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THE LEGITIMACY OF DEFENSIVE TACTICS IN TENDER OFFERS

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In a corporate world preoccupied with takeover attempts, attention naturally gravitates to the defensive tactics employed by target[1] corporations attempting to fend off exchange or tender offers. The Williams Act, the federal statute governing takeover bids, was enacted over a decade ago.[2] The body of case law defining a target's legitimate course of conduct during an exchange or tender offer, however, is still in its infancy.

This lack of clearly articulated standards permits target management to engage in a wide variety of defensive tactics, some of

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[1] In the tender offer context, the "target" is the corporation whose shares are being sought by another corporation, referred to as the "bidder," in an effort to obtain control.

[2] 15 U.S.C. §§ 78m(d), (e), 78n(d), (e), (f) (1976) (added by Pub. L. No. 90-439, 82 Stat. 454 (1968)). The Williams Act amended the Securities and Exchange Act of 1934 by adding §§ 13(d), (e) and 14 (d), (e), (f). Unless otherwise stated, references herein are to the amended Securities and Exchange Act of 1934.

which are of questionable legitimacy.[3] Target management may advise the shareholders that the board of directors considers the tender offer "inadequate";[4] it may pursue active opposition such as an unprecedented dividend increase[5] or a defensive merger.[6] It may even take an action normally thought adverse to the shareholders' interest,[7] and assert that the tactic is now "in the best interests of the shareholders."[8] The variety of defensive tactics has been limited only by the fertile imaginations of the target's board, management, investment bankers, counsel, and other consultants.[9]

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[3] Ambiguity with respect to the scope of permissible target defenses becomes especially troubling in light of Judge Friendly's admonition that the contestants in a tender fight

> act quickly, sometimes impulsively, often in angry response to what they consider, whether rightly or wrongly, to be low blows by the other side. Probably there will no more be a perfect tender offer than a perfect trial. Congress intended to assure basic honesty and fair dealing, not to impose an unrealistic requirement of laboratory conditions that might make the new statute a potent tool for incumbent management to protect its own interests against the desires and welfare of the stockholders.

Electronic Speciality Co. v. International Controls Corp., 409 F.2d 937, 948 (2d Cir. 1969). For a discussion of *Electronic Speciality,* see Note, *Defensive Tactics Employed by Incumbent Management in Contesting Tender Offers,* 21 STAN. L. REV. 1104, 1115-19 (1969).

[4] *See, e.g.,* Weeks Dredging & Cont., Inc. v. American Dredging Co., 451 F. Supp. 468, 471-72 (E.D. Pa. 1978); Emhart Corp. v. USM Corp., 403 F. Supp. 660, 661-62 (D. Mass.), *vacated on other grounds,* 527 F.2d 177 (1st Cir. 1975); Cauble v. White, 360 F. Supp. 1021, 1025-26 (E.D. La. 1973). For example, in *Emhart,* the target corporation communicated to its shareholders through press releases, advertisements, and letters that the tender offer was "quite inadequate" and was an attempt to seize control of the target "at bargain-basement prices." 403 F. Supp. at 662.

[5] *See, e.g.,* Humana, Inc. v. American Medicorp, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286 (S.D.N.Y. Jan. 5, 1978). *See also* Klaus v. Hi-Shear Corp., 528 F.2d 225, 233 (9th Cir. 1975).

[6] *See, e.g.,* Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145 (S.D.N.Y. 1977); Royal Indus., Inc. v. Monogram Indus., Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976); SEC v. Thermal Power Co., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,265 (D.D.C. Aug. 1, 1975) (SEC complaint).

[7] *See, e.g.,* Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145 (S.D.N.Y. 1977) (defensive sale of stock to friendly third party).

[8] *See* notes 5-7 *supra.*

[9] *See* Butler, *Management's Responsibility in Responding to a Takeover,* in SEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION (PLI) 221 (R. Mundheim, A. Fleischer & B. Vandegrift eds. 1976):

> Counsel and public accountants should be retained immediately upon learning of an offer, both to evaluate the legal and financial aspects of the tender and to prepare and evaluate the defense possibilities. . . .
>
> . . . [R]etention of investment banking advisers is an open question. . . . If an exchange offer is made, it is almost mandatory to retain an investment bank-

This Article will propose a set of solutions to these problems.[10] The solutions must provide standards that are fair, definite, and clear—for both the target and the bidder. Because recommendations should build on the duties of target management under both the Williams Act and state law, these duties will be outlined first. This Article will then propose a set of specific disclosure guidelines that target management should follow in tender offer contests. Finally, it will evaluate a number of defensive tactics and will propose a test to assess their legality.

I

Duty of the Target

The Williams Act provides the federal framework for assessing the legality of defensive tactics.[11] According to its sponsor, Senator Harrison Williams of New Jersey, the Act was designed to protect the legitimate interests of the target corporation, its management and its shareholders, and simultaneously to enable both the target and the offeror to present fairly their cases to the

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> ing firm to evaluate the fair value of the securities being offered. In a cash tender, the ueed is less clear.

Id. at 230-31.

[10] This Article will consider only defensive tactics used after a bidder has announced its inteutions. It will not analyze preventive defensive measures taken by a company to make it less susceptible to a takeover bid prior to any bidder's indication of interest.

The Division of Corporation Finance of the SEC receutly issued a public release stating its views coucerning the disclosure of anti-takeover proposals in proxy statements. Securities Exchange Act Release No. 15,230 (Oct. 13, 1978), [1978] FED. SEC. L. REP. (CCH) ¶ 81,748. The Division specifically identified fourteen kiuds of defensive corporate charter amendments or provisions, including reincorporation in a state with an anti-takeover statute, "supermajority" approval requirements for mergers, and favoring officers with long-term "sweetheart" contracts that cannot be abrogated or rescinded. The Division indicated that certaiu basic disclosures should be made with respect to these proposals. These include: (1) the reason for the proposal; (2) the overall effects of the proposal; (3) the advantages and disadvantages of the proposal; (4) how the proposal will operate; (5) whether the proposal was voted on by the board of directors, and, if so, the result; (6) the effect that the proposal will have on a corporation's stock listed on an exchange; and (7) comparison of the proposal with relevant provisions of state laws. *See generally* Rose & Collins, *Porcupine Proposals*, 12 REV. OF SEC. REG. 977 (1979).

[11] Prior to the enactment of the Williams Act in 1968, a takeover bidder could avoid federal registration and disclosure requirements by attemptiug to gain control of a target corporation through au exchange or cash tender offer. As a result, the target's shareholders lacked the information necessary to assess the offer or the future value of retained securities in the event the takeover succeeded. *See* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 22 (1977).

shareholders.[12] But the Supreme Court took a narrower view of the Act's purpose in *Piper v. Chris-Craft Industries, Inc.*[13] In holding that a defeated tender offeror lacks standing to sue under the Williams Act, the Court stated: "[T]he sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer."[14] Tactics, then, presumably should be measured solely by their effect on target shareholders. To protect these shareholders, both state and federal law impose two duties on the target's management when responding to tender offers: a duty to disclose and a general fiduciary duty.

A. *Duty to Disclose*

Under certain circumstances, section 14(d) of the Williams Act[15] and statutes in many states[16] require the target to disclose

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[12] Senator Williams stated: "We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids." 113 CONG. REC. 24664 (1967). *See* Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 59 (1975) (Williams Act designed to protect shareholders without giving unfair advantage to target or bidder); Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1276 (5th Cir. 1978) (underlying purpose of Act is to protect investors through full disclosure by both sides), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp., 99 S. Ct. 2710 (1979).

At least one commentator has suggested that the draftsmen of the Act also sought to discourage takeover attempts by subjecting the offeror to disclosure requirements. *See* Jorden & Woodward, *An Appraisal of Disclosure Requirements in Contests for Control Under the Williams Act*, 46 GEO. WASH. L. REV. 817, 827-28 (1978).

[13] 430 U.S. 1 (1977).

[14] *Id.* at 35. The *Piper* Court held that a competing tender offeror, when suing in its capacity as a takeover bidder, has no standing to sue for damages under § 14(e). For case notes on *Piper*, *see, e.g.*, Comment, *Tender Offerors: Enter the Control Battle at Your Own Risk*, 15 SAN DIEGO L. REV. 771 (1978); 55 J. URB. L. 178 (1977).

The Williams Act may have other purposes in addition to that of investor protection. In construing § 17(a)(1) of the Securities Act of 1933, an anti-fraud provision similar to § 14(e), the Supreme Court recently stated: "[N]either this Court nor Congress has ever suggested that investor protection was the *sole* purpose of the Securities Act." United States v. Naftalin, 99 S.Ct. 2077, 2082 (1979) (emphasis in original). For an analysis of *Naftalin*, see Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L.J. 163 (1979).

[15] Section 14(d)(4) provides:

> Any solicitation or recommendation to the holders of such a security to accept or reject a tender offer or request or invitation for tenders shall be made in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78(n)(d)(4) (1976). Pursuant to this section, the SEC has promulgated rules pertaining to disclosure in tender offer situations. *See* notes 68-70 and accompanying text *infra*.

[16] *See* E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 207-25, 232-45 (1977).

information relevant to the shareholders' decision to accept or reject a tender offer. In addition, to shield shareholders from potential misconduct by both the offeror and the target, section 14(e) of the Act contains a broad antifraud provision prohibiting all persons from making material misrepresentations or nondisclosures, or from engaging in "any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or . . . any solicitation of security holders *in opposition to or in favor of any such offer, request, or invitation.*"[17] This section applies with marked emphasis to the target corporation and its management, as the Second Circuit aptly noted in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*[18] Referring to a possible violation of section 14(e) by the Piper family, the court remarked:

> By reason of the special relationship between them, shareholders are likely to rely heavily upon the representations of corporate insiders when the shareholders find themselves in the midst of a battle for control. Corporate insiders therefore have a special responsibility to be meticulous and precise in their representations to shareholders.[19]

B. *The General Fiduciary Duty in the Tender Offer Context*

In addition to the specific duty of adequate and fair disclosure, corporate directors and other insiders owe a general fiduciary duty to the corporation's stockholders. Defensive tactics that are not solely communicative in nature must be measured by this duty. Most states impose on corporate management a fiduciary duty which is independent of federal law.[20] Moreover, prior to the Supreme Court's decision in *Santa Fe Industries, Inc. v. Green,*[21] a number of federal courts had held that the Williams

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[17] 15 U.S.C. § 78n(e) (1976) (emphasis added).

Many states have laws with general antifraud provisions, *See, e.g.,* N.Y. GEN. BUS. LAW §§ 352, 352-c, 353, 353-A (McKinney 1968). In addition, some states have followed the lead of the Williams Act and enacted disclosure statutes for tender offer situations. *See* OHIO REV. CODE ANN. § 1707.041 (Page 1978); VA. CODE §§ 13.1-528 to -534 (Michie Supp. 1978). At least one state has even enacted an antifraud statute specifically controlling takeover situations. *See* NEV. REV. STAT. § 78.3777 (1973). *See generally* E. ARANOW, H. EINHORN & G. BERLSTEIN, *supra* note 16, at 207-57.

[18] 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973).

[19] *Id.* at 364-65.

[20] *See, e.g.,* Singer v. Magnavox Co., 380 A.2d 969, 975 (Del. 1977).

[21] 430 U.S. 462 (1977).

Act also imposed a fiduciary duty.[22] Following *Santa Fe,* however, some district courts have concluded that assessing the legitimacy of defensive tactics is not a matter within the purview of section 14(e).[23] Such an examination, these courts have asserted, involves scrutinizing the business judgments of management and management's adherence to the fiduciary duties owed to its shareholders which are subjects under the province of state law rather than the federal securities laws.[24] In short, these courts have held that section 14(e), at least insofar as it applies to a target corporation's use of defensive tactics, merely requires full and fair disclosure.[25] Upon analysis, it will become apparent that such an interpretation of section 14(e)'s reach stems from an overly broad reading of *Santa Fe* that does not comport with the spirit and intent of the Williams Act.

In *Santa Fe,* a corporation's controlling shareholder attempted to "freeze-out" the minority shareholders by using Delaware's short-form merger statute.[26] The Supreme Court held that management's breach of its fiduciary duties did not violate section 10(b) of the Exchange Act and rule 10b-5 promulgated thereunder unless the plaintiff-minority shareholders could show misrep-

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[22] *See, e.g.,* Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1156-58 (S.D.N.Y. 1977).

[23] *See, e.g., In re* Sunshine Mining Co. Sec. Litigation, No. 77 Civ. 4020 (S.D.N.Y. May 25, 1979); Berman v. Gerber Prods. Co., 454 F. Supp. 1310, 1318 (W.D. Mich. 1978); Halle & Stieglitz, Filor, Ballard, Inc. v. Empress Int'l, Ltd., 442 F. Supp. 217 (D. Del. 1977); Altman v. Knight, 431 F. Supp. 309, 314 (S.D.N.Y. 1977).

[24] *See, e.g.,* Altman v. Knight, 431 F. Supp. 309 (S.D.N.Y. 1977). In *Altman,* the target corporation acquired another corporation as a defensive tactic to block the bidder's tender offer. The plaintiffs brought a derivative action under § 14(e), alleging that the acquisition served no valid business purpose. Relying upon *Santa Fe,* the district court held that, even if no valid business purpose existed, the acquisition alone did not constitute a manipulative or deceptive act under § 14(e). Furthermore, the acquisition did not require shareholder approval. Any misrepresentations made by management regarding the transaction could not have caused the plaintiffs' alleged injuries flowing from deprivation of the opportunity to tender their shares. Consequently, the court concluded that the claim should be decided under state corporate law, again citing *Santa Fe. Id.* at 313-14.

[25] *See* note 23 *supra.* One commentator has also viewed the Williams Act as merely a disclosure statute. Note, *Target Management and Tender Offers: Proposals for Structuring the Fiduciary Relationship,* 15 HARV. J. LEG. 761, 782 (1978).

[26] 430 U.S. at 465-67. Under Delaware's "short-form merger" statute (DEL. CODE ANN. tit. 8, § 253 (Michie 1975)), the board of directors of a parent company owning at least 90% of the stock of a subsidiary can vote to merge with the subsidiary and to purchase the minority interest with cash payments. If they so choose, minority shareholders may petition the Delaware Court of Chancery for the payment of the "fair value" of their shares rather than the amount offered by the parent company.

resentation or lack of disclosure.[27] The Court noted that the application of a "federal fiduciary principle" could interfere with the traditional regulation of corporate conduct.[28] Deferring to the states, the Court concluded that:

> Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overriden.[29]

The Court found no such indication, either in the language of the statute[30] or in its legislative history.[31] The Court, quoting from its opinion in *Cort v. Ash,* also stated that " 'except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.' "[32]

Upon initial examination, the *Santa Fe* decision could present obstacles to imposing a federal fiduciary duty on target management under section 14(e). First, the language of section 14(e) closely tracks that of rule 10b-5, under which the *Santa Fe* Court found no general fiduciary duty.[33] Second, the central purpose of the Williams Act is to ensure that a target corpora-

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[27] "[T]he claim of fraud and fiduciary breach ... states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." 430 U.S. at 473-74. For court decisions construing § 10(b) after *Santa Fe,* see Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied,* 434 U.S. 1079 (1978); Cole v. Schenley Indus., Inc., 563 F.2d 35 (2d Cir. 1977); Biesenboch v. Guenther, 446 F. Supp. 98 (E.D. Pa.), *aff'd,* 588 F.2d 400 (3d Cir. 1978).

[28] 430 U.S. at 479. In Great W. United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir.), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp., 99 S. Ct. 2710 (1979), the Fifth Circuit noted that in most states, a shareholder claiming a breach of fiduciary duties by directors must overcome a presumption that directors acted properly and that few plaintiffs have successfully met this burden. 577 F.2d at 1279 n.51.

[29] 430 U.S. at 479.

[30] *Id.* at 474-77.

[31] *Id.* at 477-79.

[32] *Id.* at 479 (emphasis in original) (quoting 422 U.S. 66, 84 (1975)). In *Cort,* the Supreme Court held that a shareholder of a corporation had no private cause of action against the corporate directors for violations of the Federal Election Campaign Act, nor may he maintain a derivative action for violations of the Act. The Court held that the Campaign Act assured that federal elections are "free from the power of money" and that "protection of ordinary shareholders was at best a secondary concern." 422 U.S. at 81-82. The Court also noted that the Act's legislative history gave no indication that corporate shareholders should have a right to damages for violation of the Act.

[33] *See* note 27 and accompanying text *supra.*

tion's shareholders receive full and fair disclosure of all material facts relating to the bidder's proposal and, if the target's management chooses to support or oppose the offer, full and fair disclosure of the facts relating to the offer as perceived by target management.[34] Thus, the preeminent philosophy of the Williams Act is identical to the philosophy of the entire Exchange Act: Shareholders and potential investors should receive all important information relevant to the operations of registered companies so they, in turn, can make informed investment decisions.[35]

But even within the context of rule 10b-5, the *Santa Fe* decision may not present an insurmountable obstacle for plaintiffs seeking to invoke a federal cause of action for breach of fiduciary duty.[36] Lower courts, faced with a case of great unfairness, may seek to avoid *Santa Fe*'s holding by stretching to find some form of deception.[37] Alternatively, courts may expand *Santa Fe*'s defi-

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[34] *See* 15 U.S.C. § 78n(e) (1976). In Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145 (S.D.N.Y. 1977), the district court, in construing § 14 of the Act, stated that:

> The primary purpose of Congress in adopting the Williams Act was to ensure that the public shareholder confronted with a tender or exchange offer would be provided with complete and truthful information about the offeror, the terms and probable consequences of the offer and interests and qualifications of any person recommending acceptance or rejection of an offer.

Id. at 1152 (footnote omitted); *see* note 87 *infra.*

[35] H.R. REP. No. 1383, 73d Cong., 2d Sess. 11 (1934). This report to the Exchange Act stated: "No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." *See* Berman v. Gerber Prods. Co., 454 F. Supp. 1310, 1321 (W.D. Mich. 1978).

[36] The original proposal for rule 13e-3, which governs "going-private" transactions, published for comment by the Commission in November of 1977, Securities Exchange Act Release No. 14,185, (November 17, 1977), included the requirement that a "going-private" transaction be both substantively and procedurally fair to unaffiliated security holders. Many commentators expressed the view that the Commission should not attempt to regulate the fairness of "going-private" transactions because such regulation was more properly the province of the states. The Commission, on August 2, 1979, adopted rule 13e-3 and Schedule 13E-3 which require the issuer to state whether it reasonably believes that the going-private transaction is fair or unfair to unaffiliated security holders. While the Commission deferred its decision on the promulgation of a "federal fairness requirement" until it could review the efficacy of the rule 13e-3 adopted, it nevertheless continued to adhere to the position that "the views expressed in the 1977 release are sound and therefore specifically affirms those views." Securities Exchange Act Release No. 16,075 (August 2, 1979).

[37] *See* Note, *The "New Fraud" Becomes No Fraud: Santa Fe Industries, Inc. v. Green,* 31 Sw. L.J. 739, 749 (1977).

nition of deception, as the Second Circuit apparently did in *Goldberg v. Meridor.*[38] The *Goldberg* case involved a challenge to a corporation's proposed issuance of shares to a parent corporation for allegedly inadequate consideration. The suit alleged that the defendant's prospectus and press releases which described the transaction contained misleading disclosures and nondisclosures.[39] The majority noted that if the inadequacy of the consideration had been disclosed, the minority shareholders could have sought injunctive relief under New York law.[40] Judge Friendly then found that failure to disclose this unfairness was material because of the possibility of injunctive relief, and thus it constituted deception within the meaning of rule 10b-5.[41] Dissenting, Judge Meskill asserted that the majority's holding ignored Supreme Court precedent:

> Those who breach their fiduciary duties seldom disclose their intentions ahead of time. Yet under the majority's reasoning the failure to inform stockholders of a proposed defalcation gives rise to a cause of action under 10b-5. Thus, the majority has neatly undone the holdings of *Green, Piper* and *Cort* by creating a federal cause of action for a breach of fiduciary duty that will apply in all cases, save for those rare instances where the fiduciary denounces himself in advance.[42]

The *Goldberg* rationale has evidently been adopted by the Ninth Circuit in the recent case of *Kidwell ex rel. Penfold v. Meikle*:[43]

> [T]here is room for Rule 10b-5 liability after *Santa Fe Industries* even when the only deceived parties are shareholders who are not entitled to vote on the transaction in question, and even though there may be a breach of fiduciary duty under state

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[38] 567 F.2d 209 (2d Cir. 1977), *cert. denied,* 434 U.S. 1069 (1978).

[39] *Id.* at 211-12.

[40] *Id.* at 218-20.

[41] *Id.* In concluding that the press releases contained materially misleading disclosures, Judge Friendly employed the following widely recognized principle:

> [T]here is deception of the corporation (in effect, of its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests (in effect, the minority shareholders' interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction.

Id. at 217.

[42] *Id.* at 225 (dissenting opinion, Meskill, J.).

[43] 597 F.2d 1273 (9th Cir. 1979). *See also* Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977).

> law. Indeed, under the *Goldberg* rationale, it is precisely because there are state-law remedies for the shareholders that a deception can be found. Inadequate disclosures lull into security those shareholders who might bring derivative actions under state law to enjoin the securities transactions if all material facts were revealed.[44]

As law review commentators as well have recognized, the *Goldberg* and *Meikle* opinions possibly open wide the doors of federal courts to suits involving breaches of fiduciary duty.[45]

Apart from *Goldberg* and viewing the Williams Act on its own footing, its basic purpose can only be fulfilled if some form of fiduciary duty is recognized as arising from section 14(e). It must be remembered that the central purpose of the Williams Act is to ensure that a target corporation's shareholders receive all the information they need to make an informed investment decision.[46] The purview of the Act therefore should not be limited to the adequacy of disclosure but instead should be extended to protect a shareholder's right to make a decision rather than allowing management to make the investment decision for him. The *Santa Fe* decision allows judicial effectuation of this intent; the opinion explicitly authorizes extension of the federal securities laws into

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[44] 597 F.2d at 1292.

[45] As stated by one commentator:

> [G]eneral application of the standard will allow a large number of suits involving breach of fiduciary duties against corporate directors into federal court under rule 10b-5. As the dissent indicated, all breaches of fiduciary duty will give rise to an action under rule 10b-5 except in those rare instances when a breaching fiduciary adequately discloses his intentions in advance. Once the fiduciary has decided to execute a securities transaction not in the best interests of the corporation, he faces two unattractive alternatives: he can fully disclose all details to the minority shareholders and thereby subject the transaction to a possible injunction, or he can conceal pertinent information from the minority and proceed with the transaction. By choosing to withhold information for fear of litigation by minority shareholders, he alters the total mix of information available and indicates his belief that the information would be significant to a reasonable disinterested director. A federal cause of action will thus arise whenever a fiduciary opts not to disclose facts that the minority could use to enjoin him.

46 GEO. WASH. L. REV. 861, 875 (1978) (footnotes omitted). *See* Note, Goldberg v. Meridor: *The Second Circuit's Resurrection of Rule 10b-5 Liability for Breaches of Corporate Fiduciary Duties to Minority Shareholders,* 64 VA. L. REV. 765, 774-77 (1978).

[46] Note particularly the legislative history underlying the Act to support this assertion. *See* text accompanying notes 48-50 *infra.*

areas previously governed solely by the states when Congress clearly intended such an expansion.[47]

The legislative history of the Williams Act evinces a clear congressional intent to protect shareholders who are faced with the difficult investment decision that must be made when presented with a tender offer. Congress chose to effectuate this end by making certain that a target's shareholders received all material information relating to their decision and rejected the notion that a target's management should make the decision for the corporation in line with its fiduciary duties to the shareholders.[48] The assumption underlying Congress' approach to investor protection under the Williams Act was that an investor has the freedom to make his own decision after being fully informed.[49] Disclosure, no matter how extensive, matters little if the target's management can employ defensive tactics that deprive or otherwise materially impede the investor's freedom of choice. The Williams Act, accordingly, provides shareholders with the right to hear a fair presentation of the material facts relating to their investment decision when confronted with a tender offer, and to make the investment decision upon receipt of the information.[50]

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[47] *See* notes 28-32 and accompanying text *supra*. The Supreme Court, in SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), recognized that Congress may create federal fiduciary standards relating to transactions in securities. *Santa Fe*, 430 U.S. at 471 n.11. In *Capital Gains*, the Court said that "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effecutate its remedial purposes." 375 U.S. at 195 (footnotes omitted).

[48] The Fifth Circuit's opinion in *Kidwell* noted that Congress, in passing the Williams Act, chose a "market approach" to investor protection rather than a "fiduciary approach." A market approach is based on the concept that shareholders should make their own fully-informed investment decisions. Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1276 (5th Cir. 1978), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp. 99 S. Ct. 2710 (1979). A fiduciary approach, as defined by the Fifth Circuit, relies upon the business judgment of corporate directors in accordance with the fiduciary duties owed to shareholders. *Id.* at 1279.

[49] The Fifth Circuit noted in *Kidwell* that shareholders have a "right" created under the Williams Act to hear a fair presentation of the material facts: "The function of federal regulation is to get information to the investor by allowing both the offeror and the incumbent managers of a target company to present fully their arguments and then to let the investor decide for himself." *Id.* at 1276. Such an interpretation accords with the Act's legislative history; the Act was "designed to make the relevant facts known so that shareholders have a fair opportunity to make their decision." HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, DISCLOSURE OF CORPORATE EQUITY OWNERSHIP, H.R. REP. NO. 1711, 90th Cong., 2d Sess. 5, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2811, 2813.

[50] If, as the Williams Act's legislative history and the *Kidwell* decision suggest, shareholders have a right to hear a fair presentation of the material facts relating to a tender offer,

Both the House and Senate Reports state that: "[The bill] is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case."[51] Senator Kuchel, a strong proponent of the Act, testified that the legislation was necessary to ensure that the target's shareholders would have sufficient information with which to make "an informed investment decision."[52] Even more to the point, Chairman Cohen, testifying on behalf of the Securities and Exchange Commission, stated that the purpose of the bill was "to provide the investor, the person who is required to make a decision, an opportunity to examine and to assess the relevant facts and to reach a decision without being pressured and *without being subject to unwarranted techniques which are designed to prevent* that from happening."[53]

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those rights are illusory if a target's management can avoid liability by disclosing that they intend to deprive or impede the shareholders' opportunity to consider an offer.

[51] House Comm. on Interstate and Foreign Commerce, Disclosure of Corporate Equity Ownership, H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4, *reprinted in* [1968] U.S. Code Cong. & Ad. News 2811, 2813; Senate Comm. on Banking and Currency, Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids, S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967). Note also the following language from the Senate Report: "As a practical matter, unless incumbent management explains its position publicly, the investor is severely limited in obtaining all of the facts on which to base a decision whether to accept or reject the tender offer." *Id.* at 2.

[52] *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Senate Subcomm. on Securities of the Comm. on Banking and Currency*, 90th Cong., 1st Sess. 46 (1967) [hereinafter cited as *Senate Hearings*]. According to SEC Chairman Cohen, a second purpose of the bill was "to eliminate conditions surrounding the offer which discriminate unfairly among those who may desire to tender their shares or unreasonably restrict their freedom of action with respect to deposited shares at a time when there is no assurance that the tender of their shares will be accepted." *Takeover Bids: Hearing on H.R. 14475 Before the House Subcomm. on Commerce and Finance of the Comm. on Interstate and Foreign Commerce*, 90th Cong., 2d Sess. 11 (1968) [hereinafter cited as *House Hearing*]; *Senate Hearings, supra* at 33. Spokesmen who testified on behalf of the American and New York Stock Exchanges also assumed that the objective of the proposed legislation was to furnish investors "with all material facts before being asked to make an investment decision." *Senate Hearings, supra,* at 104 (statement of Ralph S. Saul, President, American Stock Exchange). *See id.* at 86 (statement of G. Keith Funston, President, New York Stock Exchange) (timely and adequate disclosure serves several purposes, including allowing "[t]he public [to be] able to make reasoned investment decisions."); *House Hearing, supra,* at 47 (statement of Donald L. Calvin, Vice President, New York Stock Exchange) ("[w]hat we are interested in here is that shareholders have ample time to make an informed decision."). Even industry witnesses acknowledged that the bill was intended to provide the target shareholder with adequate "information in order to make a prudent decision on whether to accept or reject the offer." *Senate Hearings, supra,* at 52 (statement of Herbert F. Kahler, Secretary and General Counsel, International Silver Co.).

[53] *Senate Hearings, supra* note 52, at 15 (statement of Chairman Cohen) (emphasis added).

Thus, while the application of section 14(e) may in certain circumstances require only an examination of the relevant disclosures for their adequacy, in those circumstances where a target's shareholders are effectively precluded from or impeded in considering the bidder's offer because of defensive actions taken by management, an examination of the motivations behind and the purposes of a particular defensive action must be undertaken. Although such an inquiry has traditionally been undertaken when evaluating whether management has violated its fiduciary duties under state law,[54] it is difficult to perceive of a more viable method for determining whether management acted to deprive the shareholders of their right, or to materially impede them in the exercise of their right, to consider a bidder's offer. In fact, perhaps it can be said that the Williams Act created the federal fiduciary principle that a target's management, when confronted with a tender offer, cannot act to preclude or to materially impede the target corporation's shareholders' consideration of the offer and the making of their own investment decision.[55]

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[54] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 n.16 (1977).

[55] Under the existing law, the target's insiders owe their primary allegiance to shareholders in tender offer situations. Accordingly, the Williams Act was intended to require that the target's shareholders, rather than management, make an informed decision following full disclosure. For the sake of the future course of the law, however, the ultimate wisdom of this congressional approach should be scrutinized.

Regardless of the current law, some commentators argue that noninvestor interests should be considered in corporate decisionmaking and that, even in tender offer situations, management should control the corporation's response to a takeover bid, after considering both investor and noninvestor interests. *See, e.g.*, Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978). This argument proceeds from the premise that equity investment is merely an alternative means of capitalizing a business; therefore, shareholders should not acquire paramount rights to direct the affairs of the corporation. Or, in other words, that "by raising money in the public markets and by participating in the ongoing trading markets a corporation and its management do not thereby become absolutely subservient to the interests of investors." *Id.* at 901.

Steinbrink gave four reasons for his conclusion that, theoretically, management should direct a target company's response to a tender offer. First, tender offers are no longer the tool solely of corporate raiders and plunderers. *Id.* at 885-87, 889-90. Rather, they have become a respectable alternative means of corporate acquisition. Second, if tender offers are merely another method of corporate acquisition, management naturally should play a leading role in shaping a corporate response because they are the ones most capable of evaluating the adequacy of the offer and soliciting competing bids. *Id.* at 891-99. Third, interests vary within the shareholder group. Only some may wish to sell and management is in a good position to judge whether their sale may adversely affect the broader interests of the entire shareholder group. *Id.* at 894-99. Fourth, noninvestor as well as investor interests are arguably pertinent to shaping the target's response to a tender offer. *Id.* at 899, 902.

Ironically, Steinbrink concluded his argument by recommending that management obtain approval for its actions from a majority of shareholders. *Id.* at 907-08. He probably

C. *The Fiduciary Duty's Effect on Management's Response*

Because they are fiduciaries, corporate directors and other insiders may resist a tender offer under state law only if they objectively deem that the offer is inconsistent with the interests of the

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intended that this proposal support management's decision. But this recommendation manifests a lack of conviction in his policy reasons for allowing management to decide. If management is the appropriate decisionmaker, no reinforcement should be needed. This is particularly true in view of Steinbrink's position that shareholders cannot competently decide whether a tender offer is wise. *Id.* at 891.

Similarly, it has been argued that because corporations owe a duty to society-at-large as well as to their stockholders, a change in the target's control, having a possible adverse impact on societal interests, must be opposed regardless of the merits of the offer to its shareholders. *Id.* at 899, 902. The social responsibility of corporations is a hotly debated topic and many noninvestor interests potentially relevant in the tender offer context can be named: the loyal employees' interest in the target, the target's responsibility to the environment and the community's stake in the target as a local employer, for example. If noninvestor interests are relevant in responding to tender offers, management may be the most appropriate decisionmaker because an individual shareholder cannot effectively weigh these societal concerns when he is primarily concerned with his *own* investment. *See generally* Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972). In a stockholder derivative action based on Colorado law, the Tenth Circuit stated that the obligations and duties of a corporate officer, in this case engaged chiefly in the publication of a large metropolitan newspaper, are threefold: to the stockholders, the employees, and the public. *Id.* at 1091. The court further remarked:

> A corporation publishing a newspaper such as the Denver Post certainly has other obligations besides the making of profit. It has an obligation to the public, that is, the thousands of people who buy the paper, read it, and rely upon its contents. . . .
>
> Such a newspaper corporation, not unlike some other corporations, also has an obligation to those people who make its daily publication possible. A great number of the employees are either members of a profession or highly skilled and specialized in their crafts. Many of them have dedicated their lives to this one endeavor. The appellants' sincere interest in their employees also refutes the allegation of illegal design.

Id. at 1094-95 (footnotes omitted).

The authors agree that under certain circumstances, a corporation in its daily functions may take into account the interests of its employees and the surrounding community. However, the Williams Act was specifically designed to promote the interests of the target's shareholders. As a consequence, during a tender offer, their interests must be considered preeminent.

While this Article does not argue that a corporation owes no duty to the public other than to its stockholders, or that the target's management must assess tender offers solely in terms of their effect on its shareholders' pocketbooks, its thrust is that, under the Williams Act, shareholders and not management must decide the fate of the target. Contrary to the above arguments, investors may well be in the best position to accommodate all competing interests. Each shareholder best represents his own economic interest, and tender offers, both in their mechanism and their immediate effects, most directly concern the shareholders' property and financial interests. Furthermore, shareholders are members of society-at-large and are more likely to constitute a representative cross-section than are the target's insiders. If there are indeed legitimate societal interests at stake in a proposed tender offer, corporation and its shareholders.[56] Resistance by management to preserve their jobs and status are breaches of their fiduciary duties.[57] Moreover, insiders as fiduciaries, regardless of their good faith beliefs, must maintain objectivity.

Although courts have declined to recognize the strong affinity of most corporate directors and other insiders toward their corporations, this factor merits consideration. Only a rare individual can affiliate closely with a corporation and still view an offeror's takeover attempt with detachment. Many insiders sincerely believe that the corporation is worth more than the offer. But even a sincere belief may have little basis in commercial reality.[58] Insid-

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a concerned management can communicate them to the shareholders. If the management's powers of persuasion and the shareholders' own balancing of interests do not result in a response to the takeover bid consistent with the alleged noninvestor interests, the validity of those interests may be suspect.

Finally, permitting the target's insiders to preclude or impede shareholder consideration of a tender offer due to noninvestor interests would merely amplify present opportunities for misconduct. Managements now plausibly argue that almost any defensive tactic is in the best interests of the target's shareholders. Allowing them to rely on noninvestor interests would provide another source of smokescreen for masking unacceptable motives for opposing takeover bids. Accordingly, consideration of noninvestor factors would unduly add to the indefiniteness of the law and would increase the courts' reliance on the purported expertise of the target's insiders. Such an interpretation, as urged by some commentators, would not comport with the spirit of the Williams Act nor would it comply with the insiders' fiduciary duties under state law.

[56] Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969):

> [M]anagement has the responsibility [under state law] to oppose offers which, in its best judgment, are detrimental to the company or its stockholders. In arriving at such a judgment, management should be scrupulously fair in considering the merits of any proposal submitted to its stockholders. The officers' and directors' informed opinion should result from that strict impartiality which is required by their fiduciary duties.

Id. at 712-13. *See* Butler, *supra* note 9, at 224-29; note 16 *supra*.

[57] *See* Commonwealth Oil Ref. Co. v. Tesoro Petro. Corp., 394 F. Supp. 267, 273-74 (S.D.N.Y. 1975). *See also* Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977). Note the following statement of state fiduciary obligation issued by the Delaware Supreme Court in *Singer*:

> While technically not trustees, . . . [corporate directors] stand in a fiduciary relation to the corporation and its stockholders. . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.

Id. at 977 (quoting Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (1939)).

[58] Most shareholders do not share this strong attachment to the target corporation. Rather, they invest for the purpose of realizing as large a return as possible. In tender offer and exchange offer situations these shareholders consider seriously such factors as

ers must acknowledge that objectivity is difficult to maintain. Accordingly, management should take special care to make its assessment of the tender offer as neutral and thorough as possible. At the very least, management should employ independent investment bankers and legal counsel to scrutinize the offer.[59]

In light of its fiduciary duty to the stockholders, target management responding to a tender offer—even if it deems the offer inadequate—should consider at least two factors. First, they should estimate the percentage of shareholders who would tender their stock given adequate disclosure. Regardless of management's view of the offer, many shareholders may accept an offer for a variety of meritorious reasons. For example, those seeking capital gains may take the offer to realize a significant premium over the stock's current market price. Alternatively, shareholders interested in a regular source of income may receive significantly higher dividends from the offeror under the terms of an exchange offer than from the target.[60] By resisting the offer, management may deprive such shareholders of the maximum profits from their investment. Management owes a duty to its transient shareholders as well as its shareholders of long standing and should discover the aims and goals of all types of shareholders.[61] Taking these factors into consideration, if management's resistance is not objectively well-founded, the insiders may be liable to the shareholders for depriving them of the opportunity to tender their stock.[62]

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the premium offered by the bidder, the dividend policy of both the target and the offeror, and the future growth prospects of both corporations. Directors' unsubstantiated feelings that the tender offer is inadequate should be deemed irrelevant by the courts.

[59] *See* note 9 *supra.*

[60] *See* Note, *The Courts and the Williams Act: Try A Little Tenderness,* 48 N.Y.U. L. REV. 991 (1973). This commentator remarks that most shareholders wish only to maximize their investment. Thus, in determining whether to tender, target shareholders

> must decide whether to disinvest and accept the offered premium. In order to make this decision, many shareholders will merely question whether the offering price is sufficiently above the market price; if it is, they will tender. Some shareholders will be swayed by other considerations, primarily the target's future under the offeror's control.

Id. at 995 (footnotes omitted).

[61] As the Second Circuit noted in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969): "The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders." *Id.* at 849.

[62] *See* Reeves v. Texas Gulf, Inc., 78 Misc. 2d 579, 357 N.Y.S.2d 662 (Sup. Ct. 1974). A law review commentator has recently argued: "Improper motivation is not, however, management's only failure in responding to tender offers. When management chooses litigation as its response, the stockholders who are damaged thereby should subsequently be permitted

Second, in determining whether to oppose a tender offer, management should weigh the political and economic costs to the corporation and its shareholders of a prolonged takeover battle. Even if management should ultimately prevail, the internal conflict potentially resulting from the takeover attempt may destroy the value of the defense. If the target's board of directors split deeply over their response to the bidder's offer, or if a large number of shareholders indicate that they wish to tender, the political costs of opposition may be prohibitive.[63] Moreover, the insiders should consider the costs of litigation in opposing a takeover attempt. A prolonged takeover struggle may strain the target's financial resources, particularly if it is a relatively small or marginally profitable corporation.[64] In view of these adverse consequences, target's management should acquiesce to, or at least not oppose, a tender offer if it concludes that the probable costs of fighting the takeover attempt outweigh the detrimental effects of the offer.[65]

If the target's management determines, after considering its fiduciary obligations, that a tender offer is not in the best interest of the corporation or its shareholders, it may then implement all appropriate defensive tactics. The following sections of this Article will examine certain tactics and the circumstances under which they may be legitimately employed. As is discussed in the next section, the extent of the target's disclosure of the terms of the tender offer to its shareholders is critically important.

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to challenge such action irrespective of the board's motivation." Weiss, *Tender Offers and Management Responsibility,* 23 N.Y.L. SCH. L. REV. 445, 451 (1978).

[63] Although a majority of shareholders may wish to maximize their investments, others may hold the stock for different reasons. As Judge Duffy commented in Singer v. Magnavox Co., 380 A. 2d 969 (Del. 1977): "[O]thers may have differing investment goals, tax problems, a belief in the ability of . . . management to make them rich, or even a sentimental attachment to the stock which leads them to have a different judgment as to the desirability of selling out." *Id.* at 977 n.8 (quoting Jutkowitz v. Bourns, No. 000268 (Cal. App. Dep't Super. Ct. Nov. 19, 1975)).

[64] As one reporter has recently pointed out: "The takeover trend bas also been a bonanza for the investment bankers and lawyers who advise both the acquiring companies and their targets." NEWSWEEK, Feb. 12, 1979, at 68.

[65] One commenator has observed that "management may be doing a disservice to a large number of stockholders where it seeks judicial intervention to enjoin the offer. The fiduciary obligation of directors is, by definition, owed to all stockholders." Weiss, note 62 *supra,* at 452.

II

"INADEQUACY" OF THE OFFER—TARGET MANAGEMENT'S DUTY TO DISCLOSE

Under the Williams Act, target management may abstain from either publicly supporting or opposing the tender offer.[66] Once management decides to resist or support the takeover attempt, however, certain obligations accrue.[67] Rule 14d-4, promulgated by the Securities and Exchange Commission (SEC) pursuant to section 14(d)(4) of the Act, requires the target's management to file a Schedule 14D with the Commission if it decides to make a recommendation to its shareholders.[68] In addition, much of the information revealed in a Schedule 14D disclosure must also be summarized in any recommendation communicated to the shareholders.[69] This requirement obligates management to disclose the reasons supporting its recommendation.[70] Although rule 14d-4 may serve a useful function in certain circumstances, the heart of the federal enforcement process lies in section14(e), the antifraud provision.[71]

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[66] *See* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 220 n.2 (1973):

> [T]he failure of [§ 14(d)-(e)] to require incumbent management to make a statement regarding the offer was not inadvertent. The legislative history of the Williams Bill clearly indicates that Congress was well aware of the importance of a statement by incumbent management setting forth its views regarding the offer.

Id. (citing S. REP. No. 550, 90th Cong., 1st Sess. 2 (1967); H.R. REP. No. 1711, 90th Cong., 2d Sess. 2 (1968)). In February 1979, the Commission requested comments on rules requiring target's management to make a statement expressing either favor, disapproval, or the inability to take a position. *See* Securities Act Release No. 6,022, Exchange Act Release No. 15,548, Investment Company Act Release No. 10,575 (Feb. 5, 1979).

[67] *See* Butler, *supra* note 9, at 226-29.

[68] Rule 14d-4, 17 C.F.R. § 240.14d-4 (1978); Schedule 14D, 17 C.F.R. § 240.14d-101 (1978). Disclosure requirements of rule 14d-4 and Schedule 14D include management's reasons supporting its recommendations, any arrangements or understandings between target management and the offeror, the identity and employment capacity of the persons making recommendations to the shareholders, and information as to all transactions affected during the 60 days prior to the filing of the Schedule in the securities that are the subject of an exchange offer.

[69] Rule 14d-4(c), 17 C.F.R. § 240.14d-4(c) (1978). *See* Note, *A Proposal for Affirmative Disclosure by Target Management During Tender Offers*, 75 COLUM. L. REV. 190, 200-01 (1975).

[70] *See* note 68 *supra*.

[71] *See* note 17 and accompanying text *supra*. At least one commentator believes that § 14(d) and (e) do not sufficiently protect shareholders' interests. That author criticized these subsections primarily because the target corporation can avoid the disclosure requirements

Management's recommendation to its shareholders that they should reject an unfriendly tender offer because it is "inadequate"[72] must be measured—like all communications to shareholders—by the standards of section 14(e). Scrutiny under section 14(e) is needed in this situation because management often unfairly contrasts the strong performance and expectations of the target with the problems and dreary prospects of the offeror.[73] These communications may provide reasons why shareholders should reject a tender offer. But management is often unduly quick to pinpoint the offeror's weaknesses, neglecting to mention the positive aspects of the offer—that it may provide a substantial premium over the current market price of the target or impressive dividends over those currently generated by the target, for example.[74] This type of information is critically important to the prudent investor faced with the difficult decision of whether to tender his shares.[75]

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of the Williams Act by declining to make a recommendation to its shareholders. To remedy this situation, the commentator recommends that an affirmative duty be imposed on target management to disclose material nonpublic information in its possession. Such an approach, this commenator argues, complies with the strong congressional policy of the Williams Act favoring fair and complete disclosure for the benefit of the target's shareholders. Note, *supra* note 25, at 778-84, 785-89. But Congress specifically avoided requiring such a duty. *See* note 28 *supra*.

[72] *E.g.*, Humana, Inc. v. American Medicorp., Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286 (S.D.N.Y. Jan. 5, 1978); Emhart Corp. v. USM Corp., 403 F. Supp. 660 (D. Mass.), *vacated on other grounds*, 527 F.2d 177 (1st Cir. 1975).

[73] *See, e.g.*, Weeks Dredging & Cont., Inc. v. American Dredging Co., 451 F. Supp. 468, 471-72 (E.D. Pa. 1978); A & K Railroad Materials, Inc. v. Green Bay & W.R.R., 437 F. Supp. 636, 642-43 (E.D. Wis. 1977). In *A & K Railroad*, the target president stated in a newspaper article that in his opinion the offeror "is not a reliable and responsible organization in financial matters, such as the maneuvers they are now attempting." 437 F. Supp. at 642. The court found that this statement did not constitute a § 14(e) violation.

[74] *E.g.*, Emhart Corp. v. USM Corp., 403 F. Supp. 660, 662 (D. Mass.), *vacated on other grounds*, 527 F.2d 177 (1st Cir. 1975); Cauble v. White, 360 F. Supp. 1021, 1026 (E.D. La. 1973). For example, in *Cauble* the offeror sought to make a cash tender offer of $41 per share. The defendant's description of the offer failed to mention that the market price of the target's stock, over the months prior to the proposed offer, had fluctuated between $29 and $33 per share. In addition the defendant misleadingly stated that the stock price should be $100 per share when he had no basis for such a statement. *Id.*

[75] In providing for shareholder protection, the Williams Act "is founded on the principle that full and fair disclosure of all material facts must be made in connection with all tender offers so that investors may have the benefit of all significant facts in making their investment decisions." Missouri Portland Cement Co. v. H.K. Porter Co., 535 F.2d 388, 393 (8th Cir. 1976); *see* Pargas, Inc. v. Empire Gas Corp., 423 F. Supp. 199, 210 (D. Md. 1976).

Accordingly, if the bidder has not directly communicated the terms of the offer, such as where the target refuses to supply the bidder with a shareholder list,[76] it should be incumbent upon target management to describe the terms. In *Humana, Inc. v. American Medicorp, Inc.*,[77] Medicorp, in both a press release and a letter to its investors, described the Humana offer as "inadequate" and "not in the best interests of shareholders."[78] In these communications, Medicorp failed to describe any of the positive aspects of the Humana offer, including the opinion of its own investment advisor, who valued the Humana preferred stock, which was one subject of the exchange offer, at a clear premium over the market price of Medicorp stock.[79] Holding that Medicorp's description of the Humana offer violated section 14(e), the court enunciated the following principle:

> [O]nce Medicorp chose to communicate [to its shareholders] and, in particular, to characterize the offer as "inadequate" and "not in the best interests of" the shareholders, it was obligated to furnish its stockholders with all the information it had from Humana so that the stockholders would be sufficiently informed to react intelligently to the offer and would not be unfairly influenced by management's subjective presentation.[80]

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[76] A key question that remains unsettled is whether the target corporation must turn over its shareholder list to an unfriendly tender offeror. In Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1163 (S.D.N.Y. 1977), Judge Weinfeld held that once target management turned over its shareholder list to a friendly offeror, it was obligated under the Williams Act to do the same for a competing offeror:

> Management's decision to turn its shareholder list over to a "friendly" offeror and to withhold it from a competing offeror would offend express congressional concern in adopting the Williams Act that both the offeror and management (and here a friendly offeror) have an "equal opportunity to fairly present their case," and that "public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information regarding [the offer]." In effect, the shareholder's ability to make up his own mind about competing tender offers upon a full presentation of all material facts is impaired by this sort of management action.

Id. at 1165 (footnotes omitted). *See generally* Note, *Tender Offers and Bidder Access to Target Company Shareholder Lists*, 1978 BRIGHAM YOUNG U.L. REV. 436. *But see* A & K Railroad Materials, Inc. v. Green Bay & W.R.R., 437 F. Supp. 636, 642-45 (E.D. Wis. 1977). The SEC's proposed tender offer rules provide for access by the bidder to the target's shareholder list. The Commission anticipated final rulemaking action on this proposal by Fall, 1979. *See* [1979] FED. SEC. L. REP. (CCH) ¶ 81,935.

[77] [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286 (S.D.N.Y. Jan. 5, 1978).

[78] *Id.* at 92,824-25.

[79] *Id.* at 92,833. *See generally* note 35 and accompanying text *supra*.

[80] [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) at 92,833. Some courts have ordered the defendant who issues the misleading statement to send a corrective letter to

Requiring full disclosure of the terms of the offer only slightly burdens target management and has particular value when management describes the bidder in less than glowing terms. Unless the target's shareholders receive all relevant information relating to the terms of the offer, they may well discount all representations made by the bidder.

As an additional check on such a shareholder reaction, management also should disclose all *material* facts relating to the favorable aspects of the offer if it advises the shareholders that the offer is inadequate. In determining the proper materiality standard in the tender offer context, attention once focused on *Mills v. Electric Auto-Lite Co.*,[81] where the Supreme Court, in a proxy solicitation case, formulated a materiality standard that turned on whether the misstatement or omission "might have been considered important by a reasonable shareholder."[82] But in *TSC Industries v. Northway, Inc.*,[83] another case involving a proxy solicitation, the Court adopted a more stringent standard focusing on whether there was a "substantial likelihood that a reasonable shareholder would consider [the omitted or misstated infor-

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the corporation's shareholders. For example, in *Weeks Dredging*, a newspaper article quoted the target's president as saying that the corporation's stock was worth $150 per share and that the company was "shaping up all right." Weeks Dredging & Cont., Inc. v. American Dredging Co., 451 F. Supp. 468, 471-72 (E.D. Pa. 1978). The court found that both of these statements violated § 14(e) of the Williams Act and ordered the corporation's president to write a corrective letter to shareholders which stated:

> I am writing to you with reference to an article that you may have seen or heard about that appeared in the *Philadelphia Evening Bulletin* on January 13, 1978. In that article, I was quoted as saying that the value of American Dredging stock was conservatively worth $150 per share. This valuation was based on my estimation of the value of the assets of the Company on a per share basis and not on what I believed you could receive on the market today for your shares. In order for the shareholders to realize significantly more than the current market price of the shares at this time, it would be necessary for the company's earnings position to improve.
>
> Furthermore, in the *Bulletin* article, I was quoted as saying that the Company was "shaping up all right." By that statement I meant that the Company was realizing a profit this year and that that profit was the result of a settlement award in a condemnation proceeding. However, it was not meant and should not mean to you that the operating revenues from the Company's dredging business had increased; in fact, the Company has suffered an operating loss in 1977 in its dredging business.

451 F. Supp. at 472. For a similar misstatement by an insider followed by a court order to send a corrective letter, see Cauble v. White, 360 F. Supp. 1021, 1029 (E.D. La. 1973).

[81] 396 U.S. 375 (1970).

[82] *Id.* at 384.

[83] 426 U.S. 438 (1976).

mation] important in deciding how to vote."[84] Courts have generally applied the *Northway* standard to tender offer communications.[85]

For example, when an exchange offer is made, most shareholders would consider the value of the offered securities important in assessing the offer. If management has valued the securities offered by the bidder, and particularly when it retains an independent consultant with corporate funds to appraise the offer, the shareholders should be apprised of this valuation.[86] Similarly, in an exchange offer, shareholders would deem important the amount of dividends they would receive if they accepted the offer. Accordingly, management should inform target shareholders of the offeror's dividend rate. The materiality of other omitted information probably must be determined on an ad hoc basis. The focus of the test, however, should remain the same: Courts should assess materiality through the eyes of a reasonable investor who owns the target's stock primarily to make a profit on his investment.[87]

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[84] *Id.* at 449. Yet this standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable shareholder to *change* his vote. *Id.*

It is interesting to note that the *Humana* court stated that the target, once having recommended rejection of the offer, was obligated to furnish its shareholders with *all* information it possessed regarding the bidder, not merely material information. Humana, Inc. v. American Medicorp, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. ¶ 96,286 (S.D.N.Y. Jan. 5, 1978). Because of the huge mass of information that a target normally receives from an offeror, however, the court in all likelihood meant that only material information need be communicated. But because of management's subjective disposition, all doubts regarding materiality should be resolved in favor of stockholder transmission.

Also, although a statement may not be false, it may be misleading in the context in which it is made. If a reasonable shareholder would draw false conclusions from the statement, then the communication may well be deficient under the Williams Act. *See* Weeks Dredging & Cont., Inc. v. American Dredging, Inc., 451 F. Supp. 468, 478 (E.D. Pa. 1978).

[85] *See, e.g.*, Weeks Dredging & Cont., Inc. v. American Dredging, Inc., 451 F. Supp. 468, 477 (E.D. Pa. 1978); Royal Indus., Inc. v. Monogram Indus., Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,144 (C.D. Cal. Nov. 29, 1976). For decisions which applied the more lenient materiality test before *Northway*, see, e.g., Missouri Portland Cement Co. v. H.K. Porter Co., 535 F.2d 388, 393 (8th Cir. 1976); Pargas, Inc. v. Empire Gas Corp., 423 F. Supp. 199, 210 (D. Md. 1976).

[86] *See* Berman v. Gerber Prods. Co., 454 F. Supp. 1310, 1326 (W.D. Mich. 1978) (target's representation that offering price was inadequate while failing to disclose opinion of investment banker that such offering price was fair and substantial stated to be violative of section 14(e)).

[87] The goal of full and fair disclosure for the benefit of shareholders is a central ingredient of the Williams Act. The concept of materiality should be viewed in this light. As stated by Senator Williams:

When applying this standard, courts should be sensitive to the plight of shareholders, who are often bombarded with conflicting information during the midst of a hostile tender offer. First the bidder, then the management of their own corporation, and often the press barrage the beleaguered investors.[88] After these assaults on three fronts, shareholders must choose between the bidder's offer and the recommendation of their corporation's management. But the battle to persuade the investors all too frequently is one-sided; as the Second Circuit noted in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,[89] "shareholders are likely to rely heavily" on management's representations. Thus, management has "a special responsibility to be meticulous and precise" in communications to shareholders,[90] and any doubts concerning questions of materiality should be resolved in favor of disclosure.[91]

Not only should the substance of the disclosure be accurate, but the presentation must be designed to fairly inform shareholders of all material facts in a straightforward manner. Target management cannot fulfill its special obligation to shareholders by disclosing the beneficial aspects of the offer in a way that lessens their significance. For instance, if management makes broad statements that the tender offer is "inadequate" or an exchange

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> The committee has taken extreme care to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takover [sic] bid. The bill is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case.

S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967).

[88] A target's management may retain a public relations firm for tbe purpose of improving the image of the target's management, or even tarnishing the bidder's image during the course of the offer. For a description of the types of publicity a target's management may wish to generate, see E. ARANOW & H. EINHORN, *supra* note 66, at 268-71.

[89] 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

[90] *Id.* at 364-65.

[91] Courts should resolve doubts in favor of disclosure because some shareholders may consider important a factor that management thought to be insignificant. As stated by the district court in Commonwealth Oil Ref. Co. v. Tesoro Petro. Corp., 394 F. Supp. 267 (S.D.N.Y. 1975):

> [I]t must always be remembered that the protections of the Williams Act extends to all shareholders of the target company—both those who intend to divest themselves of ownership and those who do not. Both groups must be assured full, fair and adequate disclosure so that their decision to tender or retain their shares will be predicated upon a knowledgeable and informed evaluation of the alternatives.

Id. at 273.

offer is of "speculative value" in the text of a letter to shareholders, while inserting the favorable aspects of the offer in a footnote or in an addendum to the shareholder letter, it may well violate section 14(d).[92] Management should ensure that all material facts, regardless of whether they support or oppose its position, are disclosed to the target corporation's shareholders on as equal a basis as practicable.

Often, however, merely communicating their disapproval of a bidder's offer fails to satisfy a target's insiders; rather, they will opt to oppose the offer with more forceful defensive tactics. The next section of this Article proposes a framework for judicial evaluation of the legality of defensive tactics.

III

Proving the Legitimacy of Defensive Tactics— The Recommended Analytical Framework and Its Application

Once management decides to oppose a tender offer, it faces the delicate question of what defensive tactics to employ.[93] In the selection process, management must consider several factors, including the likelihood of success by the bidder, the current market price and dividend rate of the target, and the number of target shares held by friendly and hostile stockholders. For example, if the insiders believe that shareholders are likely to approve the offer, management may enter into a defensive merger.[94] Alternatively, if management controls only a small percentage of the outstanding stock, it may decide to issue or sell additional shares to a friendly third party,[95] or even make its own tender offer to its shareholders,[96] so that the bidder will be less likely to acquire the desired percentage of the target's stock.

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[92] The Williams Act "discloses a clear congressional determination that full and *fair* disclosure is required in connection with every tender offer." Pargas, Inc. v. Empire Gas Corp., 423 F. Supp. 199, 210 (D. Md. 1976) (emphasis added).

[93] A number of works have discussed tactical strategies target management should consider. *See, e.g.*, E. Aranow & H. Einhorn, *supra* note 66, at 219-76; Butler, *supra* note 9, at 221; Note, *supra* note 3.

[94] Two authors have characterized a defensive merger as "not a defense tactic, but rather a form of orderly retreat, and one would expect that unless such a merger was being actively considered prior to the tender offer, it would be viewed by incumbent management only as a last, albeit very effective, resort." Schmults & Kelly, *Cash Take-Over Bids—Defense Tactics*, 23 Bus. Law. 115, 132 (1967).

[95] *See, e.g.*, Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 114 (S.D.N.Y. 1977).

[96] *See, e.g.*, Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975).

Regardless of the defensive tactics employed, state law and the Williams Act mandate that target management owes its allegiance to the shareholders. Maneuvers used to perpetuate management's status or in some manner to prevent an informed decision by the target's shareholders violate these protective laws. Therefore, the legitimacy of a given defensive tactic should turn not only on the tactic used, but also on the effect of the tactic on the shareholders' right to decide, the reasons management relies upon for employing the tactic, and the extent of disclosure to the shareholders.

A. *The Recommended Analytical Framework*

Courts assessing the legality of defensive tactics under the Williams Act have adopted a variety of tests, but most courts currently apply one of two tests: the "business purpose" test and the "primary purpose" test. Courts applying the business purpose test search for a valid business purpose for management's employment of the maneuver.[97] In contrast, those that have adopted the primary purpose test query whether the principal or primary purpose of the defensive tactic was to benefit the target corporation's shareholders or to impede the bidder's takeover attempt.[98]

Under the business purpose test, target management can justify its conduct by merely showing that the tactic employed had some business purpose.[99] In fact, some courts find for management unless the plaintiff proves that the *sole* purpose of the man-

[97] *See, e.g.,* Humana, Inc. v. American Medicorp, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286, at 92,833 (S.D.N.Y. Jan. 5, 1978) ("the record does contain evidence of sound business reasons for increasing the cash dividend and issuing a stock dividend"). Other courts have stated this test negatively. *See, e.g.,* Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1158 (S.D.N.Y. 1977) ("[Applied Digital's] burden of proof . . . is to demonstrate . . . that the defendants had no valid business purpose in attempting to effect the sale of Milgo stock to Racal").

[98] *See, e.g.,* Royal Indus., Inc. v. Monogram Indus., Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,136 (C.D. Cal. Nov. 29, 1976) ("this Court finds that the sole, primary, compelling and controlling purpose of the Sar acquisition was to thwart the Monogram tender offer").

[99] *See, e.g.,* Humana, Inc. v. American Medicorp, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286, at 92,833 (S.D.N.Y. Jan. 5, 1978) (evidence of sound business reasons for dividend increase resulted in finding of no potential showing for a breach of Williams Act despite extraordinary departure from prior policy and timing of increase—two days after tender offer announcement).

agement's maneuver was to defeat the tender offer and that this sole purpose was unrelated to any legitimate business objective.[100]

The business purpose test poses a nearly insurmountable obstacle for plaintiffs challenging defensive tactics. Regardless of the tactic employed, management can easily manufacture a "legitimate" corporate purpose for its action, even when it employed the tactic solely to perpetuate its own status. This is particularly true when management employs expert counsel to lay a foundation for and to structure its actions. In addition, many courts are reluctant to substitute their own judgment for management's business judgment. Besieged with business reasons justifying the use of a maneuver, a court applying the business purpose test frequently finds itself compelled to legitimize the corporate conduct.[101] Except in the most egregious cases, management will predictably prevail and deprive the target shareholder of the opportunity to consider the bidder's offer. This judicially-imposed result eviscerates the legislative policy choice embodied in the Williams Act.

The second test used by the courts, which looks to the primary purpose underlying the corporate conduct,[102] is more consistent with the intent of the Williams Act. This test, however, also fails to allocate the burden of persuasion in the most rational and flexible manner; it does not recognize that certain situations call for the application of different standards in order to reach the

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[100] *See, e.g.*, Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1158 (S.D.N.Y. 1977).

[101] *See* Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712-13 (N.D. Ill. 1969). Another court has stated a different approach:

> [A] Delaware Court will not be indifferent to the purpose of a merger when a freeze-out of minority stockholders on a cash-out basis is alleged to be its sole purpose. In such a situation, if it is alleged that the purpose is improper because of the fiduciary obligation owed to the minority, the Court is duty-bound to closely examine that allegation even when all of the relevant statutory formalities have been satisfied.

Singer v. Magnavox Co., 380 A.2d 969, 979 (Del. 1977). *See* Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1157-62 (S.D.N.Y. 1977).

[102] *See* Klaus v. Hi-Shear Corp., 528 F.2d 225, 233 (9th Cir. 1975) (application of "principal purpose" test to management's issuance of stock upheld). Considerations under state law are similar. *See* Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 775 (Del. Ch. 1967). In *Condec*, the court stated "Where, however, the objective sought in the issuance of stock is not merely the pursual of a business purpose but also to retain control, it has been held to be a mockery to suggest that the 'control' effect of an agreement in litigation is merely incidental to its primary business objective." 230 A.2d at 776 (citation omitted).

most equitable results. For example, even if the primary purpose of the target's action is to defeat a takeover attempt which it believes is not in the shareholders' best interests, management should be free to take such action provided that the tactic does not preclude or materially impede the shareholders' consideration of the offer. On the other hand, if management's action effectively impedes or forecloses the shareholders from considering the offer, the complainants should not be required to demonstrate target management's motivation underlying the defensive tactic. Because of the serious consequences of this latter group of defensive tactics, management should bear the burden of persuasion to establish that its primary motivation was not to preclude or materially impede shareholder consideration of the offer.

An equitable test to assess the legality of a defensive tactic under section 14(e) should recognize the different practical effects that various defensive tactics have on the target's shareholders—the prime beneficiaries of the Williams Act. Because the fiduciary duty aspects of the Williams Act focus on the right of shareholders to make an informed decision, target management's acts should be scrutinized in relation to their encroachment on this right. A defensive tactic that effectively impedes or precludes the shareholders from considering a tender offer should not be judged by the same standards used to judge a defensive tactic that has little effect on such consideration. Although courts have applied different tests in evaluating defensive tactics, no distinctions have yet been drawn with respect to the effect of the particular tactic upon the shareholder.

The following two-tier analysis would effectuate the policies of the Williams Act and reflect the qualitative differences in the effect of defensive tactics: (1) Defensive tactics that have little effect on a shareholder's opportunity to consider the bidder's offer should not be construed to violate section 14(e) unless the target's management has made material misrepresentations or omissions with respect to the tactic;[103] (2) regarding defensive tactics that preclude or otherwise materially impede the target's shareholders' consideration of the offer, the challenging shareholder should initially be required to show that the tender offer was a factor in

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[103] As discussed in the text accompanying notes 51-55 *supra*, the concept of materiality should be liberally interpreted in assessing communications made during a tender offer battle.

inducing the target management to take the particular action at that time, thereby giving rise to a presumption that the primary reason for the action was to block or impede the takeover bid. Target management may rebut this presumption by showing that the primary reason for the action was not to effectively impede shareholder consideration of the offer.[104]

In applying the proposed test, courts must decide, at the threshold, whether the defensive tactic has little effect on a shareholder's opportunity to consider the bidder's offer, or whether it precludes or otherwise materially impedes shareholder consideration of the offer. As a matter of definition, all defensive tactics arguably impede the bidder's offer. For practical application, however, this test should focus on whether the target's shareholders, rather than target management, will make the ultimate decision as to the disposition of their shares of stock and the future of the target corporation.[105]

B. *Defensive Tactics Not Precluding or Materially Impeding Shareholder Consideration*

Examples of defensive tactics that generally will not affect a shareholder's right to consider a bidder's offer include dividend increases,[106] and under certain circumstances, the identification and seduction of a "white knight."

1. *Dividend Increases*

Target management may raise dividend rates in order to discourage or help defeat tender offers. A dividend increase can cause an increase in the market price of the target's stock to rise

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[104] Rule 301 of the Federal Rules of Evidence provides:

> In all civil actions and proceedings not otherwise provided for by Act of Congress or by these rules, a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.

[105] In addition, even assuming that the business objective in employing a certain defensive tactic was to serve a legitimate corporate end, that measure may never have been engaged in *at that time* if there had not been an unfriendly tender offer. *See generally* Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975).

[106] For a discussion of the similar use of stock splits, see note 117 *infra*.

in reflection of the increased return per share.[107] In the event of a tender offer, it can reduce the difference between the bidder's offer and the market price so that the offering price appears less attractive to the target's shareholders.[108]

Shareholders usually benefit from this defensive maneuver; they obtain a greater return on their investment while retaining the option of accepting the offer. Thus, the target should not be required to absolutely freeze its dividend policy once an offer is announced. But to prevent misleading the shareholders, target management should point out that an increase in the stock's market price may be due to the dividend increase rather than to the market's perception of improved prospects for the corporation. Target management should also furnish the shareholders with full information regarding the dividend increase. This disclosure should include: (1) The reason for the increase, (2) prospects for continuing that dividend level, and (3) the effect of the dividend on the company's ability to sustain its current growth rate. Failure to provide this information, particularly when target management does not realistically expect to continue paying its higher dividend rate, should constitute a deceptive or fraudulent practice proscribed by section 14(e) of the Williams Act.[109]

Under the business purpose test currently used by many courts, a finding of any valid business reason to support the change in dividend policy results in a conclusion of no violation. This test is incorrectly focused and imposes too few disclosure re-

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[107] *See* Schmults & Kelly, *supra* note 94, at 117-18; Note, *supra* note 3, at 1119-20.

[108] *See generally* E. ARANOW & H. EINHORN, *supra* note 66, at 245-46.

> When industrialist George W. Murphy bid for shares of Sharon Steel Corporation in June 1966, Sharon promptly boosted the annual dividend from 60 cents to 80 cents a share. This maneuver is one of the most common responses in attempting to rebuff an unsolicited takeover bid; more than one third of the companies in our study undertook this defense. The strategy behind it is the dual hope of winning shareholder support with more income and of driving up the price of the stock. Although it may be claimed that management is unethical in "buying off" shareholders with "their own" profits, the tactic has often had the desired effect and cannot be ignored.

Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135, 143 (March-April 1967).

[109] The drafters of the Williams Act intended for it to protect the target corporation's shareholders. If courts are to construe the statute to fulfill this objective, they must scrutinize the target corporation's actions and ensure that full and complete disclosure is made to the shareholders. The motives for increasing dividends must be revealed or the

quirements upon target management. For example, in *Humana, Inc. v. American Medicorp, Inc.*,[110] two days after the bidder announced that it intended to make an exchange offer, Medicorp, the target, raised its dividend rate from fifteen to fifty cents per share and declared a four percent stock dividend, the first such dividend in the company's history.[111] In determining whether Medicorp's dividend tactic violated section 14(e) of the Williams Act, the district court applied the business purpose test:

> It is difficult to believe that the extraordinary departure from prior dividend policy approved by the Medicorp Board two days after Humana advised it of the offer was not prompted at least in part by Medicorp's unhappy reaction to the offer itself. However, the record does contain evidence of sound business reasons for increasing the cash dividend and issuing a stock dividend.[112]

The court's holding, although a sound application of the business purpose test, demonstrates the inadequacy of that test. First, management satisfied the test[113] despite the court's implication that the proposed exchange offer was the primary motivating factor behind the dividend increase.[114] Second, looking for a business purpose ignores important Williams Act policies; even if an action had a business purpose, management's misleading or nonexistent disclosures may have prevented the shareholders from making the informed decision that the Williams Act guarantees them. Hence, the business purpose test, in this context, removes the decision from the shareholders and gives it to the insiders. The confluence of these factors permitted target management to avoid adequate disclosure of the reason for the dividend increase. In its letter to shareholders announcing the

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shareholders will not possess all the relevant information to make an informed decision on the tender offer.

[110] [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286, at 92,823 (S.D.N.Y. Jan. 5, 1978).

[111] *Id.* at 92,824.

[112] *Id.* at 92,833. For an analysis of the business purpose test and its drawbacks, see text accompanying notes 99-101 *supra*. The court further remarked: "Medicorp was doing well and it is not at all clear that the dividends actually authorized September 29th were not perfectly justifiable on the basis of business considerations alone." *Id.*

[113] *Id.* at 92,824-25. Such reasons included the growing strength of the corporation, increased earnings and gross revenues, a low debt to equity ratio, and a tenfold rise in the price of Medicorp's stock during the previous three years.

[114] *Id.* at 92,833. Even assuming that the business objective in employing a certain defensive tactic served a legitimate corporate end, that measure may never have been undertaken *at that time* without an unfriendly tender offer.

new dividend policy, Medicorp attributed the increase to the growing strength of the corporation;[115] it made no mention that the dividend change was due, at least in part, as a reaction to the proposed exchange offer. Because it could easily establish a business purpose, Medicorp escaped liability on this point with little difficulty.[116] Under a test more closely tailored to the objectives of the Williams Act, management's failure to disclose the material reasons for the change in dividend policy should constitute a section 14(e) violation.[117]

2. *Defensive Mergers*

Management may also resist a takeover bid by negotiating a merger with a third party, or "white knight." This tactic tends to be a last resort for management, and, frequently, can be successful.[118] If the target's management believes that the bidder's tender offer will be successful when presented to its shareholders but also believes that a merger could be negotiated with a third party that would be more beneficial to the target's shareholders, man-

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[115] *Id.* at 92,824.

[116] The *Humana* court did grant a preliminary injunction against the target management for making misleading disclosures, but the court found other grounds for this decision—the disclosures relating to the dividend increase were not sufficient to justify an injunction. *Id.* at 92,833.

[117] A stock split is a defensive tactic which often causes the target's stock price to rise independently of the bidder's offer. Although a stock split may result in a price increase in the target's stock, it does not change the target's ownership or control and does not impede the bidder's ability to make an offer or the target's shareholders ability to consider it. The adequacy of the disclosure regarding the stock split should be the primary concern of the courts. If disclosure is complete and accurate, courts should hold that the stock split does not violate § 14(e).

[118] *See* Hayes & Taussig, *supra* note 108, at 146-47. An example illustrates this tactic's effectiveness.

> In February 1966 a cash tender offer was announced on behalf of a then-undisclosed group of investors at $65 a share. The group was seeking 60% of the outstanding shares. The management of Phoenix, which had been showing heavy underwriting losses and a resultant depressed market price for its stock, was caught completely by surprise; the president was reportedly about to take off on a vacation trip. After a number of ineffectual countermoves, the Phoenix management announced it had begun merger discussion with the Travelers group of insurance companies. The rumored terms were better than the outstanding tender offer. This blunted the bidding group's attack, and the offer was withdrawn. In May the merger was submitted to shareholders of both Phoenix and Travelers and approved, giving Phoenix shareholders Travelers stock valued at approximately $73 a share.

Id.

agement normally should not be precluded from seeking such a defensive merger.[119]

Defensive mergers usually follow a rather predictable pattern. Because it knows the details of the original bid, the white knight typically offers more favorable terms to the target's shareholders. The bidder may parry this prospective defensive merger by (1) proceeding with its original tender or exchange offer, (2) raising the price of its offer, or (3) proposing its own merger with the target, to be considered in the same proxy vote as the white knight's proposal. Management must play this game fairly by taking care not to "stack the deck" with misleading disclosures regarding the tender offer, with misleading statements regarding the proposed merger,[120] or through sales of stock to the white knight prior to the shareholder's vote.[121] The contest is ultimately decided by the shareholders, who select the offer that they prefer. In this context, it is important to note that while the proposal of a defensive merger may make it less likely that the bidder's offer will be accepted by the target's shareholders, the shareholders still retain the right to receive the bidder's offer and to make their own determination.

Although a defensive merger is a more radical tactic than a dividend increase, it does not usurp the decisionmaking power of the target's shareholders, nor does it harm them economically. It is therefore difficult to understand why a defensive merger should be prohibited even if its "primary purpose" is to block the likely success of the bidder's offer. So long as the shareholders are given full and accurate disclosure about both the bidder's offer and the proposed defensive merger with the white knight, they should be given the opportunity to choose the alternative which they deem most beneficial to their interests. Allowing the

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[119] A board has particular responsibilities as to certain defensive steps, such as encouraging a defensive merger. If a merger can be arranged with a sound company in a tax-free transaction for securities which plainly appear to have a value higher than the cash tender price, it is obvious that the board is acting in the best interests of the shareholders in approving the merger and recommending rejection of the tender. Even for those shareholders who wish cash, the recommendation of a friendly merger at a higher price in securities will normally result in an increase in the target's stock price so that those holders can sell in the open market. Risks to the management are also substantially eliminated since any such merger will require the approval of the target company's sharebolders.

Butler, *supra* note 9, at 233-34.

[120] *See* H.K. Porter Co. v. Nicholson File Co., 482 F.2d 421 (1st Cir. 1973).

[121] *See* text accompanying notes 125-32 *infra.*

shareholders their free choice in a fair game promotes the fundamental objectives of the Williams Act.

C. *Defensive Tactics Which Preclude or Materially Impede Shareholder Determination*

Defensive tactics that impede or preclude a target's shareholders from considering a bidder's offer should be judged under a more stringent standard than the disclosure test advanced for defensive tactics that allow shareholders to make their own investment decision. Currently, under the primary purpose test, management all too often can prevail by obfuscating the actual reason for the tactic. This situation, however, can be easily remedied by altering the analaytical framework of these situations. The party challenging the target's defensive tactics should have to demonstrate that the bidder's offer was a factor in inducing target management to take the defensive action at that time. Once the plaintiff proves the above, target management then should be required to rebut the presumption by showing that the primary purpose of the particular defensive tactic was not to effectively impede or preclude shareholder consideration of the offer.[122]

Imposing a rebuttable presumption on the target corporation in this manner makes good sense. First, the target's management has the easiest access to information explaining the purpose of its tactics.[123] Second, this test does not interfere with a corporation's internal affairs; it merely requires the target corporation to explain its conduct, after the plaintiff establishes basic facts that tend to show a violation of the Williams Act. If target management can rebut this presumption, then courts should hold that section 14(e) has not been violated.

Any management action that precludes or materially impedes the shareholders from considering a hostile takeover offer arguably arose from a desire to defeat the tender offer. Any other position ignores the realities of the corporate world. Management, however, may have seriously contemplated the challenged action

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[122] The test proposed in this Article would apply only to civil actions, and not to criminal actions. The authors express no opinion on the proper presumptions for criminal cases.

[123] *See* McCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 343, at 806-07 (2d ed. E. Cleary 1972); Morgan, *Some Observations Concerning Presumptions,* 44 HARV. L. REV. 906, 911 (1931).

before it knew of the takeover attempt.[124] Or a very attractive corporate opportunity may have arisen during the course of a tender offer, and management may have unquestionably pursued it even in the absence of the offer. In such situations, courts should focus on whether target management intended its actions to benefit the shareholders or to effectively impede or preclude their consideration of the bidder's offer.

Examples of defensive tactics that preclude or materially impede shareholder consideration of a bidder's offer include issuance of stock to a friendly party and defensive acquisitions.

1. *Issuance of Stock*

Issuing shares to a friendly party constitutes one defensive tactic open to management. This action might discourage a bidder from making an offer or reduce the probability that the bidder will acquire the desired percentage of the target's stock. While this hostile ownership of a large block of the target's stock may dull a bidder's enthusiasm, this tactic also directly dilutes the shareholders' ownership and voting rights. Consequently, this action lessens each shareholder's voice in determining whether the bidder will acquire the requisite ownership of shares.

Applied Digital Data Systems, Inc. v. Milgo Electronic Corp.,[125] illustrates the manner in which a target's sale of stock can be detrimental to a shareholder's right to consider a bidder's offer. After Applied Digital announced its intent to make an exchange offer for Milgo's stock, the target negotiated the sale of 312,000 unissued common shares to a friendly third party.[126] These shares constituted approximately 15.5 percent of the total shares of common stock and, when coupled with management's 6.5 per-

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[124] But the management's knowledge of the particular takeover attempt may be irrelevant. Where the bidder has made a prolonged effort to gain control, the relevant time frame should be the beginning of the bidder's struggles rather than the start of its last campaign. Thus, in Klaus v. Hi-Shear Corp., 528 F.2d 225, 233 (9th Cir. 1975), the Ninth Circuit affirmed the district court's finding that the principal purpose of the issuance of stock to a trust was to dilute the bidder's voting strength. This holding discounted evidence indicating that management had contemplated such a sale for over a year. *Id.* A possible reason for this outcome may be that the bidder had sought control for approximately the same length of time.

[125] 425 F. Supp. 1145 (S.D.N.Y. 1977).

[126] The proposed purchaser of the stock was Racal Electronics, a United Kingdom corporation. Racal and Milgo each owned a 50% interest in another United Kingdom corporation which distributed Racal's products in foreign markets. In 1974 and 1975, Racal con-

cent ownership interest,[127] would have ensured that over 20 percent of Milgo stock was owned by parties hostile to the tender offer. If the negotiated sale were consummated, the remaining Milgo shareholders could not receive a tax-free exchange, because less than eighty percent of Milgo's shares would have been exchanged.[128]

In addition, the Milgo management structured the sale so that shareholder approval would not be required. Management had originally planned to sell 382,300 shares or 18.4 percent of Milgo's common stock but lowered the amount to 15.5 percent when informed that the New York Stock Exchange would not qualify the higher number of shares for listing on the Exchange without shareholder approval. Thus, not only did the target's management choose a defensive tactic which foreclosed shareholders from considering the bidder's offer, but it consciously designed a maneuver that bypassed shareholder approval.[129]

Judge Weinfeld held that the plaintiff had shown "to the degree necessary to justify preliminary relief" that the sale had no valid business purpose and that its "sole purpose was in fact to defeat the proposed exchange offer and prevent the Milgo shareholders from exercising their rights under it."[130] He therefore issued a preliminary injunction restraining Milgo from consummating the sale of its stock.[131]

A target's sale of stock or shares during a tender offer should receive close scrutiny. Although the *Applied Digital* cðurt reached the proper result, other cases may not provide a factual pattern that clearly reveals management's purpose. When a target's management attempts to ensure defeat of a takeover attempt by selling stock to a friendly third party, it materially impedes and possibly precludes shareholder consideration of the bidder's offer. Such action evidences a feeling by management that its shareholders cannot be entrusted with ultimate control over the corporation.

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templated purchasing Milgo stock, but the plans were abandoned prior to Applied Digital's offer. *Id.* at 1148-49.

[127] *Id.* at 1158.

[128] *Id.* at 1158 n.50. *See generally* I.R.C. § 368(a)(1).

[129] The court stated that: "There can be no question that the purpose of the reductions [in the number of shares sold to Racal] was to eliminate the need for stockholder approval." 425 F. Supp. at 1159.

[130] *Id.* at 1158.

[131] *Id.* at 1161.

A target choosing to sell stock will probably argue, as did Milgo's management, that it sought to infuse working capital into the corporation to take advantage of corporate opportunities.[132] Certainly a sale of shares for cash will provide a corporation with additional funds to finance existing or proposed projects. In most instances, this fact will create difficulty in showing that the transaction has no business purpose. A management sensitive to the protection of shareholder interests, however, should recognize that sales of stock during the pendency of a takeover attempt can dramatically affect the balance of power within a corporation; such a management should give serious consideration to the suspension of sales of stock discussed and negotiated prior to a bidder's announcement. As the *Milgo* Court noted, a target's management should not be permitted to sell stock if it would "deprive [the] shareholders of opportunities accruing to them by virtue of their stock ownership."[133] At the very least, the Williams Act should require a target's management to demonstrate that the primary purpose of a stock sale during a takeover attempt was not to materially impede or preclude shareholder consideration of the bidder's offer.

2. *Defensive Acquisition*

A target corporation may decide to block the bidder's takeover attempt by acquiring another corporation. If the corporation is acquired through an exchange of stock, the number of outstanding shares in the target corporation will be increased. Just as in the direct issuance of stock for cash to friendly parties, this action may thwart a bidder because he may be unable to acquire a sufficient percentage of stock.

Alternatively, management may seek a defensive acquisition of a company in the bidder's business for the purpose of interposing an antitrust obstacle to the bidder.[134] Either the target's

[132] *Id.* at 1158.

[133] *Id.*

[134] *See* E. ARANOW & H. EINHORN, *supra* note 66, at 254-56. These measures can be as successful as they are ingenious.

> One company, on learning of an impending bid from another firm, promptly acquired a business that competed with the bidder in lines accounting for 80% of its total sales. The move, of course, was designed to raise the specter of monopoly in connection with the expected bid. When the bid was announced, the subject company filed an antitrust suit, confident that the bidder would be forced to withdraw. This proved correct, since to divest itself of the conflict of interest would have meant severing practically the whole company.

Hayes & Taussig, *supra* note 108, at 146.

management or the Antitrust Division of the Department of Justice may institute suit to block the bidder's takeover attempt because of potential violations of the federal antitrust laws.[135]

Although sales of stock to friendly parties often materially impede the stockholders' ability to make their own determination about the future of the company by diluting their ownership interest, a defensive acquisition, by raising antitrust barriers, may totally preclude the shareholders from considering the offer. Thus, management should bear the burden of demonstrating that its primary purpose in making the defensive acquisition was not to materially impede or preclude shareholder consideration of the bidder's offer.

In *Royal Industries, Inc. v. Monogram Industries, Inc.*,[136] the court considered the legitimacy of a target corporation's defensive acquisition in light of section 14(e). On October 21, 1976, Monogram announced its intentions to make a cash tender offer to Royal shareholders[137] for a majority of Royal's common stock.[138] On the following day, Royal's management and counsel set procedures in motion to acquire Sar Industries, Inc., one of Monogram's competitors,[139] and a company with whom Royal had no prior contact.[140] A Letter of Intent was executed on October 26th which provided for a cash payment by Royal of over one million dollars for fifty-one percent of Sar's stock,[141] and an

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[135] *See, e.g.*, Humana, Inc. v. American Medicorp, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,286, at 92,833 (S.D.N.Y. Jan. 5, 1978). The Hart-Scott-Rodino Antitrust Improvements Act of 1976 erected a technical antitrust hurdle to the tender offeror. A tender offeror, unless exempt from the Act's provisions, must notify the Justice Department or the Federal Trade Commission 15 days prior to purchasing any voting securities. 15 U.S.C. § 18a (1976). These government agencies then have the opportunity to evaluate the transaction for possible antitrust violations. The Act, however, does not obligate the offeror to provide advance notice to the target corporation of the impending offer nor does it extend the minimum time for withdrawal of shares tendered by a target shareholder. For a discussion of the Act, see Leiman, *Recent Developments in Takeovers*, in EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION (PLI) 207, 219-23 (R. Mundheim, A. Fleischer & B. Vandegrift eds. 1977).

[136] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976).

[137] *Id.* at 91,134.

[138] *Id.*

[139] *Id.* at 91,134.

[140] Royal's attorneys received a phone call from Sar's attorney, who indicated that Sar had an antitrust lawsuit pending against Monogram and "would like to he helpful to Royal." *Id.* at 91,135.

[141] A press release issued by Royal failed to specifically mention the actual cash proposed to be paid to Monogram but instead only referred to it as a "sum of cash." The court

agreement by Royal to advance funds as needed by Sar without any assessment of interest charges on the advances.[142]

The court found that Royal had violated section 14(e) because the "sole, primary, compelling and controlling purpose of the Sar acquisition was to thwart the Monogram tender offer."[143] Although the *Royal* court reached the proper result, few courts will again be furnished with a factual record so replete with evidence of management's improper purpose.[144]

As with the sale of stock to a friendly party, a target's management should be held strictly accountable for negotiating a defensive acquisition which deprives shareholders of their opportunity to consider a bidder's offer. By requiring management to justify its actions once the plaintiff has made a showing that the action was precipitated by the bidder's offer, target corporations will be less inclined to waste shareholders' assets through hastily arranged and economically unsound acquisitions. By allocating the presumptions in this manner, target management may well find it in their best interests to take their responsibilities under the Williams Act seriously. If this result occurs, the target corporation shareholder will be the ultimate beneficiary.

CONCLUSION

The principle underlying the Williams Act is that shareholders of a public corporation are entitled to decide the fate of their company when it becomes the subject of a tender offer. A target's management, then, should not be allowed to effectively usurp this shareholders' right by taking actions that preclude or materially impede a shareholder's right to decide, or to provide shareholders with less than full disclosure of all the material facts that might affect their decision. If the target decides to oppose the bidder's offer as being inadequate, it must be particularly careful to ensure that its characterization of the bidder's offer is objectively well

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found this designation of the price to be a deliberate non-disclosure of a material fact. *Id.* at 91,142.

142 Sar had $0.00 in net sales for the last reported period preceding the acquisition. *Id.* at 91,135.

143 *Id.* at 91,136.

144 The court used harsh language throughout its opinion in deriding the purposes of Royal's management. The court found a statement by Royal tbat the " 'acquisitions of Sar fits the corporate growth plan of Royal' " to be false and misleading in "that the only way the acquisition of Sar comports with any 'plan' of Royal management is that it is a part of a plan to thwart Monogram's proposed offer." *Id.* at 91,142.

founded. If the target decides to use defensive tactics that are not solely communicative in nature, the test used to judge the legitimacy of the tactic should vary with the effect that the tactic has on a shareholder's right to decide. Tactics that are taken for the purpose of materially impeding or precluding a shareholder's right to decide are illegitimate no matter how complete the disclosure may be surrounding the use of the tactic. Conversely, tactics that do not preclude or materially impede a shareholder's decision are perfectly proper, even when undertaken for the primary purpose of defeating the bidder's offer, if full disclosure is made. These standards would effectuate the policy of the Williams Act and would turn a fast game into a fair game.