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The Restructuring of the Relationship Between Shareholders and the Corporate Entity: Reflections on Berle and Means

Rafael A. Porrata-Doria, Jr.*

I. Introduction

This Article is an examination and reassessment of Professors Berle and Means' seminal theory of the nature of the relationship between a corporation, its shareholders, and its management.[1] Because of its importance to modern corporate law,[2] this relationship is examined in the context of two recent corporate antitakeover defensive techniques:[3] the creation of super common stock, and management's deliberate discrimination against suspected hostile shareholders.

Professors Berle and Means were the first to argue that, because of changes in the nature of the corporation and the economy, management, not shareholders, assumed control of the corporate entity.[4] Management achieved control by taking charge of the machinery of shareholder voting.[5] Berle and Means concluded that the modern

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1. This theory is set forth in A.A. BERLE & G.C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) [hereinafter BERLE & MEANS]. In 1967, a revised edition of this work appeared, in which the authors argued that the American industrial experience since 1932 confirmed and affirmed the validity of their original assertions. All citations to Berle and Means' work in this article will be citations to the revised edition (1967).

2. *See, e.g.*, E.S. HERMAN, CORPORATE CONTROL, CORPORATE POWER (1981); J.W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAWS OF THE UNITED STATES 1780-1970 (1970); Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Ratner, *The Government of Business Corporations, Critical Reflections on the Rule of 'One Share, One Vote'*, 56 CORNELL L. REV. 1 (1970).

3. For a discussion of recent hostile corporate takeovers and the defensive techniques developed to resist them, *see infra* notes 72-103 and accompanying text.

4. BERLE & MEANS, *supra* note 1, at 64-65.

5. *Id.* at 78-84. In effect, management usurped control of the corporation from its shareholders by nominating slates of candidates for the entity's board of directors and controlling the agents who cast proxy ballots on behalf of the shareholders. Since share ownership in modern corporations is widely distributed among thousands of shareholders so that no single shareholder or group has enough votes to control the results of the election for directors, most shareholders become apathetic and either do not vote or blindly approve management's slate.

shareholder was not an owner of the corporate entity but a *rentier*[6] or type of unsecured creditor, with no rights other than a satisfactory return on investment and the right to liquidity.[7] This theory of the nature of the corporate entity has been the subject of much discussion and debate, and has been enthusiastically adopted by a number of authors.[8]

Traditional theorists view the corporate relationship as one in which the shareholders, as owners of the corporation, control the corporate entity through their voting power, which enables the shareholders to elect the enterprise's board of directors and to approve fundamental corporate transactions.[9] As corporate entities grow larger and more complex, the shareholders, for purposes of efficiency, delegate the day to day operations of the enterprise[10] to a group of agents called management.

This Article explores Berle and Means' reasoning and theory about the nature of the modern publicly traded corporation, and shows that their perception and cry for legal reform have already been substantially implemented in modern corporate regulation. This Article also demonstrates that Berle and Means' theory may, perhaps, furnish another explanation for the recent explosion in hostile corporate takeovers, mergers, and acquisitions.[11] Hostile takeovers[12] have, of course, engendered a rash of defensive tactics through which the management of potential target corporations have attempted to protect themselves.[13]

Two recent antitakeover defensive techniques, designed to thwart hostile takeovers both before and after an offer is made by a raider, are examined. Additionally, this examination illustrates the relationship between Berle and Means' theory and increased hostile

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The resulting board of directors would, of course, be subservient to management. *Id.*

6. A *rentier* is defined as a "man of independent means;" a "holder of an annuity;" or one who "has a small private income . . . a small investor." CASSELL'S FRENCH-ENGLISH ENGLISH-FRENCH DICTIONARY 639 (rev. ed. 1981).

7. BERLE & MEANS, *supra* note 1, at 300-02.

8. *See infra* note 51 and accompanying text.

9. BERLE & MEANS, *supra* note 1, at 125-26.

10. *Id.* at 123.

11. According to one estimate, 2,543 merger deals, with a total price of $122 billion, were struck during 1984 alone. O'Connell, *Do Mergers Really Work?*, BUS. WK., June 3, 1985, at 88. This trend does not appear to be abating; on the contrary, an examination of the Wall Street Journal on almost any given day will reveal several ongoing takeover battles.

12. *See infra* notes 72-103 and accompanying text.

13. *See* Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44 (1983). *See also* McCord, *Limiting Defensive Tactics in Tender Offers: A Model Act for the Protection of Shareholder Decision Making*, 17 SEC. L. REV. 415, 417-22 (1985) (limitation of defensive techniques is justifiable on grounds of economic efficiency and limiting conflicts between interests of management and shareholders).

takeover activity.

The first defensive technique is the entrenchment of corporate control in a minority group of shareholders by abandonment of the traditional one-share one-vote requirement for common shares, and the development of super common stock with multiple voting rights and second class common stock with reduced or nonexistent voting rights.[14] This development has been the subject of intense debate.[15] Indeed, the United States Securities and Exchange Commission (SEC) recently issued a regulation that severely restricts the public trading of these securities.[16]

The second defensive technique is discriminatory treatment by management of a shareholder whose reputation or behavior indicates a hostile intent aimed at current corporate management. This technique, recently approved by the Delaware Supreme Court,[17] has been enthusiastically espoused in at least one recodification of the corporate statutes of a major industrial state.[18]

The author believes that management's wholesale embrace of dual class recapitalizations and of discriminatory treatment of hostile shareholders is based on an extrapolation of Berle and Means'

14. *See, e.g.*, Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271 (Del. Ch. 1986); Packer v. Yampol, No. 86-8432 (Del. Ch. Apr. 18, 1986) (LEXIS, States library, De file); National Educ. Corp. v. Bell & Howell Co., No. 83-7278 (Del. Ch. Aug. 25, 1983) (LEXIS, States library, De file); American Pacific Corp. v. Super Food Servs., Inc., No. 82-7020 (Del. Ch. Dec. 6, 1982) (LEXIS, States library, De file); Societe Holding Ray D'Albion S.A. v. Saunders Leasing Sys., Inc., No. 81-6648 (Del. Ch. Dec. 16, 1981) (LEXIS, States library, De file); Telvest, Inc. v. Olson, No. 79-5798 (Del. Ch. March 8, 1979) (LEXIS, States library, De file); Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1977); Kersten v. Pioneer Hi-Bred Int'l, Inc., 626 F. Supp. 647 (N.D. Iowa 1985); ASARCO Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985); Amalgamated Sugar Co. v. N.L. Indus., 644 F. Supp. 1229 (S.D.N.Y. 1986), *aff'd*, 825 F.2d 634 (2d Cir. 1987); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985); Baron v. Strawbridge & Clothier, 646 F. Supp. 690 (E.D. Pa. 1986).

15. *See, e.g.*, FISCHEL, ORGANIZED EXCHANGES AND THE REGULATION OF DUAL CLASS COMMON STOCK (1986); Dent, *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725 (1986); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. LAW & ECON. 395 (1983) [hereinafter Easterbrook & Fischel-Voting]; Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares—Their History, Legality and Validity*, 15 SEC. REG. L.J. 37 (1987); Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427 (1964); Ratner, *supra* note 2; Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986); Note, *Corporate Voting: Majority Control*, 61 ST. JOHN'S L. REV. 218 (1988); Note, *Dual Class Recapitalization and Shareholder Voting Rights*, 87 COLUM. L. REV. 106 (1987).

16. *See* Voting Rights Listing Standards-Disenfranchisement Rule, Release No. 34-25891, 20 Sec. Reg. & L. Rep. (BNA) No. 28, at 1124 (July 15, 1988) [hereinafter Release No. 25891] and Securities Exchange Act of 1934, Regulation 19c-4, to be codified at 17 C.F.R § 240.19c-4. The effective date of the Rule is July 7, 1988.

17. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

18. *See* Act of December 21, 1988, P.L. 1444, No. 177, Commonwealth of Pennsylvania; 15 PA. CONS. STAT. ANN. §§ 101-7726 (Purdon Supp. 1989).

thesis relating to shareholder vote. In essence, it is acceptable under these techniques for management to defend against hostile takeovers by diluting the vote of the majority of the shareholders or by discriminating against the raider because, as Berle and Means noted, shareholders' votes are irrelevant since most shareholders have no desire to have, and do not use, their right to vote. This analysis, however, is not supported by the evidence.

Clearly, Berle and Means' theory has been overextended and overapplied[19] and, perhaps, no longer reflects reality.[20] Specifically, this Article concludes that the extension of the two takeover defense mechanisms represents an unwise and dangerous precedent.

II. The Shareholder and the Corporate Entity: From Owner to *Rentier*

Traditional theorists seeking to explain the nature of the corporation believe that a corporation is a voluntary association of individuals who have entered into a social contract to conduct a common activity and divide the risks and profits therefrom.[21] The individual parties (the shareholders) to this contract are in fact the owners of the entity and control its operations.[22] Managers are actually the shareholders' agents and conduct the day to day business of the enterprise for the benefit of the shareholders.[23]

Although considered a creature of contract,[24] the corporation appears to have been conceptualized as a creature analogous to the state and, as such, was to be operated in a democratic fashion: by the majority vote of its members, the shareholders.[25] This conceptualization appears to be borrowed directly from political theory. The system of corporate governance advocated by the traditional view re-

19. *See infra* notes 72-103, 160-62 and accompanying text.

20. *Id.*

21. *See* Easterbrook & Fischel-Voting, *supra* note 15, at 401.

22. BERLE & MEANS, *supra* note 1, at 123-24.

23. *Id.* at 293-94; Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257, 1271 (1985).

24. Indeed, Professors Easterbrook and Fischel have gone as far as to describe corporate law as "a standard form contract for issues of corporate structure. To the extent they anticipate the desires of the contracting parties, these off the rack principles reduce the number of items to be negotiated and the costs of negotiating them." Easterbrook & Fischel-Voting, *supra* note 15, at 401. On the other hand, a number of other commentators argue that the analysis of the corporate enterprise as a "nexus" of contracts is seriously flawed. *See, e.g.*, CLARK, AGENCY COSTS VERSUS FIDUCIARY DUTIES (1985) in PRATT & ZECKHAUSER, PRINCIPALS AND AGENTS: THE STRUCTURES OF BUSINESS 55-64, 66-69 (1985); Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985).

25. Easterbrook & Fischel-Voting, *supra* note 15, at 395-97; Ratner, *supra* note 2, at 9-11.

sembles a system of political checks and balances: shareholders, through a number of specific techniques, can limit and counteract the otherwise absolute power of the managers of the enterprise. Indeed, the concept of corporate democracy appears to be more political than legal in nature.[26]

The legal system bestowed upon the shareholders significant rights and powers meant to insure control of the entity and its operations. For example, shareholders had the exclusive right to elect[27] and remove[28] the members of the board of directors. Moreover, management assured shareholders that the determination and distribution of dividends would not impair the corporation's capital.[29] Furthermore, the shareholders had the exclusive power to alter the corporation's articles of incorporation, the fundamental contract document which, among other things, determined the corporation's capital structure.[30] Through the institution of preemptive rights, the corporation's shareholders also had the right to ensure that their proportionate interest in the enterprise would remain undiluted should the incorporated entity seek to expand.[31] Thus, the shareholders could check and balance the powers of the enterprise's managers.[32] The traditional model, in effect, viewed the corporation as an entity whose affairs would be guided by management for the benefit of the owners, each of whom would take an active (but indirect) part in the corporation's business through the mechanism of the shareholder vote.[33]

In 1932, Professors Berle and Means postulated that, because of enormous changes in the United States economy in the late nine-

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26. There appears to be a close connection between the fields of law and political science. Indeed, American political science has been viewed as having an extremely "legalistic" approach that views political science as primarily the study of constitutions and legal codes. A.C. ISAAK, SCOPE AND METHODS OF POLITICAL SCIENCE 33 (1969). One factor that has been advanced as an explanation for this phenomenon is that in the 19th century most American political scientists received their graduate training in European, usually German, universities. The political science professors in these institutions were members of law faculties, and tended to think in an extremely legalistic fashion. *Id.*

27. BERLE & MEANS, *supra* note 1, at 196.

28. *Id.* at 129.

29. *Id.* at 124, 135-36.

30. *Id.* at 186-95.

31. Preemptive rights are rights given to shareholders by a corporation (either by statute or by the corporation's articles of incorporation) allowing the shareholders, each time the corporation issues new shares, to purchase a percentage of the new issue that equals his or her percentage of ownership of the already outstanding stock (of the same class) of the corporation. The purpose of these rights is to ensure the preservation of the balance of power among shareholders in the event of an expansion of the corporate entity. CLARK, CORPORATE LAW 719 (1986). In public corporations, preemptive rights are very rare. *Id.*

32. BERLE & MEANS, *supra* note 1, at 133-35, 160-63.

33. *Id.* at 293-94; Easterbrook & Fischel-Voting, *supra* note 15, at 399.

teenth and early twentieth centuries, the traditional model had, in fact, become obsolete.[34] Berle and Means saw the American economy as being dominated by enormous conglomerates with far-flung and diversified operations whose shares were owned by thousands of widely dispersed, small shareholders.[35] These conglomerates shared a remarkable phenomenon: control by management, not by shareholders.[36] These managers were not the traditional entrepreneurs who were also shareholders, but technocrats possessing unique skills who became, in effect, professional managers.[37] Since the corporation's owners were numerous and widely dispersed, and none of them possessed a large enough holding to achieve control of the corporation, the corporate proxy became the only vehicle by which shareholder voting could be effectuated. Management, by seizing control of the proxy machinery, could in effect nominate and elect directors who represented its interests rather than the interests of the shareholders.[38] The individual shareholder, relatively powerless because of the small size of his holding, would generally acquiesce and elect management's slate of candidates.[39] The individual shareholder's voting power, therefore, became worthless and irrelevant.[40]

This new breed of corporate managers would, of course, seek to perpetuate itself in office and strengthen its ability to direct the corporation's affairs.[41] By perpetuating themselves in office, these corporate technocrats could enjoy the perquisites of power and prestige in a major enterprise without taking any of the financial risks to which the entrepreneurs who had founded the enterprise had been exposed. Surely this was a desirable outcome.[42] Management achieved this objective by influencing the legal system to eliminate many of the traditional powers allocated to shareholders and, in turn, depositing those powers with the board of directors.[43]

Berle and Means saw that, as a result of this separation between share ownership and control, the shareholder was, in effect, left with a piece of paper that represented loose expectations that management would run the enterprise in a way that would benefit

34. BERLE & MEANS, *supra* note 1, at 58-65.
35. *Id.* at 44-54.
36. *Id.* at 78-83; E.S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 9-14 (1981).
37. BERLE & MEANS, *supra* note 1, at 112-14.
38. *Id.* at 82.
39. *Id.* at 80-82.
40. *Id.* at 76-82. *See also* Easterbrook & Fischel-Voting, *supra* note 15, at 403-06.
41. BERLE & MEANS, *supra* note 1, at 113-16.
42. *Id.* at 115.
43. *Id.* at 128-40.

the shareholder and that management would not abuse its position to the shareholder's detriment.[44] With no ability to control or to make demands on management, the shareholder, whose capital had been risked to create and expand the corporate enterprise, was left totally subservient to management's will.[45] The share of the corporation's assets was valuable only to the extent that management and the corporation performed in such a way as to increase the value of the corporation's assets.[46]

Why would any rational human being utilize his scarce capital in this fashion? Because, as Berle and Means noted, the shareholder's investment was highly liquid and could be easily disposed of in the securities markets.[47] Therefore, the shareholder exchanged control and ownership of the corporate entity for liquidity. The shareholder's expectations about the value of his investment and his entitlement to dividends are perennially evaluated (and hopefully validated) by the securities markets.[48] In short, the investor is gambling that his investment will increase in value, which will result in a profit upon resale. Management, therefore, has an especially strong incentive to produce a strong corporate performance since a weak performance, either real or perceived, will cause the value of the corporation's shares to decrease and the shareholders to dispose of their investment.[49]

Berle and Means' analysis has been the subject of much discussion,[50] and a number of authors enthusiastically adopted Berle and Means' thesis.[51] Berle and Means' analysis sets forth a theory of corporate development, under which the corporate entity has a life and inevitable development independent of its shareholders. In the birth and infancy of the corporate entity, a group of entrepreneurs enter into a contract whereby resources are pooled into a common enterprise in return for shares of the resulting corporation. In an infant corporation, shareholders normally constitute management and are involved in the day to day operations of the corporate business. Thus, in an infant corporation, ownership of shares constitutes total control

44. *Id.* at 244.
45. *Id.*
46. BERLE & MEANS, *supra* note 1, at 250-51.
47. *Id.* at 248-52.
48. *Id.* at 252.
49. *Id.* at 250. *See also* E.S. HERMAN, *supra* note 36, at 103-13.
50. *See, e.g.*, BERLE & MEANS, *supra* note 1, at xxii.
51. *See, e.g.*, A. CHAYES, THE MODERN CORPORATION AND THE RULE OF LAW IN THE CORPORATION IN MODERN SOCIETY 25 (1959); E.S. HERMAN, CORPORATE CONTROL, CORPORATE POWER (1981); R.B. STEVENSON, JR., CORPORATION AND INFORMATION (1980).

of the corporate entity. This infant corporation will, generally, be quite small in size. As the corporation seeks to expand, its managing shareholders will desire to acquire additional capital by selling shares to individuals who are not interested in becoming, and who are not permitted to become, involved in the day to day operations of the business, but who are content to leave this task to the original owner-managers. In such an adolescent corporation, management begins to emerge as a distinct group with interests different from those of the shareholders. Shareholders, because of their still limited numbers, continue to retain a measure of control of the enterprise although the newer shareholders have a lesser degree of control than the original shareholders of the infant corporation. The adolescent corporation eventually becomes a mature corporation,[52] the entity described by Berle and Means. Berle and Means implied that this evolution is the inevitable result of the economy's development and expansion.

Berle and Means' theory, in effect, leaves the shareholder as a mere *rentier*, the owner of a piece of paper that no longer represents mere ownership of a portion of the corporate entity, but which has intrinsic value of its own, and which may entitle its owner to a specific stream of payments in the future. Indeed, the value of such a piece of paper is related more to the market's perception of its value and to the public's perception of the accuracy and stability of the market than to the profitability of its underlying corporate entity. Thus, it is possible, as happened on October 19, 1987, for shares to lose their value and for the market to crash in spite of the fact that the underlying corporate entities remain profitable and expanding.[53]

52. BERLE & MEANS, *supra* note 1, at viii-xxxviii.

53. *See, e.g., Evaluating the October '87 Crash*, N.J. L.J., Nov. 17, 1988, at 53 (The October 1987 stock market crash was caused by overvaluation of stocks linked to the success of the policies of the Reagan administration, the takeover boom, and the absence of high inflation.); *It's Time for America*, BUS. WK., Nov. 16, 1987, at 158-63 (Deficit spending and excessive foreign debt caused the crash of 1987.); *The Stock Market is a Lousy Economic Forecaster*, FORBES, Nov. 30, 1987, at 32-34; *Why the Market Crash Won't Cause a Recession*, FORBES, Nov. 30, 1987, at 120-24 (The stock markets respond to their "internal momentums" and are not an accurate reflection of the economy.); *Different Worlds: Crash is Viewed with Detachment on Main Street*, Wall St. J., Dec. 30, 1987, at 1, 19 (The October 1987 stock market crash was not perceived as a serious event by those outside the financial community.); *Black Monday: What Really Triggered the Market's Crash on October 19*, Wall St. J., Dec. 16, 1987, at 1, 20 (Proposed tax changes that would make takeovers much less attractive and a wider than generally expected trade deficit triggered investor sell orders. A number of internal stresses within the financial markets allowed an early sell off to rage out of control.); *Speculative Fever Ran High in the 10 Months Prior to Black Monday*, Wall St. J., Dec. 11, 1987, at 1, 14 (A number of "esoteric ideas," including the adoption of "breakup value" as a standard for company valuation, a surge in takeovers and leveraged buyouts, a "liquidity surge" and overutilizations of the options and futures markets, triggered a speculative fever that led to

More importantly, Berle and Means postulated in 1932, and reaffirmed in 1967, that the nature of the corporate social contract in modern society changed drastically and, most importantly, changed voluntarily. Accordingly, corporate law had to be restructured to take into account these changes.[54] In other words, the corporate social contract had to be renegotiated.

In fact, the author believes that the legal system has already conducted such a renegotiation, severely eroding the power of shareholders to control corporate affairs. For example, most states amended their corporation statutes to significantly restrict the powers of shareholders and expand those of management, including the power to, under certain circumstances, issue corporate shares, and designate powers, rights, and preferences without shareholder intervention.[55] The courts also interpreted directors' duties of care and loyalty in an extremely deferential fashion, refusing to intervene in board actions unless entered into in bad faith or without a rational business purpose.[56]

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vastly overvalued stocks.).

54. BERLE & MEANS, *supra* note 1, at 309-13.

55. *See, e.g.*, Delaware General Corporation Law, DEL. CODE ANN. tit. 8, §§ 151(a), (g) (1983 & Supp. 1988) (Permits the board of directors of a corporation to issue "blank check" stock (the issue of which has been previously authorized in its articles of incorporation) with powers, designations, rights, and attributes designated thereby without shareholder intervention.).

56. *See, e.g.*, McCord, *supra* note 13, at 422-25; Baysinger & Butler, *supra* note 23, at 1262-67.

Moreover, in recent times, claims that a corporation's board of directors violated their fiduciary duties of care and loyalty to the corporation and its shareholders arose mainly in the context of hostile takeovers. *See, e.g.*, Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 265-66 (2d Cir. 1984) (defense tactic challenged as breach of duties of care and loyalty); Panter v. Marshall Field & Co., 646 F.2d 271, 285 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981) (shareholders have legal remedy if directors breach their fiduciary duty during defense of tender offer); Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 374 (2d Cir. 1980) (defensive tactic challenged by shareholders as breach of fiduciary duty during defense of tender offer); Enterra Corp. v. SGS Associates, 600 F. Supp. 678, 681 (E.D. Pa. 1985) (substantial shareholder alleged board of directors breached fiduciary duty to corporation and shareholders by entering into standstill agreement that restricted substantial shareholder's ability to purchase corporation's stock); EAC Indus. v. Frantz Mfg. Corp., No. 85-8003, slip op. at 23 (Del. Ch. June 28, 1985) (LEXIS, States library, De file) (director's participation in block purchases challenged as breach of fiduciary duty); Edelman v. Phillips Petroleum Corp., No. 85-7899, slip. op. at 35 (Del. Ch. Feb. 12, 1985) (LEXIS, States library, De file) (plaintiff alleged board adopted recapitalization agreement with improper motive and in grossly negligent manner); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769, 773 (1967); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548, 554 (1964). In these situations, courts in Delaware and other jurisdictions analyzed such claims under the business judgment rule, which provides that the courts will not disturb the decisions of the board without evidence that the board acted in bad faith or without a rational business purpose. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 285 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981) (no evidence of self-dealing, fraud, overreaching, or other bad conduct sufficient to give rise to inference that impermissible motives predominated). *Accord* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) (applying New York law, directors afforded wide lati-

Indeed, the federal securities laws[57] present another example of the renegotiation of the corporate contract. The securities statutes provide that, as long as corporate management discloses truthfully the material facts about a transaction, the corporation's securities can be sold to the public regardless of the merits of the transaction. The underlying principle behind this approach appears to be that, as long as accurate information about a corporate entity is available for the market to assimilate and to assign a value to the investment, investors can make an informed investment decision.[58] Thus, the legal renegotiation of the corporate social contract, which was advocated by Berle and Means, appears to have taken place.

The question of whether the corporate democracy model of corporate governance set forth in traditional corporate theory is an adequate or accurate method of governing the firm is beyond the scope of this Article. Berle and Means, however, advocated the legal renegotiation of the corporate social contract to take into account the changing nature of the corporate entity. This renegotiation of the corporate social contract is somewhat excessive because it fails to take into account the nature of corporate entities that do not conform to Berle and Means' model. Berle and Means admitted that their model describes and applies only to the large, publicly owned megafirms,[59] and that the majority of corporations in the United States are not megafirms, but small corporations with limited assets.[60] Indeed, the situation has not changed since the time of Berle and Means.[61] Thus, the renegotiated corporate social contract is applicable to only a small percentage of existing corporations. Unfortunately, there is no corporate social contract for the remaining, overwhelming majority of traditional infant or adolescent corporations.

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tude in devising strategies to resist unfriendly advance); Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 382-83 (2d Cir. 1980) (directors presumed to have acted properly and in good faith); Enterra v. SGS Associates, 600 F. Supp. 678, 685-87 (E.D. Pa. 1985) (presumption of business judgment rule does not apply when board acted fraudulently or in bad faith or self-interest.).

57. Securities Act of 1933, 15 U.S.C. §§ 77a to bbbb (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to i (1982).

58. *See, e.g.*, II L. LOSS, SECURITIES REGULATION 785-86 (2d ed. 1961); D.L. RATNER, SECURITIES REGULATION IN A NUTSHELL 30-35 (1981).

59. BERLE & MEANS, *supra* note 1, at 18.

60. *Id.* Berle and Means' thesis is, however, that the small percentage of megafirms, with billions of dollars in assets, have dominated and continue to dominate the American economy. *Id.* at 18-46.

61.

> In 1981, the number of active corporations was estimated to be 2,812,000. Statistical Abstract of the United States 516 (1985). In terms of dollar assets, the spectrum of corporate size in 1981 has been broken down in the table below:

The inevitable process of development towards maturity simply does

Assets	Total Assets Billions	% Distribution	Number of Active Corporations (thousand)	% Distribution
under $100,000	$ 50	.6	1,570	55.8
$100,000-$1 mil.	$ 322	3.8	1,004	35.7
$1 mil.-$10 mil.	$ 526	6.2	201.1	7.1
$10 mil.-$25 mil.	$ 275	3.2	17.5	.6
$25 mil.-$50 mil.	$ 296	3.5	8.4	.3
$50 mil.-$100 mil.	$ 374	4.4	5.2	.2
$100 mil.-$250 mil.	$ 540	6.3	3.4	.1
$250 mil. and over	$6165	72.1	3.1	.1

As the table illustrates, over 90 percent of U.S. corporations had assets of under one million dollars, or, stated another way, the proportion of corporate millionaires to the total number of corporation was less than one in ten. Breaking this down even further, the biggest block of corporations have assets between $10,000 and $1,000,000, and the median corporation has assets of slightly under $100,000. A. Conard, Corporations in Perspective 100, 101 (1976). Thus it would appear that in terms of size, corporations are spread along an unbroken spectrum, with the greatest concentration in numbers at the lower end.

It is also apparent from the table that, although corporations with assets of over ten million dollars constitute about 1.3 percent of the total number of corporations, they also control 89 percent of the total corporate assets.

Another important consideration is the number of investors. Although there is less information with regard to investors than to other aspects of corporate size, the available data on shareholders appear to fit the general pattern of corporate statistics. In 1984, Exxon, which ranked first in sales ($90.9 billion), had about 832,600 shareholders; General Motors, ranked second ($83.9 billion) had 957,000 shareholders. But over 90 percent of the total corporations have ten or fewer shareholders, 1 percent have more than one hundred, and fewer than one hundred corporations have more than one hundred thousand. Conard, *supra* at 119.

In summary, it is evident that since the greatest concentration of numbers is found in corporations with assets between $10,000 and $1,000,000 and with less than ten shareholders, if there were such a thing as the typical American corporation it certainly would not be the corporate giant. While an emphasis on the

not appear to have occurred for most American corporations. Moreover, Berle and Means did not question the applicability and appropriateness of traditional corporate theory, and of the legal rules of traditional corporate law, to the infant or adolescent corporation.

Additionally, a partial solution appears to have evolved in answer to the problem of separation of ownership and control in modern megafirms described by Berle and Means: the large institutional investor. Berle and Means admitted that these institutions, including insurance companies, mutual funds, and pension plans, control large blocks of shares of most major corporations.[62] Indeed, these institutional investors hold either the majority, or a substantial minority, of the shares of most megafirms,[63] rendering them capable of exercising substantial influence, if not actual control, over these firms. Berle and Means and other writers dismissed this phenomenon by noting that, since institutional investors are only interested in maximizing return on investment, these investors will either support management or sell their investment.[64] There is some evidence, however, that institutional investors are willing to become active,[65] will not support management unconditionally, and, on occasion, will oppose manage-

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> multibillion-dollar enterprise is doubtless valuable to the macroeconomist as an indicator of U.S production, for the lawyer to have the same focus is misleading. For in the development of a body of corporate law appropriate to govern such diverse entities, it is important that rules of law be considered in light of their applicability to corporations of widely different dimensions.

SOLOMON, SCHWARTZ & BAUMAN, CORPORATIONS LAW AND POLICY, MATERIALS AND PROBLEMS 7-8 (2d ed. 1988).

62. BERLE & MEANS, *supra* note 1, at xx. *Accord* CLARK, *supra* note 31, at 94-95 n.1; EISENBERG, THE STRUCTURE OF THE CORPORATION 53-56 (1976).

63. EISENBERG, *supra* note 62, at 53-57.

64. BERLE & MEANS, *supra* note 1, at 244-52; Easterbrook & Fischel-Voting, *supra* note 15, at 425-26. Indeed, Berle and Means utilized the institutional investor as another example of the dilution of individual control of corporate entities. *Id.* There is, however, some evidence that, as institutional investors acquire even larger amounts of corporate shares, they come under increasing pressure to maximize performance by cultivating their existing investments rather than switching into new ones, because of the difficulty in liquidating enormous dollar holdings, and because equally attractive alternative investments may not be readily available. EISENBERG, *supra* note 62, at 61.

65. *Id.* Indeed, Professor Ryan notes that:

> More importantly their [institutional investors'] role as the dominant equity holders adds an interesting fillip to the now-orthodox Berle and Means observation about the management controlled corporation: although the control groups in many public corporations are still able to perpetuate themselves without owning a majority of the outstanding shares, the institutional investor is a much greater potential threat to or problem for management because of the size of institutional holdings and because of their sophistication as working investment professionals.

Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 149 (1988).

ment.[66] Indeed, the California Public Employees Retirement System (PERS), the nation's largest public pension fund (with $46.8 billion in assets), and the Teachers Insurance and Annuity Association and College Retirement Equities Fund (TIAA/CREF), among others, have recently submitted a number of shareholder resolutions to be considered at the upcoming annual meetings of companies as diverse as Avon Products, Inc., International Paper Company, and Lockheed Corporation.[67] These resolutions oppose antitakeover charter provisions and seek to prevent management from keeping records on how shares are voted.[68] In another dispute, PERS is seeking to have the management of Texaco, Inc. create a special committee to ensure that managers and directors consider shareholder views and concerns.[69] In other words, institutional investors have begun to assert their power as substantial shareholders of corporate entities and are beginning to acquire substantial influence over corporate management. Thus, Berle and Means' model of an omnipotent management and powerless shareholders may no longer be completely applicable to the megafirms that were studied.

Moreover, another solution to the problem of the separation of ownership and control described by Berle and Means may be emerging in the modern megafirm. Indeed, through the increasingly common technique of the management buyout,[70] it appears that the sep-

66. *See, e.g.*, EISENBERG, *supra* note 62, at 57-63, 65 n.1. Moreover, during recent SEC hearings on the advisability of adopting a rule dealing with shareholder voting rights, a significant number of institutional investors strongly argued against any rule that would allow management to dilute shareholder voting rights. Ryan, *supra* note 65, at 147-51. *See also* Voting Rights Listing Standards-Disenfranchisement Rule, Release No. 34-25891, 20 Sec. Reg. & L. Rep. (BNA) No. 28, at 1124, 1126-30 (July 15, 1988). *See also New York Pension Funds to Meet Exxon About Alaska Spill and Their Holdings*, Wall St. J., Apr. 10, 1989, at A7A (New York City pension funds, upset about Exxon's handling of oil spill, demand changes in corporate policy); *Pension Funds Plot Against Takeover Law*, Wall St. J., Apr. 5, 1989, at C1 (three large pension funds to ask several large corporations to drop the protective umbrella of Delaware's antitakeover law). This behavior is arguably inconsistent with assertions of institutional investor passivity.

67. Ryan, *supra* note 65, at 157-60. *See California's New Crusader for Shareholder Rights*, BUS. WK., Jan. 30, 1989, at 72.

68. Ryan, *supra* note 65, at 157-60. *See California's New Crusader for Shareholder Rights*, BUS. WK., Jan. 30, 1989, at 72.

69. Ryan, *supra* note 65, at 157-60. *See California's New Crusader for Shareholder Rights*, BUS. WK., Jan. 30, 1989, at 72.

70. A management buyout is a leveraged buyout effected by a company's management. A leveraged buyout typically involves four distinct transactions: (1) the formation of a new company to acquire all the assets or shares of an existing operating company or to acquire the assets of an operating division of a multi-division company; (2) the cash purchase of those assets or shares and a distribution to public shareholders of cash or a combination of cash and senior securities; (3) loans to the new company from banks and other institutional lenders to furnish the cash; (4) the distribution of the new company's equity to members of its management or to its various lenders. DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517, 519 (1988). *See also* Oesterle & Norberg,

aration of control and ownership is giving way to a unification of these attributes in the same group of individuals. If, as Berle and Means speculated, ownership of a corporate entity became a rather insignificant attribute and control alone conferred relatively risk-free wealth, power, and status to the entity's managers, why, then, is the management buyout phenomenon becoming so pervasive?[71]

III. The Current Takeover Feeding Frenzy: A Culmination of Berle and Means?

One of the most controversial phenomena in modern business history is the recent proliferation of hostile corporate takeovers, mergers, and acquisitions.[72] The increase in takeover attempts has engendered the development of a rash of defensive tactics through which the management of potential target corporations have attempted to protect themselves.[73]

These tactics have been divided by a commentator into techniques for use prior to the making of a hostile takeover offer (shark repellents) and techniques for use after a hostile offer is made (defensive techniques).[74] Shark repellents include requiring super majority approval for the removal of a director or for changes in the corporation's form, bylaws, and articles of incorporation;[75] creating lock-up amendments that require a higher vote to amend supermajority voting provisions once adopted;[76] providing senior management with golden parachute employment contracts;[77] and

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Management Buyouts, Creating or Appropriating Shareholder Wealth?, 41 VAND. L. REV. 207 (1988).

71. In 1986, 4,024 merger and acquisition transactions, with a value of $190,512.3 million, were completed. Over one fifth of these transactions were leveraged buyouts. By June of 1987, completed buyouts for the year totaled $34.3 billion. DeMott, *supra* note 70, at 517.

72. *See supra* notes 11, 13 and accompanying text.

73. *See, e.g.*, Block & Miller, *supra* note 13, at 44 (increase in hostile takeover activity resulted in novel and innovative defense tactics). *See also* McCord, *supra* note 13, at 417-22 (limitation of defensive techniques is justified on grounds of economic efficiency and limiting conflicts between interests of management and shareholders).

74. Baysinger & Butler, *supra* note 23, at 1267.

75. *See* Gilson, *The Case Against Shark Repellent Amendments: Structural Limits on the Enabling Concept*, 34 STAN. L. REV. 775, 780-83 (1982) (purpose of provisions is to impede transfer of control of board of directors).

76. Baysinger & Butler, *supra* note 23, at 1268.

77. A golden parachute employment contract is a special termination agreement that shelters executives from the effects of a corporate takeover by providing executives who are dismissed, or who resign as a result of a change in the control of a corporation, with either continued compensation for a certain period of time or a lump sum payment. Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909, 909-12 (1985) (golden parachutes are becoming commonplace); *see also* Note, *Golden Parachute Agreements: Cushioning Executive Bailouts in the Wake of a Tender Offer*, 57 ST. JOHN'S L. REV. 516, 516-18 (golden parachutes insulate management and are unfair to

making the corporation unpalatable by providing it with a poison pill.[78] Defensive techniques include: paying greenmail to an unwanted bidder;[79] selling the corporation's crown jewels;[80] merging with a white knight;[81] engaging in the pac man defense;[82] and, the ultimate defense, the Jonestown defense.[83] Indeed, the range of defenses that management can create to fend off unwanted takeover attempts seems to be limited only by the imagination and creativity of corporate counsel.

Courts have generally reacted to these hostile takeover attempts and the defenses thereto in the context of allegations that the target corporation's board of directors violated their fiduciary duties of care and loyalty to the corporation.[84] The courts applied the business judgment rule, which provides that decisions of a corporation's board of directors will not be disturbed in the absence of evidence that the board acted in bad faith or without a rational business purpose.[85] This determination involves a factual analysis that varies considerably from case to case.[86] Indeed, courts found the use of the same

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the corporation).

78. A poison pill is a dividend distributed by a corporation to its shareholders in the form of convertible securities or warrants. In the event of a takeover attempt, the dividend can be converted into common stock held by the bidder, thus presenting a would-be bidder with the prospect of a severe dilution of his earnings if the tender offer is successful. Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 705 (1984).

79. A company targeted for takeover can pay greenmail to an unwanted corporate suitor and settle the raider's tender offer by purchasing all of the stock of the target company bought by the raider in the open market at a significant premium over its market price. The end result of this transaction is a significant profit to the raider. *Id.* at 705.

80. A target company can sell its crown jewels by selling to a friendly suitor one of the company's subsidiaries that is particularly attractive to the raider, enabling the friendly suitor to make a friendly merger proposition or tender offer that the target company will favor. *Id.* at 701. *See, e.g.*, MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239 (Del. Ch. 1985), *aff'd*, 505 A.2d 454 (Del. 1985).

81. A white knight, a company that maintains a friendly relationship with the target company, has been persuaded by the target company's management to make a competing tender offer in order to defeat the hostile raider's tender offer. Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, 89 CASE & COM. 35, 51 (1984).

82. A target company engages in the pac man defense by launching an equally hostile tender offer for the stock of the raider. If each company succeeds in buying control of the other, both companies will be effectively paralyzed. Greene & Junewicz, *supra* note 78, at 702. The classic example of the pac man defense is the Bendix-Marietta takeover battle. *See* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 627-28 (D. Md. 1982) (attempt by Martin Marietta to prevent takeover by Bendix). *See also* H. LAMPERT, TILL DEATH DO US PART 53 (1983) ("Mexican Standoff" could result if each company buys control of the other.).

83. The target company uses the Jonestown defense, also known as the scorched earth defense, when it decides to liquidate itself, either in whole or part. Greene & Junewicz, *supra* note 78, at 701; Reiser, *supra* note 81, at 44.

84. *See supra* note 56 and accompanying text.

85. *Id.*

86. This factual analysis, which is identical to a court's analysis of whether the actions of a board of directors are the product of an informed business judgment, can be quite exten-

defensive technique in two different takeover situations to be permissible in one case and impermissible in the other.[87]

The legislative response to the increase in hostile takeover attempts has consisted primarily of the adoption by various states of legislation that makes a successful hostile takeover attempt extremely difficult or almost impossible.[88] Indeed, in *CTS Corporation v. Dynamics Corporation of America*,[89] the United States Supreme Court held that one such statute enacted by Indiana[90] was justified by the state's interests in defining attributes of corporate shares and in protecting shareholders. Thus, the statute did not violate the commerce clause of the federal constitution.[91]

The increase in hostile takeover activity may be related to Berle and Means' thesis. If, as Berle and Means believed, a corporate shareholder is merely an investor and not an owner of a corporation,[92] then hostile takeover activity, at least from the point of view of the hostile bidder, is merely a means of making an investment that results in the highest return in the shortest possible time. This purpose is achieved by buying an asset (control of a corporate entity) that either can be sold at a higher price or dismantled and liquidated for a profit. Indeed, from the perspective of Berle and Means, a purchaser of control is the owner.

Corporate managers would then view the corporation as a sta-

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sive and complex. For example, in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court, in attempting to ascertain whether approval by the board of directors of a friendly cash-out merger with another company was the product of the board's informed business judgment, carefully examined all the actions of management and the board of directors in minute detail. *Id.* at 864-70. The *Smith* court held that the merger was not the product of the board's informed business judgment because the board was grossly negligent in evaluating the merger proposal before it. *Id.* at 884.

87. *Compare* Condec v. Lunkenheimer, 43 Del. Ch. 353, 357, 230 A.2d 769, 776-77 (1967) (issuance of stock to white knight for improper purpose of retaining control invalid and not protected by the business judgment rule) with Treadway Companies v. Care Corp., 638 F.2d 357, 379-80 (2d Cir. 1980) (issuance of stock to white knight for the purpose of protecting the corporation from attack by a hostile bidder proper and protected by the business judgment rule).

88. *See* IND. CODE §§ 23-1-17-1 to 17-5 (Supp. 1986) (held not to violate the federal constitution in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987); *see infra* notes 89-91 and accompanying text; 15 PA. CONS. STAT. ANN. § 1611 (Purdon Supp. 1989); DEL. CODE ANN. tit. 8, § 203 (1988) (held not to violate the commerce clause of the federal constitution and not to constitute an impermissible delegation of authority in City Capital Associates v. Interco, Inc., No. 88-424-JJF (U.S.D.C. D. Del. Sept. 23, 1988).

89. 481 U.S. 69 (1987).

90. The statute, IND. CODE § 23-1-17-1 to 17-5 (Supp. 1986), provided that any entity that acquired "control shares" (as defined therein) in a corporation subject thereto acquired the voting rights attached to such shares only to the extent granted by resolution of the majority of the shareholders of the corporation. CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 73 (1987).

91. *CTS Corp.*, 481 U.S. at 87-94.

92. *See supra* notes 44-46 and accompanying text.

ble, productive member of society with a distinct legal personality and interests that may differ from those of the shareholders and that should, of course, be protected.[93] Hostile takeover activity, therefore, is undesirable because it can disrupt the corporation's normal productive activity, can result in the corporation's dismemberment, and can have a negative impact on the nation's economy.[94] Indeed, corporate managers would be quick to assert that hostile bidders, whose sole interest is a quick profit at the expense of the corporate entity, clearly do not engage in a desirable activity.[95] Thus, corporate management should have the encouragement of the legal system and the ability to create defensive techniques to protect the corporation from hostile takeovers.[96] Indeed, the legislature and judiciary have tended to view hostile takeover activity as disruptive of the stability of corporate entities and support defensive techniques to protect these entities from the depredations of corporate takeover artists.[97]

By contrast, those who do not accept Berle and Means' thesis of the shareholder as a passive *rentier* and who think of the shareholder as an essential part of the corporate entity would emphasize the role of the shareholder in hostile takeover situations. Since the shareholders are the true owners of the corporate entity, the purpose of a corporation, and of corporate law, should be to maximize shareholder welfare and benefits.[98] In other words, the good of the enterprise, as viewed by corporate shareholders, is the functional equivalent of the good of the shareholders. Thus, management would not be an important party in takeover activity because managers are mere agents for the corporation's true owners, the shareholders.[99] From this point of view, hostile takeover activity is desirable and should be encouraged because it stimulates corporate management to greater efficiency, which results in increased profits and maximized shareholder welfare.[100] Furthermore, hostile takeovers allow shareholders to choose between competing parties seeking to purchase the shareholder's investment. This competition ensures that the selling shareholders will receive a better price for their shares, which enhances the share-

93. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 109-12 (1979).

94. *Id.* at 104-05.

95. *Id.* at 114.

96. *Id.* at 120-24, 130.

97. *See supra* note 88 and accompanying text.

98. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-68 (1981) [hereinafter Easterbrook & Fischel-Proper Role].

99. Baysinger & Butler, *supra* note 23, at 1271.

100. Easterbrook & Fischel-Proper Role, *supra* note 98, at 1169-71.

holder's welfare.[101] Accordingly, takeover defense mechanisms artificially interfere with a desirable process, and should be severely restricted or prohibited entirely.[102] Indeed, this point of view has been adopted in at least two congressional bills, both of which place restrictions on hostile tender offers.[103]

The relationship between Berle and Means' theory and hostile takeover activity becomes clearer upon examination of two takeover defense techniques: the creation of supershares (a shark repellent), and management's discrimination of shareholders when responding to a hostile tender offer (a defensive technique).

IV. The Shareholder, the Corporation, and Pre-Offer Defense Techniques: Dual Class Recapitalization

A new takeover defensive technique has achieved recent prominence: the creation of two or more classes of shares with different voting powers.[104] This recapitalization typically results in a number of insiders retaining control of a corporate entity without owning the majority of its shares.[105]

There are several means of achieving insider control by corporate recapitalization. The recapitalization can consist of an arrangement in which the same class of common stock has two different voting powers and a cap is placed on the number of votes that each share can cast in a shareholder vote.[106] The recapitalization can also be arranged by having the voting power of a class of common or preferred stock determined by the amount of time the shares are held.[107] In addition, the same class of stock can have different voting rights dependent on the identity of the shareholder.[108] Another tech-

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101. *Id.* at 1177-80.

102. *Id.* at 1164, 1174-80.

103. *See, e.g.*, S. 1323, 100th Cong., 1st Sess. (1987) (extends the period of time that tender offers would be required to be held open, prohibits the payment of greenmail, and requires the registration of arbitrageurs); H.R. 2172, 100th Cong., 1st Sess. (1987) (also prohibits the payment of greenmail and extends the period of time that tender offers must be held open, and prohibits the acquisition of more than ten percent of the shares of a corporation except by tender offer).

104. Seligman, *supra* note 15, at 687.

105. *Id.*

106. Providence & Worcester Co. v. Baker, 378 A.2d 121 n.2 (Del. 1977). In *Providence & Worcester*, the corporation's articles of incorporation provided that each stockholder had one vote for every share of the common stock of the company that he owned, not to exceed fifty votes. Such a shareholder also had one vote for every twenty shares, over fifty shares, that he owned. No shareholder was entitled to vote more than one-fourth of the total number of shares of common stock issued and outstanding. *Id.*

107. Kersten v. Pioneer Hi-Bred Int'l, Inc., 626 F. Supp. 647, 648 (N.D. Iowa 1985); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 408 (S.D.N.Y. 1985).

108. Amalgamated Sugar Co. v. N.L. Industries, 664 F. Supp. 1229 (S.D.N.Y. 1986),

nique utilizes a dual set of common stock, one of which has the right to cast a significantly higher number of votes and is non-transferable.[109] Finally, recapitalization can be achieved by creating a super-preferred class of stock that is entitled to cast a large number of votes on matters to be decided by common stock holders.[110]

The near-universal rule at the end of the nineteenth century was that each share of common stock was entitled to one vote.[111] Recapitalization arrangements represent a departure from this rule and have generated a significant amount of controversy and commentary.[112]

The debate over the one-share one-vote rule[113] appears to have crystallized into several distinct arguments. Some commentators believe that since shareholders are the owners of the corporation, the shareholder vote is the leading method to control management. A dilution of the one-share one-vote rule allows a minority to control corporate affairs, rendering the majority of the shareholders powerless.[114] This situation leads to an entrenched, complacent management and possesses great potential for abuse.[115]

Professors Berle and Means argued, however, that manage-

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aff'd, 825 F.2d 634 (2d Cir. 1987); ASARCO Inc. v. Court, 611 F. Supp. 468, 470-73 (D.N.J. 1985);

109. Baron v. Strawbridge & Clothier, 646 F. Supp. 690, 693 (E.D. Pa. 1986); Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271, 273-75 (Del. Ch. 1986); Societe Holding Ray D'Albion S.A. v. Saunders Leasing Sys., Inc., No. 81-6648 (Del. Ch. Dec. 16, 1981) (LEXIS, States library, De file).

110. Packer v. Yampol, No. 86-8432 (Del. Ch. Apr. 18, 1986) (LEXIS States library, De file).

111. Ratner, *supra* note 2, at 8. The origin of the one-share one-vote rule is quite obscure. Some commentators speculated that the rule was borrowed from political theory and founded on a fear that corporations would become too powerful if not subjected to "democratic type controls." Ratner, *supra* note 2, at 8-10; Kerbel, *supra* note 15, at 47-49. Other commentators suggested that the one-share one-vote rule arose because of a logical function; it is easier and cheaper to organize corporate elections if each share is given one vote. Easterbrook & Fischel-Voting, *supra* note 15, at 408-09.

112. *See, e.g.*, *supra* note 15 and accompanying text.

113. The debate concerns mainly the availability of one vote per share for common shareholders. There does not seem to be any problem with restricting voting rights for preferred shareholders, who presumably are paying for their preferences with reduced voting rights. *But see* Kersten v. Pioneer Hi-Bred Int'l, Inc., 626 F. Supp. 647 (N.D. Iowa 1985); ASARCO Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (these cases involved the issuance of preferred shares that were found to fundamentally alter the voting rights of common shareholders).

114. Note, *Dual Class Capitalization and Shareholder Voting Rights*, 87 COLUM. L. REV. 106, 112 (1987); *Impact of Corporate Takeovers, Senate Hearing 99-187 before the Senate Comm. on Banking, Housing and Urban Affairs*, 99th Cong., 1st Sess. at 840, 1172-73 (1986) [hereinafter *Hearings*]. *See also* Easterbrook & Fischel-Voting, *supra* note 15, at 406-09.

115. *Hearings*, *supra* note 114, at 840, 1172-73; Easterbrook & Fischel-Voting, *supra* note 15, at 406-09; Release No. 25891, *supra* note 16, at 1126-28.

ment's usurpation of control of the proxy machinery leads to an irrelevant shareholder vote. Shareholders have no desire or are powerless to intervene in the management of the corporation.[116] Other commentators have argued that, since shareholders are merely investors in the corporate entity,[117] shareholder voting is irrelevant. The market's liquidity, the availability of the derivative action, and the rules against management fraud are the only protection against abuse to which a shareholder should be entitled.[118] Other commentators have asserted that since the one-share one-vote rule is clearly political and a corporation does not resemble a political entity,[119] the rules of democratic behavior should not be applicable to the corporation.[120]

The market institutions' response to this debate gives credence to the argument that the perception of shareholders as enfranchised *rentiers* is politically unacceptable. The New York Stock Exchange adopted a rule, which was briefly suspended, prohibiting the trading on the Exchange of common stock that possesses the right to more or less than one vote per share.[121]The American Stock Exchange created a series of less stringent guidelines that allow listed companies' stock bearing the right to more or less than one vote per share to be traded in certain circumstances.[122] The North American Securities

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116. BERLE & MEANS, *supra* note 1, at 76-82, 128-31.

117. Some commentators have argued that shareholders should be allowed to decide whether they wish to give up their proportional voting powers to management. *See, e.g.*, Dent, *supra* note 15, at 733-35, 743-46.

118. *See* A. CHAYES, *The Modern Corporation and the Rule of Law*, in THE CORPORATION AND MODERN SOCIETY, 38-45 (1959).

119. FISCHEL, *supra* note 15, at 2-3; Easterbrook & Fischel-Voting, *supra* note 15, at 396, 412.

120. FISCHEL, *supra* note 15, at 2-3; Easterbrook & Fischel-Voting, *supra* note 15, at 396, 412.

121. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 3 (1983), *reprinted in Hearings, supra* note 114, at 1134-41.

122. The American Stock Exchange, in a policy statement known as the "Wang formula" (derived from understandings with Wang Laboratories prior to the listing of its stock for trading in 1976), indicated that it will allow the listing of limited vote common stock if certain requirements are met:

> The limited voting class of the common must have the ability — voting as a class — to elect not less than 25% of the board of directors;
>
> There may not be a voting ratio greater than 10 to 1 in favor of the "super" voting class on all matters other than the election of directors;
>
> No additional stock (whether designated as common or preferred) may be created which can in any way diminish voting power granted to the holders of the limited voting class. For example, should a listed company create a "blank check" voting preferred, this issue would not be permitted to vote with the limited voting class, since to do so would diminish the limited voting issue's rights. Instead, the preferred would have to vote with the "super" voting issue;
>
> The Exchange will generally require that the "super" class lose certain of its attributes should the number of such shares fall below a certain percentage of

Administrators Association[123] adopted a statement of policy declaring that an issue of stock bearing less than one vote per share is unfair, unless the shareholder has been given something in return for the loss of the right to one vote per share. In addition, eighteen states adopted regulations prohibiting the issuance of stock with unequal voting rights.[124]

A limited number of cases involving dual class recapitalization have been decided by the courts.[125] In *Providence & Worcester Co. v. Baker*,[126] the Delaware Supreme Court held that a technique, which actually *enfranchised* small shareholders by limiting the number of votes to be cast by large shareholders, was acceptable.[127] On the other hand, limiting the number of votes based on the identity of the shareholder[128] or on the amount of time the shareholder has held the stock[129] was held to be an unacceptable technique because it created two different voting rights in the same class of stock.[130]

At least three courts have approved the creation of dual class stock based on an offering to all shareholders and approved by an informed vote of all shareholders.[131] Conversely, a recapitalization creating dual class stock that does not require approval by the corporation's shareholders is not acceptable.[132] Furthermore, if shareholder approval is the product of a coercive or uninformed vote, the arrangement is unacceptable.[133]

Unfortunately, an analysis of the cases reveals that the courts' holdings are limited. The courts have invalidated recapitalization ar-

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the total capitalization.

While not specifically required, it is strongly recommended that a dividend preference be established for the limited voting issue.

Seligman, *supra* note 15, at 704 n.90.

123. The North American Securities Administrators Association (NASAA) is an organization of state and provincial officials enforcing state blue sky laws pertaining to the sales of securities. ENCYCLOPEDIA OF ASSOCIATIONS 322 (22d ed. 1988).

124. Seligman, *supra* note 15, at 713 & n.113.

125. *See supra* notes 104-110 and accompanying text.

126. 378 A.2d 121 (Del. 1977).

127. *Id.* at 122-24.

128. ASARCO Inc. v. Court, 611 F. Supp. 468, 476-78 (D.N.J. 1985).

129. Kersten v. Pioneer Hi-Bred Int'l, Inc., 626 F. Supp. 647, 647-49 (N.D. Iowa 1985); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 408-10 (S.D.N.Y. 1985).

130. *See supra* notes 107-08, 128-29 and accompanying text.

131. Packer v. Yampol, No. 86-8432, slip op. at 31-40 (Del. Ch. Apr. 18, 1986) (LEXIS, States library, De file); Societe Holding Ray D'Albion S.A. v. Saunders Leasing Sys., Inc., No. 81-6648, slip op. at 4-6 (Del. Ch. Dec. 16, 1981) (LEXIS, States library, De file); Baron v. Strawbridge & Clothier, 646 F. Supp. 690, 696-98 (E.D. Pa. 1986).

132. American Pacific Corp. v. Super Food Servs., Inc., No. 82-7020, slip op. at 8-13 (Del. Ch. Dec. 6, 1982) (LEXIS, States library, De file); Telvest, Inc. v. Olson, No. 79-5798, slip op. at 9-16 (Del. Ch. March 8, 1979) (LEXIS, States library, De file).

133. Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271 (Del. Ch. 1986).

rangements that created two different voting powers within the same class of stock.[134] The courts have also invalidated any recapitalizations involving rearrangements of shareholder voting rights that were not approved by an informed and free shareholder vote.[135] These cases, however, did not decide the question of whether or not all common stock should have the right to one vote per share or whether dual class recapitalization plans are per se impermissible. Furthermore, a review of the case law reveals that courts are reluctant to invalidate any recapitalization that has been approved by an informed vote of the shareholders.[136]

The Securities and Exchange Commission (SEC) has attempted to resolve the debate by another method. In a recent release,[137] the SEC adopted a new rule[138] under the Securities Exchange Act of 1934[139] that addresses voting rights in shares traded on the public market. The SEC, concerned with the proliferation of commentaries regarding the one-share one-vote rule, conducted a study and held a number of hearings on the issue.[140] The SEC stated that the new rule was the result of these hearings and of a significant concern about shareholder disenfranchisement.[141]

The new SEC rule forbids an exchange or association from listing for trade or trading any common stock or any other equity security of a domestic issuer, if the issuer of the security issues any class of security or takes any other corporate action that has the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock registered in accordance with the Securities Exchange Act of

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134. *See supra* notes 128-29 and accompanying text.

135. *See supra* notes 131, 133 and accompanying text.

136. *See supra* notes 127, 131 and accompanying text. The courts seem to agree with Professor Dent's argument that shareholders are capable of and should be allowed to decide whether they wish to give up their proportional voting powers to management. *See supra* note 119 and accompanying text. This does not take into account, however, Professors Berle and Means' assertion that shareholders have no control over the voting process. *See supra* note 118 and accompanying text. On the other hand, the courts appear to be highly reluctant to validate a dual stock recapitalization that appears to be an egregious, outright or involuntary disenfranchisement of common shareholders. *See supra* notes 128-33 and accompanying text.

137. Release No. 25891, *supra* note 16.

138. *Id.* (to be codified at 17 C.F.R. § 240.19c-4).

139. *See supra* note 57 and accompanying text.

140. Release No. 25891, *supra* note 16, at 1124-26. It is interesting to note that at these hearings, a number of commentators questioned the SEC's authority to adopt a rule imposing substantive corporate law standards on exchange listed companies. *Id.* at 1128. Indeed, the SEC found it necessary to include in the Release promulgating the new rule an extensive discussion in support of its authority to engage in rulemaking in this area. *Id.* at 1142-46.

141. Release No. 25891, *supra* note 16.

1934.[142] This restricting action is known as the forbidden effect.[143]

The new rule also states that corporate action imposing any restriction on the voting power of shares of the issuer's common stock held by a beneficial holder of record shall be presumed to have the forbidden effect, which prevents the listing of the issuer's securities, if the action is based on the number of shares held by such beneficial or record holder.[144] A similar presumption attaches to the imposition of any restriction on the voting power of shares of the issuer's common stock held by a record holder if the restriction is based on the length of time the shares were held by the beneficial or record holder.[145] Furthermore, any issuance of securities through an exchange offer by the issuer for shares of an outstanding class of the issuer's common stock shall be presumed to have the forbidden effect if the securities issued have voting rights greater than or less than the per share voting rights of any outstanding class of the issuer's common stock.[146] Last, a stock dividend, or any other type of distribution of stock in which the securities issued have voting rights greater than the per share voting rights of any outstanding class of the issuer's common stock, shall also be presumed to have the forbidden effect and shall be banned from listing or trading.[147]

The new rule specifically provides, however, that the mere issuance of securities pursuant to an initial registered public offering shall not be presumed to have the forbidden effect.[148] A registered public offering that results in the issuance of any class of securities with voting rights not greater than the per share voting rights of any outstanding class of the issuer's common stock shall also not be presumed to have the forbidden effect.[149] Moreover, the issuance of any class of securities to implement a bona fide merger or acquisition, with voting rights not greater than the per share voting rights of any outstanding class of the common stock of the issuer, standing alone, shall also benefit from the presumption of validity.[150] Last, standing alone, corporate action taken pursuant to state law requiring a

142. Release No. 25891, *supra* note 16, at 1147 (to be codified at 17 C.F.R. § 240.19c-4(a)).
143. *Id.*
144. Release No. 25891, *supra* note 16, at 1147 (to be codified at 17 C.F.R. § 240.19c-4(c)(1)).
145. *Id.* (to be codified at 17 C.F.R. § 240.19c-4(c)(2)).
146. *Id.* (to be codified at 17 C.F.R. § 240.19c-4(c)(3)).
147. *Id.* (to be codified at 17 C.F.R. § 240.19c-4(c)(4)).
148. *Id.* (to be codified at 17 C.F.R. § 240.19c-4(d)(1)).
149. Release 25891, *supra* note 16, at 1147 (to be codified at 17 C.F.R. § 240.19c-4(d)(2)).
150. *Id.* (to be codified at 17 C.F.R. § 240.19c-4(d)(3)).

state's domestic corporation to condition the voting rights of a beneficial or record holder of a specified threshold percentage of the corporation's voting stock on approval of the corporation's independent shareholders shall also be presumed to be valid.[151]

The SEC took a middle-of-the-road position in the one-share one-vote debate. The SEC has reaffirmed the principle that the shareholders' right to vote is important and not irrelevant.[152] The SEC does not accept shareholder disenfranchisement.[153] Moreover, the new rule reflects the SEC's recognition that there is a real danger of shareholder disenfranchisement if corporations are allowed to dilute shareholder voting rights without limitation.[154]

The SEC chose to prohibit transactions that create two different voting rights for the same class of stock or change the shareholder compact relative to the voting rights of stock classes by creating a superpowerful voting stock.[155] The SEC hesitated, however, to forbid all dual stock recapitalizations because there may be valid reasons for creating disparate stock voting rights in certain situations.[156] The SEC also expressly approved corporate action taken pursuant to state statutes that impose requirements designed to retard or prevent hostile corporate takeovers.[157]

What, then, is the tentative result of this debate? Clearly, the proliferation of dual class recapitalization plans is rooted in the perception that hostile takeover attempts are undesirable because they threaten the stability of a corporate entity's management.[158] The author believes that management's wholesale embrace of dual class recapitalization is an extrapolation of the Berle and Means' thesis relating to the shareholder vote. In essence, it is acceptable for a corporation's management to defend against hostile takeovers by diluting the vote of the majority of the shareholders because, as Berle and Means demonstrated, most shareholders have no desire to have, and do not use, their right to vote, thereby rendering the shareholder vote irrelevant.[159]

The author, however, believes that this analysis is not sup-

151. *Id.* (to be codified at 17 C.F.R. § 240.19c-4(d)(4)). The new rule has a grand fathering provision that precludes its application to dual class recapitalization plans that were proposed or adopted prior to July 7, 1988. Release No. 25891, *supra* note 16, at 1136-37.

152. Release No. 25891, *supra* note 16, at 1130-32.

153. *Id.*

154. *Id.*

155. *Id.* at 1135-37.

156. *Id.* at 1133-35.

157. Release No. 25891, *supra* note 16, at 1138-40.

158. *See supra* notes 93-96 and accompanying text.

159. *See supra* notes 38-40 and accompanying text.

ported by the evidence. Contrary to Berle and Means' predictions, shareholder voting is not obsolete, but is thriving.[160] For example, it is common practice to have a shareholder vote on a number of matters that are not required to be submitted to a vote by state corporate law, including matters related to hostile takeovers.[161] Indeed, takeovers could be viewed as situations in which the effectiveness of the shareholder vote is validated. Perhaps Berle and Means prematurely chronicled the passing of the traditional concerned, activist individual shareholder. There is some evidence that the institutional shareholder, who owns significant amounts of the stock of major corporations, is assuming the traditional role of activist and concerned shareholder, and is becoming a significant influence in the modern corporate equation.[162] The right to control the election of management through substantial shareholdings enables the institutional investor to become a significant check and balance against an omnipotent management.

Commentators note that voting is not only relevant but also important. First, voting is a mechanism within the contractual relationship of a corporation whereby all decisions not covered by law are made.[163] Since shareholders are the residual claimants to the corporation's income and assets, shareholders have the incentive to make these decisions.[164] Furthermore, voting is an important way of policing management and holding management accountable.[165] Even if voting is seldom, if ever, used to oust management, the mere existence of the power serves as a deterrent to omnipotent management.[166] Moreover, if the relationship between the shareholder and the corporation is contractual, the right to vote is the consideration for the common shareholder's contract with the corporation.[167] The only absolute right or attribute that a shareholder receives in consideration for advancing funds to the corporation and becoming its shareholder is the right, exercisable through the vote, to choose the corporation's management and to be consulted on fundamental changes in the corporate entity. Voting is important to management

160. Easterbrook & Fischel-Voting, *supra* note 15, at 406-07.

161. *Id.* at 417-18.

162. *See supra* notes 62-72 and accompanying text.

163. Easterbrook & Fischel-Voting, *supra* note 15, at 403.

164. *Id.*

165. *Id.* at 412.

166. *Id.*

167. Berle and Means dedicated a substantial part of their treatise to a description and discussion of how the traditional protections that corporate law gave to shareholders were gradually eliminated. BERLE & MEANS, *supra* note 1, at 119-40.

because the voting mechanism is the key to control of the corporate entity in the present system of corporate law.

Although there may be valid business reasons for dual class recapitalization,[168] the technique can be destructive when used to restructure the contract between the common shareholders and the corporation by leaving the shareholders powerless to affect any corporate decisions. Some commentators note that shareholders can and should have the ability to give up voting rights if so desired.[169] The possibility cannot be ignored, however, that an extremely powerful management can coerce a shareholder's decision. The SEC model took a sensible middle-of-the-road approach to this issue in order to resolve the one-share one-vote controversy. State legislatures should adopt the SEC's approach of forbidding transactions that have the effect of either creating two different voting rights for the same stock or changing the shareholder compact relative to the voting rights of classes of stock by creating a superpowerful voting stock.

V. The Shareholder, the Corporation, and Post-Offer Defensive Techniques: Discriminating Against the Raider-Shareholder

A second takeover defensive technique that achieved recent prominence is the conscious and direct discrimination by the corporation against a shareholder who is viewed as having interests inimical to those of the corporation. The discriminatory self tender utilized in *Unocal Corp. v. Mesa Petroleum Co.*[170] exemplifies this defensive technique. In *Unocal*, Mesa, the owner of fourteen percent of Unocal's common stock, commenced a two tier, front-end-loaded tender offer[171] for thirty-seven percent of Unocal's stock at a price of $54.00 per share payable in cash. The second tier of the offer was to acquire the remainder of Unocal's publicly held shares through an exchange of securities purportedly worth $54.00 per share.[172] Uno-

168. For example, estate planning and to enable foreign investors to invest in sensitive industries in which foreign majority ownership is either prohibited or restricted. *See* Kerbel, *supra* note 15, at 46.

169. *See, e.g.*, Dent, *supra* note 15, at 733-35; Release No. 25891, *supra* note 16, at 1131. *See also supra* note 131 and accompanying text. One question that arises in this context is why shareholders would voluntarily choose to give up their voting rights, since, as discussed above, they seem to be extremely important.

170. 493 A.2d 946 (Del. 1985).

171. A "two tier, front-end-loaded tender offer" is a takeover device by which a generous cash amount is offered for a controlling stake in the target company and thereafter a plan is announced for following up this offer with a second-step merger at a lower price per share payable in cash and securities. Mirvis, *Two-Tier Pricing: Some Appraisal and Entire Fairness Valuation Issues*, 38 BUS. LAW. 485 (1983); Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, 89 CASE & COM. 35, 40 (1984).

172. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985).

cal's board of directors rejected the offer as grossly inadequate.[173]

Unocal's board of directors met one week later and decided, as a defense against Mesa's offer, to initiate a self tender[174] for its own stock at a price of between $70.00 and $80.00 a share.[175] The shares of Unocal owned by Mesa were excluded from Unocal's self tender offer.[176] However, Unocal's directors were encouraged to tender their shares in response to the self tender.[177] Mesa, claiming that Unocal's selective exchange offer was legally impermissible, commenced litigation against Unocal.[178]

The Delaware Chancery Court, citing *Fisher v. Moltz*,[179] decided that even if Unocal had a proper purpose for initiating the self tender, and the self tender did not unduly favor one group over another, Unocal had the burden of showing that the self tender was fair to all Unocal shareholders.[180] Finding that Unocal had not met the burden, the court issued a temporary restraining order barring Unocal from continuing the self tender while excluding Mesa.[181]

In a second opinion ruling on Mesa's motion for a preliminary injunction,[182] the Delaware Chancery Court stated that the basic issue in the case was the question of whether corporate directors owed fiduciary duties to shareholders who they perceived to be acting contrary to the best interests of the corporation as a whole.[183] Unocal argued, in effect, that a director's fiduciary duty to treat all shareholders fairly should be suspended for any shareholder perceived to be a threat to the company.[184] The court disagreed with Unocal, held

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173. *Id.* at 950.

174. A self tender offer is a defense device ". . . by which the incumbent management can oppose a hostile takeover attempt by purchasing the company's shares on the market, thereby precluding acquisition of those shares by the control seeking group or company." Note, *Corporate Law-Corporations May Exclude Raiders from Defensive Self-Tender Offers in Warding Off Hostile Takeovers-Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)*, 14 FLA. ST. U.L. REV. 301 (1986) [hereinafter Note, *Corporate Law*].

175. *Unocal*, 493 A.2d at 950-51.

176. *Id.* at 951.

177. *Id.*

178. 493 A.2d at 949.

179. No. 79-6068 (Del. Ch. Dec. 28, 1979), *cited in* 5 DEL. J. CORP. L. 530 (1980). In *Fisher*, a corporation offered to purchase all of its shares of stock from certain former employees but not from others. The Delaware Chancery Court held that, in these situations, a burden was imposed upon the corporation to show that there is a valid corporate purpose for limiting the offer and in doing so it has not unduly favored one group over another. The court held the corporate defendant had not met this burden. 5 DEL. J. CORP. L. at 531-32.

180. Mesa Petroleum v. Unocal Corp., No. 85-7997, slip op. at 6-7 (Del. Ch. Apr. 29, 1985) (LEXIS, States library, De file).

181. *Id.* at 8-9.

182. Mesa Petroleum v. Unocal Corp., No. 85-7997, slip op. at 6-7 (Del. Ch. May 13, 1985) (LEXIS, States library, De file).

183. *Id.* at 14.

184. *Id.* at 18.

that the business judgment rule did not apply to the transaction,[185] and issued a preliminary injunction barring Unocal from continuing the self tender.[186]

The Delaware Supreme Court reversed,[187] noting that the business judgment rule is applicable in takeover situations. However, the court held that before the business judgment rule applied, it must be shown that the directors had reasonable grounds to believe, based on good faith and reasonable investigation, that a danger to the corporation existed because of the raider's stock ownership.[188] The court then examined the facts surrounding Unocal's self tender and found that such reasonable grounds existed, and that the self tender was a reasonable response to the threat posed to the corporation.[189] The court then held that Unocal's self tender was entitled to the protection of the business judgment rule,[190] reversed the Chancery Court

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185. The court, in response to Unocal's argument, noted that: "Although shareholders may, at times, be treated differently consistent with the director's fiduciary duties . . . there appear to be no cases approving an abdication of those duties." *Id.* (citation omitted). Furthermore, the court continued:

> Any suspension of fiduciary duties as to a raider is all the more suspect because, under the standards governing defensive maneuvers, the target's directors need not *establish* that the raider would harm the company, they only must show a good faith belief. Mesa has a $1 billion investment in Unocal and is its largest shareholder. Good faith beliefs are not sufficient justification to discriminate against such a shareholder.

Id. at 18-19. The court went on to hold that:

> Based on the foregoing, I conclude that the exchange offers' exclusion of Mesa cannot be justified as a defensive maneuver without departing from the established principles of fiduciary duty governing directors' treatment of their shareholders . . . . [T]he business judgment rule does not apply to selective tender offers. Moreover, even if *Fisher* were not followed, business judgment rule would not apply under the facts of this case because the directors stand to derive a personal benefit from their participation in the exchange offer which will not be shared by all shareholders generally.

Id. at 19 (citation omitted).

186. *Id.* at 19.

187. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985).

188. *Id.* at 954-55.

189. *Id.* at 956-57.

190. In support of its holding, the court noted that:

> Mesa, while pursuing its own interests, has acted in a manner which a board consisting of a majority of independent directors has reasonably determined to be contrary to the best interests of Unocal and its other shareholders. In this situation, there is no support in Delaware law for the proposition that, when responding to a perceived harm, a corporation must guarantee a benefit to a stockholder who is deliberately provoking the danger being addressed. There is no obligation of self-sacrifice by a corporation and its shareholders in the face of such a challenge.
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> . . .
>
> Under those circumstances the board's action is entitled to be measured by the standards of the business judgment rule. Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as

of Delaware's decision, and vacated the injunction.[191]

The Delaware Supreme Court's decision goes beyond merely approving a self tender that excludes a raider as a defensive technique to a hostile takeover attempt. The *Unocal* court seems to assert the principle that a board of directors' duty to protect the corporation's interests and those shareholders who are sympathetic to management is superior to the duty to protect *all* shareholders equally.[192] Some argue that the court appeared to take a bifurcated approach to the evaluation of a board's duty to the corporation's shareholders. Those shareholders who "agree with the interests of the corporation" or management are covered by the board's duty to protect the entity's shareholders, but those who are perceived to be a threat to the corporation or management are not covered by this duty.[193] It can be argued, however, that the *Unocal* decision constitutes a license to discriminate[194] against anyone who is perceived to be a threat to the corporation.[195]

The Delaware Supreme Court seems to indicate that discrimination against a shareholder who is unreasonably perceived by a board of directors as a threat to the corporation's interest will be

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> fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.

Id. at 958.

191. *Id.* at 959.

192. Note, *Unocal Corp. v. Mesa Petroleum Co.: A New Era of Fiduciary Duty*, 38 BAYLOR L. REV. 687, 706 (1986).

193. *Id.* at 707. Other commentators argue that the *Unocal* opinion is more a reflection of the Delaware Supreme Court's hostility towards two-tier offers, which it believes are coercive. Dennis, *Valuing the Firm and the Development of Delaware Corporate Law*, 17 RUTGERS L.J. 1, 36-37 (1985).

194. Dennis, *supra* note 193, at 36-37. Furthermore, that seems to be precisely the purpose behind the recent amendment to the Pennsylvania Business Corporation Law. *See* 15 PA. CONS. STAT. ANN. § 1906 (Purdon Supp. 1989). Indeed, this statutory section provides that:

> An amendment or plan may contain a provision classifying the holders of shares of a class or series into one or more separate groups by reference to any facts or circumstances that are not manifestly unreasonable and providing mandatory treatment for shares of the class or series held by particular shareholders or groups of shareholders that differs materially from the treatment accorded other shareholders or groups of shareholders holding shares of the same class or series . . . .

15 PA. CONS. STAT. ANN. § 1906(a) (Purdon Supp. 1989). The drafters' commentary to this section provides that:

> [t]his section authorizes "black hat-white hat" treatment of shareholders, and the facts or circumstances forming the basis for a disparate treatment of shareholders are specifically intended to include the identity of the individual shareholders.

PENNSYLVANIA BAR ASSOCIATION, COMMITTEE ON BUSINESS ASSOCIATIONS OF THE SECTION ON CORPORATION, BANKING AND BUSINESS LAW, TITLE 15 REVISION SUBCOMMITTEE, BUSINESS CORPORATION LAW OF 1985 WITH OFFICIAL SOURCE NOTES AND COMMITTEE COMMENTS 251 (1985) [hereinafter PA BAR ASS'N].

195. PA BAR ASS'N, *supra* note 194, at 251.

protected by the business judgment rule.[196] The board must simply act in good faith and with reasonable diligence.

According to the *Unocal* court, once a board discriminates against a shareholder based upon good faith and a reasonable investigation, the business judgment rule insulates the discriminatory action unless the "primary purpose" was the board's desire to entrench itself and maintain control over the corporation.[197] The problem is determining what is a board of director's "primary purpose" in a takeover situation.[198] Does "primary" motive mean the sole motive, the motive of a majority of the board, or the motive of a plurality of the board?[199] How can a court ascertain the dominance of one particular motive?[200] Furthermore, what if the board puts an undue amount of weight on its desire to remain in power, but this motive is not "primary"?[201]

Once the good faith test articulated by the Delaware Supreme Court in *Unocal* is met, the board of directors can discriminate against a shareholder whom it views as hostile if the board has a reason that can be articulated. The principle articulated by the *Unocal* court, even though apparently founded on hostility towards two-tier tender offers, is not limited to hostile takeover situations. The discrimination tactic can conceivably be applied to any threat instituted by a shareholder against a corporate interest.

The *Unocal* court's endorsement of a corporation's discrimination of hostile shareholders is another unfounded offshoot of the legal system's acceptance of the Berle and Means analysis. Since a corpo-

196. Note, *Unocal Corp. v. Mesa Petroleum Co.*, 72 VA. L. REV. 851, 864 (1986) [hereinafter Note, *Unocal*].

197. Note, *Corporate Law, supra* note 174, at 306. Indeed, such was the case in EAC Indus. v. Frantz Mfg. Corp., No. 85-8003 (Del. Ch. June 28, 1985) (LEXIS, States library, De file), in which the Delaware Chancery Court held that the funding of an employee's stock ownership plan to acquire the defendant corporation's stock *after the majority of its stock had been acquired by a raider* constituted a discriminatory maneuver whose sole purpose was the entrenchment of current management and which was not protected by the business judgment rule. *Accord*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (board of director's failure to protect the rights of Revlon's shareholders to obtain the best price for their stock when it became clear that the breakup of the company was inevitable by favoring bondholders held impermissible).

198. Note, *Corporate Law, supra* note 174, at 306.

199. *Id.* at n.37.

200. *Id. Unocal* has been read by two prominent commentators to suggest that the "proportionality review" suggested therein is "primarily a formal, rhetorical instruction rather than a substantive standard of review. Under this reading, the new standard . . . serves chiefly to signal judicial concern and to invite planners to proceed with their defenses only after constructing a record that demonstrates reasonableness and that articulates a 'threat.' " Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is there Substance to Proportionality Review?*, 44 BUS. LAW. 247, 252 (1989).

201. *See* Note, *Unocal, supra* note 196, at 867.

ration is an entity with interests separate from those of its shareholders, the corporation's interests should be protected from hostile factions, including shareholders.[202] A shareholder is a mere investor, a *rentier*, whose main concern is the protection of his investment value and liquidity and who has or should have no further rights.[203]

This position is not, however, supportable, even under Berle and Means' analysis, because it conflicts with a central tenet: the right not to be discriminated against or abused[204] is one of the few rights that shareholders of the modern corporation retain.[205] Indeed, other courts have been unwilling to allow such discrimination to occur.[206]

Thus, this particular takeover defensive technique represents the extreme extrapolation of Berle and Means' analysis. This extrapolation has no support in corporate law, even under Berle and Means' analysis, and should be abandoned.

VI. Conclusion

Berle and Means' reasoning and perceptions about the nature of the modern publicly traded corporation enjoy substantial influence in modern corporate law. Their plea for a renegotiation of the legal contract between the corporation, shareholders, and management to reflect the perceived separation between ownership of corporate stock and control of the corporate entity appears to be substantially implemented in modern corporate regulation. This implementation is exemplified by the entrenchment of corporate control in a minority group of shareholders, the abandonment of the traditional one-share one-vote principle, and the creation of super stock with multiple voting rights. Modern corporate regulation appears to substantially empower corporate managers at the expense of shareholders, who are viewed as predominantly passive investors with a very narrow interest in the corporate entity. In the eyes of Berle and Means, shareholders are powerless and unimportant because they have lost control of the voting machinery that elects management and, thus, have

202. *See supra* notes 93-96 and accompanying text.

203. *See supra* notes 44-49 and accompanying text. Interestingly enough, the Delaware Supreme Court disparagingly refers to a corporation's short term shareholder as a "speculator" whose interests are somehow less worthy of protection than those of long term "investors" in the corporation. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955-56 (Del. 1985).

204. *See supra* note 44 and accompanying text.

205. *Id.*

206. In Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (D.C.N.Y. 1985), the court held that a "rights plan" that created two different categories of shareholders whose rights would depend on the date on which they acquired their shares constituted an impermissible discrimination. *Accord* ASARCO Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985).

little power to affect or control the actions of management. Perhaps this view of shareholders furnishes an explanation for the recent explosion in hostile corporate takeovers, mergers, and acquisitions.

Clearly, the techniques of dual class recapitalization and discriminatory actions against certain shareholders constitute extrapolations of the Berle and Means' analysis of the shareholder vote.[207] Berle and Means' prediction of the demise of the shareholder vote has not occurred. To the contrary, there is evidence that the shareholder vote is thriving, that shareholders are not powerless and unimportant, that shareholders are regaining control of corporate entities, and that the separation of ownership and control is disappearing. Thus, this particular extrapolation appears to be somewhat excessive.

On the other hand, discriminatory treatment by management of shareholders whose reputation or behavior had indicated a hostile intent to current corporate management, which was approved by the Delaware Supreme Court in *Unocal*, appears to be an offshoot of the legal system's acceptance of the Berle and Means analysis. This technique, however, conflicts with one of the central tenets of Berle and Means' analysis: the right not to be discriminated against or abused is one of the few rights that shareholders of the modern corporation retain.

Berle and Means' theory has been overextended and overapplied, and perhaps no longer reflects reality. Specifically, the extrapolation of the Berle and Means analysis into two takeover defensive techniques represents an unwise and dangerous precedent. Thus, Berle and Means' theory relating to the relationship among a corporation, shareholders, and management should be reconsidered.

207. These two techniques were chosen as examples for discussion and are only two of the many extrapolations of the Berle and Means analysis of the shareholder vote present in modern corporate law. The author believes that an examination of any of these other extrapolations of the Berle and Means hypothesis regarding corporate control and the shareholder vote will yield the same result.