount sufficient to cover fees and expenses). There is reason to question these professional investor studies. There must be some benchmark against which to measure the trading profits of professional investors given the betas of their investment portfolios. Otherwise, it is impossible to tell whether they made a profit that sufficiently reflected the risk level of the portfolio. The professional investor studies use CAPM as the appropriate benchmark. As commentators have noted, to the extent CAPM is open to question, so are the studies themselves. See Gordon & Kornhauser, *supra* note 90, at 782-86. Moreover, questions regarding the validity of CAPM taint EMH. *But see id.* at 781. If capital markets are efficient, CAPM ought to be a correct description of risk compensation. To the extent that alpha risk factors influence compensation, they do so because such factors as transaction and information costs inhibit full diversification or because investors have not recognized the benefits of full diversification. Each of these explanations contradicts a premise of EMH. See discussion *supra* part II.A.2.

115. See Ray Ball, *Anomalies in Relationships Between Securities Yields and Yield-Surrogates*, 6 J. FIN. ECON. 103, 118 (1978) (concluding that investors receive excess returns after the announcement of earnings increases); Guy Charest, *Split Information, Stock Returns and Market Efficiency-I*, 6 J. FIN. ECON. 265, 279 (1978) (concluding that investors receive excess returns for

over, the supportive studies prove both too much and too little. They prove too much because they imply that professional investors' research activities are not justified. If the market price reflects all publicly available information, professional investors should not incur the cost of research and analysis. This paradigm leads to a paradox. The research of professional investors is what makes the market efficient in the semi-strong sense, but this efficient status should lead them all to cease research activities.¹¹⁶

It seems more likely that the market establishes an equilibrium point for the acquisition and analysis of information. This equilibrium ought to be reached where researchers earn at least, but no more than, a competitive return. The implication is that the market never reflects all publicly available information because, contrary to EMH's assumptions, information is not costlessly available.¹¹⁷ Although an equilibrium may be reached that makes it unprofitable to engage in market-wide research, it may be profitable for researchers with expertise in particular areas to identify companies that have been inefficiently priced or undervalued by the market.

The tests supportive of the semi-strong form of EMH also prove too little because they are to some extent circular. The supportive tests show that professional investors cannot make trading profits by outguessing the market. According to EMH, if a stock is selling on the market for \$50 per share, the best estimate of the stock's future value is \$50 per share. If a professional investor buys at \$50 believing the stock is really worth \$60 and later sells at \$50, his transaction would be cited as confirmation of the validity of the semi-strong form of EMH. However, this analysis assumes that the market price at the time of sale is the best indicator of the stock's value at that time. It may be that the investor was entirely correct and that his ratable interest in the future profits of the company justified a \$60 present value at the time of purchase.¹¹⁸ The systematic empirical evidence regarding the semi-strong form of EMH is

up to three months following announcements of stock splits); Gilson & Kraakman, *supra* note 110, at 626 & n.205; Gordon & Kornhauser, *supra* note 90, at 841-46; William K.S. Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986) (collecting studies); Ross L. Watts, *Systematic "Abnormal" Returns After Quarterly Earnings Announcements*, 6 J. FIN. ECON. 127, 139-43 (1978) (concluding that the market takes over two quarters to adjust to earnings announcements); see also Elroy Dimson & Paul Marsh, *An Analysis of Brokers' and Analysts' Unpublished Forecasts of UK Stock Returns*, 39 J. FIN. 1257 (1984) (concluding that trading based on analysts' forecasts over a one-year period would have led to significant trading profits).

116. See Gordon & Kornhauser, *supra* note 90, at 786.

117. See Bebchuk, *supra* note 99, at 207; Gordon & Kornhauser, *supra* note 90, at 786-96. There is also some reason to question the EMH assumption that all investors are perfectly rational. Valuation depends on predictions about the future translated into present value. Sociological evidence demonstrates that the process by which people "assign subjective probabilities is subject to a variety of biases that can lead to verifiably incorrect estimates and, ultimately, decisions." GILSON, *supra* note 87, at 99; see Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974).

118. See Gordon & Kornhauser, *supra* note 90, at 801-02 (noting that the studies assume that any misvaluation in the price of a security is resolved by the time of the second trade).

not sufficient to cause the courts to accept the market price of a target company stock as determinative of value.¹¹⁹

There is also strong intuitive evidence that undercuts the semi-strong form of EMH. On October 19, 1987, the Dow Jones Industrial Index fell 508 points, or 22.6%.¹²⁰ Yet, no piece of information sufficient to cause a decline of that magnitude was disclosed on October 19.¹²¹ As a consequence, the trading on Black Monday seems to have been caused by purely speculative concerns. Traders sold in droves on Black Monday because they believed others would sell and drive stock prices down. Black Monday suggests that stock prices are often set by concerns other than predictions about future income flows discounted for time and risk.¹²²

Black Monday is inconsistent with EMH unless EMH is sharply limited. EMH may be viewed as a prediction about future market prices rather than real values.¹²³ So limited, the semi-strong form of EMH asserts only that the

119. See Bebchuk, *supra* note 99, at 207-10; Gordon & Kornhauser, *supra* note 90, at 824-30.

120. Lawrence J. DeMaria, *Stocks Plunge 508 Points, A Drop of 22.6%; 604 Million Volume Nearly Doubles Record*, N.Y. TIMES, Oct. 20, 1987, at A1.

121. A presidential task force concluded that the market decline was triggered by the unexpectedly high trade deficit, which raised interest rates, and proposed tax legislation, which made certain takeovers less likely. The task force concluded that once selling began, it quickly spun out of control and placed the equity market in free fall as a consequence of a liquidity crisis and a lack of coordination among the stock, index futures, and options markets. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS at v to vi, 69 (1988). In other words, two events that should have led to a small decline in an efficient market led to a catastrophic decline as investors panicked and raced each other to sell.

122. See Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 288 (1983) (noting that market professionals are concerned with such factors as market momentum); Douglas R. Sease, *Is the High-Priced Stock Market Really Overvalued?*, WALL ST. J., Aug. 19, 1991, at C1 (quoting the opinion of one market analyst that at the beginning of a business cycle "interest rates and market dynamics are much more important than looking at value"); Robert J. Shiller, *Do Stock Prices Move Too Much To Be Justified by Subsequent Changes in Dividends?*, 71 AM. ECON. REV. 421, 433-35 (1981) (questioning whether the volatility of market prices is consistent with EMH); Robert J. Shiller, *Fashions, Fads, and Bubbles in Financial Markets*, in KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 56 (John C. Coffee et al. eds., 1988) ("[T]here is evidence that fashions, fads, or bubbles do importantly influence prices of speculative assets.").

123. See COPELAND & WESTON, *supra* note 87, at 339 ("Professional investment may be likened to newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole." (quoting JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY* 156 (1936))); GILSON, *supra* note 87, at 2 (Supp. 1990) (noting that EMH predicts only that "information available to securities traders will not support profitable trading strategies," not that "share prices are well informed estimates of the present value of the cash flows expected from underlying corporate assets"); Gordon & Kornhauser, *supra* note 90, at 827 (noting that EMH claims that the market is speculatively efficient, not that it is allocationally efficient); Lowenstein, *supra* note 122, at 275 (noting that EMH theorists define value as "the value shares would have in trading transactions"); Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377, 415 (1990) (noting that the stock market is efficient in an informational but not a funda-

current market price of a security contains all publicly available information about its future trading prices. When EMH is restricted in this way, it has no legitimacy as the basis for legal takeover policy. Target company directors could plausibly assert that their company is undervalued and that a given premium bid does not adequately capture future returns discounted for time and risk. If directors can offer sufficient proof on this issue, takeover defense is justified as a means of preventing the bidder from stealing from target company shareholders that value which exists but has not yet been recognized by the market.¹²⁴

3. Evidence on the Strong Form of EMH

The empirical evidence on the strong form of EMH is damaging to those who support a per se rule against preclusive defensive tactics.¹²⁵ Studies demonstrate that corporate insiders, as well as specialists on the major exchanges (who possess nonpublic information about unexecuted trades), outperform the market as a whole when trading.¹²⁶ These studies imply that: in-

mental valuation sense); Wang, *supra* note 115, at 344 (noting that EMH "does not imply that prices reflect intrinsic or fundamental value").

124. There is evidence that the market systematically undervalues certain types of assets. For example, shares in closed-fund investment companies, holding companies with large investments in marketable securities, and natural resource companies trade at a discount to their underlying asset values. Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 901-06 (1988). Moreover, there is reason to believe that such discounts appear in the market generally. *See id.* at 907-14. Kraakman offers two explanations for the phenomenon of discounting. Either the market discounts share prices because traders believe that management will inefficiently invest future profits or the market has made a valuation error based on "noisy" trading. *Id.* at 897-98. The first of these explanations is simply a variant on the inefficient management hypothesis and counsels against preclusive defensive tactics. The second suggests that the bidder's premium may be nothing more than an attempt to capitalize on an undervalued company and suggests that target management should oppose inadequate offers. *See id.* at 933-39; *see also* Andrei Shliefer & Lawrence H. Summers, *The Noise Approach to Finance*, 4 J. ECON. PERSP. 19 (1990) (arguing that the market is inefficient because investors are not fully rational and arbitrage is limited).

125. *See* Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Last (?) Reply*, 2 J.L. ECON. & ORG. 253, 259 (1986) ("[I]t is generally believed that market prices do not fully reflect all [inside] information.").

126. *See* COPELAND & WESTON, *supra* note 87, at 376-77; Jerome B. Baesel & Garry R. Stein, *The Value of Information: Inferences from the Profitability of Insider Trading*, 14 J. FIN. & QUANTITATIVE ANALYSIS 553, 557-69 (1979); Gilson & Kraakman, *supra* note 110, at 556 n.27; Jeffrey F. Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410, 424, 427-28 (1974); Arthur J. Keown & John M. Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981); James H. Lorie & Victor Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J.L. & ECON. 35, 52-53 (1968); Victor Niederhoffer & M.F.M. Osborne, *Market Making and Reversal on the Stock Exchange*, 61 J. AM. STAT. ASS'N 897 (1966). The very act of trading on the part of insiders may cause the market to incorporate the information they possess or at least to incorporate its import. Corporate insiders are required to report their trading activity. 15 U.S.C. § 78p(a) (1988). The public may well react to such information by mimicking the actions of the insiders, on the theory that the insiders know something that the public does not. To this extent, trading by insiders becomes partly reflected in

siders are trading on the basis of material nonpublic information, in which case the strong form of EMH is inaccurate and their conduct is illegal;¹²⁷ insiders have a superior ability to analyze publicly available information,¹²⁸ in which case the semi-strong form of EMH is again called into question; or both. Whatever the explanation, these studies demonstrate that target company directors can credibly claim that their opinion on value is superior to the market's. The courts should be willing to receive evidence on the target company's intrinsic value and should not defer to the market.

D. Evidence on the Impact of Successful Takeover Defense

Leaving aside the direct evidence on the validity of EMH, EMH proponents have argued that studies on the wealth effects of tender offer defense demonstrate that preclusive defensive tactics should be prohibited.¹²⁹ The evidence does not support this view. A study by the investment banking firm of Kidder, Peabody & Co. demonstrates that a majority of target companies that defeated hostile tender offers between 1973 and 1984 and remained independent for at least one year saw their discounted stock prices exceed the offer price.¹³⁰ Thus, the Kidder study supports the view that defensive tactics should not be precluded on economic efficiency grounds.

market price, although more slowly and less extensively than with respect to the weak and semi-strong forms of EMH. See Gilson & Kraakman, *supra* note 110, at 572-79.

127. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). Of course, directors who do not trade have no obligation to, and may legitimately prefer not to, disclose all material information about their companies. See Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988); *Texas Gulf Sulphur*, 401 F.2d at 848; discussion *infra* part IV.B. As a consequence, there is every reason to believe that directors often have better information than the market.

128. See *Paramount Communications v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277 (Del. Ch. July 14, 1989) (noting that target company directors may have "understood better than the public market for the firm's shares what the value of their firm was"), *aff'd*, 571 A.2d 1140 (Del. 1990); Stout, *supra* note 2, at 1271-72.

129. See, e.g., *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 500-02 (7th Cir.) (Easterbrook, J.), *cert. denied*, 493 U.S. 955 (1989).

130. See KIDDER, PEABODY & CO., SUMMARY OF DEFEATED HOSTILE TENDER OFFERS: 1973-1984 (1984). The Kidder study discounts the target company stock price back to the time of the offer using the rate of inflation, as measured by the Consumer Price Index, as the discount rate. The Kidder study has been criticized for relying on the Consumer Price Index, rather than the rate of growth of the S&P 500, as the source of the discount rate. Two studies using Kidder's data conclude that target company stock values did not on the average exceed the tender offer consideration within two years of the offer if the offer price is assumed to grow at the rate of the S&P 500. Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 287-91 (1984); John A. Pound, *Takeover Defeats Hurt Stockholders: A Reply to the Kidder Peabody Study*, MIDLAND CORP. FIN. J., Summer 1986, at 33, 36. A later study argues that, if the two-year limitation is dropped, the stock prices of a majority of target companies defeating tender offers did exceed the tender offer consideration adjusted for the rate of growth in the S&P 500. DONALD G. MARGOTTA & FELICIA MARSTON, LONG-TERM RESULTS OF DEFEATED TENDER OFFERS (June 1987) (Northeastern Univ. College of Bus. Admin. Working Paper: 87-29).

The Kidder study has been criticized for including in its sample companies that were ultimately acquired at premium prices and did not remain independent for the long term.¹³¹ But the better approach is in fact to include target companies that are subsequently acquired. When a target company employs defensive tactics to defeat an offer and is later acquired at a price that exceeds that of the defeated offer, defensive tactics have created value for target company shareholders. Moreover, removing companies that were ultimately acquired from the Kidder study only changes the study's conclusion from pro-defense to neutral. Of the thirty-eight target companies in the study that ultimately remained independent, nineteen saw their discounted stock prices exceed the offer price.¹³²

The Kidder study has also been questioned by the results of cumulative abnormal return studies.¹³³ These studies examine profitability by comparison to what companies should have earned given their betas and the overall performance of the market. They assume the validity of the CAPM model as well as the semi-strong form of EMH. To the extent that CAPM and the semi-strong form of EMH are open to question, so are the studies.¹³⁴ More significantly, the strong form of EMH, rather than the semi-strong form, is the appropriate referent, and it is not supported by the empirical evidence.¹³⁵

The cumulative abnormal return studies show that target companies that defeat tender offers and remain independent suffer negative cumulative abnormal returns over a period of years after the bid's defeat.¹³⁶ However, they also show that target companies that defeat an initial offer but are subsequently acquired show positive cumulative abnormal returns.¹³⁷ The studies suggest that the gains in these cases outweigh the losses in cases where the target company remains independent.¹³⁸ As a consequence, the cumulative abnormal

131. Pound, *supra* note 130, at 36-37.

132. KIDDER, PEABODY & Co., *supra* note 130, at 1.

133. See, e.g., Michael Bradley et al., *The Rationale Behind Interfirm Tender Offers*, 11 J. FIN. ECON. 183, 193 (1983); Richard S. Ruback, *Do Target Shareholders Lose in Unsuccessful Control Contests?*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 137, 148 (Alan J. Auerbach ed., 1988).

134. See *supra* note 90 and accompanying text; *supra* II.C.2.

135. See *supra* part II.C.3.

136. See Bradley et al., *supra* note 133, at 193; Ruback, *supra* note 133, at 148.

137. See Bradley et al., *supra* note 133, at 193 (concluding that target companies that defend successfully, but are subsequently acquired, show cumulative abnormal returns of +17.35% up to two years after the bid); Gilson & Kraakman, *supra* note 21, at 264-65. *But see* Ruback, *supra* note 133, at 148 (concluding that target companies that defend successfully, but are subsequently acquired, show total cumulative abnormal returns of -3.23%). The difference between the Bradley and Ruback studies may be explained by the small sample used by Ruback, in which only 9 of 33 target companies initially defeated offers and were later acquired. Bradley studied 112 defeated bids, 86 of which were for target companies that were ultimately acquired.

138. See Bradley et al., *supra* note 133, at 193; Gilson & Kraakman, *supra* note 21, at 264-65; see also Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & ECON. 151, 174 (1985) (employing cumulative abnormal returns methodology to examine the use of litigation as a defensive tactic and concluding that "[t]arget management seems to take a value-maximizing gamble by litigating" and that "the actual gains from auctions

return studies, even if accepted as the norm for analysis, do not justify a per se ban on preclusive defensive tactics.¹³⁹

One reading of the empirical evidence suggests that takeover defense is valuable only to the extent it is ultimately unsuccessful.¹⁴⁰ Based on this view, we might have a legal rule that target company directors could use defensive tactics as an aid to negotiations and auctions, but not for the purpose of remaining independent. As noted above, the possibility of preclusion is necessary to enhance shareholder value when the target company's board has decided to sell the company.¹⁴¹

Moreover, although target companies that ultimately remained independent may have generated share prices that on average did not justify rejecting the tender offer consideration, a significant number of the target companies in this category profited by successful takeover defense.¹⁴² The issue is not whether a per se rule against defensive tactics is preferable to a rule of directors' *carte blanche*, but whether enough target companies were correct in defeating offers to justify the cost of case-by-case litigation. Because a substantial percentage of target companies justifiably opposed offers, case-by-case litigation is indeed appropriate.

E. Conclusion

The empirical evidence on both EMH and the effects of successful takeover defense does not, as the EMH proponents claim, justify a per se rule against preclusive defensive tactics. The market has not been, and should not be, legally determinative of value. In the words of the Delaware Court of Chancery: "[J]ust as the Constitution does not enshrine Mr. Herbert Spencer's social

compensate target shareholders for the losses of thwarted takeovers, on average"). *But see* Ruback, *supra* note 133, at 148.

139. In weighing the benefits and costs of takeover defense, it is worth noting that most target companies are ultimately acquired. One author, writing when the deferential business judgment rule governed judicial review of takeover defense, concluded that "only about twenty to twenty-five percent of target companies remain independent once there has been an initial tender offer." Coffee, *supra* note 106, at 1149. There is, therefore, a greater risk in having a per se rule against takeover defense than in allowing directors latitude. Such a per se rule would threaten the aggregate gains to target shareholders in the 75% of the cases in which the target company is ultimately acquired. Allowing directors latitude would impose potential costs in the 25% of the cases in which the target company remains independent.

140. *Cf.* Gilson & Kraakman, *supra* note 21, at 264 (arguing that "successful target defenses may indeed make shareholders better off—but only if target firms are subsequently acquired in a later transaction").

141. *See supra* text accompanying notes 99-104, 106-08.

142. *See* William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 392-402 (surveying the wealth effects of a variety of defensive tactics and concluding that for each tactic a substantial number of cases have positive outcomes). The Kidder Peabody study concludes that 50% of targets that remained independent saw their discounted stock prices increase above the offer price. *See supra* text accompanying note 132. The Ruback study concludes that 21% of targets that remained independent had positive total cumulative abnormal returns. *See* Ruback, *supra* note 133, at 148.

statics, neither does the common law of directors' duties elevate the theory of a single, efficient capital market to the dignity of a sacred text."¹⁴³

III. SHAREHOLDER CHOICE

The empirical evidence on EMH and the effects of successful takeover defense demonstrate that an economic choice must be made in the tender offer context. Rational actors can take the position that a premium tender offer is inadequate and should be rejected. Courts and commentators have suggested that any economic choice regarding tender offers must be made by the target company's shareholders.¹⁴⁴

This solution is unworkable because the tender offer process is inherently coercive. Although courts and commentators have recognized the coercive impact of tender offers,¹⁴⁵ they have underestimated the extent of the problem. This part argues that the coercion inherent in the tender offer process is virtually absolute. In most cases, shareholders have no choice but to tender. Courts and commentators have also suggested that tender offer coercion can be eliminated if the offeror makes an all-cash, all-shares offer and announces that it intends to effect a second-step merger at the tender offer price.¹⁴⁶ This part argues that this form of offer does not solve the problem of tender offer coercion.

The following hypothetical will be used as an aid to analysis. Assume that the market price of the target company's stock is \$50 per share. A bidder makes a premium tender offer, conditions its offer on obtaining 51% of the target company's stock, and intends to enforce the condition.¹⁴⁷ If the bidder obtains 51% of the target company's stock, the offer succeeds and the bidder purchases tendered shares at the offer price. If 51% of the target company's shares are not tendered, the offer fails and the bidder returns any tendered

143. *Paramount Communications v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1990).

144. See *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 798 (Del. Ch. 1988); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112-15 (Del. Ch. 1986); Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1700-06 (1985); Gilson, *supra* note 13, at 845-48; *cf.* *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 81-84 (1987) (upholding a state antitakeover statute that enhanced the goal of shareholder choice).

145. See, e.g., *Radol v. Thomas*, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982) (noting that "any tender offer is likely to be coercive to some degree"); Bebchuk, *supra* note 144, at 1717-33; Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113-14 (1979); Lowenstein, *supra* note 122, at 307-09.

146. See *infra* note 166 and accompanying text.

147. Approximately 90% of all tender offers are conditioned on the bidder's obtaining sufficient control to effect a squeeze-out merger. See, e.g., *Amanda Acquisitions Corp. v. Universal Foods Corp.*, 877 F.2d 496, 499 (7th Cir.) (Easterbrook, J.), *cert. denied*, 493 U.S. 955 (1989). This condition usually requires that the bidder obtain at least 51% of the target company stock. See *supra* note 3 (noting that state law typically requires a 51% or 67% shareholder vote to effect a merger); see also *Leebron*, *supra* note 107, at 162 (noting that "the acquisition of a substantial minority interest without control is rarely the subject of a tender offer").

shares. No target shareholder owns enough stock to affect the outcome of the offer.¹⁴⁸ If the tender offer process gave target shareholders a free choice, a target shareholder should tender if and only if the value of the offer exceeds his estimate of the value of the target company as an independent concern.¹⁴⁹

A. Partial Offers

1. The Two-Tiered Offer

The classic example of a coercive tender offer is the two-tiered tender offer.¹⁵⁰ Assume that a bidder offers to purchase 51% of a target company for \$100 and announces its desire to effect a second-step merger at \$50 per share if the offer succeeds.¹⁵¹ Under ideal conditions a target shareholder should tender if and only if the blended value of the offer (\$75 per share) is higher than his estimate of the target company's independent value. However, a rational target shareholder who believes that his company is worth more than \$75 per share should nevertheless tender.

Either enough target shareholders will tender to satisfy the 51% condition and allow the offer to succeed or they will not. Our hypothetical shareholder's decision is irrelevant because he does not own enough shares to affect the outcome of the offer. If the offer succeeds, the target company's value as an independent concern is also irrelevant because the target company is not going to remain independent. The only relevant comparison is between the tender offer price (\$100) and the second-step price (\$50). Our hypothetical shareholder should tender to sell as many of his shares for \$100, and as few for \$50, as possible.¹⁵² If the offer fails, nothing our hypothetical shareholder does makes any difference. All tendering shareholders get their stock back.¹⁵³ Therefore, our hypothetical shareholder should tender without regard to his view on the

148. This condition is realistic. See Bebuchuk, *supra* note 144, at 1720 ("[T]he shareholder will pay little attention to the question of how his decision will affect the probabilities of the two possible outcomes of the bid—the bidder gaining control over the target and the bidder failing to do so."). One study found that no single shareholder owned as much as a 10% stake in 169 of the 200 largest nonfinancial public corporations. See Robert J. Larner, *Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963*, 56 AM. ECON. REV. 777 (1966).

149. See Bebuchuk, *supra* note 144, at 1700-06.

150. A two-tiered tender offer is "a partial tender offer . . . coupled with an announced plan to follow up with a second-step merger at a lower price per share." Theodore N. Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485, 485 (1983).

151. The two-tiered offer is legal under federal law. See *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 630 (D. Md. 1982) (noting that the Williams Act proscribes only deceptive practices). Under state law, the only impediment is that minority shareholders dissenting from the merger may seek appraisal. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703-04 (Del. 1983). However, appraisal typically does not include any gains flowing from the combination. See, e.g., DEL. CODE ANN. tit. 8, § 262(h) (1991). Therefore, the control premium included in the first-step tender offer price need not be included in the second-step merger price.

152. See Bebuchuk, *supra* note 144, at 1721 ("[I]f the bid is going to succeed, the shareholder will always be better off tendering, no matter how high his estimate of the independent target's value.").

153. See *id.*

merits of the tender offer.¹⁵⁴

The courts and commentators have recognized the coercive effect of the two-tiered tender offer.¹⁵⁵ They have failed to recognize that the coercion is virtually absolute.¹⁵⁶

154. Thus, the offer should succeed even if all target shareholders view it as undesirable. This phenomenon, where individuals acting rationally achieve a result that is irrational from the group's perspective, is known in the realm of game theory as the prisoner's dilemma. See Bebchuk, *The Case for Facilitating Competing Tender Offers*, *supra* note 106, at 1040; Lowenstein, *supra* note 122, at 307. The problem is that target company shareholders are unable to communicate with each other for the purpose of taking collective action. In most cases, no single shareholder owns enough stock to justify shouldering the expense of such coordination. Collective action is impossible unless the target company's board acts on behalf of the shareholders or implements defensive tactics that delay the offer long enough to allow a shareholders meeting to evaluate the offer. In these cases the cost of collective action is dispersed among all shares.

155. See *Bendix*, 549 F. Supp. at 630; *Radol v. Thomas*, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985); ADVISORY COMMITTEE ON TENDER OFFERS, SEC. & EXCH. COMM'N, REPORT OF RECOMMENDATIONS 25-26 (1983); Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 337 (1974); Jesse A. Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 SEC. REG. L.J. 291, 291-93 (1984); Edward F. Greene & James J. Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 679-81 (1984); Lowenstein, *supra* note 122, at 308; Mirvis, *supra* note 150, at 489 & n.8; Oesterle, *supra* note 97, at 56-63; Note, *supra* note 13, at 1966.

156. See Bebchuk, *supra* note 144, at 1733 (concluding that "[m]y claim is not that the current distortions are irresistible, but rather that they are substantial"). The text's conclusion will not be true if two of the hypothetical's assumptions are relaxed. First, if a target shareholder owns enough shares to affect the outcome of the offer, he will tender if, and only if, the expected gain from tendering outweighs the expected gain from not tendering. Consider the following hypothetical: The market price of target company shares is \$50 per share; the bidder offers \$100 per share for 100% of the target company; a large shareholder believes that the target company is worth \$120 per share as an independent concern; the post-takeover value of minority shares is \$50 per share; there is a 100% chance that the offer will succeed if the large shareholder tenders; and there is a 50% chance that the offer will succeed if the large shareholder does not tender. As will be demonstrated, the coercion inherent in this type of offer is the same as that inherent in the two-tiered offer. See discussion *infra* part III.B.1. If the large shareholder tenders, he receives \$100 per share in value. If he does not tender and the offer succeeds, he has \$50 per share in value. This result must be discounted for the 50% chance that it will occur, giving an expected value of \$25 per share. If the large shareholder does not tender and the offer fails, the discounted value from not tendering is \$60 per share (\$120 x 50%). The total expected value from not tendering is \$85 per share (\$25 + \$60). Since the expected value from tendering (\$100) is larger than the expected value from not tendering (\$85), the large shareholder is coerced into tendering. However, when the large shareholder's estimate of the target company's independent value exceeds \$150 per share, he will take the gamble of not tendering. Thus, our large shareholder faces significant pressure to tender but the pressure is not absolute.

Second, the bidder may elect to purchase tendered shares if it does not obtain control. Bebchuk is able to conclude that the pressure to tender is not absolute because he does not accept this assumption. See Bebchuk, *supra* note 144, at 1721. In this instance, a target shareholder will tender if and only if the expected gain from tendering exceeds the expected gain from not tendering, given his view of the likelihood of the offer's success. See *id.* at 1722. Although this case is a possibility, it is unlikely. Most bidders are unwilling to purchase a substantial block of shares unless they can be certain of acquiring 100% of the target through a second-step merger. See

2. *The Pure Partial Offer*

Rather than offering to purchase 100% of the target company in two unequal steps, the bidder may offer \$100 per share for 51% of the target company and allow remaining minority shareholders to keep their target company shares.¹⁵⁷ In this case, the only relevant comparison is between the offer price and the post-takeover value of minority shares in the target company. This value may be more or less than the value of target company shares prior to the tender offer.

The value of target company shares may be increased by the acquisition of a controlling interest by the bidder. If the bidder can improve target company management or create synergies, all target company shares should increase in value.¹⁵⁸ However, acquisition of a control block by the bidder creates the danger that the bidder will engage in self-dealing at the expense of the minority. The bidder has the power to divert target company assets to its own use or to force a second-step merger on terms favorable to it and unfavorable to the minority.¹⁵⁹ Although such actions are subject to legal challenge, enforcing

supra note 147 and accompanying text (noting that 90% of all tender offers are conditioned on the bidder's obtaining sufficient control to effect a squeeze-out merger). At the very least, most bidders will insist on gaining control of the target company. Of course, it may be possible to obtain working control without obtaining an absolute majority. See *Essex Universal Corp. v. Yates*, 305 F.2d 572, 579 (2d Cir. 1962) (observing that a 28.3% owner is "almost certain to have share control as a practical matter"); *Freedman v. Restaurant Assocs. Indus.*, C.A. No. 9212 (Del. Ch. Oct. 16, 1987) (holding that individuals owning 37% of a corporation's stock had control); *Bebchuk*, *supra* note 144, at 1718-19. *But see In re Sea-Land Shareholders Litig.*, C.A. No. 8453 (Del. Ch. May 22, 1987) (holding that a 39% shareholder did not have control). Making the control threshold less than 51% does not change the analysis. Assume that a 30% stake gives the bidder control and the bidder conditions its offer on obtaining this amount. If the offer succeeds, every target company shareholder should tender. If the offer fails, a target shareholder's tender decision is irrelevant.

157. A pure partial offer may be defined as an offer to buy a controlling interest in a corporation but less than all its shares without any promise to acquire post-takeover minority shares. See *Finkelstein*, *supra* note 155, at 291.

158. There is evidence that after consummation of partial offers the post-takeover value of minority shares exceeds the pre-takeover market price. See Michael Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345 (1980). Two commentators have argued that target shareholders may encroach upon the bidder's acquisition gains in value-enhancing takeovers by refusing to tender and viewed nontendering shareholders as free riders. See Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 43 (1980). However, a bidder will normally employ a squeeze-out merger to eliminate all target shareholders and avoid this scenario. See *Leebron*, *supra* note 107, at 185. The bidder will postpone effecting a squeeze-out merger only where it has the capacity to profit from self-dealing or believes it can effect a later squeeze-out merger on more favorable terms than would have been available immediately following the tender offer. See *Bebchuk*, *supra* note 144, at 1711-12.

159. See *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128, 1137 (D. Or. 1984) (noting that acquisition of a 51% interest would "subject the remaining shareholders to a captive status"); *Bebchuk*, *supra* note 144, at 1710-13; *Finkelstein*, *supra* note 155, at 293; *Greene & Junewicz*, *supra* note 155, at 678-79.

minority rights is costly and the judicial system is less than perfect.¹⁶⁰ Therefore, just as acquirors typically pay a control premium that reflects the benefit of increased empowerment,¹⁶¹ there should be a diminution in the post-takeover value of minority shares to reflect the cost of disempowerment.

Although we cannot determine with certainty how the gains and losses from the acquisition of a control block will balance out in individual cases, powerless minority shares should be worth less than shares in a control block. As a result, the post-takeover value of minority shares should be less than the bid price. Assume that the costs and benefits to minority shareholders resulting from the acquisition cancel out.¹⁶² The hypothetical partial offer is then equivalent to the two-tiered offer discussed above because, in either case, the post-takeover value of minority shares is \$50.

The coercion analysis is the same as that for the two-tiered offer. If the offer succeeds, a target shareholder should tender because the offer price (\$100) is higher than the post-takeover value of minority shares (\$50). If the offer fails, the shareholder's tender decision does not matter. Therefore, a rational target shareholder should tender without regard to his view of the value of the target company as an independent concern.¹⁶³

B. All-Cash, All-Shares Offers

1. No Second-Step Merger Announced

Instead of using the classically coercive two-tiered and partial offers, a bidder may offer to purchase 100% of the target company's shares. Assume that a bidder makes an all-cash, all-shares offer at \$75 per share but does not promise to purchase nontendered shares in a second-step transaction. This offer looks less coercive than the offers discussed above because, if the offer succeeds, no target company shareholder is forced to accept minority shares after the tender offer.¹⁶⁴

However, the all-cash, all-shares offer does not eliminate tender offer coercion. If the offer succeeds, an all-cash, all-shares offer is indistinguishable from a pure partial offer from the perspective of a nontendering target shareholder. In either case, a nontendering shareholder will be a powerless minority shareholder; and in either case, the post-takeover value of minority shares should be less than the premium offer price. Therefore, as in the case of the pure partial offer, a rational target shareholder should tender without regard

160. See Bechuk, *supra* note 144, at 1711-12.

161. See, e.g., *Essex Universal Corp. v. Yates*, 305 F.2d 572, 573-74 (2d Cir. 1962); *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387, 388 (N.Y. 1979).

162. See *Greene & Junewicz*, *supra* note 155, at 681 ("In the case of the partial offer, the market price of the target company's securities predictably tumbles to pre-offer levels after expiration of the offer.").

163. The courts have recognized the coercive nature of the pure partial offer. See, e.g., *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1135 n.7, 1145 (Del. 1990).

164. See *Greene & Junewicz*, *supra* note 155, at 731 (suggesting that the all-cash, all-shares offer does not pose the same concerns as partial and two-tiered offers).

to his view on the desirability of the offer. There is general recognition that the all-cash, all-shares offer is coercive.¹⁶⁵

2. *Second-Step Merger at the Tender Offer Price*

Some courts and commentators believe that tender offer coercion can be eliminated if the bidder makes an all-cash, all-shares offer and promises to purchase remaining minority shares at the tender offer price.¹⁶⁶ According to this view, target shareholders do not face a penalty for not tendering. If they do not tender, but enough of their colleagues do and the offer succeeds, nontendering shareholders seem to receive the same value as tendering shareholders in the second-step merger. Therefore, every shareholder seems free to vote on the merits of the offer when he makes his tender decision.

The promise of a second-step merger at the same nominal price as the tender offer does not eliminate tender offer coercion. Assume that a bidder offers to purchase 100% of target company shares for \$75 per share. If 51% tender and the offer succeeds, the bidder promises to acquire remaining minority shares in a second-step merger at \$75 per share. Such a second-step promise does not eliminate tender offer coercion because the second-step price, although nominally at the same value as the tender offer, is worth less in real terms.

The nominal second-step price must be discounted for the time value of money. Tendering shareholders receive \$75 per share immediately. Nontendering shareholders receive \$75 per share in the future. Assume that the second-step merger takes two months to consummate¹⁶⁷ and that the annual discount rate is 15%.¹⁶⁸ The real value of the second step is reduced to \$73.17.

The nominal second-step price must also be discounted for the risk that a second-step merger will not occur. Although the bidder may promise to effect a second-step merger at the tender offer price, there is no guarantee that it will be able to do so. The bidder's financing, whether from internal or external

165. See Bebhuk, *supra* note 144, at 1722 (noting that coercion exists "whether the bid is partial or for all shares"); Gilson & Kraakman, *supra* note 21, at 254 n.29.

166. See *City Capitol Assocs. v. Interco Inc.*, 551 A.2d 787, 797-98 (Del. Ch. 1988); *Robert M. Bass Group, Inc. v. Evans (Macmillan I)*, 552 A.2d 1227, 1239-41 (Del. Ch. 1988); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112 (Del. Ch. 1986); Gilson & Kraakman, *supra* note 21, at 254; Lowenstein, *supra* note 122, at 93; Prentice & Langmore, *supra* note 123, at 461-62; Gregg H. Kanter, Comment, *Judicial Review of Antitakeover Devices Employed in the Noncoercive Tender Offer Context: Making Sense of the Unocal Test*, 138 U. PA. L. REV. 225, 228 n.20 (1989).

167. See, e.g., *Cinerama, Inc. v. Technicolor, Inc.*, C.A. No. 8358 (Del. Ch. June 24, 1991) (second-step merger took eight weeks to effect after consummation of a tender offer); *Shapiro v. Pabst Brewing Co.*, C.A. No. 7339 (Del. Ch. July 30, 1985) (second-step merger took twelve weeks to effect after consummation of a tender offer); Bebhuk, *supra* note 144, at 1710.

168. As of August 12, 1991, the interest rate on six-month T-bills was 5.4%. *Money Rates*, WALL ST. J., Aug. 13, 1991, at C19. The average market risk premium has historically been about 9%. See BREALY & MYERS, *supra* note 92, at 141.

sources, may disappear.¹⁶⁹

There is also no guarantee that the bidder will be willing to proceed with a second-step merger. The bidder's promise to purchase minority shares in a second step is typically stated in language that is less than airtight. For example, the bidder will often say only that it intends to effect a second-step merger at the tender offer price.¹⁷⁰ If it becomes disadvantageous for the bidder to proceed with the second step, as it would if events in the real world caused target company shares to decline substantially after the tender offer, the bidder may attempt to avoid fulfilling its promise.

Assume that discounts for the time value of money and the risk that a second-step merger at the tender offer price will not occur reduce the real value of the second-step merger in our hypothetical to \$72 per share. As a result, the tender offer has a value of \$75 per share, and the second-step merger has a value of \$72 per share. This form of offer is indistinguishable from the two-tiered offer discussed above and coercive for all the same reasons. If the offer succeeds, every shareholder would prefer to have \$75 rather than \$72 in value and that is the only comparison that matters.¹⁷¹ The courts and commentators may have believed that an all-cash, all-shares offer that promises a second-step merger at the tender offer price is noncoercive because they assumed that any reduction in the value of the second step is *de minimis*. Although this is an empirical question whose result is hardly clear and would seem to vary in individual cases, the magnitude of the difference between the offer price and the value of the second step is irrelevant. There can be no disputing that \$75 is worth more than \$72 and that every rational shareholder would prefer the former value to the latter. The analysis would be the same if the real value of the second step were \$74.99. As a consequence, even if the discounts to the nominal second-step price are small, target shareholders are still forced to tender.

169. For example, the United Airlines Pilots Union was required to abandon its highly publicized \$6.75 billion bid for United when its financing fell through. *Revised UAL Plan Seen*, N.Y. TIMES, Dec. 4, 1989, at D2. Salomon Brothers and Goldman Sachs were required on several occasions to delay and restructure the financing for the \$1.5 billion leveraged buyout of Southland Corporation. *Bond to Refinance Salomon Bridge Loan in \$850 Million Debt Deal*, CORP. FIN. WK., June 13, 1988, at 1.

170. In *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1134 (Del. 1987), the bidder made an all-cash, all-shares offer and announced that it "would seek to acquire all remaining shares in a second-step transaction at [the tender offer price]." *Id.* at 1339. The second-step transaction, like the tender offer itself, was subject to financing. *See id.* As the Delaware Supreme Court correctly noted, "[N]o specific second step transaction had been devised and . . . there was no firm commitment to do so." *Id.*

171. The Delaware Supreme Court has recognized that the promise of a second-step merger at the same nominal price as the tender offer does not eliminate tender offer coercion. In *Ivanhoe*, the bidder made an all-cash, all-shares offer at \$105 per share and announced that it would seek to acquire remaining minority shares at the same price. *Id.* at 1339. The court noted that the offer "fit perfectly the mold" of the coercive two-tier partial tender offer. *Id.* at 1342.

C. Solutions to the Problem of Tender Offer Coercion

As demonstrated above, tender offers are coercive because (a) the tender offer price is always greater than the post-takeover value of minority shares, and (b) the target shareholder's "vote" on the tender offer is connected to the tender decision. As a consequence, rational shareholders should tender to ensure that they obtain the higher tender offer price. However, if the vote on the tender offer is disconnected from the tendering decision, tender offer coercion evaporates. If target company shareholders could vote "no" on the tender offer and still tender if enough of their colleagues voted "yes" to allow the offer to succeed, each shareholder could freely express himself on the merits of the offer. At least three strategies are available to serve this end.

First, Professor Bebchuk has suggested that Congress change federal tender offer procedure. Under Professor Bebchuk's proposal, a bid would be allowed to proceed if and only if a majority of target company shares voted in favor of the bid. Shareholders would simultaneously mark their transmittal forms with their views on whether the bid should succeed or fail and their desires if the bid succeeds. Presumably, all target shareholders would express a desire to tender in the event the bidder obtained sufficient shareholder support to purchase a controlling interest. Under this scheme, all target company shareholders could vote freely on the merits of the offer.¹⁷²

Second, some states have enacted control share acquisition statutes.¹⁷³ These statutes deny a bidder the ability to vote shares that were obtained in a tender offer and comprise a control block unless a majority of the target company's disinterested shares agree to grant such voting rights. Although such statutes do not formally impede the bidder's ability to acquire shares in a tender offer, their practical effect is to force the bidder to condition its offer on winning the requisite vote and leave its offer open until the vote has been concluded.¹⁷⁴ This scheme eliminates tender offer coercion because a target company shareholder can vote to deny the bidder voting rights but still tender if enough of his colleagues disagree and the bid proceeds.¹⁷⁵

Third, the bidder itself can eliminate tender offer coercion. If the bidder makes an all-cash, all-shares offer, unconditionally promises a second-step merger at the tender offer price, puts the financing for the second-step merger in escrow, and pays interest on the second-step financing, there is no coercion.

172. See Bebchuk, *supra* note 144, at 1747-49.

173. See, e.g., ARIZ. REV. STAT. ANN. §§ 10-1211 to 10-1217 (Supp. 1990); MASS. GEN. LAWS ANN. ch. 110D, §§ 1-8, ch. 110E, §§ 1-7 (West 1990); MINN. STAT. ANN. § 302A.671 (West Supp. 1991); MO. ANN. STAT. § 351.407 (Vernon 1991); OHIO REV. CODE ANN. § 1701.83.1 (Anderson Supp. 1990); WIS. STAT. ANN. § 180.25(9) (West Supp. 1990). The constitutionality of the control share acquisition statute was upheld in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

174. See *CTS*, 481 U.S. at 84-85.

175. Although control share acquisition statutes serve the same purpose as Bebchuk's proposal and are equally effective at eliminating tender offer coercion, they force the bidder to delay its offer for sufficient time to have a shareholders meeting and entail greater transaction costs. See *id.*; Bebchuk, *supra* note 99, at 222-23.

Putting the financing in escrow eliminates the risk that the bidder will not be able to proceed with the second-step merger. Paying interest makes the present value of the second step equal to the tender offer price. As a consequence, the real value of the second step is the same as that of the tender offer. A target company shareholder who believes that the independent value of his company exceeds the tender offer price is not pressured into tendering because there is no economic penalty for not tendering.

Although the elimination of tender offer coercion is conceivable, it is not yet a reality. Congress, in its wisdom, has not seen fit to adopt Professor Bebchuk's scheme. Although control share acquisition statutes have been popular, many states, most notably Delaware, do not have such statutes. Bidders are not in the habit of making iron-clad guarantees to proceed with second-step mergers at tender offer prices plus interest.

Thus, the current scheme is one in which target company shareholders have virtually no choice when making tender decisions. If EMH were established beyond question, the system would be akin to corporate eminent domain. Any bidder could seize a target shareholder's property by paying a price in excess of the prevailing market price.¹⁷⁶ Such a system would be objectionable on the grounds that tender offers are contractual rather than tortious in nature and that our system relies on property rules rather than liability rules in the contractual sphere.¹⁷⁷

Moreover, once it is admitted that EMH can be questioned, tender offer coercion legitimizes a form of stealing in those cases where target company shares are undervalued by the market. Thus, although one might wish for a system in which shareholders could exercise a free choice, that system does not yet exist. It is wishful thinking to argue that the potential for eliminating the problem of tender offer coercion justifies leaving the tender decision solely in the hands of shareholders.¹⁷⁸

IV. THE ROLE OF THE TARGET COMPANY'S BOARD

As a consequence of tender offer coercion, the target company's board must have the capacity to oppose inadequate tender offers. The target company's board should also have this power because directors have a duty to make decisions on acquisition proposals and because directors are best situated to make such decisions.

176. Opponents of defensive tactics have not denied that tender offer coercion exists. Rather, they have argued that such coercion is beneficial because premium takeovers are value-creating and forcing shareholders to tender is socially productive. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 *YALE L.J.* 698, 710-11 (1982); *cf.* Grossman & Hart, *supra* note 158, at 43 (viewing nontendering shareholders as free riders who reduce the bidder's acquisition gains and, therefore, the disciplining effect of the market for corporate control).

177. *See* Bebchuk, *supra* note 99, at 200; Haddock et al., *supra* note 97, at 705-08.

178. *But see* Bebchuk, *supra* note 99, at 216 n.34, 222-23.

A. The Duties of Target Company Directors

In all American jurisdictions, it is the job of the board of directors to manage, or supervise the managing of, the corporation's business.¹⁷⁹ The board's affirmative concurrence is usually required by statute for all sale-type transactions.¹⁸⁰ The tender offer is indistinguishable from the more traditional statutory methods of transferring assets. Therefore, target directors should have the power to resist tender offers.¹⁸¹

One commentator has argued that, as a matter of statutory construction, directors should lack the power to adopt preclusive defensive tactics. According to this view, the legislature specified various acquisition methods requiring the assent of the target company's board. Since the power to preclude tender offers was not among them, the legislature's inaction should be interpreted as denying in the tender offer context the power the board has to prevent other sale-type transactions.¹⁸² However, most state corporation statutes were passed before the tender offer became a popular method of acquisition.¹⁸³ Therefore,

179. See, e.g., CAL. CORP. CODE § 300(a) (West 1990); DEL. CODE ANN. tit. 8, § 141(a) (1983); N.Y. BUS. CORP. LAW § 7.01 (McKinney 1986).

180. See, e.g., DEL. CODE ANN. tit. 8, §§ 251(b), 271(a), 275(a) (1990) (governing mergers, sales of substantially all of a corporation's assets, and liquidations). One commentator has argued that sale-type decisions also require shareholder concurrence and, therefore, that target company directors should not have access to defensive mechanisms without shareholder approval. See Gilson, *supra* note 13, at 848 n.106. However, shareholder concurrence is only required if the board decides to proceed with the transaction. The board may veto a statutory sale-type transaction without shareholder participation.

181. The Delaware Supreme Court has often noted that the board's power to act in the takeover defense context is related to its general authority to manage the corporation's business and its power to disapprove sale-type transactions. See *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990); *Mills Acquisition Co. v. Macmillan, Inc. (Macmillan II)*, 559 A.2d 1261, 1280 (Del. 1989); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *Reylon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1353 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953-54 & n.8 (Del. 1985).

The Delaware Supreme Court has also held that, in exercising their statutory duties to approve mergers, directors have an affirmative obligation not to facilitate an offer at a price below a company's intrinsic value. See *Smith v. Van Gorkom*, 488 A.2d 858, 875-78 (Del. 1984). This duty extends to the tender offer context, where the directors' power to act rests on the common law. See *Paramount*, 571 A.2d at 1150 n.12; *Macmillan II*, 559 A.2d at 1280 ("[Delaware law demands not only that] corporate fiduciaries absolutely refrain from any act which breaches the trust reposed in them, but also to affirmatively protect and defend those interests entrusted to them. Officers and directors must exert all reasonable and lawful efforts to ensure that the corporation is not deprived of any advantage to which it is entitled."). The standard by which the board's conduct is reviewed, however, is different in the merger and tender offer contexts. When the board acts with respect to a merger, the board's conduct is reviewed under the business judgment rule. When the board takes defensive action in response to a tender offer, its conduct is reviewed under *Unocal*. See *TW Servs., Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,181-82 (Del. Ch. Mar. 2, 1989).

182. Gilson, *supra* note 13, at 849.

183. E.g., William H. Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882, 889 & n.29 (1978).

state legislatures probably intended that like situations be treated similarly. Their silence should not be interpreted in accordance with the familiar maxim, *expressio unius est exclusio alterius*.¹⁸⁴

Opponents of preclusive defensive tactics have also argued that, whatever the views of state legislatures on the dates their corporation statutes were passed, these statutes have been amended over time. Once the tender offer became a widespread acquisition technique, state legislatures could have been expected to add tender offer defense to the list of the board's acquisition-related powers had they desired the board to play a role in the tender offer process.¹⁸⁵ Nevertheless, most state legislatures have not done so.¹⁸⁶

Once again, legislative silence should not be interpreted as intending to proscribe preclusive defensive tactics. When faced with the problem of defensive tactics, the courts filled in the gaps in the legislative scheme and granted to target company directors a power similar to that enjoyed in other sale-type contexts.¹⁸⁷ State legislatures, therefore, had no need to act in this area. Far from indicating a desire to restrict defensive tactics, legislative silence in the face of court decisions approving defensive tactics should be construed as assent to this line of common law authority.¹⁸⁸

As a matter of policy, opponents of defensive tactics have argued that the utility of the tender offer process lies precisely in the fact that it is the one method of acquisition that does not require the assent of the target company's board.¹⁸⁹ The tender offer process is a creature of federal law, which allows bidders to make offers directly to shareholders of the target company. However, federal law is concerned only with the integrity of the tender offer process.¹⁹⁰ The ability of target company directors to defend against an offer is governed by state law.¹⁹¹ It seems odd to argue that state courts should allow

184. See SUTHERLAND STATUTORY CONSTRUCTION § 47.23 (Norman J. Singer ed., 5th ed. 1992). Translated, this maxim of statutory construction means "the expression of one thing is the exclusion of another." BLACK'S LAW DICTIONARY 581 (6th ed. 1990).

185. See Gilson, *supra* note 13, at 849.

186. *But see* OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1990) (upholding defensive action by a target company board unless a plaintiff can prove by clear and convincing evidence that the board violated its fiduciary duties).

187. See *supra* text accompanying notes 13-15 and note 181.

188. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 385-86 (1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-82 (1982).

189. See, e.g., *Bebchuk*, *supra* note 144, at 1704-05; Gilson, *supra* note 13, at 850.

190. See, e.g., 15 U.S.C. § 78n(d)(6) (1988) (requiring the bidder to purchase shares pro rata if the number of tendered shares exceeds the number the bidder is willing to purchase); 17 C.F.R. § 240.14d-10 (1990) (requiring the bidder to make the offer to all target company shareholders on the same terms); *id.* § 240.14d-100 (regulating the provision of information by the bidder to target company shareholders); *id.* § 240.14d-101 (regulating the provision of information by the target company's board to shareholders); *id.* § 240.14e-1 (requiring the bidder to keep the offer open for at least twenty days).

191. See *Schreiber v. Burlington N., Inc.*, 472 U.S. 1 (1985) (holding that the Williams Act does not govern fiduciary duty claims); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (holding that Rule 10b-5 does not govern fiduciary duty claims). Direct state regulation of the tender offer process violates the Commerce Clause of the United States Constitution. *Edgar v. Mite Corp.*,

bidders to use the tender offer process to evade the general state law scheme, which requires board assent to all sale-type transactions. The board should have the power to oppose undesirable tender offers because the board is the corporate actor charged with making such decisions.

B. *The Target Company's Board as the Best Decision-Maker*

The state law policy that gives the board a central role in tender offer transactions is sound. In most cases, the board is in a position to make a better decision than the target company's shareholders on the merits of the offer. The board often has better information about the target company than the company's shareholders.¹⁹²

Some have argued that if directors have superior information about a target company, they should do nothing other than pass that information along to shareholders with an explanation of why the information suggests that the tender offer should not be accepted.¹⁹³ This solution is flawed for a number of reasons. First, as demonstrated in Part III, shareholders will have little opportunity to act on the directors' information if they conclude that the information requires declining the offer.

Second, some inside information cannot be made public because disclosure would decrease the value of the information. For example, target company management may know that certain mineral rights are available for purchase at bargain prices. To disclose this information would be self-defeating.¹⁹⁴ In

457 U.S. 624, 640 (1982) (plurality). Therefore, the states could not give the target company board the same statutory veto power that they have in other sale-type contexts. However, the states may permit defensive tactics that have the effect of precluding offers because the states have the power to govern internal corporate affairs without regard to the indirect impact on tender offers. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 88-89 (1987).

192. See *supra* part II.C.3. The relevant issue in the tender offer context is the future value of the target company. This value depends less on historical information than it does on assessment of soft information regarding future plans and values. See *Bebchuk, supra* note 99, at 209. The board usually has information about the specific way in which it plans to run the business in the future and projections of future performance that shareholders do not have. It is well recognized that it is more advantageous to a bidder to pursue a friendly acquisition than a hostile one because in the former case the bidder can receive nonpublic information about the target company. See, e.g., *Bebchuk, The Case for Facilitating Competing Tender Offers, supra* note 106, at 1054-55; *Gilson, supra* note 13, at 850 & n.112. If the target company board can be expected to have information that the bidder, which has presumably done an extensive analysis of the target company, does not have, it should also be expected to have information that its own shareholders and the market do not have.

193. E.g., *Gilson, supra* note 13, at 859; *Schwartz, supra* note 106, at 241.

194. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-49 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *Goodwin v. Agassiz*, 186 N.E. 659, 660 (Mass. 1933); see also *Dale A. Oesterle, The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 125-26 (1986) ("[D]ivulging inside information often damages the interests of both the target and its shareholders."); *Christopher Rebel J. Pace, Determining Price Inadequacy with Neutral Decision Making and Expert Assistance: A Principled Way To "Just Say No,"* 16 DEL. J. CORP. L. 57, 70-71 (1991) ("[W]hile the market value of a stock may be the best publicly-available indicator of a firm's value, it is not a perfect indicator of value because it

addition, forcing the board to disclose all information relevant to value would make it impossible for the target company's board to negotiate with the bidder. Since the bidder does not have to disclose its information relating to the value of the acquisition, the target company's board would be at an unfair disadvantage.

Third, the tender offer process does not give the shareholders enough time to perform the same analyses as the board. Presumably the board is concerned on an ongoing basis with the value of the company's shares and whether the market accurately reflects that value. If the board's view is based on material, nonpublic information that the board disseminates in the middle of a tender offer contest, the shareholders will have limited time to analyze such information. If defensive tactics were prohibited, bidders would be able to close their offers within twenty days,¹⁹⁵ which may not be enough time for shareholders to digest and analyze new information promulgated by the board.¹⁹⁶

Fourth, the shareholders' ability to analyze information is complicated by the fact that the tender offer process is not static. In response to the bidder's offer, the target company board usually considers a wide range of alternatives, including pursuing the company's current business plan,¹⁹⁷ restructuring the company,¹⁹⁸ or seeking out a white knight.¹⁹⁹ Only the board has complete information regarding all these alternatives at any given time. From the shareholders' perspective, it is difficult even to discern which strategy to compare to the bidder's proposal.

Fifth, individual shareholders lack the financial incentive to perform the same investigation as the board regarding the company's value. It will usually be the case that no single shareholder owns enough stock to warrant his incurring the cost of analyzing all the information necessary to arrive at an accurate estimate of target company value.²⁰⁰ Investigation by individual shareholders would also result in duplication of effort. Allowing the board to examine value disperses the investigation costs among the entire body of shareholders and makes investigation economical. In this sense, shareholders benefit from economies of scale.

cannot account for information not yet known to the market.").

195. See 17 C.F.R. § 240.14e-1 (1990).

196. See *Bebchuk*, *supra* note 125, at 259 ("[T]he verification, digestion, and evaluation of information takes time."); *Lipton*, *supra* note 56, at 70 (suggesting that 90 to 120 days are required to allow shareholders sufficient time to consider all the information relevant to a proxy fight in the tender offer context); *Lowenstein*, *supra* note 122, at 317 (recommending that the Williams Act be amended to give shareholders six months to consider takeover related issues).

197. *E.g.*, *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990).

198. *E.g.*, *British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc.*, 664 F. Supp. 1519, 1528 (S.D.N.Y. 1987); *Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829, 835 (D. Minn. 1986), *aff'd in part & vacated in part*, 811 F.2d 414 (8th Cir. 1986); *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 790 (Del. Ch. 1988).

199. *E.g.*, *Mills Acquisition Co. v. Macmillan Co. (Macmillan II)*, 559 A.2d 1261, 1272 (Del. 1989); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1986); *In re Holly Farms Corp. Shareholders Litig.*, 564 A.2d 342, 343-44 (Del. Ch. 1989).

200. See *Oesterle*, *supra* note 194, at 129 n.50.

Even if shareholders have the same information as the target company's board, and the same incentive and opportunity to analyze it, the board is still in a better position to make tender offer decisions. As previously noted, the evidence that trading insiders outperform the market is at least partly explicable on the basis of their superior expertise.²⁰¹ Specialization of the managerial function is one of the benefits of the large public corporation.²⁰² Most managers should be better estimators of a company's value than shareholders.²⁰³

V. CHECKING THE BOARD'S DISCRETION

If directors were perfectly loyal agents, it would be unnecessary to place checks on their discretion. We could trust target company directors to employ takeover defense solely for the benefit of shareholders. Any checks on director discretion would be counterproductive because the directors are in the best position to determine whether takeover defense is justified in particular cases. However, in the real world there is always a danger that the directors will act to further their own interests rather than those of shareholders.²⁰⁴ This danger is magnified in the takeover defense context because perpetuation of the directors' perquisites and power is at issue.²⁰⁵ There are two mechanisms that serve to keep director agency costs within limits: shareholder action and judicial review.

A. Shareholder Action

According to the paradigm of corporate democracy, shareholders elect directors to run the corporation. Shareholders who object to board action have no power to prevent the directors from pursuing their chosen course.²⁰⁶ The shareholders' recourse is to remove the directors.²⁰⁷

This ideal solution poses some practical difficulties. Because shareholdings

201. See *supra* note 128 and accompanying text..

202. See Easterbrook & Fischel, *supra* note 176, at 700.

203. See Carney, *supra* note 142, at 415 ("It is highly unlikely that investors as a group would make decisions superior to those of loyal management."). But see Pace, *supra* note 194, at 67 n.52 ("Many sophisticated investors are probably as capable as management, given equal access to relevant information, in understanding and dissecting company valuations.").

204. The danger that an agent will act in his own interest rather than that of his principal is the familiar problem of agency costs. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

205. See generally Easterbrook & Fischel, *supra* note 6, at 1168-74 (discussing agency costs in the takeover context).

206. See, e.g., *People ex rel. Manice v. Powell*, 94 N.E. 634, 637 (N.Y. 1911) ("[T]he stockholder cannot act in relation to the ordinary business of the corporation, nor can they control the directors in the exercise of the judgement vested in them by virtue of their office.").

207. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (noting in the takeover defense context that "[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out").

are dispersed, an individual shareholder will seldom assume the cost of monitoring the board's conduct and taking corrective action via a proxy fight.²⁰⁸ Moreover, in the takeover defense context, a proxy fight may not be a viable option. If the target company board resists a bid and the annual meeting date is distant, shareholders may not have the power to call a special meeting for the purpose of electing new directors or nullifying defensive mechanisms.²⁰⁹ Even if target company shareholders possess the power to call a special meeting, there is no guarantee that the bidder will be willing to extend its bid so that the proxy process can be completed.

The bidder, unlike target company shareholders, does have enough at stake to consider waging a proxy fight against the target company's board. However, the proxy fight mechanism also has a number of disadvantages from the bidder's perspective. It is potentially lengthier and more expensive than the tender offer process.²¹⁰ The bidder must pay its own expenses up front, and it gets reimbursed from the target company's treasury only if it wins the proxy fight. The target company's board can pay the entire expense of the contest out of the corporate treasury, win or lose.²¹¹ The proxy mechanism is also biased in favor of the incumbents.²¹² Collectively, employees often own a substantial amount of stock²¹³ and tend to favor incumbent management.²¹⁴ In addition,

208. See Easterbrook & Fischel, *supra* note 6, at 1170-71; Gilson, *supra* note 13, at 843; Grossman & Hart, *supra* note 158, at 42.

209. The method of setting annual meeting dates is usually specified in a corporation's bylaws. See, e.g., DEL. CODE ANN. tit. 8, § 211(b) (1991). The board always has the power to call a special meeting of stockholders. Shareholders have such power only to the extent it is specified in the corporate charter or bylaws. See, e.g., *id.* A typical bylaw provision gives shareholders owning a specified percentage of the company's stock the power to call a special meeting. See, e.g., *Auer v. Dressel*, 118 N.E.2d 590, 592 (N.Y. 1954) (noting that a company's bylaws permitted stockholders owning a majority of the company's capital stock to call a special meeting).

210. Federal law allows tender offers to be consummated twenty days after commencement. 17 C.F.R. § 240.14e-1 (1991). By contrast, AT&T's recent proxy fight against the board of NCR took three months from the time the fight was announced to completion. See Eben Shapiro, *A.T.&T. Buying Computer Maker in Stock Deal Worth \$7.4 billion*, N.Y. TIMES, May 7, 1991, at A1. The AT&T/NCR contest illustrates another limitation of the proxy-fight mechanism. Although AT&T captured a majority of votes at NCR's annual meeting, it was able to replace only one-third of NCR's directors because NCR had a staggered board. To replace a majority of directors, AT&T would have been required to wait another year. See Larry Black, *AT&T Raises Offer for NCR*, THE INDEPENDENT, Apr. 23, 1991, at 18.

211. *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 170 A. 226, 227 (Del. Ch. 1934); *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291, 292-93 (N.Y. 1955).

212. See Ronald J. Gilson, *Just Say No to Whom?*, 25 WAKE FOREST L. REV. 121, 123 (1990) (questioning the utility of the proxy process in light of "management domination of the proxy machinery and the collective action problems associated with shareholder voting").

213. See John Hoerr, *"We're Not Going To Sit Around and Allow Management To Louse Things Up."* BUS. WK., May 18, 1987, at 107 ("[E]mployees own at least 20% of nearly 30 publicly traded companies with more than 1,000 workers.").

214. See *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 274 (Del. Ch. 1989) (upholding creation of Employee Stock Ownership Plan ("ESOP") that issued 14% of target company outstanding stock to its employees, despite recognition that employee voters tend to favor management "based upon its easy access to the employees and their likely concern about job

some percentage of shareholders will usually cast all their votes with management.²¹⁵

Despite these limitations, bidders may find it worthwhile to use the corporate election machinery to wage battles against defensive tactics. Although proxy fights were once thought to cost more and take longer than tender offers, these differences have narrowed as takeover litigation has become drawn out and expensive.²¹⁶ The bias inherent in the proxy process has been reduced over time as institutional investors have come to dominate the market.²¹⁷ Although traditionally supporters of management, institutional investors have become more confrontational.²¹⁸

There are sound reasons for bidders to prefer the proxy process to the tender offer process. The proxy process provides fewer opportunities for interference by target company directors. Whereas takeover defense is reviewed under the *Unocal* standard, attempts to manipulate the corporate machinery for the purpose of obstructing a bidder's proxy fight are reviewed less deferentially. To postpone a shareholders meeting, or take other action designed to impede the bidder, the target company's board must demonstrate a compelling justification.²¹⁹ Moreover, if the bidder wins the proxy fight, it also wins the takeover

security"). The courts' reaction to ESOPs as a defensive mechanism has been mixed. Compare *British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc.*, 664 F. Supp. 1519, 1528-29, 1531 (S.D.N.Y. 1987) (upholding ESOP) and *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 635 F. Supp. 246, 1066 (S.D.N.Y. 1986) (accepting ESOP without discussion) and *Weinberg v. Cameron*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,377 (D. Haw. Mar. 21, 1980) (upholding ESOP) with *Norlin v. Rooney Pace Inc.*, 744 F.2d 255, 266-67 (2d Cir. 1984) (rejecting ESOP) and *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 233 (9th Cir. 1975) (same) and *Podesta v. Calumet Indus.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,433 (N.D. Ill. May 9, 1978) (same).

215. See Joseph A. Grundfest, *Just Vote No or Just Don't Vote*, 729 PRACTICING L. INST. 829, 845 (1991) (noting the "knee-jerk support for incumbent boards").

216. See, e.g., *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 498 (7th Cir.) (Easterbrook, J.), cert. denied, 493 U.S. 955 (1989) (over five months between initial bid and resolution of litigation); *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1147 (Del. 1990) (over eight months between initial bid and resolution of litigation); *Mills Acquisition Co. v. Macmillan Co. (Macmillan II)*, 559 A.2d 1261, 1272 (Del. 1989) (over three months between initial bid and resolution of litigation where the Delaware Supreme Court rendered an oral decision in advance of its written opinion); *TW Servs., Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,176 (Del. Ch. Mar. 2, 1989) (over four months between initial bid and resolution of litigation where case was not appealed); *Polaroid*, 559 A.2d at 281 (over five months between initial bid and resolution of litigation where case was not appealed).

217. As of 1989, institutional investors owned over 45% of total equities in the United States. Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 447 (1991).

218. See Lipton, *supra* note 56, at 8-9; Rock, *supra* note 217, at 449-51; Steinberg, *supra* note 84, at 30-31. There are also indications that employee owners are becoming more aggressive. See Alan Hyde & Craig H. Livingston, *Employee Takeovers*, 41 RUTGERS L. REV. 1131 (1989).

219. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988). *But cf. Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1122, 1124-25 (Del. Ch. 1990) (phrasing the test in the context of a proxy fight over a tender offer as whether target company directors "have exercised corporate

battle. It has the power to nullify any remaining takeover defense and need not fear future defensive action against its bid. Bidders are beginning to turn back to the proxy fight, and away from exclusive reliance on the hostile tender offer, as a way of removing incumbent management.²²⁰

The proxy process is also a more socially desirable way to resolve takeover battles than the tender offer process in certain respects. Proxy fights are conducted over a period of time sufficient to allow the shareholders to receive and digest information relevant to the tender offer.²²¹ Unlike the tender offer process, the proxy process does not contain any coercion. Every target shareholder can vote as he likes on the issue of whether the incumbents or the bidder should control the target company's board, and therefore on whether the tender offer should succeed or fail. If a target company shareholder votes for the incumbents and the bidder wins the election, no penalty is imposed on the dissenting shareholder. He may still tender into the bidder's offer with all the shareholders who voted for the bidder and receive the same consideration as

power inequitably" and noting that in such cases "the 'enhanced' business judgment form of review of *Unocal* and the non-business judgment review of [cases including *Blasius*] come . . . to resemble each other").

220. See John J. Gavin, *Changes in Corporate Control and Governance Communicated Through Proxy Power*, 704 PRACTICING L. INST. 91 (1990); Carl L. Reisner, *The Use of the Proxy Machinery as a Catalyst for Fundamental Corporate Change*, 696 PRACTICING L. INST. 649 (1990); Steinberg, *supra* note 84, at 31 (noting "the resurgence of the proxy contest as a viable mechanism to oust incumbent management"). Even if the bidder does not win the proxy fight, if it obtains a substantial percentage of the vote, the demonstration of shareholder discontent may be sufficient to force the target company board to accede to the bidder's wishes. In 1988, The Bank of New York ("BNY") mounted a proxy fight against the board of Irving Bank Corporation for the purpose of facilitating its tender offer. Although BNY lost, it obtained 48.6% of the vote. Sarah Bartlett, *The Clumsy Quest for Irving Bank*, N.Y. TIMES, Sept. 18, 1988, § 3, at 1. Within four months of the conclusion of the proxy fight, Irving's board rescinded its defensive tactics and allowed BNY's offer to proceed. *Anatomy of a Takeover*, N.Y. TIMES, Oct. 6, 1988, at D5; *The Long Bitter Fight for Irving*, AM. BANKER, Oct. 6, 1988, at 15. Similarly, AT&T recently resorted to a proxy fight against the board of NCR to facilitate its tender offer rather than to litigation challenging the validity of NCR's defensive tactics. Although AT&T obtained 66% of the shareholder vote, it was unable to obtain immediate control of NCR because NCR had a staggered board and AT&T did not obtain the 80% needed to remove directors without cause. See Jeremy Warner, *Pressure Grows on NCR To Discuss Bid*, THE INDEPENDENT, Mar. 25, 1991, at 21. Nevertheless, the NCR board agreed to a sweetened deal with AT&T within five weeks of the proxy contest. Leslie Wayne, *Behind the Drop in Proxy Fights*, N.Y. TIMES, Mar. 19, 1991, at D10; see also Grundfest, *supra* note 215 (arguing that shareholders can increase management discipline by refusing to vote in uncontested elections and conveying its lack of confidence in management).

221. See *Stahl v. Apple Bancorp, Inc.*, 579 A.2d at 1124 (allowing directors to postpone a proxy fight over a tender offer to give shareholders enough time to receive and digest information). Of course, one might still object that, even if shareholders have and understand all relevant information, they are still in a worse position than the target company board to assess the merits of a tender offer. See *supra* part IV.B. However, the legitimacy of all the board's actions, including its defensive tactics, rests on election by the shareholders. Although the board may be better situated to decide takeover questions, the proxy process must be the one sphere in which shareholders have an absolute say. See *Blasius Indus. v. Atlas Corp.*, 564 A.2d at 666.

they receive.²²²

B. Judicial Review

Despite the promise of the proxy process as a method for challenging incumbent management, its inherent limitations require supplementation with an effective system of judicial review of defensive tactics as a check on management.²²³ Contrary to the Delaware Supreme Court's apparent view in *Paramount*, the critical issue in the takeover defense context is the one identified by the chancery court in that case: Does the bid price fairly reflect the intrinsic value of the target company?²²⁴ The target company's board should not be allowed to obstruct a takeover by taking the Olympian position that it prefers to continue with its current business plan. The burden of proof on the comparative value question should rest with the target company's board because the board is best informed regarding the target company intrinsic value and has the best access to proof of such value.²²⁵

Although the court should be willing to listen to the board's proof on value, it should subject the board's proof to a searching inquiry.²²⁶ The board should not be allowed to rest on an unsubstantiated opinion of an investment banker that the bid price is inadequate.²²⁷ As an initial matter, the board should be required to explain what strategy it intends to pursue if the bid is defeated.²²⁸ Identifying this strategy allows comparison of the relevant values.²²⁹ If the

222. The lack of coercion in the proxy process was noted in *Bebchuk*, *supra* note 99, at 222-23.

223. Of course, case-by-case review is only justified if "the game [is] worth the candle." *Gilson & Kraakman*, *supra* note 21, at 265. A per se rule against defensive tactics would also limit management discretion and at considerably less cost. However, as demonstrated above, case-by-case review seems superior to any per se rule. *See supra* part II.D.

224. *See* discussion *supra* part I.C.3; *Kalajian*, *supra* note 52. The target company board is also entitled to require that the bidder fairly share any gains flowing from the combination with target company shareholders. *See supra* part II.B.1.

225. Where the facts lie peculiarly within the knowledge of one party, that party is typically allocated the burden of proof. *See, e.g.*, CHARLES T. MCCORMICK, *MCCORMICK ON EVIDENCE* § 337, at 950 (Edward W. Cleary ed., 3d ed. 1984).

226. *See* *Gilson & Kraakman*, *supra* note 21, at 271 (noting that the court should examine "the specificity and completeness of management's plan, the deliberations of the target's board, expert testimony from both sides, and, most important, the firm's performance history").

227. *See id.* at 268.

228. *See id.* at 268-69.

229. The situation becomes complicated if the board's strategy is to negotiate with the bidder. Forcing the board to disclose at what price it would accept the bidder's offer would make it impossible to negotiate. If such a rule were the law, the bidder, secure in the knowledge it could ascertain the board's best price through litigation, would have no incentive to negotiate. This process would be unfair because the bidder would not have to disclose or justify its offering price and, although the target company board would have to sell at a price determined to be fair by the courts, the bidder would not have to buy. A potential solution is to allow directors to make an in camera submission of proof, which would include a declaration that the board's goal is to negotiate, the price at which the board would accept the bidder's offer, and the board's justification for the acceptance price. Such a procedure would allow the court to review the board's conduct without tipping the contest unfairly in favor of the bidder.

board defends against an offer because it wishes to pursue its current business plan, to have its defensive actions upheld the board should be required to prove that it reasonably believes that its business plan will generate profits that, when discounted to present value using an appropriate discount rate, have a greater value than the bid price. If the board wishes to pursue a restructuring alternative to the bid, it should be required to prove that it reasonably believes that the present value of the restructuring exceeds that of the bid.²³⁰

When employing *Unocal* in heightened form, a court must be careful not to usurp the board's function. The court should make a judicial inquiry regarding the sufficiency of evidence, not a business inquiry. The court should ask whether the directors have satisfied their burden under *Unocal* of proving that they acted reasonably, not whether the court, had it been in the position of the target company's board, would have acted differently. A range of board responses to any takeover bid will usually be reasonable. As long as target company directors choose a reasonable response, their conduct should be upheld.²³¹

Such judicial self-restraint does not represent a reversion to the business judgment rule. Indeed, the heightened form of *Unocal* review suggested above was seemingly employed *sub silentio* by the Delaware Court of Chancery prior to the supreme court's decision in *Paramount*. For example, in *Pillsbury* the chancery court rested on broad principles of shareholder choice to invalidate defensive tactics.²³² The court may have taken this approach because it believed it was not able to inquire into the substance of the target company's

230. The courts have recently treated restructuring values as directly comparable to tender offer values. See *Robert M. Bass Group, Inc. v. Evans (Macmillan I)*, 552 A.2d 1227, 1241-44 (Del. Ch. 1988); see also *TW Servs., Inc. v. SWT Acquisition Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,181 (Del. Ch. Mar. 2, 1989) (suggesting that restructurings and sales are equivalent). This view is open to criticism on the ground that a sale of the company liquidates 100% of the target company shareholder's interest but a restructuring does not. In the case of a restructuring, the stub share can itself be the later object of a premium tender offer. However, this criticism should not lead to the conclusion that the values cannot be compared, only that they cannot be compared directly. Any premium applicable to the stub share attaches only to that portion of the shareholder's original equity that is left after payment of the restructuring dividend. For example, in *Interco* the board proposed a restructuring dividend it valued at \$66 per share, which left a stub share valued at \$10 per share. *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 793 (Del. Ch. 1988). Accepting the board's values, the restructuring dividend drained 87% of the value from the company. This 87% can never again be the subject of a premium offer. If 50% were an appropriate takeover premium, the target company board would be justified in turning down offers below \$81 per share but not those above \$81 per share (i.e., \$66 + 1.5(\$10) = \$81).

231. See *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1145 n.29 (Del. 1990) (noting that *Unocal* "implicitly acknowledges that courts should not impose their own business judgment upon independent directors who reasonably respond to a threat to the corporate enterprise in good faith and on an informed basis"). But see Kalajian, *supra* note 52 (suggesting that the court should decide on the merits whether a tender offer is adequately priced); Pace, *supra* note 194, at 88-90 (suggesting that the court, assisted by valuation experts, should determine whether the offer price falls within a range of adequate prices).

232. See *supra* text accompanying notes 49-52.

defensive actions under the supreme court's precedents. However, a substantive *Unocal* analysis suggests that the chancery court was correct to rule against the target company's board.²³³

The pre-tender offer price of Pillsbury's stock was \$39 per share.²³⁴ The bidder's final \$63 offer represented about a 60% premium. The Pillsbury board summarily dismissed the offer as inadequate.²³⁵ Because the board realized that it could not simply obstruct the bidder's offer, the board proposed a restructuring it valued at \$68 per share. This value was based in part on exceedingly optimistic forecasts that assumed, without any discernible justification, that Pillsbury's corporate performance would improve substantially.²³⁶ A better rationale for the result in *Pillsbury* would have been that the board failed to meet its *Unocal* burden of proving that it either reasonably believed the \$63 bid price to be inadequate or that it reasonably believed the restructuring was worth \$68 per share. A similar analysis can be applied to the other Delaware chancery court cases striking down defensive tactics on shareholder choice grounds.²³⁷

Whether the target company's board deserved to prevail under a heightened form of *Unocal* review in *Unocal*, *Ivanhoe*, and *Paramount* is harder to discern because the Delaware Supreme Court decided these cases in favor of the board without making any extensive examination of whether it was reasonable to believe that the bid price was less valuable than the alternative chosen by the board.²³⁸ However, just as the chancery court couched decisions that could have been based on lack of proof regarding value in the language of shareholder choice, the Delaware Supreme Court may have reached decisions in these cases for unspoken economic reasons and couched its language in terms of a lenient *Unocal* analysis. If this is the case, the *Unocal* standard may be more stringent than the supreme court cases suggest.

233. For a similar view of *Pillsbury*, see Kalajian, *supra* note 52.

234. There was evidence that the price of Pillsbury's stock was also depressed by an unjustified accumulation of assets. The Pillsbury board recognized that, by the mid-1980s, the individual values of its diversified businesses exceeded the market price of its stock. *Grand Metro. Pub. Co. v. Pillsbury Co.*, 558 A.2d 1049, 1051 (Del. Ch. 1988).

235. *Id.* at 1052.

236. *Id.* at 1057.

237. See Kalajian, *supra* note 52. In *Anderson, Clayton*, the target company's board responded to a \$56 tender offer with a \$60 self-tender for 65% of the company that precluded the bidder's offer. The target company's investment banker never opined that the bidder's offer was inadequate. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 110 (Del. Ch. 1986). In *Macmillan I*, the target company's board responded to a \$64 bid with a restructuring it valued at \$64.15. The board continued to maintain its opposition to the bid after it was raised to \$73. *Robert M. Bass Group, Inc. v. Evans (Macmillan I)*, 552 A.2d 1227, 1236-37 (Del. Ch. 1988). In *Interco*, the target company's board rejected as inadequate a \$74 tender offer that represented about a 70% premium over the pre-tender offer market price and fit comfortably within the initial \$68 - \$80 valuation range provided by the board's investment banker. The board also proposed a restructuring it valued at \$76; however, the market price of *Interco's* stock did not exceed \$70 after the announcement of the restructuring. *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 791-93 (Del. Ch. 1988).

238. See *supra* parts I.A., I.C.3, and note 66.

CONCLUSION

Preclusive defensive tactics have the potential to generate large gains for target company shareholders. Such tactics may increase the premiums paid after negotiations and auctions and serve as a shield against inadequate bids. Although such tactics place the primary decision-making power with respect to tender offers in the hands of the target company board, the board ought to have this power. Target shareholders have little or no choice but to accept premium tender offers. The target company's board is in the business of, and is better at, making decisions regarding whether and at what price to sell the company. Therefore, a per se ban on preclusive defensive tactics is not justified.

Preclusive defensive tactics also threaten to impose large agency costs on target shareholders. As a consequence, judicial review of takeover defense must be rigorous. Although *Paramount* suggests that judicial review of defensive tactics will be deferential, its holding is more limited than much of the expansive language in the opinion.²³⁹ The Delaware Supreme Court cases have alternated between decisions favorable to bidders and decisions favorable to target companies.²⁴⁰ This trend probably involves nothing more than the march of the common law as later cases test the limits of earlier ones. The next major takeover defense case may well demonstrate that the *Unocal* standard is stronger than *Paramount* suggests. There is, therefore, reason to believe that Delaware will come to have a balanced position and allow access to preclusive defensive tactics subject to effective judicial review.

239. See *supra* note 85 and accompanying text.

240. Target directors prevailed in *Unocal* and *Moran*. They were then dealt a setback in *Revlon*. Target directors were victorious in *Ivanhoe* but were defeated again in *Macmillan II*. *Paramount* represents the latest victory for the target directors. See *supra* notes 27-39 and accompanying text; *supra* part I.C.