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Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance

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REGULATING THE MARKET FOR CORPORATE CONTROL: A CRITICAL ASSESSMENT OF THE TENDER OFFER'S ROLE IN CORPORATE GOVERNANCE

*John C. Coffee, Jr.**

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INTRODUCTION

Better answers often await better questions. In the wake of a recent series of provocative articles dealing with contested tender offers,¹ several questions have been vigorously debated:

1. In large measure, this debate has pivoted around the thesis advanced by Professors Easterbrook and Fischel in a series of stimulating articles. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161 (1981) [hereinafter cited as Easterbrook & Fischel I]; Easterbrook & Fischel, *Corporate Control Transactions*, 91 *Yale L.J.* 698 (1982) [hereinafter cited as Easterbrook & Fischel II]; Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 *Stan. L. Rev.* 1 (1982) [hereinafter cited as Easterbrook & Fischel III]. These challenging articles have drawn a critical response from those who share the same fundamental economic premises as do Professors Easterbrook and Fischel and those who do not. For responses written from a basically similar economic perspective, see Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 *Harv. L. Rev.* 1028 (1982)

(1) Should management of the target company be allowed to resist a hostile tender offer in order to remain an independent company?² Which, if any, of the various "shark repellent" measures by which a potential target can make itself unattractive to a bidder are justified?³

[hereinafter cited as *Bebchuk I*]; *Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 *Stan. L. Rev.* 23 (1982) [hereinafter cited as *Bebchuk II*]; *Carney, Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 *A.B.F. Research J.* 341; *Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *Stan. L. Rev.* 819 (1981) [hereinafter cited as *Gilson I*]; *Gilson, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 *Stan. L. Rev.* 775 (1982) [hereinafter cited as *Gilson II*]; *Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 *Stan. L. Rev.* 51 (1982) [hereinafter cited as *Gilson III*]. For other writers that have criticized the position of Professors Easterbrook and Fischel from a vantage point that shares few of their premises, see *Lipton, Takeover Bids in the Target's Boardroom*, 35 *Bus. Law.* 101 (1979) [hereinafter cited as *Lipton I*]; *Lipton, Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 *Bus. Law.* 1017 (1980) [hereinafter cited as *Lipton II*]; *Lipton, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 *N.Y.U. L. Rev.* 1231 (1980) [hereinafter cited as *Lipton III*]; *Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 *Colum. L. Rev.* 249 (1983).

2. Professors Easterbrook and Fischel have argued for a rule of managerial passivity under which management of the target company could take no action either to resist a bid, to buy back shares of the target offered to it by a potential hostile bidder or, to seek another friendly bidder (the proverbial "white knight") to make a counter bid. See Easterbrook & Fischel 1, *supra* note 1, at 1164, 1194-1204. Essentially, Lucian Bebchuk and Professor Gilson concur as to the illegitimacy of defensive tactics which seek to maintain the target corporation as an independent entity. However, both Bebchuk and Gilson believe that greater allocational efficiency results if target management is permitted to facilitate competing bids. See *Bebchuk II*, *supra* note 1, at 24-25 & n.8, 39-45; *Gilson III*, *supra* note 1, at 62-66.

In contrast, Professor Lowenstein and Martin Lipton have argued it is desirable that management be able to resist the takeover, although in Professor Lowenstein's proposal the authorized scope of resistance would be limited and would be principally intended to give shareholders a more informed, or less pressured choice. Lowenstein, *supra* note 1, at 322-33. Of all these commentators, only Martin Lipton takes the view that the normal business judgment discretion accorded to the board of directors in other areas of corporate law should extend to the context of corporate control contests. See *Lipton I*, *supra* note 1, at 113-20. However, Professor Carney approaches this same result by conceptualizing the takeover contest as one between the bidder and target shareholders, in which management of the target is serving as the faithful agent of its shareholders in seeking to obtain a higher price for their shares. Carney, *supra* note 1, at 382-84.

Notwithstanding the apparent consensus within the academic community that most defensive measures are undesirable, courts have continued, with only occasional exceptions, to permit managerial resistance to takeovers by almost any means. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690 (2d Cir. 1980); *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981).

3. The term "shark repellent" is typically used to refer to "amendments to a potential subject company's certificate of incorporation or by-laws that have been devised to discourage unsolicited approaches from unwanted bidders." See Advisory Comm. on Tender Offers, U.S. Sec. & Exchange Comm'n, Report of Recommendations 141 (July 8, 1983) [hereinafter cited as *SEC Tender Offer Report*]. Under this category fall tactics such as supermajority provisions, fair price provisions, and staggered boards. See generally, M. Lipton and E. Steinberger, *Takeovers and Freezeouts* §§ 6.2-6.3 (1978); *Friedenburg, Jaws III: The Impropriety of Shark-Repellent*

(2) If defensive tactics were generally forbidden, should the target company's management still be permitted to encourage competing bids thereby creating an auction?;⁴ and

(3) Do hostile takeovers in the aggregate promote economic efficiency or only a preoccupation with short-run profit maximization at the expense of strategic planning, research, and innovation?⁵

Significant as these issues sound, it is nonetheless the thesis of this Article that these are the wrong questions from which to undertake a public policy analysis of the hostile takeover. Put bluntly, these are questions of secondary (albeit substantial) significance, because they either presuppose the answers to more fundamental questions or assume that the hostile takeover is a monolithic phenomenon, which, depending on the commentator, is either efficiency enhancing or inhibiting and which therefore should either be encouraged or discouraged in the aggregate. The fallacy in this over-aggregated perspective is that it ignores the possibility that takeovers may have varied and even offsetting effects. Some takeovers may promote economic efficiency, some may result in a misallocation of economic resources, and some may be neutral in

Amendments as a Takeover Defense, 7 Del. J. Corp. L. 32 (1981); Hochman & Folger, *Deflecting Takeovers: Charter and By-Law Techniques*, 34 Bus. Law 537 (1979). Because the board typically has power to amend the by-laws (but never the certificate of incorporation), shark repellents are sometimes within the control of the board, but more generally require shareholder ratification. The board of directors of the target may also engage in defensive actions not requiring shareholder approval, including "lock-ups" of stock or assets with allies or competing bidders, "Pac-Man" counter tender offers, "crown jewel" sales of prized assets and "poison pill" issuances of securities convertible upon a takeover into securities of the bidder, resulting in dilution of the bidder's stock. Although this overview does not exhaust by any means the variety of defense techniques, it should serve to make one basic point: what the target's board of directors can do without shareholder approval to block a takeover is potentially enormous and socially far more dangerous than what it can do by securing such approval. Limitations on board discretion therefore appear more important than restrictions on shareholder action.

4. This is the heart of the dispute between Professors Easterbrook and Fischel, on one side, and Professor Gilson and Lucian Bebchuk, on the other. For a summary of their views see Symposium, 35 Stan. L. Rev. 1 (1982).

5. Most of those who have participated in the debate over the desirability of encouraging competing bids have shared the view that takeovers promote efficiency, increase shareholder wealth, and result in greater corporate accountability. In contrast, Professor Lowenstein and Martin Lipton have offered dissenting views. See *supra* note 1. This opposite view that takeovers promote inefficiency and waste—chiefly by diverting managerial attention and energies within both the bidder and target firms—has been broadly stated by academics outside of the law schools, most notably by faculty at the Harvard Business School and at the Kennedy School of Government. See R. Reich, *The Next American Frontier*, 140-72 (1983); Hayes & Abernathy, *Managing Our Way to Economic Decline*, Harv. Bus. Rev., July-Aug. 1980, at 67, 73-74; Reich, *The Next American Frontier*, The Atlantic Monthly, March 1983, at 52-55; Hayes, Bendix et al.—A Perspective from Harvard: The Undermining of Business Credibility, N.Y. Times, Oct. 10, 1982, at F2, col. 3; cf. Eating Companies is Wrong, Economist, Oct. 2, 1982, at 71; Nordhaus, The Vanity of the Takeover Game, N.Y. Times, Oct. 3, 1982, at F3, col. 1.

terms of economic efficiency, but involve substantial wealth transfers between the participating classes that arguably are involuntary.⁶

Equally important, the questions listed above are “lawyers’ issues”—important, to be sure, to litigators and courts in specific cases—but still peripheral to the central public policy issue of the role that the hostile takeover can and should play in our system of corporate governance. The first question of whether directors of a target company may legitimately resist a takeover illustrates this. In reality, managerial resistance to a takeover has only a marginal impact on the outcome of corporate control contests. In most cases, there is little that the target can do to remain an independent company once a hostile bid has been made, and statistically only about twenty to twenty-five percent of target companies remain independent once there has been an initial tender offer.⁷ Realistically, the target’s choice is between ravishment by the hostile suitor or a hastily arranged shotgun wedding with the “white knight.”

6. Wealth transfers can occur in a variety of ways in takeovers. Bidders can overpay for the target firm, thereby indirectly transferring wealth from shareholders of the bidder to shareholders of the target. Conversely, if target shareholders are compelled to sell their shares to the bidder at a price below their pre-tender offer trading price in the market (which may happen when there is a partial tender offer for less than all the target’s shares followed by a takeout merger at a price below the original market price), then target shareholders transfer wealth to the bidder’s shareholders. A third technique, which will be discussed *infra* notes 301–09 and accompanying text, is a wealth transfer within a single firm. An example would be one in which the value of the bidder’s common stock goes up in the wake of an acquisition, but the value of its previously outstanding debt securities goes down because of the risk associated with the increased leverage in the bidder’s capital structure. See *infra* note 306 and accompanying text. Wealth transfers may result either from an error of judgment (i.e., the bidder pays too much because it overvalues the target) or from a conflict of interest (i.e., the bidder pays too much because its management is more interested in increasing the size of its corporation than in maximizing value for shareholders). Similarly, on the target’s side, wealth transfer may occur as a result of a conflict of interest (such as a takeout merger at a depressed price because the majority shareholder is seeking to take the target corporation private) or because an unaffiliated bidder can credibly threaten that shareholders who do not tender to it will be eliminated in a takeout merger at a lower price.

Even if wealth transfers are seen as exploitative, it does not follow that therefore they are inefficient. In effect, they transfer money from the pockets of one class of shareholders to those of another, which is a result that does not reduce aggregate shareholder wealth. See Carney, *supra* note 1, at 344 n.15. Decreases in aggregate shareholder wealth occur only in those cases where one party’s loss exceeds the other party’s gain. For example, if the stock of the bidder were to fall by \$10 million in the aftermath of an acquisition in which it paid an \$8 million premium to the target, and this decline were the market’s response to the takeover, there would be an aggregate loss of \$2 million. This Article would describe such a transaction as an “inefficient control transfer.” Still, although one can object to a transaction involving a wealth transfer as unfair because it was either accomplished in a coercive way or as a result of a conflict of interest, these factors do not alone make the transaction inefficient.

7. Various statistics exist on this point, and they vary from period to period. The most recent data compiled by W.T. Grimm & Co. shows that between 1979 and 1982, 75% of 299 cash tender offers made were completed successfully; about half of the targets in this study that successfully resisted an initial hostile offer were eventually taken over by a white knight. See Bleakley, *The Perils of the Takeover Game*, N.Y. Times, Jan. 15, 1984, at F10, col. 2. For earlier periods, see Austin & Mandula, *Tender Offer Trends in the 1980s*, *Mergers & Acquisitions*, Fall 1981, at 46–47

Either way, the eventual displacement of senior management is likely.⁸ Moreover, because fiduciary duties are typically enforced through derivative actions, any attempt to redefine fiduciary duties in order to restrict defensive tactics is likely to founder on the general unwillingness of courts to expose corporate officials to enormous financial liability, at least in the absence of unequivocal misbehavior.⁹ Thus, the more important policy question is the broader issue of implementation—what alternative mechanisms of social control are available besides direct litigation against corporate officials?

The need for a broader focus also requires redefinition of the second question of whether the target should be permitted to conduct an auction once a hostile bid has been made. Opponents of auctions argue that they chill the incentive of the first bidder to search out undervalued corporations, and thus

(estimating that less than 20% of target corporations survive as independent companies); M. Lipton & E. Steinberger, *Takeovers and Freezeouts* § 1.1.6, at 6 (1978). The odds, however, may shift in the target's favor to a fifty/fifty probability of successful resistance once the size of the target exceeds \$1 billion in market value of its securities. Thus, a memorandum circulated to its clients by the Wachtell, Lipton, Rosen and Katz law firm in 1981 concluded that "the authors' own experience indicates that about 10 percent of the targets of cash tender offers for all of the shares of the target remain independent, but . . . where the target is a large company, i.e., market value of \$1 billion or more, more than 50 percent remain independent." *Takeovers: An Outline of Current Practice* (unpublished) § 1.4, at 7-8 (1981).

8. One survey by Lamalie Associates, Inc. covering takeovers involving \$300 million or more between 1978 and 1982 found that 52% of the executives in the target company that is taken over leave within three years. See Antilla, *Takeovers: Who Stays On?*, *Dun's Bus. Month*, Jan. 1982, at 107; see also *infra* notes 265-89. For a follow-up study of executive departure in the wake of a hostile takeover, see Ingrassia, *Employees at Acquired Firms Find White Knight Often Unfriendly*, *Wall St. J.*, July 7, 1982, at 23, col. 3; Tomasson, *The Trauma in a Takeover*, *N.Y. Times*, Jan. 9, 1982, at 31, col. 3 (follow-up of acquisitions of Kennecott, Conoco and Texasgulf).

Although patterns vary, the displacement of senior management is particularly likely because their former responsibilities for strategic planning and capital budgeting disappear once the firm becomes a captive entity within a larger organization. For a further analysis of executive turnover in hostile takeovers, emphasizing that many departures are also voluntary, see *infra* notes 265-74 and accompanying text.

9. This author has previously argued that courts have historically been reluctant to expose corporate fiduciaries to potentially astronomical liabilities unless the underlying conduct strikes them as morally egregious. As a result, the traditional duty of due care is likely to be enforced by courts only if liabilities are reduced to a reasonable level by imposing a ceiling on maximum liability. See Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 *Colum. L. Rev.* 261, 316-18 (1981); see also American Law Institute, *Principles of Corporate Governance and Structure: Restatement and Recommendations* § 7.06(d) (Tent. Draft No. 1, 1982) (adopting such a ceiling). The judicial nullification thesis that courts will not enforce even desirable standards if the penalties seem disproportionate—a phenomenon much evidenced in the history of the criminal law when capital punishment was the prescribed penalty for minor offenses—applies as well in the context of takeover defensive tactics, where outside directors who do not materially benefit typically approve the defensive tactic and may face enormous potential liability. Other commentators have agreed with the assessment that courts are unwilling to impose financial liability on such persons for takeover defense tactics and so have recommended injunctive remedies under federal law. See, e.g., Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 *Vand. L. Rev.* 1087, 1120 n.189 (1982) (citing § 7.06 of ALI statement).

reduce the likelihood of an offer being made.¹⁰ Proponents of auctions reply that competitive control contests promote allocative efficiency by directing assets to their highest valued use.¹¹ The winning bidder presumably pays the highest price, they argue, based on its belief that it can realize greater value from the target's assets than can the other bidders. Even within the four corners of this debate, it should be obvious that more needs to be considered than simply the behavior permitted of target management. Depending on how takeovers are evaluated, a variety of means exists by which the law can facilitate or retard an auction market for corporate control, or otherwise influence the frequency of takeovers, and the importance of many of these overshadows the attempted regulation of target management's conduct.¹²

Finally, the third question—do takeovers in the aggregate promote or retard economic efficiency?—illustrates the fallacy of overaggregation by ignoring the possibility that takeovers may have offsetting and inconsistent effects. An exclusive focus on their aggregate impact masks precisely the question on which public policy should most carefully focus: are there diseconomies that regulatory measures or other public policy choices can minimize? Once the issue of the diseconomies in takeovers surfaces, the critical question in the debate over the auction market becomes whether a higher frequency of takeovers would exacerbate these diseconomies.

What then are the most fundamental issues surrounding the hostile takeover? This Article would state them in descending order of significance as follows:

10. If a potential hostile bidder knows that the target will go to the highest bidder in a competitive auction, or that management can favor a "white knight" bidder by issuing authorized but unissued shares from the corporate treasury at a price below the hostile bidder's bid (execute a "lock-up"), the hostile bidder's incentive to search for potential targets is chilled. See Easterbrook & Fischel III, *supra* note 1, at 2-3. One study of competing bids found that the first bidder was unsuccessful in acquiring control of the target in 75% of the cases in which a competing bid was made. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 *J. Fin. Econ.* 141 (1983). Such a pattern should be visible to the potential hostile bidder and should chill its incentive, unless other special factors are present. See *infra* notes 86-92 and accompanying text.

Nonetheless, before one concludes that the current market for corporate control is unduly chilled, it must be noted that in 1983, according to W.T. Grimm & Co., the leading tabulator of such data, the number of announced acquisitions reached 2,422—a nine-year high—and involved a total consideration of \$73.5 billion. See Williams, Frenzy and Style in the Merger Boom, *N.Y. Times*, Jan. 15, 1984, at F1, col. 2.

11. It is an uncontroversial proposition of economics that the highest bidder in an auction is likely to be the most efficient user of the assets being sold. See, e.g., Bebchuk, *supra* note 1, at 1048. Absent an auction, assets might still move to their highest valued use, but with greater transaction costs and delay.

12. For example, extending the period the offer must remain open encourages an auction market and reducing that period discourages one. Auctions can also be facilitated or discouraged by the legal treatment accorded two-tier or partial bids, exchange offers of bidder securities for the target's securities, and lock-ups. If one wished wholly to discourage auctions, the most direct remedy would be to accord the first bidder an exclusive period in which to consummate its offer, forbidding competing bids during this period.

(A) What is the potential capacity of the hostile takeover as a mechanism of corporate accountability? How should it be reconciled with other alternative mechanisms that rely either on internal monitoring within the firm or other external monitors, such as courts or public agencies?

(B) Are there diseconomies that would be associated with greater reliance on the hostile takeover? Can these diseconomies be minimized without also reducing the disciplinary capacity of the takeover or decreasing shareholder wealth?

(C) Would a policy intended to maximize the frequency of takeovers necessarily maximize the wealth of target and bidder shareholders or of all shareholders generally?

The difference between these two sets of questions is the difference between a monolithic theory of the hostile takeover and a pluralistic one—between certainty and a degree of agnosticism. Only the second set asks if we can disaggregate the takeover phenomenon in order to adjust the relative balance between the social benefits and diseconomies associated with takeovers. That these latter questions have not been extensively discussed is largely attributable to the “all or nothing” character of the recent debate. Much as ships pass in the night, the two principal sides have not engaged each other in a focused dialogue, but have simply asserted arguments based on conflicting premises.

On one side, those writing in the “law and economics” tradition have shared a fundamental premise—namely, that the hostile takeover performs a desirable disciplinary function by replacing inefficient management, deterring fiduciary abuse and enforcing greater sensitivity on the part of management to the market’s judgment.¹³ The root source of this tradition is the classic article by Henry Manne, written almost twenty years ago, which identified the

13. This thesis received a qualified endorsement in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). Justice White’s majority opinion describes the hostile tender offer in the following terms: The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.

Id. at 643. The opinion then cites Easterbrook & Fischel I, *supra* note 1, and Fishel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 *Tex. L. Rev.* 1 (1978), to substantiate this proposition. 457 U.S. at 643–44.

In contrast, the SEC Advisory Committee on Tender Offers has produced a report which is far more equivocal in tone about the efficiency-enhancing characteristics of the hostile takeover. See SEC Tender Offer Report, *supra* note 3. It finds

After considerable study, discussion and consideration of commentators’ views, the Committee finds that there is insufficient basis for concluding that takeovers are either *per se* beneficial or detrimental to the economy or the securities markets in general, or to issuers or their shareholders, specifically. While in certain cases takeovers may have served as a discipline on inefficient management, in other cases there is little to suggest that the quality of management of the target company was at issue. Similarly, while the

“market for corporate control” as a major constraining force on managerial discretion and inefficiency.¹⁴ Since the appearance of Manne’s seminal piece, his ideas have been extended and formalized by a host of subsequent writers to the point that it is now commonplace within this literature to describe the hostile takeover as the principal mechanism of corporate accountability.¹⁵

Although this Article agrees that the capital market can and does perform a socially desirable function in monitoring and deterring managerial inefficiency, it will argue this thesis has been overstated and has not received the critical scrutiny it deserves. Two basic criticisms will be advanced. First, the discipline generated by the market for corporate control is sufficiently limited that it can serve only as a remedy of last resort for massive managerial failures and not as the principal enforcer of corporate accountability. Second, any attempt to significantly increase the frequency of hostile takeovers may lead to serious diseconomies.

On the other side of this debate, the critics of takeovers have largely disdained any attempt at economic analysis and have instead formulated a critique of hostile takeovers that often seems to border on old-fashioned populism. Some of these critics have advanced broad claims, arguing either (a) that hostile takeovers produce only “paper profits” and a preoccupation with short-run profit maximization, which undesirably divert management’s attention from the pursuit of greater operational efficiency,¹⁶ or (b) that the stock

threat of takeover may cause certain managements to emphasize short term profits over long term growth, there is little evidence that this is generally true Therefore, the Committee concluded that the regulatory scheme should be designed neither to promote nor to deter takeovers.

Id. at xvii. In this Article’s view the last quoted sentence is a *non sequitur*, because in the light of the conflicting evidence and opinions, the Committee should have considered how to maximize the benefits and minimize the liabilities associated with takeovers. Still, it is obvious that the professionals in this field (who primarily staffed the Committee) have more doubts than did the Supreme Court in *Edgar v. MITE Corp.* about the effects of the hostile takeover.

14. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965). Manne’s focus was not specifically on hostile tender offers, which were then just beginning to become highly visible, but rather on acquisitions, mergers, and control contests generally.

15. See, e.g., Gilson I, *supra* note 1, at 841 (“Indeed, . . . the market for corporate control may be the only potentially serious force for limiting management discretion.”). This Article will argue that this view both overstates the potential of the market for control and understates the potential efficacy of other modes of corporate accountability—such as independent boards or intra-corporate litigation. More importantly, a choice between them is not necessary, except to the extent that total reliance on the market for control inhibits or preempts internal monitoring controls. In addition, before one writes off modes of accountability other than the capital market, it must be observed that no mechanism including the capital market has been systematically implemented. Not only are managerial efforts to resist a takeover permitted and shark repellent provisions upheld, but other modes of accountability are also constrained. Independent boards are compromised by the widely prevalent practice of allowing incumbent management to dominate their selection. The potential utility of derivative litigation is largely checked by the doctrine that the board may terminate litigation it deems not to be in the corporation’s best interest. See Coffee & Schwartz, *supra* note 9.

16. See R. Reich, *supra* note 5, at 140–72.

market is so inefficient as to make it unlikely that tender offers will focus selectively on companies with inferior managements.¹⁷ These assertions suffer from serious flaws: the first claim is essentially an impressionistic critique that relies chiefly on anecdotal evidence and never explains adequately why shareholders should not be able to determine the optimal time frame within which the profits are to be maximized in the business they own.¹⁸ The second claim has only a limited relevance because it fails to appreciate that bidders should still focus disproportionately on marginal firms whose weak managements make possible a turnaround profit, even if the stock market does, as they claim, systematically undervalue all public corporations.¹⁹

As a result, these critics of the takeover have been unable to place their objections within the context of any larger coherent theory that explains why greater reliance on the market for corporate control could be problematic. In contrast, the proponents of the hostile takeover have a clear model of the desirable relationship between shareholders and their management that is rooted in the central assumptions of modern institutional economics. The modern theory of the firm sees the corporation as essentially an agency relationship in which shareholders are the principals and management their agents. From this perspective, the problems of corporate governance are then viewed as those of reducing the "agency costs" that the principals must incur in order to monitor their agents and prevent either fiduciary abuse or indolent "shirking."²⁰ In this view, the market for corporate control provides the

17. See Lowenstein, *supra* note 1, at 268-309.

18. Although some commentary has suggested that, in the absence of the threat of a takeover, management would be free to concentrate on long-term profit maximization, see Hayes & Abernathy, *supra* note 5, at 75-76, it does not follow that the shareholders' interests are necessarily best served by such a focus. Basic financial analysis dictates that payments that are distant in time must be discounted to present value in order to reflect the time value of money and the increased riskiness of the distant payment. This implies, in turn, that current earnings are worth more than distant payments over the long term. In fact, if we assume a corporation with constant earnings, an unrealistic but simplifying assumption, it is clear that at a realistic discount or capitalization rate of 20% the present value of the payments expected over the next five years will exceed the present value of all payments thereafter expected from the sixth year to infinity. In any event, in a reasonably efficient stock market, share prices will reflect whether management is properly optimizing the time frame within which shareholders wish it to maximize profits. If management concentrates excessively on either the long or short term, share prices will fall. Hence, the standard assumption in corporate finance theory is that management should seek to maximize the value of the corporation's shares, since this will necessarily involve the appropriate tradeoff that shareholders desire between long- and short-term profit maximization.

19. This argument rests on a faulty premise. No necessary linkage exists between the claim that the stock market is efficient and the claim that hostile takeovers should lead in the aggregate to a substitution of superior management for inferior management. The only assertion critical to the thesis that takeovers discipline management is that an efficient bidder will realize it can earn a superior return by acquiring assets that are currently inefficiently managed, and thus it will offer a premium to the firm's existing stockholders. Only if the stock market is so perversely inefficient that it capitalizes inefficient firms at a higher value than efficient firms is this premise contradicted. This argument is further developed *infra* notes 65-72 and accompanying text.

20. The standard statement of this theory is set forth in Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976);

optimal mechanism for reducing agency costs.²¹ Whenever a corporation's shares sink below their potential value under efficient management, an incentive arises for a superior management to purchase the company at this discounted price and so realize the turnaround profit. The constant search for these discounted bargains, it is argued, both motivates the managements of marginal firms toward increased performance, lest they become targets, and deters conduct injurious to shareholders—all without the need for regulatory intervention. If accepted, this theory suggests a policy prescription that some proponents of hostile takeovers have been quick to endorse: the more the law can reduce the tender offer premium necessary to secure working control of the target corporation, the easier and more frequent hostile takeovers will become, thereby reducing agency costs and increasing shareholder wealth.²² This Article will refer to such a policy as a "zero premium policy."

The fuller implications of this prescription will receive a closer examination shortly. The point of immediate relevance is that, given the focus of modern institutional economics on the desirability of reducing agency costs, the recent critics of hostile tender offers have not countered, or even re-

see also Fama, *Agency Problems and the Theory of the Firm*, 88 *J. Pol. Econ.* 288 (1980) (recommending primary reliance on compensation incentives as a means of ensuring efficiency in management); Fama & Jensen, *Separation of Ownership and Control*, 26 *J. L. & Econ.* 301 (1983) (advocating a decision hierarchy to monitor and ratify agents' decisions). Essentially, the Jensen and Meckling article reinterpreted the famous Berle and Means thesis that the separation of ownership and control in large organizations implied that management was unconstrained by its stockholders. Under this view management in effect hired capital, rather than itself being hired by shareholders. See A. Berle & G. Means, *The Modern Corporation and Private Property* (1932). As reinterpreted by Jensen and Meckling, the modern theory of the firm recognizes that stockholders cannot be assured of the faithful performance of their agents—the management—and that therefore costs—referred to as "agency costs"—must be borne to restrain managers from "shirking" or entering into self-dealing transactions. However, Jensen and Meckling hypothesize that the owners of the firm can align management's interests with their own through contractual devices—such as performance-based compensation or stock options—so as to give management a strong incentive to maximize the value of the firm's shares. Jensen & Meckling, *supra*, at 323-38. For a different view of the relationship between shareholders and managers, which does not see either as the agent of the other, but rather sees both as coventurers, see Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 *Yale L.J.* 1521 (1982).

21. For an unqualified statement that the hostile tender offer can discipline inadequate performance and self-dealing, see Easterbrook & Fischel I, *supra* note 1, at 1169-71. In their analysis, Professors Easterbrook and Fischel explicitly use the term "agency costs," and view the primary motivation for takeover activity to be the expected "reduction in agency costs, which makes the firm's assets worth more in the hands of the acquirer than they were worth in the hands of the firm's managers." *Id.* at 1173. They argue that both shareholder monitoring and intra-firm monitors such as independent directors are inadequate to reduce such costs. *Id.* Thus they conclude that a hostile bidder is the best monitor because it can surmount the free rider problem that leaves individual shareholders without substantial incentives to expend resources on monitoring and enforcement. This Article agrees that the free rider problem confounds shareholder monitoring as an enforcement device. It argues, however, that Professors Easterbrook and Fischel give an inadequate account of the potential of intra-firm monitoring. See *infra* notes 254-63 and accompanying text.

22. See Easterbrook and Fischel II, *supra* note 1, at 698, 714-15, 737.

sponded to, the basic policy premises of the foregoing model. Objections about a preoccupation with short-term profit maximization, the diversion of managerial attention, or the irrationality of the stock market simply do not lead to a joinder of the critical issue: whether we should seek to maximize the frequency of hostile takeovers in order to minimize the "agency costs" that shareholders must incur to hold their management accountable.

Accordingly, the challenge for those who doubt that the hostile takeover can serve as the primary engine of corporate accountability is to explain coherently why the market for corporate control is not alone adequate to monitor corporate fiduciaries. That challenge defines the principal focus of this Article. This Article will argue that any program that seeks to maximize the frequency of takeovers will likely fail to minimize agency costs to the same degree that other techniques of accountability can and also seems likely to produce significant diseconomies that will adversely affect not only shareholder welfare but also the more important goal of the efficient allocation of economic resources. This argument does not deny that the hostile takeover can play a substantial role in reducing agency costs, but rather postulates that a zero premium policy will prove ultimately counterproductive to this goal.

Because this Article makes several interconnected arguments, a roadmap of its contents seems desirable at the outset. This Article is in four parts. Part I examines the existing debate, which has focused on the interests of shareholders in wealth maximization. It attempts to identify the various factors that must be balanced in determining whether shareholders benefit more from a policy that attempts to maximize the frequency of hostile takeovers or from one that seeks to induce an auction and thereby minimize takeover frequency by raising the premium necessary to obtain control. In focusing on the relationship between the size of the takeover premium and the frequency of takeovers, Part I submits that this relationship provides the optimal policy lever by which to regulate the market for corporate control. Because the relationship is an inverse one, Part I argues that a conscious policy aimed at affecting the size of the takeover premium represents the soundest, least intrusive form of public regulation of the market for corporate control.

Part II then seeks to measure the potential disciplinary capacity of the hostile takeover as an instrument of corporate accountability. It concludes that the disciplinary capacity of the takeover is substantial, but limited.

Part III examines the potential diseconomies associated with takeovers and argues that they would be exacerbated by a significantly higher frequency of takeovers. Part III will argue that four principal diseconomies are risked by a movement toward a substantially higher frequency of takeovers.

First, a higher frequency of takeovers may enhance the likelihood of inefficient transfers of control.²³ In part, this conclusion relies on the argu-

23. An inefficient transfer of control is one in which assets move from a more efficient user to a less efficient one. In such an instance, there is a social welfare loss in addition to possible wealth transfers between the two classes of participating shareholders. If it is assumed that the

ment that the bidder's management has an incentive to undertake size-maximizing acquisitions, which serve management's interests but represent essentially a transfer of wealth from the bidder's shareholders to those of the target. Well-known literature on the economies of the firm has long argued that managements seek to maximize growth even when it is contrary to the shareholders' best interests.²⁴ But such "empire building" is not the only way in which inefficient transfers could occur. More generally, the likelihood of erroneous business decisions may be significantly enhanced when a bidder, acting on information relatively inferior to that possessed by the target's management, is enabled to obtain working control of a corporation and reverse existing policies. Put more simply, low takeover premiums invite the bidder to undertake a "crapshoot," despite its inferior knowledge of the nature of the gamble, while high takeover premiums, such as those a competitive auction market ensures, require the bidder to be more certain that its judgment is superior to that of the target's management.²⁵

market is efficient, an inefficient transfer of control would be demonstrated if the postacquisition value of the bidder's securities in the market plus the total cash consideration paid the target's shareholders were less than the pretransaction value of the bidder's and target's securities, determined as of a date reasonably before the transaction's announcement and with all stock prices adjusted for market movements. This Article does not contend that such transfers will predominate over efficient transfers (that is, those in which the posttransaction values computed as explained above exceed their pretransaction values), but that they will increase as a proportion of all takeovers, and at some point increase to such a degree as to reduce the aggregate social welfare gains from takeovers.

24. The "managerial literature" of the firm includes writings by such economists as William Baumol, John Kenneth Galbraith, Oliver Williamson, Robin Marris and Harvey Leibenstein; the intellectual antecedents of this school can be found in the work of Nobel prize winner Herbert Simon. Although each of these writers sketches a slightly different model, their models share common elements, including (1) a tendency for growth maximization to be preferred by managers over profit maximization, (2) substantial opportunities for managerial discretion, including the discretion to consume perquisites, (3) a desire to expand staff, and (4) a failure to pursue cost minimization strategies, except in times of severe financial constraint. Under each of these models, acquisitions may be desired by the bidder's managers where they would be unprofitable to its shareholders. For their relevant works, see W. Baumol, *Business Behavior, Value and Growth* (rev. ed. 1967); J. Galbraith, *The New Industrial State* (1967); O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975); O. Williamson, *Corporate Control and Business Behavior: An Inquiry Into the Effect of Organization Form on Enterprise Behavior* (1970); O. Williamson, *The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm* (1964); Leibenstein, *Allocative Efficiency vs. "X-Efficiency,"* 56 *Am. Econ. Rev.* 392 (1966); R. Marris, *The Economic Theory of "Managerial" Capitalism* (1964); Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 *J. Econ. Lit.* 32 (1980). Professors Easterbrook and Fischel offer a brief refutation of the managerial literature in their first article. See Easterbrook & Fischel I, *supra* note 1, at 1185-86. For a closer analysis, see W. McEachern, *Managerial Control and Performance* 7-21 (1975).

25. This second argument has particular relevance because the motives in corporate control contests have changed over the last two years. Increasingly, bidders are no longer seeking to integrate the target's assets with their own, but instead plan a "bust-up"—a liquidation in which some or all the assets of the inefficient bidder are sold to realize the anticipated margin by which their liquidation value exceeds their "going concern" value. Recent control contests involving

Second, a shift in managerial behavior in the direction of risk preference seems likely. Most obviously, the behavior of target company managements may have already begun to shift in this direction because a regime in which the threat of the takeover were maximized would create an incentive for target managements that were underperforming the market to accept high-risk gambles in order to stave off the threat of a takeover.²⁶ Additionally, potential targets appear to be turning to the leveraged buyout at an increasing rate as an anticipatory response to the threat of a takeover—again with the consequence that a socially undesirable degree of leverage is encouraged. The problem is not limited to target managements but extends to bidders as well. Although concern has been expressed that bidders may on occasion exploit and transfer wealth from target shareholders, another form of wealth transfer seems more likely, but has received less attention: highly leveraged takeovers may transfer wealth from creditors of the bidder to its shareholders.²⁷ This intra-firm wealth promises no increased efficiency, but may give rise to a dubious incentive to increase the degree of leverage in the bidder's financial structure.²⁸ Not only are traditional creditors thereby adversely affected, but so also are other essentially fixed-interest claimants in the corporation, such as employees, who also suffer when increased risk is accepted that promises them no corresponding higher returns.

Third, there is the problem of "excess deterrence." Although it is desirable to deter shirking and fiduciary abuse, the goal of policy planning should be to optimize the level of deterrence, not maximize it. A simple illustration of

TWA, GAF and, most notably, Gulf Oil as targets have all been fueled by the insurgent group's belief that a significant portion of the target's assets should be sold or spun-off. See Nulty, Boone Pickens, Company Hunter, *Fortune*, Dec. 26, 1983, at 54 (describing Mesa Petroleum's proposal to place certain Gulf Oil assets in royalty trust); Spriggs & Tovey, *Breaking Up Gulf*, *N.Y. Times*, Nov. 13, 1983, § 3, at 2, col.2 (debate on wisdom of plan and desirability of insurgent-proposed divestitures); Smith, *GAF Proxy Defeat Reflects Revolt by Impatient Institutional Holders*, *Wall St. J.*, May 12, 1983, at 35, col. 3 (insurgents promised to sell GAF's two main units, its chemical and roofing divisions, if takeover succeeded).

Although such contests may be desirable, this Article will argue that these insurgent groups have, on average, far less information and expertise than target managements; hence, they have a greater potential for error. However, their willingness to pay substantial premiums may evidence a confidence in their judgment that is likely to come either from superior information or from their recognition that the incumbent management is clearly inferior. Thus, this Article argues that policy should encourage payment of a substantial premium in order to discourage less competent or excessively optimistic bidders.

26. The most predictable such gamble is that perceived targets will undertake their own acquisition program. See *infra* notes 299-300 and accompanying text.

27. See *infra* notes 301-10 and accompanying text. Note also that any diseconomy associated with an increasingly leveraged (and hence risky) financial structure will not necessarily be reflected in reduced stock prices for bidder companies, because the burden of this diseconomy falls chiefly on groups other than shareholders. To the extent that shareholders, as residual claimants, and creditors, as fixed interest claimants, have conflicting interests, stock market price data cannot be relied upon as a proxy for overall economic efficiency.

28. See *infra* notes 301-06 and accompanying text.

the difference would be a professor who threatened to flunk the bottom ninety percent of his students. In all likelihood, this would produce not greater motivation, but outrage and fatalistic resignation. Similarly, the motivational impact of the hostile takeover has been inadequately examined. Social scientists and business school academics who have studied the dynamics of organizational change have long warned against simplistic theories of motivation and have stressed the assimilation difficulties that have frequently characterized even friendly acquisitions.²⁹ The simple view that takeovers mean that good managements replace bad oversimplifies the more complex reality that corporate cultures are not easily changed, and abrupt efforts to do so may result more in demoralization than increased efficiency.

Fourth, and possibly most important, any substantial increase in the frequency of control transactions may substantially impair the market for managerial services. Although the point appears to have eluded the proponents of the hostile takeover, this labor market is today probably the primary mechanism by which marginally inefficient corporations can improve their managerial performance. The ability of a marginal firm to improve its efficiency through hiring superior executive talent depends on precisely those conditions that a zero premium policy would eliminate. As executive tenure is made less secure by a higher frequency of takeovers, the capacity of firms to secure executive services predictably will be reduced in direct proportion to their need to resort to it. Correspondingly, the costs of securing superior management will also be increased in proportion to the degree that the corporation is perceived to be a takeover target. This is a socially undesirable result because it interferes with the classic function of a market: namely, the movement of goods or services to those having the greatest need and willing to pay the highest price for them. Indeed, to the extent that managers are discouraged from moving to an insecure position, there may be no realistic risk premium at which corporations needing an infusion of managerial talent can acquire it. Instead, anxious executives may begin to migrate away from marginally inefficient firms. The bottom line, then, is that conditions for perfect efficiency in the market for corporate control may entail substantial inefficiency in the market for executive services.

The linkage between these two markets is emphasized here at the outset to underscore a basic policy choice: one can opt either for moderate reform or for a revolutionary restructuring of corporate governance, but not for both simultaneously. In Judge Friendly's metaphor,³⁰ the hostile takeover represents the corporate guillotine; its sharp blade achieves reform through a traumatic amputation of one senior management staff and the substitution of another. Undoubtedly, there is a role for this remedy, and at times nothing

29. See *infra* notes 286, 288-97 and accompanying text.

30. Judge Friendly has characterized the takeover bid as "the sharpest blade for the improvement of corporate management." See Friendly, *Make Haste Slowly*, in *Commentaries on Corporate Structure and Government* 525, 532 (D. Schwartz ed. 1979).

else will work. But the good physician turns to surgery only as the last resort; to encourage corporate rehabilitation and permit it to work, one must reserve the sentence of the guillotine for those most serious cases when lesser reforms would be inadequate.

Serendipitously, one policy seems capable of doing just this: a policy of encouraging a competitive auction market for corporate control, which should bid takeover premiums up to their highest sustainable level. The prevalence of high takeover premiums should tend to mitigate the foregoing diseconomies without significantly reducing the desirable deterrent impact of the hostile takeover. Although others have argued the case for a competitive auction market as a means of increasing shareholder wealth, the very different focus of this Article will be on the macroeconomic effect of public policies toward the hostile takeover.

These critical comments about the hostile takeover must, however, be kept in perspective. At present, the empirical data provides considerably more evidence that takeovers increase aggregate shareholder wealth than that they decrease it.³¹ The current level of takeover activity thus may provide relatively little cause for alarm. But, the absence of observed adverse effects at the current level of takeover activity does not imply that such effects would not appear if the level of activity were increased to the potentially hyperbolic level that a zero premium policy implies. Once again the danger of over-generalization arises here, because a focus that is restricted to the aggregate effect of takeovers ignores the possibility of offsetting impacts. At any given level of takeover activity, one set of impacts may predominate, while at another level, the reverse may be true. The critical policy question thus becomes how to manipulate those incentives and penalties available to the legal system so as to encourage acquisitions thought desirable and discourage those thought undesirable. In short, how can we best adjust the balance between efficient and inefficient transfers of control?

31. Several studies have found that bidders fail to profit from takeovers, while several have found the converse. See *infra* note 56. However, because all studies agree that target shareholders profit significantly, it seems more likely that the aggregate effect of takeovers, after netting out the potentially different effects on target and bidder shareholders, is positive. That is, the target shareholders appear to gain more than the bidder shareholders lose. Also, because these two classes are at least partially overlapping to the extent that shareholders hold diversified portfolios, there are likely to be relatively few "losers" among shareholders due to the current level of takeover activity. One discordant note must, however, be sounded: Using a different and more sophisticated methodological approach, one recent study of mergers has found that the loss suffered by acquiring-firm shareholders was significant and outweighed the gains experienced by target firm shareholders. See Malatesta, *The Wealth Effects of Merger Activity and the Objective Functions of Merging Firms*, 11 *J. Fin. Econ.* 155 (1983); see also Firth, *Takeovers, Shareholder Returns, and the Theory of the Firm*, 94 *Q.J. Econ.* 235 (1980) (in sample of British firms, gains to target shareholders offset by losses to bidder shareholders); Osborne, *Returns to Shareholders of Acquiring and Acquired Companies: The Case of Acquisitions of Technology-Based Firms in the Over-the-Counter Market* (SEC Capital Market Working Paper No. 3 1980) (finding targets' gain to be matched by bidders' loss).

Based on this mixed assessment of the takeover phenomenon, Part IV then turns to the problem of implementation. It reviews the recent proposals made in the Report of the SEC's Advisory Committee on Tender Offers³² and in the SEC's response thereto. In light of this Article's assessment of the impact of an increase in the frequency of hostile takeovers, Part IV then outlines a balanced policy that seeks to (1) preserve a stable auction market while maintaining an adequate incentive to the initial bidder; (2) discourage inefficient empire building; and (3) focus the deterrent threat of the takeover on those companies having the highest probability of benefiting from a substitution of management. In sum, such an agenda seeks less to chill or encourage takeovers in the aggregate, than to utilize the takeover as an effective, if imperfect, mechanism of accountability. Ultimately, a balanced approach must recognize both the social utility of a market for corporate control as well as the possibility of market failure and the need for limited regulatory interventions.

I. SHAREHOLDER WEALTH MAXIMIZATION: THE FIRST FRAME OF REFERENCE

A sensible public policy assessment of the hostile takeover must begin with a comprehensive model of the interests that are at stake. Target shareholders are not the only group affected by a policy change that either fosters or chills takeovers. Even without considering nonshareholder constituencies,³³ it is evident that both shareholders of the bidder corporation and shareholders of other nonparticipating corporations are also affected to the extent that any resulting increase or decrease in the frequency of takeovers influences corporate behavior generally. Moreover, there may be multiple and even offsetting impacts on each of these groups. In overview, any equation that attempts to assess the wealth effects of a public policy toward takeovers on shareholders must recognize at least the following five variables:

- (1) the policy's impact on the size of the takeover premium that the bidder must pay to obtain control (the "premium size effect");
- (2) its impact on the probability that a tender offer will be made (the "probability effect");
- (3) its impact on the value of the bidder's shares (the "bidder effect");
- (4) its effect on the deterrence of misconduct and inefficiency generally and hence on the value of shares in corporations (the "deterrent effect"); and

32. See SEC Tender Offer Report, *supra* note 3.

33. Much of the adverse impact on nonshareholder groups is simply the normal consequence of the pursuit of economic efficiency, as excess or nonproductive plants, resources, and personnel are eliminated. However, one consequence of a high rate of takeover activity adversely affecting nonshareholder groups—a shift toward greater leverage in corporate financial structures and a higher tolerance for risk than is economically efficient from the overall standpoint of those supplying the firm's capital—may lead to a real diseconomy. See *infra* notes 309-15 and accompanying text.

(5) its negative effect on stock values to the extent it encourages either diseconomies or wealth transfers to nonshareholder classes, such as to creditors or management (the "diseconomy effect").

In this Part, a closer examination will be given to each of these variables affecting shareholder wealth. To date, the principal attempts to assess the impact of the hostile takeover on shareholder welfare have uniformly omitted one or more of these variables from their equation (usually the last two). Section A examines the existing debate and identifies the principal positions taken by prior commentators. Section B then analyzes how the first two of the foregoing variables—premium size and offer probability—are affected by policies that seek to favor or retard an auction market for corporate control. Although there has been extensive debate over this question, section B concludes that this debate is simply not resolvable unless one can estimate the elasticity of demand for corporate control. Next, section C assesses the arguments for and against shark repellent charter amendments as a means of enhancing premium size. Although a case in favor of such amendments is acknowledged, it cannot be adequately assessed without a consideration of the fourth variable listed above—the deterrent effect—which has a probable inverse relationship with the justifications for shark repellents. Section D examines this tradeoff between the deterrent effect and the premium size effect, and, finally, section E undertakes a preliminary examination of one aspect of the diseconomy effect: the likelihood that under a regime of more frequent takeovers, target managements would respond by preempting the control contest with a leveraged buyout.

A. *A Scorecard of the Players and Their Positions*

Those who have sought to explain the phenomenon of the hostile takeover have usually begun with its most striking fact: bidders have been willing to pay extraordinarily high premiums (sometimes over 100%) for the stock of target corporations,³⁴ even though the securities so solicited were presumably

34. Professor Bradley has computed the average premium in a successful tender offer (based on market price two months prior to the offer's announcement) to be 49%. See Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 54 J. Bus. 345 (1980). A later study by Professors Jarrell and Bradley estimated that the average cash tender premium had risen to "about 73%" in the wake of state takeover statutes; this percentage was computed based on the target's share price 40 days prior to the offer. See Jarrell & Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 J. Law & Econ. 371, 373 (1980). Premium size varies over time. Statistics compiled by W.T. Grimm & Co. show that the median premiums paid in public tender offers ranged between 41% and 60% during 1978 through 1980, based on the closing market price for the target company's stock five business days prior to the announcement of the offer. Considerable variations are likely even within a single period; for example, in 1979, when the median was 49.6%, 14 transactions were at premiums under 20% and 7 were at premiums of 99.9% or greater. See W.T. Grimm & Co., *1979 Merger Summary*, figure 26, at 21. Another approach is to measure premium size by computing the rate of return to target shareholders in terms of the "abnormal" return after adjustment for marketwide price changes. Overall, this data appears to show that target shareholders receive "abnormal" returns of approximately 30% from tender offers as opposed to only 20% from mergers. See Jensen &

efficiently priced because they were typically traded on major stock exchanges. Why are such lucrative premiums paid? Most of the explanations can be grouped under one of the following four headings:

1. *The Disciplinary Hypothesis.* — Viewed through the lens supplied by the “market for corporate control” thesis, the role of the tender offer is to replace inefficient management. The bidder, it is argued, pays a premium over the market price because it believes that the target’s assets have not been optimally utilized and that under superior management they would earn a higher return, thereby justifying the tender offer premium. In this light, the higher the premium, the greater the degree of mismanagement that the bidder must perceive.³⁵ So viewed, the hostile tender offer appears a benign and socially desirable phenomenon, which benefits both the bidder and the target’s stockholders, who simply divide among themselves the value that the incumbent management’s inefficiency denied them.

The Disciplinary Hypothesis places special weight on the target management’s resistance to the takeover to demonstrate that the anticipated gain that motivated the acquisition was probably predicated upon the displacement of an inefficient target management. In principle, combining two firms could create value for any of a number of reasons not involving the prior mismanagement of either. Whatever the motive, economic theory predicts that the parties—here, the two classes of shareholders—will voluntarily enter into any mutually advantageous transaction. If one firm is making inefficient use of its assets, the Coase Theorem³⁶ in substance predicts that another firm which can

Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 *J. Fin. Econ.* 5, 7–12 (1983).

35. For a concise statement of this position, see Easterbrook & Fischel III, *supra* note 1, at 1.

36. The Coase Theorem, which is the central organizing principle behind much of the recent “law and economics” literature, can be stated as follows: In the absence of transaction costs, an efficient allocation of economic resources will result, regardless of the content of legal rules of liability. Although the initial placement of legal liability will influence the distribution of wealth between the parties, it will not affect the attainment of a Pareto optimal allocation of resources. For the classic statement of the rule, see Coase, *The Problem of Social Cost*, 3 *J.L. & Econ.* 1, 2–8 (1960).

The proposition is probably best understood in terms of the simple illustration used by Coase. Assume a cattle ranch adjoins a corn field owned by a different farmer. Cows on the ranch tend to invade the cornfield to eat the corn. Although this amounts to a trespass and results in liability for the rancher, Coase shows that to rational individuals this fact is irrelevant to their ability to reach an economically efficient result. The outcome—that is, whether the cows will continue to be allowed to trespass—depends on which activity (ranching or farming) is more efficient. If liability is placed on the rancher, this becomes simply one more cost that he must incur as a cost of production, and he will seek to produce until these marginal costs equal his marginal benefits. Thus, he may either accept liability or pay (“bribe”) the farmer to allow continued trespass. Conversely, if liability were not placed on the rancher, then the farmer incurs an added cost (the corn so consumed or the “bribe” paid to the rancher to stop the trespass), which becomes but another marginal cost to him, and he also will produce to the point that these marginal costs equal the marginal benefits. Either way, the land will be devoted to the more highly valued use. Assuming no transaction costs, rules of legal liability do not affect the outcome, but only the allocation of wealth between the farmer and the rancher, because legal rules determine only which party has to “bribe” the other.

obtain greater value from the same assets will "bribe" the less efficient firm's stockholders to let it do so. This view that "winners bribe losers" implies that an efficient allocation of resources generally will result, regardless of legal rules and without regulatory interventions.³⁷ Normally, this will occur through a "friendly" merger or acquisition, because both sides gain and neither has a reason to resist. Still, the efficient outcome may be frustrated if managerial resistance to the acquisition precludes it. From a Coasean perspective, such resistance is comprehensible only if the interests of the target's management deviated from those of its shareholders. Such a conflict would arise either because the management of the target expected to be replaced by the bidding firm, or because it saw an opportunity to demand a side payment for its acquiescence.³⁸ The significance of this perspective then lies in its clear implication that "hostile" acquisitions are disproportionately motivated by the bidder's desire to realize enhanced value through replacing an inferior management while "friendly" acquisitions are typically motivated by other business considerations that pose less of a threat to the incumbent management.³⁹ This logic also leads to the conclusion that hostile bids have a unique role in corporate governance as a policing mechanism.

Although a variety of objections can be raised against this analysis,⁴⁰ it must be emphasized that the "zero takeover premium" policy advocated by

37. In effect, the bidder shareholders and the target shareholders are in the same position as the rancher and the farmer in Coase's example, *supra* note 36. Although legal rules that entitle the target to resist takeovers allow the target shareholders to hold out for a larger "bribe," such rules should not affect the movement of assets to the more efficient user. In the absence of high transaction costs, rational shareholders will agree to sell the assets if offered a higher price than that justified by their own use of the assets. Although Coase recognized that the efficient result could be prevented by injunctive or similar remedies, he argued in effect that the law should not be abused in this manner, but should encourage the parties to bargain.

38. See Easterbrook & Fischel 111, *supra* note 1, at 1 ("In most cases resistance reflects either mismanagement . . . or manager's self-protection (to the extent its point is to preserve managers' jobs or 'sell' their acquiescence in exchange for bonuses or promises of future employment)."). From a Coasean perspective, managers may in effect be exploiting their ability to veto the transaction to obtain a share of the premium; however, the true Coasean would argue that over the long run this will only redistribute the premium between management and target shareholders and should not interfere with the movement of the assets to their more highly valued use.

39. See *id.* at 1. It may be argued that in Coasean terms, a rule of managerial passivity, such as Professors Easterbrook and Fischel propose, can be seen as a strategy to reduce transaction costs in order to permit the market to operate. However, the managers' desire for a side payment to relinquish control may also be viewed as an attempt to exact a "bribe" from shareholders. From this perspective, "golden parachutes" and similar employment contracts may be desirable because they lubricate the flow of assets to the more efficient bidder, even as they reduce the wealth retained by target shareholders as a result of the takeover. Only if transaction costs were high (an unlikely event, since management can typically enter into such an arrangement when it desires to) would it be explicable to a Coasean why such bribing behavior does not resolve the dispute.

40. The Coase Theorem has elicited a host of critical responses, some attacking it as economically oversimple, others as politically reactionary, and still others as psychologically distorted. For a representative sample, see Cooter, *The Cost of Coase*, 11 *J. Legal Stud.* 1 (1982); Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 *S.*

Professors Easterbrook and Fischel is far from a faithful extension of the Coase Theorem to the context of corporate control transactions. To be sure, the usual logic of the Coase Theorem would support restrictions on the defensive tactics that target managements may employ if those restrictions would enable the market to function. That corporate law usually entitles the board of directors to set corporate policy⁴¹ is irrelevant to the Coasean analysis. Once such restrictions were imposed, a Coasean analysis would then predict that, so long as the parties were able to bargain, assets should move, directly or indirectly, to more efficient users. Yet, it is exactly this bargaining that a zero premium policy attempts to constrain by denying target shareholders the ability to obtain an above-market price for their shares. Thus, the zero takeover premium policy advocated by Professors Easterbrook and Fischel goes well beyond the minimal goal of preventing management from blocking the market's operation and actually seeks to dictate the terms of the bargain, thereby influencing the wealth distribution between the parties.⁴² In short,

Cal. L. Rev. 669 (1979); Kennedy, Cost-Benefit Analysis of Entitlement Problems: A Critique, 33 Stan. L. Rev. 387 (1981); Regan, The Problem of Social Cost Revisited, 15 J.L. & Econ. 427 (1972). For a response to these criticisms, see Hoffman & Spitzer, The Coase Theorem: Some Experimental Tests, 25 J.L. & Econ. 73 (1982).

Many of these criticisms are relevant in the takeover context. For example, Professor Kelman has argued that individuals do not treat opportunity cost income as "real income." See Kelman, *supra*, at 678-80. This claim might explain why managers resist hostile bids and refuse in effect to cash in their chips by accepting a bribe in return for acquiescence. Even though their blocking position has value, the realization of that value would merely represent a form of consumption that is unattractive to them. This author believes that a greater problem lies in the tendency of many individuals, particularly previously successful corporate managers, to overvalue their own abilities. Within the takeover context, this has a dual significance. Target managers resist the offered premium for their company's shares because they believe they can improve the corporation's performance so that its value will exceed the premium. Correspondingly, bidders overpay because they tend to exaggerate their own competence as managers and so think that an excessive premium is justifiable. However, this view is not central to the position taken in this Article.

41. Generally, corporate law allocates the control of the corporation's business and affairs to the board of directors and not to shareholders. See Model Business Corp. Act § 35 (1971); N.Y. Bus. Corp. Law § 701 (McKinney 1963). Sales of the corporation's assets or mergers must similarly be approved first by the board and only then ratified by shareholders. Some have therefore objected that the hostile tender offer creates a "crack in the statutory scheme" which permits shareholders to make a decision functionally similar to those entrusted to the board. See Lowenstein, *supra* note 1, at 263-68. But see Gilson I, *supra* note 1, at 848-52. From a Coasean perspective, however, this is a debate only over legal rules, which by definition are irrelevant to the achievement of the efficient outcome and only affect the allocation of wealth. See *supra* note 39.

42. A rule of managerial passivity can be defended as simply an effort to reduce transaction costs and thus permit the market to operate freely. Accordingly, the position taken by Professors Easterbrook and Fischel is compatible with a neo-classical perspective in this respect. In their second article, however, they advance the broader proposition that takeover premiums should be reduced in a manner that permits all gains to be appropriated by the bidder. See Easterbrook & Fischel II, *supra* note 1, at 698, 708-15. In Coasean terms, this is the equivalent of arguing that the rancher should be able to acquire the farmer's property for use by his cows at the minimum possible price. See *supra* note 36. The Coase Theorem, however, does not concern itself with the redistributive effects of the transaction.

such a program is heretical even from a neo-classical economic standpoint, because it fundamentally seeks to subordinate normal market processes to an ulterior goal. Not surprisingly, this program has been resisted even by those who share the same fundamental premises with Professors Easterbrook and Fischel.⁴³

Still, the Easterbrook & Fischel version of the Disciplinary Hypothesis does consciously address the first four of the variables specified at the outset of this Part. Only the fifth variable—the possibility of diseconomies affecting shareholders—is not explicitly addressed by them.

2. *The Synergy Hypothesis.* — An alternative explanation of the hostile takeover views the takeover premium as justified not by the sub-optimal performance of the target, but rather as the result of the target's having a unique value to the bidder that is in excess of its value to the market generally. Put simply, the value of the combined enterprise is expected to be greater than the sum of its separate parts as independent companies. Such "synergistic gains" may be the result of a variety of factors that are independent of the inefficient management thesis: unique product complementarity between the two companies, specialized resources possessed by the target, economies of scale, cost reductions, lowered borrowing costs, or the capital market's response to the combined enterprise.⁴⁴ Professor Gilson and Lucian Bebchuk have separately articulated this view in a series of carefully reasoned articles.⁴⁵ However, their thesis is subject to two important objections. First, studies of postacquisition experiences of acquiring companies have typically found that the expected synergy seldom materializes in the form of higher profits.⁴⁶

43. See Carney, *supra* note 1, at 343–45 (arguing that shark repellent provisions are rational actions taken by shareholders of target corporations to reduce coordination costs and to protect themselves from exploitative takeovers).

44. Synergies can be divided into two distinct kinds: operating and financial. Operating synergy, for instance, would occur if combining the two firms made possible the elimination of excess facilities or staff. Financial synergy is less obvious. To the extent that the acquired firm's business cycle offsets downturns in the bidder's business cycle, then combining the two co-variant earnings streams would produce a steadier, less volatile earnings stream. The reduced risk of bankruptcy may result in lower borrowing costs and a higher stock market capitalization. On this rationale, the conglomerate firm should seek to acquire a portfolio of companies to achieve efficient diversification. See Brick, Haber & Weaver, *Financial Motives in Conglomerate Mergers: An Empirical Test*, in *Mergers and Acquisitions: Current Problems in Perspective* 205 (M. Keenan & L. White eds. 1982); Salter & Weinhold, *Diversification via Acquisition: Creating Value*, *Harv. Bus. Rev.*, July-Aug. 1978, at 166. For a general evaluation of the types of synergies in acquisitions, see Alberts, *The Profitability of Growth by Merger*, in *The Corporate Merger* 247, 247–62 (W. Alberts & J. Segall eds. 1966); Myers, *A Framework for Evaluating Mergers*, in *Modern Developments in Financial Management* 633, 633–45 (S. Myers ed. 1976).

45. See sources cited *supra* note 1.

46. For critical reviews of the postmerger performance of acquiring companies, see M. Salter & W. Weinhold, *Diversification through Acquisition: Strategies for Creating Economic Value* 27–32 (1979); Gort & Hogarty, *New Evidence on Mergers*, 13 *J.L. & Econ.* 167, 177 (1970); Hogarty, *The Profitability of Corporate Mergers*, 43 *J. Bus.* 317, 325–26 (1970); Langetieg, *An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Merger*, 6 *J. Fin.*

Second, this theory gives little attention to the disciplinary or deterrent impact of hostile takeovers.⁴⁷ These flaws do not invalidate the theory, but do suggest that it is only a partial explanation.

3. *The Empire Building Hypothesis*. — A more skeptical explanation for high takeover premiums begins from the obvious possibility that the bidder simply may have overpaid.⁴⁸ Those who take a “behavioral” view of the modern corporation have long argued that firms tend to maximize size, not profits.⁴⁹ Management may pursue size maximization, even when it is not in the interests of shareholders, for any of a variety of reasons: (1) greater size tends to correspond with higher compensation for management;⁵⁰ (2) increased size implies greater security from a takeover or other control contest;⁵¹ (3) enhanced prestige and psychic income are associated with increased size and national visibility;⁵² (4) greater size often translates into oligopolistic

Econ. 365 (1978); Mason & Goudzwaard, *Performance of Conglomerate Firms: A Portfolio Approach*, 31 *J. Fin.* 39, 45 (1976).

47. Because Professor Gilson argues that an auction market should not come at the price of a reduced frequency of takeovers, he need not concede this lesser deterrent effect. But see *infra* notes 86-95 and accompanying text.

48. For a strong statement of this position, see Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 *Yale L.J.* 1238, 1246-47 (1979); accord S. Reid, *Mergers, Managers and the Economy* 148-49 (1968).

49. See, e.g., W. Baumol, *supra* note 24, at 96; R. Marris, *supra* note 24, at 101-07; E. Penrose, *The Theory of the Growth of the Firm* (1959); Mueller, *A Theory of Conglomerate Mergers*, 83 *Q. J. of Econ.* 643 (1969); cf. E. Herman, *Corporate Control, Corporate Power* 97-98 (1981) (“but growth without a profit payoff is quite generally regarded in the business community as unsuccessful growth”). The thesis that there is a desire to build empires was also recognized long ago by famous economists, such as Joseph Schumpeter and Frank Knight. See W. McEachern, *supra* note 24, at 19.

50. Most of those taking a “behavioral” view of the firm have emphasized the connection between firm size and executive compensation in order to argue that managers have an incentive to seek growth for its own sake. Early data showing that executive compensation was more closely tied to revenues than to profits strongly supported this view. See D. Roberts, *Executive Compensation* 50-108 (1959). More recent reinterpretations have criticized the handling of this evidence. See McEachern, *supra* note 24, at 25-30, 64. McEachern’s own data finds this thesis invalid in cases where the firms have dominant shareholders, but more likely to be true for firms that lacked dominant shareholders. *Id.* at 112-13; see also E. Herman, *supra* note 49, at 96-98 (evidence mixed and inconclusive, but finding some connection between size variables and executive compensation). Still, a recent study of executive compensation in 140 large corporations by *Fortune Magazine* found no correlation between the chief executives’ compensation and return on shareholders’ equity, but a relatively high correlation between compensation and company size. See Loomis, *The Madness of Executive Compensation*, *Fortune*, July 12, 1982, at 42-52.

51. The Conoco, Getty, and Gulf acquisitions indicate that immunity from a takeover bid may not exist at any size. It is widely recognized, however, that increased size does decrease the likelihood that a bid will succeed. See E. Herman, *supra* note 49, at 101 (threat of a takeover “pushes . . . [managements] also toward growth to takeover-free size”). More generally, it has been argued that diversification through acquisitions reduces the manager’s risk because it makes his firm’s earnings more stable. See Note, *supra* note 48, at 1243-44; see also *supra* note 44.

52. The classic statement that empire building is a dominant motive of management because it seeks thereby to maximize its power, perquisites and prestige is to be found in R.A. Gordon, *Business Leadership in the Large Corporation* 305-12 (1945).

market power;⁵³ or, finally, (5) expansion offers opportunities for advancement to the executive staff of the bidding firm.⁵⁴ Under this "empire building" thesis, the high premiums paid in tender offers are less an indication of the potential latent in the target's assets than of an overly optimistic assessment by the bidder of its own capabilities as a manager. From this perspective, the takeover process may result not in greater efficiency, but only in a net transfer of wealth from the bidder's shareholders to those of the target.⁵⁵ Much empirical data suggest that these wealth transfers occur frequently, but it is considerably more difficult to argue that they predominate.⁵⁶ Nonetheless, the Empire Building Hypothesis suggests that the most important conflict of interests in corporate control contests may be on the bidder's side of the transaction—between the interests of the bidder's management and those of its own shareholders.⁵⁷ In any case, as a model which explains takeover

53. On the aggregate level, the data provide little support for the conclusion that mergers and takeovers have significantly affected aggregate concentration. See White, *Mergers and Aggregate Concentration*, in *Mergers and Acquisitions: Current Problems in Perspective*, supra note 44, at 97-111. But in any individual case, this motive may exist. Thus, for example, Mobil Oil met resistance from the Justice Department when it sought to bid for Conoco. See Ruback, *The Conoco Takeover and Stockholder Returns*, *Sloan Mgmt. Rev.*, Winter 1982, at 13, 20.

54. Cf. R. Marris, supra note 24, at 64 (noting that "expansion increases the number of high-level posts to be filled by internal promotion").

55. For a concise statement of this thesis, see Note, supra note 48, at 1238; see also Gort & Hogarty, supra note 46, at 183 (similar statement).

56. It is undisputed that in some cases bidder-shareholders have experienced dramatic declines in stock values in response to a takeover bid. In the DuPont acquisition of Conoco, for example, DuPont paid \$7.54 billion, at that time the largest acquisition in U.S. history. The value of DuPont stock fell by \$789 million (a 9.9% drop), and a \$641 million decline occurred on the day of the offer's announcement. See Ruback, supra note 53, at 17, 19, 21. Similarly, Texaco's recent offer of \$9.9 billion for Getty may have been excessive in light of the stock market's capitalization of Texaco, a much larger company, at "just over \$9 billion"; in effect, Texaco will be paying a higher price for Getty's reserves than the stock market appears to place on its own vastly larger reserves. See Nulty, *How Texaco Outfoxed Gordon Getty*, *Fortune*, Feb. 6, 1984, at 106, 109; see also MacAvoy, *What's All the Merging About?*, *N.Y. Times*, Apr. 11, 1982, at F3, col. 1 (arguing that no justifiable basis exists for the premiums paid in some recent takeovers). Similarly, a study by First Boston Corp. of recent oil industry acquisitions found that "almost without exception, the stocks of buyers of oil companies have declined following such transactions." See Nulty, supra, at 109. Nonetheless, after averaging the results of several studies, one survey has found bidders to average a gain in stock price of 3.8% (after adjustment for general market movement). See Jensen & Ruback, supra note 34, at 11, 16. This average figure is open to question on a variety of methodological grounds, both because it does not include extensive postacquisition experience and because alternate methodological approaches have been developed, which call into question much of the data so averaged. Based on this different approach to the computation of the gains, the Malatesta study found that acquirers suffer significant losses in mergers. See Malatesta, supra note 31, at 155, 177.

In any event, whatever the average result, there is evidence that in a significant number (though a minority) of the cases the overall welfare of the shareholders of both combining firms is diminished as a result of the transactions. See Carney, supra note 1, at 354 n.58 (interpreting data compiled in Jarrell & Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 *J. L. & Econ.* 371, 403 fig. IV (1980)). In such instances, one confronts not only a wealth transfer, but an absolute wealth loss.

57. See Note, supra note 48, 1238-39.

activity, the Empire Building Hypothesis focuses singlemindedly on only one variable (the effect on the bidder) and therefore cannot be taken as more than a partial explanation.

4. *The Exploitation Hypothesis.* — Gain to the bidder in a takeover can come either through the creation of new value or through the transfer of existing value from other investors.⁵⁸ Recent commentators have suggested that such wealth transfers may result from the target shareholders being trapped in a classic “prisoner’s dilemma” in which they are faced with a choice between an unsatisfactory current price offered by the bidder and a potentially even lower price in the future.⁵⁹

Two distinct scenarios have been suggested to explain how exploitation might occur. Professor Carney has pointed to the recent appearance of the two-tier bid, in which a high premium is paid in a partial bid for 51% of the target’s stock, but then a takeout merger is eventually effected at a price below the pre-tender offer market price, with the result that the average price received amounts to a net loss for the target’s shareholders.⁶⁰ Actual transactions in which the bidder acquires the target at an average price below the pre-tender trading price remain exceedingly rare, however.⁶¹

58. Professor Carney has articulated this point most clearly. See *infra* note 60 and accompanying text. His ultimate position, however, is that mere value-transferring takeovers are a self-remedying problem since shareholders can adopt defensive measures to protect themselves from exploitation. See Carney, *supra* note 1, at 349–53.

59. Carney, *supra* note 1, at 349; Lowenstein, *supra* note 1, at 307–09. Prisoner’s dilemmas arise when the affected shareholders are unable to communicate or coordinate their actions to resist a tender offer. In the case of the two-tier takeover, the inability of shareholders to coordinate their actions and resist the initial partial tender offer at an attractive premium leaves them vulnerable to the second stage merger at a price below market. Rational investors, had they been able to coordinate, might have rejected the tender offer.

60. Carney, *supra* note 1, at 349–53. The most often cited example of a two-tier bid was U.S. Steel’s successful offer for 51% of Marathon Oil in 1981 for a cash price of \$125 per share; as disclosed in advance, U.S. Steel then acquired the remaining 49% of Marathon through a subsidiary pursuant to a post-tender merger for securities having a value on a per share basis of approximately \$86. See *Radol v. Thomas*, 534 F. Supp. 1302, 1305 n.2 (S.D. Ohio 1982). Thus, the average price paid was \$105.50. For reviews of the issues that the two-tier bid raises, see Mirvis, *Two-Tier Pricing: Some Appraisal and “Entire Fairness” Valuation Issues*, 38 *Bus. Law.* 485 (1983); Note, *Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique*, 131 *U. Pa. L. Rev.* 389 (1982).

61. Professor Carney’s definition involves another questionable assumption. Even if a tender offer is unsuccessful, once it is made, the price of the target stock tends not to decline to its original level. According to Professor Carney, this shows that the stock market has revalued the stock in light of new information signaled to it by the bid. In an example that he gives, a tender offer is made for 50% of the target’s stock at \$40 per share for shares previously trading at \$30, and the trading price moves up to \$37. If the follow-up merger is at \$30 per share, the average price paid will be \$35, and Carney views this as a \$2 net loss to the target shareholders. Carney, *supra* note 1, at 350–51. This seems a dubious characterization. The market has not necessarily revalued the intrinsic worth of the shares at \$37; it could merely be speculating on the outcome and the possibility that a competing bid will be made. Other studies have also rejected the conclusion that bidders are seeking to identify undervalued targets that the market has overlooked. Instead, they have concluded that bidders are primarily seeking to exploit potential

Another, more popular form of the exploitation thesis argues that bidders overreach target shareholders by exploiting temporary depressions in the target's stock price in order to seize control of the target in a bargain purchase.⁶² A variation on this same theme views the recent high rate of takeover activity as the product of systematic undervaluation on the part of the stock market, which, it is asserted, capitalizes industrial corporations at levels well below their "going concern" value or, at times, even below their book value.⁶³ If, as the saying goes, "the cheapest oil that can be found is on the floor of the New York Stock Exchange,"⁶⁴ the rational bidder will exploit these opportunities to make a bargain purchase, rather than pay a higher price to develop equivalent plant and production facilities. Although this view that acquisitions are really bargain purchases has been sharply questioned,⁶⁵ those favoring it

synergies not available to ordinary investors. See Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers*, 11 *J. Fin. Econ.* 183 (1983). Thus, Professor Carney's view of the frequency of exploitative takeovers seems overstated—a result of his overly expansive definition of exploitation.

62. This is one aspect of Professor Lowenstein's thesis. See Lowenstein, *supra* note 1, at 274 (noting that largest recent tender offers were for natural resource companies, which were widely believed to be undervalued); *id.* at 291-94 (examining the takeover of Giddings & Lewis, Inc., whose stock was greatly undervalued in the estimation of Professor Lowenstein).

63. Market analysts have frequently made this point with respect to natural resources companies, whose assets are subject to highly volatile and cyclical price swings. Thus, this undervaluation thesis explains takeovers of companies such as Conoco, Marathon Oil, St. Joe Minerals, Kennecott, AMAX, Cities Service, and Superior Oil, the more recent control contest at Gulf, and the proposed leveraged buyout at Shell Oil. See Pollack, *Post Conoco Guessing Game*, *N.Y. Times*, Aug. 7, 1981, at D1, col. 3 ("Oil companies are attractive takeover targets, analysts say, because the current world oversupply has depressed the price of oil company stocks to about half of the asset value of those companies."); see also Lowenstein, *supra* note 1, at 291 n.169 (noting that the shares of such natural resources companies were undervalued prior to their takeovers).

This thesis has less validity as applied to industrial corporations, particularly after the bull market of 1982-83. As of late 1983, the average stock on the Standard & Poor's 400 was selling at 163% of book value. See *Stocks With More Book Value Per Buck*, *Fortune*, Oct. 31, 1983, at 184, 188. Although this may still represent undervaluation in an inflationary world, recent market activity has clearly diminished the extent of any undervaluation. Thus this thesis seems capable only of serving as a secondary explanation, applicable to specialized industries and special cases.

64. See *The Dealmakers*, *Fortune*, Jan. 24, 1983, at 56, 58 (quoting the head of the investment banking department at Donaldson, Lufkin & Jenrette).

65. As popular as the "bargain purchase" view is, it involves a basic paradox: why does the market sell established reserves of oil companies at prices well below the costs that other oil companies incur regularly to find new reserves? As MIT Economics Professor M.A. Adelman has succinctly put it, "[e]ither you have to conclude that the whole financial community and oil industry is composed of idiots, or there is something wrong with that explanation." See Blumstein, *Buying vs. Exploring for Oil*, *N.Y. Times*, Mar. 19, 1984, at D1, col. 3. Another popular explanation is that investors have a different time horizon within which they are seeking to maximize their gains than the oil firms, which are asserted to have a longer-term perspective. See Yergin, *Two Views on Oil*, *N.Y. Times*, Apr. 19, 1984, at E21. This view, however, seems equally questionable. Why do corporate firms have different time horizons from the investors who own them? This view in fact suggests a failure in corporate accountability. Another explanation much heard among Wall Street analysts is that the oil firms are worth more broken up than as a single

tend to see the stock market as either dominated by an extreme pessimism, which results in arbitrarily low valuations, or as preoccupied with short-term trading profits because institutional investors focus largely on the prospect of short-term price changes in securities.⁶⁶ Because corporate bidders continue to value target companies on the basis of their discounted future earnings, which method results in higher valuations, a disparity arguably arises between these two measures of value that justifies the tender offer premium. In effect, this view postulates that there are two distinct markets for corporate shares with only imperfect arbitrage between them: one market for corporate control and another for investment profit.⁶⁷ Once this argument is accepted, hostile tender offers can then be characterized as merely an attempt by bidders to exploit the price disparity between these two markets, which attempt promises no increased efficiency or other social benefit. The chief problem with this inefficient market argument is that, even if its debatable premise is accepted, its conclusion, that takeovers serve no beneficial function, does not logically follow. The claim that the stock market is inefficient or otherwise irrational can, of course, be argued at length.⁶⁸ Yet, stock market efficiency is neither a necessary nor a sufficient condition in order for the hostile takeover to function as an effective instrument of corporate accountability. Moreover, even in a market characterized by a substantial element of inefficiency, shareholders are not likely to benefit from a policy of chilling takeovers. Assuming that some stocks do trade at a discount because of the market's absorption with short-run profits, one still has little reason to believe that these stocks will soon rise to their "intrinsic value," at least within a time frame that permits shareholders to benefit as much as if they had accepted the tender offer.⁶⁹

entity; in this view, "the companies' other operations drag down the price of their stock so that the market price does not reflect the full value of oil in the ground." Blumstein, *supra*, at D1. In essence, this thesis is a particularized statement of the "empire building" hypothesis, since it holds that these corporations have grown beyond their optimal size and have failed to divest themselves of less profitable operations.

66. See Lowenstein, *supra* note 1, at 297-304 (arguing that institutional investors reach investment decisions by "trying to anticipate short-term price changes").

67. *Id.* at 274-75. The existence of two different markets—one for investment shares and one for control—can easily be explained by reference to neoclassical economics. Indeed, several explanations are possible. First, a bidder may be the only firm that can realize synergy in a combination, and hence be willing to pay more. Second, a bidder may be the only firm that can effectively remove the inept incumbent management. Third, a bidder should have lower agency costs and be a better inspector of corporate conduct than widely dispersed shareholders and so should be more willing to pay a premium for control. Thus they are able to realize enhanced value through the reduction of agency costs even when they retain the incumbent management.

68. For a view counter to Professor Lowenstein's, see Gilson & Kraakman, *The Mechanisms of Market Efficiency* 8 n.19 (Stanford L. Sch. L. & Econ. Program, Working Paper No. 11 1983); see also the discussion *infra* note 258.

69. Whitman and Shubik have coined a beautiful phrase that they call "The Trader's Credo": "A bargain that stays a bargain is not a bargain." M. Whitman & M. Shubik, *The Aggressive Conservative Investor* 37 (1979). Even if the bargain does subsequently rise to a value equal to, or in excess of, the tender offer premium, it is still necessary to adjust for the time value of money and any related opportunity costs the shareholder suffers. Thus, although one study by

Undervalued stocks can easily remain undervalued stocks, and shareholders who are "protected" by management in this manner from an "exploitative" offer may come to realize that a little exploitation is better than none at all. Indeed, the more systematic the undervaluation is, the more the hostile bidder appears to be a savior, rather than an exploiter, of target shareholders.

Moreover, even if we assume that the stock market is characterized by a substantial element of irrationality, this premise still does not lead to the conclusions that takeovers will therefore fail to focus on inefficient firms. Rather, if the market does undervalue most stocks, bidders must still be presumed to remain rational, and the rational bidder will always seek the greatest bargain available. Even given substantial undervaluation, the best bargains would consist disproportionately of inefficient firms. This is because in the case of the inefficiently managed firm a double gain would be possible: the bidder acquiring an inefficiently managed firm would reap both the bargain inherent in the stock market's undervaluation and the latent turn-around profit which a substitution of superior management would bring.⁷⁰ In short, the attempt to refute the Disciplinary Hypothesis by arguing that the stock market undervalues the going concern value of industrial corporations fails to recognize that a market biased toward undervaluation would still discount both efficient and inefficient firms evenly, thereby leaving intact the price differential attributable to inefficiency.⁷¹ Thus, rational bidders would remain predisposed to buy those stocks selling at the greatest discount from

Kidder, Peabody & Co. followed 38 defeated hostile tender offers between 1974 and 1982 and found that in 65% of the cases the target's stock price rose to exceed the tender offer premium, even after adjustment for net market movements, a critique of this study has shown that once a further adjustment is made for the time value of money over this interval, target shareholders would have done better to have accepted the tender offer premium. See SEC Tender Offer Report, *supra* note 3, at 118-19 (statement of Frank H. Easterbrook and Gregg A. Jarrell).

70. For example, assume that the market undervalues all industrial corporations by 50%. If so, a bidder would have an incentive to tender for an efficient corporation trading at \$100 per share because it is worth \$200 per share. Yet, an inefficient corporation trading at \$100 might be worth \$250 or \$300 a share, because its value is also depressed by the ineptness of the incumbent management. Thus, a tender for the inefficient firm would allow a \$150 gain per share on a \$100 investment, and rational bidders should tend to pursue this more attractive investment, subject only to the problem of risk aversion.

71. If there is any bias, it is likely to overvalue the inefficient target, because the net asset value of the target on liquidation should logically set a boundary beyond which the stock value can fall only marginally. For example, assume that in an efficient market, two otherwise equivalent firms, Corporation *A* and Corporation *B*, trade at \$200 per share and \$120 per share, respectively, because Corporation *B* was inefficiently managed. If we assume the same 50% discount as above, these two firms should then trade at \$100 and \$60 respectively. But, if the net asset value on liquidation was \$90 per share for each, it is possible that the inefficient corporation might not decline to \$60, because this price would be 33 1/3% below its liquidation value, and rational investors would bid the price up to a level approaching that value if they anticipated a possible liquidation. In a limited number of cases, this might reduce the relative incentive to bid for the more efficient company, although the immediacy of the liquidation gain (and its lower associated risk) may restore the differential.

their potential value, even if all stocks were selling at some discount. As a result, the inefficient market theory works as a rebuttal to the Disciplinary Hypothesis only if some plausible scenario could be given under which either (a) the market systematically undervalued efficient firms more than inefficient firms so that bidders would be biased toward acquiring the former, or (b) extreme volatility caused stock prices to fluctuate erratically, thereby permitting some efficient firms to sell periodically at relative prices below those of less efficient rivals.⁷²

5. *An Overview.* — The major watershed highlighted by the foregoing survey is between those explanations that see takeovers as creating wealth and those that see takeovers as primarily transferring existing wealth. The first two theories—the Disciplinary Hypothesis and the Synergy Hypothesis—postulate that takeovers create wealth in the form of higher stock prices, and that the bidder and target shareholders share the gains. The Empire Building and Exploitation Hypotheses view the takeover less benignly and see it as a mechanism which frequently transfers wealth between different groups of shareholders. Under the Empire Building thesis, target shareholders profit at the expense of bidder shareholders, while under the various Exploitation Hypotheses, the reverse is true, as bidder shareholders receive gains at the expense of target shareholders. Thus, if one asks “who wins and who loses from takeovers,” these different explanations give every possible answer. Yet, even though these various theories are inconsistent, it does not follow that one must be entirely valid and the others false. Rather, under a pluralistic interpretation, each theory may have a partial validity and may accurately describe the motivations underlying some (but not all) takeovers. The empirical evidence gives some support for this “disaggregated” perspective, because instances can be identified in which the gains to either class of shareholders (bidder or target) came at the expense of the other.⁷³

The pluralistic interpretation under which each of the foregoing theories has some explanatory power implies that corporate control contests sometimes create wealth and sometimes only redistribute it.⁷⁴ From a public policy perspective, wealth creation should be encouraged, but wealth redistribution discouraged. Public policy should seek to discourage mere wealth transfers

72. Some evidence exists that the stock market has a high and unexplained level of volatility. See Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?*, 71 *Am. Econ. Rev.* 421 (1981). Even if extreme market volatility is assumed, rational bidders should still seek to purchase the best bargain. Thus, if all firms were subject to periodic depressions during which they could be purchased for a fraction of their “true” value in an efficient market, the double gain available in the case of the inefficient firm, see *supra* note 70, should still encourage bidders to purchase the inefficient company when an additional turnaround profit is possible.

73. Instances in which the bidder appears to have overpaid are easily identified. See *supra* note 56. Instances in which the target shareholders appear to have been losers are rarer. But see Carney, *supra* note 1, at 349–55; *id.* at 354 n.58.

74. See *supra* note 73.

between bidder and target shareholders (in either direction), both because there are no redistributive goals to be served in this context and because wealth-transferring takeovers are likely to involve an element of coercion, which means that these transfers are not voluntary in the usual sense of that term.⁷⁵ Indeed, even where the winner's gains clearly exceed the loser's losses, it does not follow that society is entitled on efficiency grounds to disregard the fact that uncompensated losses to some group are foreseeable.⁷⁶ As a result, to mitigate the serious normative problem that arises when a public policy creates a foreseeable class of "losers," it is important that the empire building and exploitation motives be chilled.

This issue of wealth transfers in takeovers in turn brings us back to the central debate over the auction market. Arguably, an auction market for corporate control reduces the possibility that either bidder or target shareholders will be exploited. To the extent that auctions raise the takeover premium, they obviously reduce the possibility of exploitation of the target's shareholders, and, to the extent that auctions direct assets to the more efficient bidder (who in theory should be willing to pay the highest price), they enhance the likelihood that efficient bidders will triumph over inefficient empire build-

75. Essentially, this coercion is grounded on the fact that the majority can eliminate the minority at a price which is not satisfactory to the minority through the medium of the takeover merger. See Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. Rev. 624 (1981); accord Toms, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 Colum. L. Rev. 548 (1978). This problem predates the two-tier bid which introduced additional problems of overreaching and coercion. See *supra* notes 58-60 and accompanying text.

76. The concept of efficiency is usually defined in terms of subsidiary concepts known as "Pareto optimality" and "Pareto superiority." An allocation of resources is "Pareto optimal" when no other allocation is possible that would make anyone better off without leaving someone else worse off. An allocation is "Pareto superior" in relation to another allocation when it makes someone better off without making anyone worse off. See Coleman, *Efficiency, Utility and Wealth Maximization*, 8 Hofstra L. Rev. 509, 512-13 (1980). Although Pareto optimality is an unrealistic goal, takeovers may frequently—indeed, generally—be Pareto superior. If the target shareholders gain value in the form of the premium and the bidder shareholders do not experience a decline in their stock value (and creditors are unaffected), the transaction is Pareto superior.

However, if bidder shareholders lose while target shareholders gain, this cannot be characterized as a more efficient allocation of resources in the sense of being Pareto superior, even though the gains to one side are greater than the losses to the other. In general, economics does not permit interpersonal comparisons of welfare, which would be necessary here to justify some losses to one side in order to achieve greater gains on the other. But if the winning side is prepared to compensate the losing side for its losses—which the winners can do if, as is likely, their gains exceed the others' losses—then such a reallocation of resources can still be considered "efficient." Professor Carney has pointed out that this last definition of efficiency—known as "Kaldor-Hicks efficiency"—applies to the context of takeovers where, as he sees it, one side or the other frequently incurs losses. Carney, *supra* note 1, at 354. But no practical mechanism exists by which the winners can compensate the losers for their losses, nor is any inclination to compensate apparent. In response, Professors Easterbrook and Fischel have argued that shareholders hold diversified portfolios and hence are automatically compensated when the target shareholders' winnings exceed the bidder shareholders' losses. See Easterbrook & Fischel II, *supra* note 1, at 711-14.

ers.⁷⁷ Thus, auctions seem likely to minimize wealth transfers and so mitigate the severity of the normative problems surrounding the takeover.

However, the debate cannot be concluded this simply. Professors Easterbrook and Fischel raise serious counter-arguments when they claim that auctions should be discouraged, both because they chill the incentive of the first bidder to initiate a control contest and because by increasing the takeover premium necessary to secure control, they thereby shelter a greater degree of managerial inefficiency.⁷⁸ Section B will examine this debate, but its basic conclusion that neither side can clearly prove its thesis on more than a provisional basis underscores the importance of searching for policy options that can disaggregate the takeover phenomenon and chill those takeovers unlikely to result in increased efficiency.

B. Does an Auction Market Increase Target Shareholder Wealth?

At first glance, it might seem clearly in the interest of shareholders that their management solicit a higher offer once an initial bid has been made for their company's shares. After all, numerous examples exist in which the resulting auction has produced a significantly higher premium for the shareholders.⁷⁹ Nonetheless, Professors Easterbrook and Fischel have presented a provocative critique of this view. Whether auction contests benefit shareholders, they argue, depends on whether one examines the welfare of shareholders from an *ex post* or an *ex ante* perspective.⁸⁰ From an *ex post* perspective—that is, one that considers the question after the initial tender offer is made—it may appear that the shareholders benefit from the competitive bid. But from an *ex ante* perspective—that is, one that considers shareholder welfare as of a time prior to the commencement of the tender offer—the interest of shareholders is best served, they claim, by increasing the probability that an offer will be made. Thus, if the net impact of a legal rule encouraging competing bids is to reduce the likelihood of a tender offer being made at all, shareholders seemingly lose, rather than benefit, from the auction market that such a rule encourages.⁸¹

77. See *infra* notes 261-62 and accompanying text.

78. This is, of course, the core idea behind the zero premium policy advocated by Professors Easterbrook and Fischel. The more the costs of acquiring control are reduced, the greater the disciplinary capacity and deterrent threat of the takeover.

79. For example, during 1981, in each of the following competitive auctions the offering premium exceeded 100% of the target's market price as of a date four weeks prior to the bid's announcement: Marathon Oil, Conoco, St. Joe Minerals Corporation, Buffalo Forge Company. Yet, the average premium in this year was 66%, according to data supplied to the author by the First Boston Corporation, suggesting that the auction market yielded higher than average premiums (data on file at the offices of the Columbia Law Review).

80. Easterbrook & Fischel I, *supra* note 1, at 1177-78.

81. But see *infra* text at notes 97-112.

The next step in their analysis simply applies the basic economics of supply and demand to the tender offer context: as the price of any commodity rises, the demand for it almost invariably decreases.⁸² In short, the usual interaction of supply and demand means that if competitive bids drive up the tender offer premium that must be paid for corporate control, then fewer tender offers will be made. Accordingly, Professors Easterbrook and Fischel argue that shareholders should prefer a rule that requires managerial passivity in the face of the initial bid, in part because any other rule would chill the prospect of a tender offer being made.⁸³

In separate rebuttals, both Professor Gilson and Lucian Bebchuk have responded that the possibility of a competitive bid will not chill the willingness of the first bidder to undertake the costs of a tender offer.⁸⁴ The initial bidder, they argue, can still win by losing—that is, it can recoup its costs and also turn a quick profit by tendering the shares it has already purchased to the higher bidder. Although there may be considerable legal obstacles and business risks to such a game plan,⁸⁵ Gilson and Bebchuk are undoubtedly correct that any resulting chill will be insufficient to deter all hostile tender offers. Yet, their argument is not adequately responsive to the point made by Professors Easterbrook and Fischel that demand curves almost invariably slope downward to the right; as a result, any increase in the expected cost of acquiring control implies that some reduction in the demand for corporate control is virtually inevitable. Although Professor Gilson has vigorously disputed this point,⁸⁶ some decline seems inevitable for a variety of legal and institutional reasons, even apart from economic theory. First, there is a stigma associated with being a bidder who is not truly seeking control; such market irritants as Carl Icahn and T. Boone Pickens have aroused considerable resentment and are regarded within the corporate community as virtual extortionists.⁸⁷ In any case, the

82. A technical qualification is necessary: demand curves tend to slope downward to the right, but they can have kinks, bend backwards over some portion of their length, or, in the case of strange commodities known as "inferior goods," rise because of the consumer's lack of wealth. But none of these peculiar characteristics seems likely to exist in the market for corporate control.

83. Easterbrook & Fischel I, *supra* note 1, at 1174-82.

84. Gilson I, *supra* note 1, at 868-75; Bebchuk I, *supra* note 1, at 1030, 1034-38.

85. See *infra* note 90.

86. See Gilson I, *supra* note 1, at 870-71; Gilson III, *supra* note 1, at 53-62, 66. Gilson offers a number of reasons, but the most credible is that the first bidder often profits on a sale to the winning bidder if the auction drives the price of the security above the level at which it bought its shares. For example, Texas International Airlines, Inc., then a small firm, tendered for National Airlines and lost the bidding war to Pan American, but made a \$47 million profit on its sale of National stock. See Rowan, *An Airline Boss Attacks Sky-High Wages*, *Fortune*, Jan. 9, 1984, at 66, 72.

87. For a recent review of the activities of Carl Icahn, see Kirkland, *When Paying Off a Raider Benefits the Shareholders*, *Fortune*, Apr. 30, 1984, at 152, 153, and of T. Boone Pickens, see Nulty, *Boone Pickens, Company Hunter*, *Fortune*, Dec. 26, 1983 at 54.

largest recent bidders—for example, Mobil, DuPont, and U.S. Steel—clearly have shown little interest in the turnaround profit that comes from being the initial bidder who later tenders to the eventual winner.⁸⁸ Second, the first bidder has no assurance that it will be able to tender sufficient shares to the successful bidder to make a profit, particularly if the second bidder makes only a partial or two-tier bid.⁸⁹ Third, the initial bidder's ability to retain the gain it makes on any resale of the shares to the successful bidder is constrained by Section 16(b) of the Securities Exchange Act of 1934.⁹⁰ Also, in a world of competitive bids, the first bidder may increase its own exposure to a takeover, as Bendix found when its bid for Martin Marietta eventually resulted in its acquisition by Allied Corporation.⁹¹ Finally and most importantly, empirical

88. Indeed, these giants have often disdained such profits by declining to purchase the target stock in the open market in advance of the takeover—even though such a step would reduce the overall cost of acquiring control.

89. For example, if the white knight makes a tender offer for 50% (which would be sufficient to obtain control if the target's management also gave it a "lock-up" on additional unissued shares), its offer may be oversubscribed. In that case any shares tendered by the first bidder would be prorated and some returned. The shares returned by the white knight to the first bidder could later be reacquired in a takeout merger at a price potentially below the first bidder's purchase price. Additionally, although this approach has not yet been attempted, it may be possible for the white knight to limit its offer so that shares tendered by the first bidder would not be accepted. Although the SEC has sometimes suggested that a policy of equal opportunity underlies the Williams Act, thus precluding any such limited bids, no provision in the Act nor any existing rule denies a bidder the ability to make a limited offer to less than all shareholders.

90. Under § 16(b) of the Securities Exchange Act of 1934, when a holder of 10% or more of the equity securities of a "reporting" company purchases and sells the company's equity securities within a six-month period, any profits on the sale are recoverable by the company. 15 U.S.C. § 78p(b) (1982). Thus a bidder that acquires 10% or more of the target's stock and sells within six months to the white knight can be required to disgorge the portion of its gain that is allocable to the shares held in excess of 10%. A judicial exception has been created for a frustrated bidder whose shares in the target are converted into shares of the white knight pursuant to a takeout merger which the bidder opposed. However, the scope of this exception remains narrow and does not apply to an unsuccessful bidder who makes a cash sale to the white knight. See *Texas Int'l Airlines v. National Airlines, Inc.*, 714 F.2d 533, 538 (5th Cir. 1983) (refusal by court to grant exception to 16(b) rule for bidder in hostile tender offer contest), cert. denied, 104 S. Ct. 1326 (1984); see also *Reece Corp. v. Walco Nat'l Corp.*, 565 F. Supp. 158, 162 (S.D.N.Y. 1983) (16(b) liability imposed on sale of stock after unsuccessful acquisition attempt). But see *Heublein, Inc. v. General Cinema Corp.*, 722 F.2d 29, 31 (2d Cir. 1983) (16(b) not applicable in situations such as "frustrated tender offers" where there is suspicion or hostility between parties), cert. denied, 104 S. Ct. 1416 (1984). In general, it seems that cash sales by the losing bidder to the winning bidder fall within 16(b), but other transactions may not.

91. There are several reasons why a bidder may increase its own exposure to a takeover by undertaking a control contest. First, if the market believes the acquisition to be unwise or to involve an excessive price, the bidder's share price should decline, thereby increasing its vulnerability. Second, because the bidder has depleted its own cash reserves, it cannot as easily make a "Pac-Man" counter-tender offer or even a self-tender if another bidder pursues it; in effect, its debt capacity is largely exhausted and thus it becomes a less dangerous target to pursue. More-

data reveals a clear pattern: when a corporate bidder loses a control contest and the target is instead captured by a rival firm, the losing bidder's stock declines significantly.⁹² The explanation for this pattern is uncertain and may involve reputational injury to the bidder or simply the market's belief that transaction costs were wasted. But to a management concerned with maximizing its firm's stock value, this is a substantial disincentive, particularly when the data also shows that the initial bidder loses in seventy-five percent of the cases when a second bid is made.⁹³ All these reasons suggest that Professor Gilson has overgeneralized in predicting that the frequency of takeovers will not decline in a competitive environment.⁹⁴ The pre-Williams Act experience seems also to corroborate this conclusion that higher premiums imply a reduced frequency.⁹⁵

Still, one cannot leap from this simple conclusion to the broader proposition reached by Professors Easterbrook and Fischel that shareholder wealth is therefore best maximized by seeking to discourage competing bids. The fallacy in such a leap is best shown graphically and involves the shape of the demand curve for corporate control:

over, the shares this bidder acquired in the original target can be easily sold by the new bidder so that the first bidder has not successfully reduced its liquidity at this stage. This happened in the Bendix battle, as Allied sold most of Bendix's block of Marietta shares. See Rowan & Moore, *Behind the Lines in the Bendix War*, *Fortune*, Oct. 18, 1982, at 157. Finally, the original target may enter into a joint counter-tender offer for the original bidder. This also happened in the Bendix-Martin Marietta battle, as United Technologies and Martin Marietta jointly pursued Bendix. See *id.*

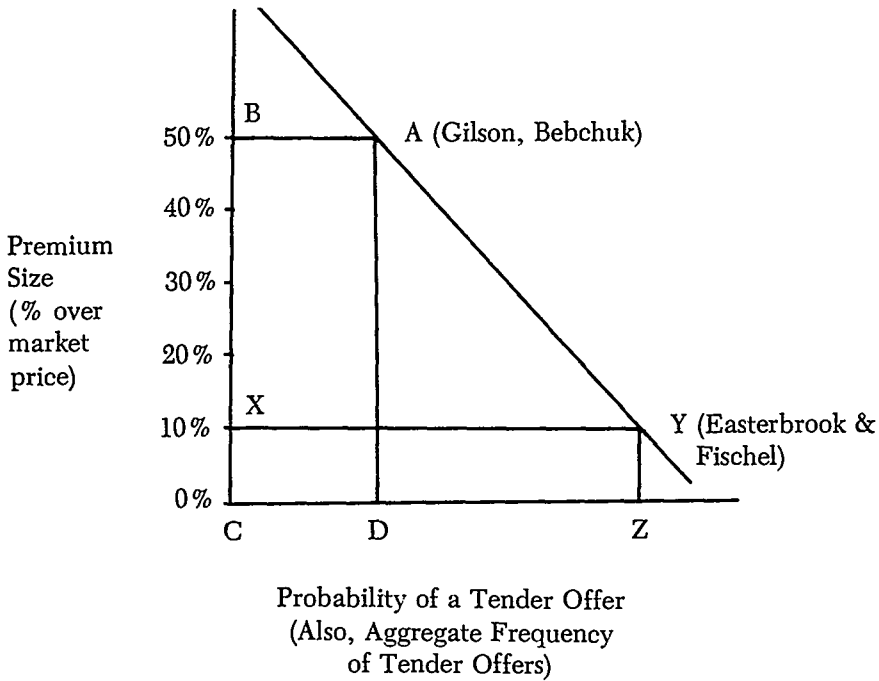
92. See Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 *J. Fin. Econ.* 183, 198-204 (1983). This study found a significantly negative market reaction when the bidder lost its takeover bid to another bidder, but not when the target remained an independent firm.

93. See Ruback, *supra* note 10, at 147. Ruback's statistic of a 75% failure rate is limited to those cases where there is a competing bid made; since competing bids are far from inevitable, the overall failure rate is considerably lower.

94. Some potential bidders—most notably the arbitrageurs who specialize in threatening a "creeping" acquisition—are, of course, not deterred by the high premiums that an auction market would entail. These noncorporate bidders (of whom Carl Icahn is the best example) also should not be deterred by the apparent negative market reaction to an unsuccessful bid. For these bidders, the greater the number of contestants, the higher is the likelihood that someone will eventually purchase their position in the target at a premium. Although this class of bidders is thus an exception to the generalization that higher premiums imply lower frequency, they represent at present only a small percentage of total bidders. Moreover, their activities appear as likely to result in a repurchase by the target corporation at a premium as in a legitimate takeover bid ultimately won by a rival bidder.

95. The Williams Act, 15 U.S.C. § 78 l-n (1982), encourages auctions by establishing minimum time periods for offers, thereby enabling targets to locate white knights more often. *Id.* § 78n(d)(5). In the years immediately following the Williams Act's passage, takeover premiums appear to have increased substantially while the frequency of takeovers in turn declined. One study, based on data involving 161 target companies acquired from 1962 to 1977, found that the average takeover premium in cash tender offers rose from 32% to 53% in the wake of the Williams Act and then increased to 73% after the passage of state antitakeover statutes in the middle and late 1970s. See Jarrell & Bradley, *supra* note 56, at 373, 388, 405. Correspondingly,

DIAGRAM A
The Demand for Corporate Control



the frequency of cash tender offers initially dropped, and thereafter fluctuated significantly, as set forth below following the passage of the Williams Act in 1968:

<u>Fiscal Year</u>	<u>Number of Tender Offers</u>
1965	105
1966	77
1967	113
1968	115
1969	70
1970	34
1971	43
1972	50
1973	75
1974	105
1975	113
1976	100
1977	162
1978	179
1979	147
1980	104
1981	205
1982	117

Point Y represents an equilibrium that might obtain were the Easterbrook/Fischel rule of passivity adopted. At Point Y, premiums are low, but the frequency of tender offers is high. Conversely, Point A shows a hypothetical equilibrium position that might result under Gilson and Bebchuk's position, which favors a competitive auction market. At Point A, tender offers have high premiums, but their frequency is low. Which position maximizes shareholder welfare? A satisfactory answer is not possible to this question, unless additional assumptions are made regarding the shape of the demand curve for corporate control.

To determine the expected takeover premium under either regime, one simply multiplies the probability of a tender offer being made by the amount of the likely premium.⁹⁶ Graphically, the ABCD rectangle represents this product under the Gilson/Bebchuk position, and the YXCZ rectangle under the Easterbrook/Fischel thesis. Which rectangle is greater (and hence which rule maximizes shareholder welfare)? The only possible answer is that everything depends on the elasticity of the demand curve. The more inelastic it is (that is, the steeper its slope), then the more the Gilson and Bebchuk prescription maximizes shareholder welfare. Conversely, the more elastic the demand for tender offers (that is, the more the demand curve approaches a horizontal line), the more Easterbrook and Fischel's preference for low premiums and high frequency improves shareholder welfare.

Do we today have any reliable information about the elasticity of this demand curve? Although there is evidence that fewer offers have been made as premiums have increased,⁹⁷ we lack reliable data by which to estimate the elasticity of the demand curve for corporate control. Any attempt at an overall assessment is further clouded by the cyclical nature of the tender offer phenomenon. Peaks and valleys have characterized the frequency of the tender offer since its first emergence in the 1960's,⁹⁸ and these fluctuations are probably attributable to swings in factors such as interest rates, economic uncertainty, credit controls, the likelihood of governmental intervention, stock market price levels, and the shifting balance of advantage between bidder and target. Still, indirect evidence provides a possible means by which

It was not until fiscal 1977 that the number exceeded the 1968 pre-Williams Act level. See SEC Tender Offer Report, *supra* note 3, at 11 n.9.

96. From an *ex ante* perspective, this "expected premium" is what the rational shareholder would wish to maximize. This formula does not, however, account for the entirety of the shareholder's interest in the legal rules regulating the market for corporate control. As will be discussed *infra* notes 134-44 and accompanying text, the shareholder also has an interest, potentially even a stronger one, in how the deterrent threat of the takeover affects the behavior of incumbent management.

97. See *supra* note 95.

98. For example, fiscal 1980 saw 104 cash tender offers, but 1981 saw 205, followed by a sharp decline in 1982 to 117. See *supra* note 95. For a discussion of the "boom and bust" cycle in acquisitions generally, see *infra* note 196.

the slope of the demand curve can be inferred. This evidence is available in two forms, each of which confirms the other. First, institutional investors appear to favor some forms of "shark repellents," at least some of the time. Second, the stock market's response to the adoption of a "shark repellent" has on average been positive. Each of these points merits a brief discussion.

Despite numerous reports that institutional investors now characteristically oppose "shark repellent" charter amendments and similar measures designed to insulate incumbent management from takeovers, shareholders continue to adopt these provisions.⁹⁹ A survey found that in fifty-five out of fifty-nine annual meetings in 1983, shareholders approved "shark repellent" charter amendments.¹⁰⁰ Although this pattern might be partially ascribed to the usual factors of shareholder apathy and managerial domination of the proxy machinery, one aspect of the pattern stands out: institutional investors appeared to draw a sharp distinction between "fair price" provisions (which typically specify a formula under which any follow-up merger between the bidder and the target must be at a price equal to, or above, that paid in the initial tender offer) and other forms of "shark repellent" provisions. A recent survey of 2,500 institutions found that institutional money managers favored "fair price" provisions by a ratio of three to one, but, conversely, opposed supermajority provisions by a ratio of three to one.¹⁰¹ What explains this dramatic difference in their response? The best answer seems to be that, although most supermajority provisions are designed to chill all takeover bids, "fair price" provisions are perceived by investors as intended to discourage only "front loaded" partial bids, which are made for a portion of the out-

99. One recent survey found that 398 firms proposed a total of 475 antitakeover amendments in the period 1960-1980. Of those 475, all but two were presented to shareholders and only ten of the proposals were rejected. See Linn & McConnell, *An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices*, 11 *J. Fin. Econ.* 361, 367-74 (1983).

100. See Allen, *Maryland Bill on Takeovers Spurs a Fight*, *Wall St. J.*, May 26, 1983, at 33, col. 3. In addition, at 45 out of the 47 annual meetings considering supermajority shareholder voting provisions, such provisions were adopted. *Id.*

101. See Blustein, *Measures to Discourage Takeovers Stir Controversy at Annual Meetings*, *Wall St. J.*, Apr. 18, 1983, at 29, col. 4 (reporting results of a study conducted by the investment banking firm of Kidder, Peabody & Co. and the proxy solicitation firm of Morrow & Co.). The evidence, however, is highly sensitive to the relative size of the institutions involved. A 1983 study by Georgeson & Co., a proxy solicitation firm, surveyed the attitudes toward shark repellents of both institutions listed as among the top 100 money managers by Institutional Investor and institutions that fell outside this category. Of the former, 65% opposed "fair price" amendments, while 28% favored them and 7% had no opinion. This group favored "staggered board" amendments by a 47% to 45% margin. Among the latter group of smaller institutions, fair price amendments were favored by a 71% to 26% margin and staggered board amendments by a 76% to 21% margin. This complete reversal depending on the size of the institution may reflect the smaller institutions' greater fear of being frozen out by a partial bid or compelled to accept the second stage of a two-tiered takeover. See *The Georgeson Report*, Issue No. 338 (July, 1983) (copy on file at the offices of the Columbia Law Review).

standing stock at a price higher than that which the bidder is prepared to pay for the remaining shares of the target.¹⁰²

In effect, "fair price" provisions increase the takeover premium, but do not necessarily give target management a means by which to resist all takeovers. Absent a "fair price" provision in the target corporation's certificate of incorporation, the cheapest strategy for the bidder is to acquire control by making a partial tender offer for fifty-one percent of the target's shares at a high premium and then acquire the remaining interest in the target at a lower price pursuant either to a merger or to post-tender offer purchases in the open. Under the Easterbrook/Fischel thesis, this tactic for minimizing the takeover premium that the bidder must pay to acquire control is in the best interests of shareholders, because it increases the probability of the offer *ex ante*.¹⁰³ Institutional investors, however, appear to disagree. Their behavior in favoring "fair price" charter provisions (but opposing other forms of shark repellents) arguably evidences a preference for a marketplace characterized by high premiums and a lower frequency of bids over one characterized by low premiums and a higher frequency. Implicitly, their behavior suggests that the most sophisticated class of investors believes the market for corporate control is sufficiently inelastic as to make auctions best serve their interests.

The second item of evidence lies in the generally positive reaction of the stock market to the adoption of a "shark repellent" amendment.¹⁰⁴ Although this evidence is mixed, it seems on balance to show both that prices go up on average when supermajority provisions are adopted and down on average when they are eliminated. The simplest explanation for this phenomenon is that the market believes that such amendments maximize value for shareholders. In turn, this market reaction suggests that the market believes the demand curve for corporate control is inelastic.

Of course, other interpretations are also possible: the stock market's upward movement in the wake of the announcement of a proposed shark

102. See Blustein, *supra* note 101 (comments of Martin Siegel, vice president of Kidder, Peabody & Co.). If the bidder makes a bid for "any and all" shares, it can anticipate receiving well over 90% of the shares tendered (unless it is outbid), and thus it will not benefit significantly by attempting to consummate the eventual takeover merger at a lower price. In contrast, the two-tier bid is an attempt to coerce shareholders into acceptance of the initial offer rather than face a merger at a lower price. See also *supra* note 60.

103. In their analysis of corporate control transactions, Professors Easterbrook and Fischel argue that so long as the takeover merger is at a price not below the market value of the target's stock prior to the transaction, the interests of shareholders are best served, since overall gains are maximized, even if these gains are likely to be wholly appropriated by the bidder. Easterbrook & Fischel II, *supra* note 1, at 703-04, 714-15. In effect, this position implies that any device to increase the takeover premium is contrary to the best interests of investors.

104. In a recent statistical study of the effect of shark repellents, Linn and McConnell found that upon announcement of the adoption of a supermajority amendment the target's stock price, after adjustment for overall market movement, rose significantly, while on the elimination of such an amendment it fell. They interpret this evidence to mean antitakeover amendments have a positive impact on shareholder wealth. See Linn & McConnell, *supra* note 99, at 379-80, 391-92, 397-98. But see DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*,

repellent amendment may reflect its view that the mere consideration of such an amendment signals that a bidder has already appeared on the scene and that a control contest is imminent. Similarly, the willingness of the institutional investors to tolerate fair price amendments may be less significant than their general hostility to other forms of supermajority provisions. Or, it may be that institutional investors are simply risk averse about being trapped in a two-tiered tender offer where they will obtain little or no premium. Yet, the institutional investor is less exposed to this danger than the ordinary investor for a variety of reasons.¹⁰⁵ Thus, if the simplest explanation is to be preferred, the market's perception that the demand for control is inelastic seems to best explain both these trends.

C. *The Uncertain Case for Shark Repellents*

Until recently, the one point on which there was a virtual consensus among academic commentators was that "shark repellent" charter amendments are inimical to shareholder welfare.¹⁰⁶ Most pointed to the obvious conflict between management's interest in insulating itself and the shareholder's interest in receiving a lucrative premium in a tender offer.¹⁰⁷ Undoubtedly as this conflict is, it still does not take us very far. From an *ex ante* perspective, the shareholder's interest in that premium has two components—the probability of the tender offer being made and the size of the premium, if the offer is made. If we assume that shark repellents have the effect of increasing the takeover premium that must be paid to secure control, while correspondingly decreasing the probability that an offer will be made, their net effect is indeterminate as an *a priori* matter. This in turn implies that it is difficult to justify a *per se* objection to them. Whether they increase that premium more than they reduce the probability of the offer being made is an issue that once again depends on the elasticity of the demand for control.

11 J. Fin. Econ. 329, 355–56 (1983) (finding evidence inconclusive, but inferring that antitakeover amendments are best explained as a device for managerial entrenchment). Linn and McConnell studied some 280 supermajority proposals, while DeAngelo and Rice assessed the effect of only 85. The two studies involved different time periods, with the Linn and McConnell study extending from 1960 to 1980 and the DeAngelo and Rice study focusing on 1974 to 1979. It is possible, of course, that the demand for control could have different elasticities during different periods.

105. The bidder seeking control has an incentive to purchase first the shares of shareholders who could most easily coordinate their actions to oppose a takeover. As repeat players in the takeover game, institutional investors, who know each other, meet this definition. Moreover, their special relationship with the investment banking firms that represent the bidder may entitle them to preferential treatment.

106. For example, Professor Gilson concludes his arguments in favor of an auction market by noting that he agrees with Professors Easterbrook and Fischel that, "[d]efensive tactics are unjustifiable." Gilson 111, *supra* note 1, at 66 (italics omitted). On balance, he appears to conclude that the prohibition of defensive tactics is an even more desirable means of regulation than the facilitation of competing bids. *Id.* at 67 n.36.

107. Management, of course, also owns shares and at a high enough price may find the offered premium even more attractive than continued tenure in office. Also, a takeover does not

In addition to affecting the size of the premium and the probability of the offer being made, shark repellents can also have another impact: properly drafted, they can increase the likelihood of equal treatment of all shareholders by in effect forcing the bidder to pay to all (or nearly all) shareholders the same premium. Absent a supermajority charter provision, the bidder could purchase a working majority interest (perhaps as low as twenty-five to thirty percent) from a small group of shareholders at a substantial premium in a privately negotiated purchase and then propose a takeout merger at a lower premium. Its ability to vote its own majority (or near majority) interest in favor of the merger would undercut the ability of other shareholders to obtain any significant premium. Conversely, the allocation of the takeover premium could be biased in favor of the last few "holdout" shareholders. Because of the nuisance value or legal obstacles that the shareholders who remain after a tender offer may sometimes pose, these holdouts might be able to secure a higher premium than those who accepted the tender offer. Again, the result is that the takeover premium is shared unequally according to tactical advantages.

In this light, a supermajority provision achieves an egalitarian result: it increases the possibility that all the pre-existing shareholders will receive the same price per share. This occurs because the bidder's ability to engage in price discrimination is weakened if, after a partial bid, it must still obtain the approval of the remaining shareholders in order to effect the takeout merger. As a general rule, the bidder must anticipate paying the price demanded by the last marginal shareholder whose vote in favor of the merger is required by the supermajority provision.¹⁰⁸ Thus, if we assume that the shareholders' supply curve slopes upward, then the higher the supermajority that is specified, the farther the bidder must travel upward along the supply curve before adequate stock is tendered. Again, this is most easily shown graphically, and Diagram B illustrates the significance to the shareholders of a hypothetical target corporation of the imposition of a supermajority provision making a favorable vote by seventy-five of the outstanding shares a precondition to any takeout merger.¹⁰⁹

invariably imply dismissal of management though management generally does leave. See *supra* notes 280-84.

108. For example, suppose the current price in the market is \$40 per share and 50% of the shareholders would tender at \$50 per share, but \$60 must be paid to obtain 70% of the stock. The effect of a charter amendment increasing the requisite majority necessary to approve a merger to 70% should be to compel a determined bidder to offer \$60 per share. Absent such a provision, the bidder would presumably tender at \$50 per share, if it were satisfied with acquiring only a 50% interest through the tender offer. Having acquired 50% and probably control, the bidder could then appoint compliant directors and secure approval of a takeout merger at a price no higher than—and possibly below—the tender offer price.

109. Diagram B does not show the impact of the supermajority provision on the probability of a takeover. Diagram B, however, is sufficient to illustrate the basic point that the higher the level of consent required, the greater the premium that must be paid.

DIAGRAM B
Target Shareholders' Supply Curve

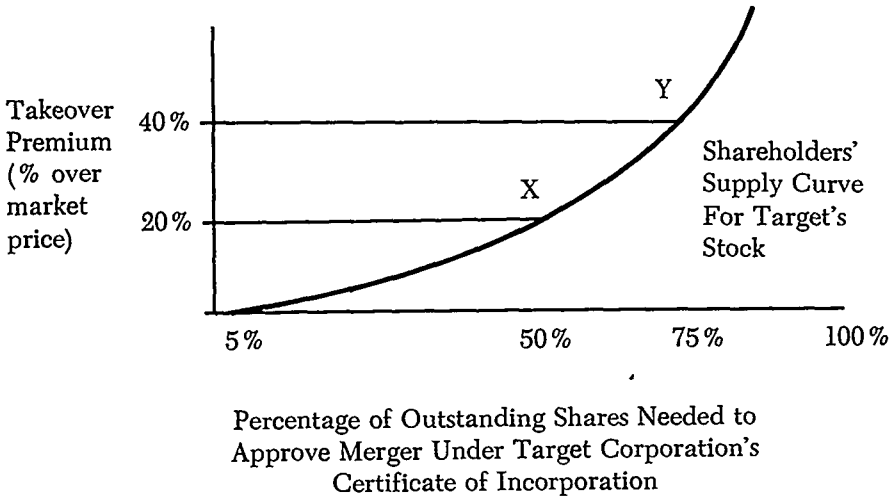


Diagram B shows that once again the key issue is the slope of the curve. Generally, supply curves are thought to slope upward on the premise that only an increase in price will bring more of a commodity to the market. The slope of the curve in Diagram B assumes that most shareholders are not prepared to sell at the current market price,¹¹⁰ and an increasing premium must therefore be paid to coax a higher percentage of them to tender. This seems a realistic assumption because the weekly trading volume in most stocks is usually only a trivial percentage of the total shares outstanding, indicating that the great majority of shareholders who did not sell at the current market price probably considered this price inadequate on the existing information available to them and would sell at it only if some exogenous reason, such as a college tuition payment or a superior investment opportunity, required them to do so.

In Diagram B, the effect of the supermajority provision is to require the bidder to intersect the shareholders' supply curve at a higher point (Point Y), with the result that the premium rises from twenty to forty percent. Indeed, the increase could be even more dramatic, because the bidder may not need to pay even a twenty percent premium to cause fifty percent of the shareholders

110. Professors Easterbrook and Fischel dispute this point. See Easterbrook & Fischel II, *supra* note 1, at 726-27. They have carried on a continuing debate with Professor Carney. See Carney, *supra* note 1, at 354-57; see also *infra* text and notes 114-23.

to tender if it can credibly threaten an even lower price in the eventual takeout merger which will eliminate those who do not tender.¹¹¹

Thus, the significance of the supermajority and similar shark repellent provisions is a dual one: they both increase the takeover premium (at some cost, of course, to the probability of an offer being made), and they lead to a more equitable allocation of that premium. Acting alone, each shareholder must balance his "asking price" against the danger that if others do sell and he does not, he can be eliminated at an even lower price in a takeout merger. Individually, each is vulnerable to price discrimination.¹¹² To protect themselves, the rational response of shareholders may be to require in advance a collective decision. In this light, a supermajority provision represents, as Professor Carney has argued, a means of shareholder coordination.¹¹³ Shareholders can better resist open market purchases or partial bids because they know that the typical objective of the bidder—a takeout merger—will ultimately require their collective consent. The price of coordination, however, is that each shareholder places himself at the mercy of the last marginal shareholder whose vote is necessary. If this shareholder either has an unrealistic view of the value of the corporation or if the bidder fears having to negotiate for the consent of such a holdout, the decline in the probability that an offer will be made may more than offset any gain in premium size. Once again, the trade-off is indeterminate.

In rebuttal, two objections to this analysis can be raised. First, it can be argued that most tender offers today are for all the target's shares and, regardless of the premium size, the vast majority of the shares are usually tendered. From this fact, it might be inferred that a supermajority provision adds little, because a higher percentage of the shares than the supermajority

111. Although it is not a certainty that a takeout merger will follow, one study found that such mergers followed within five years of a successful tender offer in 72% of the cases studied. See Dodd & Ruback, *Tender Offers and Stockholder Returns: An Empirical Analysis*, 5 *J. Fin. Econ.* 351, 352 n.2 (1977). As discussed earlier, under the two-tier bid or "front loaded" format, this follow-up merger may be at a lower price than the tender offer. See *supra* note 60. Thus, rational shareholders might sell at a price they found unattractive if they were unable to develop a coordinated resistance and expected an even less attractive price in a follow-up merger.

112. Moreover, this vulnerability is greatest in the case of the small shareholder. Because institutional investors and arbitrageurs are "repeat players" with whom bidders and their investment banking agents will have to deal in the future, there is an incentive to direct the premium to them. Such favoritism is rational from the bidder's perspective, because it is (i) more economical in the sense that block trades may be cheaper than ordinary open market purchases (because of lower brokerage commissions), (ii) legally less risky (because the fewer the purchasers, the less the chance that the bidder will be found to have made an illicit tender offer through open market purchasing), and (iii) more effective from a business standpoint because by purchasing the holdings of the largest shareholders, the bidder eliminates the only persons who could coordinate their actions so as to oppose it.

113. Carney, *supra* note 1, at 374-78.

provision would specify are typically tendered in any case. However, this argument confuses the coerced response of individual shareholders with rational shareholder bargaining. In reality, although the bidder usually seeks all the target's shares, it typically needs to obtain only a bare majority to assure itself of control. The target shareholders know this, and also realize that once the ramparts of corporate control have been seized by the bidder, they are substantially at its mercy and may be squeezed out at a lower price.

A second objection to this evaluation of shark repellents is that offered by Professors Easterbrook and Fischel, who reject the critical premise that the shareholders' supply curve turns upward. Instead, they claim that the supply curve is perfectly elastic—with the result that all shares should be purchasable at a price only nominally higher than the current market price.¹¹⁴ In support of this position, they argue that if the existing shareholders thought that the current market price was appreciably below that justified by the corporation's prospects, they would buy shares at this price, and thus the price would rise to a new equilibrium.¹¹⁵

Yet this analysis does not explain why tender offers involved relatively high premiums even before the passage of the Williams Act in 1968.¹¹⁶ In theory, in that era bidders could have bought the shares in the open market if there were a significant cost advantage to this technique as compared with a tender offer. Nor does their explanation tell us why bidders often test the market through open-market purchases prior to commencing a tender offer.¹¹⁷ This practice of market testing would be unnecessary if the supply curve were elastic, but it is very important if the bidder needs to gauge carefully the premium it will offer.¹¹⁸

114. See Easterbrook & Fischel 11, *supra* note 1, at 726-27.

115. *Id.*

116. The average premium in tender offers prior to the Williams Act appears to have been 32%. See Jarrell & Bradley, *supra* note 56, at 373. It must be assumed that prior to the passage of the Act, rational bidders used the lowest-cost technique available and would not have made tender offers if control could be purchased in the open market more cheaply. Presumably, the popularity of the tender offer among bidders was attributable to its speed, which reduced the prospect of competitive bidding, and to the element of coercion inherent in the "prisoner's dilemma" to which it gave rise. Thus, the fact that premiums were almost a third over the market price even before the Williams Act strongly suggests that the shareholders' supply curve sloped upward and was, even then, fairly inelastic.

117. See E. Aranow, H. Einhorn & G. Berlstein, *Developments in Tender Offers for Corporate Control: An Updating of a Prior Treatise on the Practical and Legal Problems Involved in Tender Offers* 20 (1977). If the price of the stock begins to rise as the bidder makes purchases in the open market prior to its tender offer, this implies either that the supply curve is inelastic (and thus a high premium will be necessary) or that news of the impending offer has been leaked. Both possibilities seem likely. Of course, such preliminary purchases are also motivated by the fact that they can be made at a cheaper price than the tender offer and thus lower the overall takeover premium.

118. Such pre-tender purchases are partly intended to gauge the size of the outstanding floating supply of the target's shares on the market or, in more economic terms, the elasticity of

In addition, cogent explanations can be given for why shareholders do not buy more shares at the current price if they consider that price too low. Economic theory has long recognized that rational individuals can have different "offering" and "asking" prices—that is, they might decline to buy at a given price and yet at the same time consider the price too low to justify selling.¹¹⁹ Among the possible explanations for such a disparity between "offering" and "asking" prices are the following: (1) The stockholders may lack sufficient wealth or credit to buy more shares;¹²⁰ (2) Further purchases, even at an attractive price, would cause the stockholders to hold an undesirably undiversified portfolio, which they could not costlessly correct;¹²¹ or (3) Tax considerations, brokerage costs or legal restrictions may make further purchases unattractive.¹²² Whatever the reason, target shareholders have in fact rejected substantial takeover premiums and yet may have shown no desire to purchase additional shares of the same corporation.¹²³ All in all, it requires a heroic suspension of disbelief to accept the Easterbrook/Fischel thesis that the shareholders' supply curve never turns upward.

Where then does this leave us for purposes of public policy analysis? Citing some of the factors just considered, Professor Carney has concluded

the shareholders' supply curve. See E. Aranow & H. Einhorn, *Tender Offers for Corporate Control: A Treatise on the Legal and Practical Problems of the Offeror, the Offeree, and the Management of the Target Company in Cash Tenders and Exchange Offers* 38-41 (1973).

Market testing occurs in another way that also shows the bidder's interest in estimating and publicly revealing the elasticity of the target's supply curve. In Mesa Petroleum's attempt to gain control of Gulf (or force it into a lucrative merger with a white knight), Mesa made an unusually small tender offer for only 8.2% of Gulf's stock. Similarly, Dome Petroleum made a tender offer for only 20% of Conoco stock three years earlier. Market analysts have interpreted these small tender offers as attempts to prove the willingness of shareholders to tender at a small to moderate premium. That is, if the offers were oversubscribed, it would show that the shareholders supply curve was relatively elastic, and it would invite potential bidders to make a much larger tender offer at a relatively low premium. See Cole, *Mesa Bids to Raise Gulf Stake*, N.Y. Times, Feb. 23, 1984, at D1, col. 6. In effect, bidders such as Mesa Petroleum and Dome Petroleum appear to be seeking to advertise the shape of the target's supply curve in order to trigger an auction.

119. For example, an individual might give very different estimates of value to a given asset (say, a house) depending on whether he was asked how much he would be willing to pay to buy it or what price he would insist upon, as its owner, before he would sell it. See Kennedy, *supra* note 40, at 401-10 (summarizing literature on the offer-asking price disparity).

120. Although wealth differences are the traditional reason for a divergence between offer and asking prices, see *id.* at 401-10, and could easily account for the inability of smaller investors to purchase at a price they considered inadequate to justify a sale, this explanation cannot account for the behavior of institutional investors.

121. See Carney, *supra* note 1, at 356.

122. For example, institutional investors often have long established rules against holding more than a defined percentage of their portfolio in any one stock. These rules are also motivated by legal considerations, such as the possibility of § 16(b) liability under the Securities Exchange Act of 1934 for "short-swing" profits if the stockholder owns more than 10% of a given class of stock in the corporation. See 15 U.S.C. § 78p(b) (1982); *supra* note 90.

123. See Carney, *supra* note 1, at 357 n.73 (citing an instance of a 94% premium, which over 15% of the shareholders of the target corporation still declined to accept).

that any restrictions on shark repellent provisions are therefore unjustified.¹²⁴ But this conclusion ignores the plain fact of managerial bias and the ease with which shark repellents can be combined with other defensive tactics—such as the lock-up or the self-tender—in order to give management an effective veto over any proposed takeover bid.¹²⁵ If shark repellents were simply a sensible means for shareholder coordination, it would be inexplicable that institutional investors—the most informed and motivated of investors—appear systematically to oppose most forms of them.¹²⁶ That such amendments are adopted in the face of institutional investor resistance testifies more to shareholder powerlessness than to the optimality of shark repellents. Also, Professor Carney's sanguine explanation of shark repellents overlooks the ease with which management can magnify the impact of a shareholder-ratified supermajority, either by subsequently issuing shares to an ally in a lock-up or by undertaking a self-tender to increase the percentage of the corporation's shares that it and its allies hold.¹²⁷

124. *Id.* at 342, 373-84.

125. Professor Carney's analysis focuses only on shareholder approved measures—such as supermajorities and fair price provisions—and ignores other forms of defense tactics, such as the lock-up, the crown-jewel option or the "Pac-Man" counter tender offer, which are management initiated. It may be implicit in his argument that he deems only shareholder-approved measures to be legitimate, but even these measures can be manipulated by management. Even if lock-ups were banned or restricted, a determined management could still encourage its allies to buy in the secondary market on the promise that future considerations would be paid for their support. Other potential allies—such as the corporation's pension fund—may have the same conflict of interest as does management.

126. See *supra* note 101 (noting that although institutional investors are divided as to the desirability of "fair price" amendments, they object to other supermajority provisions by a wide margin).

127. For example, a supermajority of 70% may not seem insurmountable at the time shareholders approve it as an intended protection against a partial bid. But if this amendment were then followed by a lock-up in which the target sold a 20% block of its authorized but unissued shares to a friendly ally, the hostile bidder would very likely be thwarted. For such an example, see *Treadway Co. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980). Additionally, if the hostile bidder had not yet purchased a significant percentage of the target's stock, the target could purchase its own shares in the open market, thereby increasing the percentage held by the ally. Finally, to induce an ally to acquire a significant percentage, the target may agree also to sell assets that it otherwise would not have sold. A good illustration of the range of tactics available to a target management is supplied by the recent efforts of Carter Hawley Hale Stores, Inc. to resist a takeover by The Limited, Inc. Following The Limited's hostile bid, Carter Hawley Hale issued a block of one million preferred shares to General Cinema, which block gave the latter 22% of the voting power in Carter Hawley Hale; General Cinema also was permitted to purchase a highly profitable subsidiary of the target—possibly as the price for making its investment. Then, using the cash received from the asset sale to General Cinema, Carter Hawley Hale offered to purchase 15% of its own stock, thereby enhancing the percentage owned by General Cinema. Finally, because some 18.5% of Carter Hawley Hale's stock is held by its employee profit-sharing plan, Carter Hawley Hale could anticipate having substantial influence over 60% of its own stock, even if all other shareholders tendered to the bidder. See Barmash, Labor Dept. Study on Carter Hawley, N.Y. Times, Apr. 23, 1984, at D1, col. 3.

Moreover, management's effective control of the proxy machinery enables it to control the formulation of any proposal for shareholder coordination. Recent research suggests that the power to control the agenda is a potent force, especially when shareholders have only the limited right to ratify or reject management's decisions.¹²⁸ As a result, shareholders may face an imperfect and deliberately limited choice. Assume, for example, that shareholders would opt for a modest sixty-five percent supermajority requirement if they could state their preferences. Knowing this, management might still propose an overly protective seventy-five percent amendment. This would present shareholders with a choice between the existing fifty percent approval requirement, which the bidder can exploit, and the seventy-five percent requirement, which management can exploit and which it proposed with the knowledge that it was closer to the true desires of shareholders than the existing even-more-imperfect alternative.

In addition to this problem of restricted choice, which forces shareholders to accept the lesser of two evils, it must also be recognized that shareholders have only limited incentives to oppose management proposals. As Professor Gilson in particular has argued, a rational apathy characterizes the behavior of shareholders. No single shareholder can fully appropriate the gain that his individual efforts might produce and so none will individually incur the costs that it would be rational for all shareholders collectively to expend.¹²⁹ As a result, a classic "free rider" problem arises. Because there is no generally available mechanism for the pro-rata sharing of costs incurred in the common defense, shareholders will not fund resistance to management to the same extent as would a single shareholder who owned all the stock.¹³⁰ This implies

128. See Levin & Plott, *Agenda Influence and its Implications*, 63 *Va. L. Rev.* 561 (1977). A series of recent empirical studies has found that management proposals to shareholders often produce stock market reactions which indicate that the proposals are not in the latter's best interests and would reduce shareholder wealth. See Bhagat, *The Effect of Pre-emptive Right Amendments on Shareholder Wealth*, 12 *J. Fin. Econ.* 189, 191-92 (1983) (citing recent studies).

129. See Gilson II, *supra* note 1, at 822-27. The literature on this problem of free riding, particularly, in connection with public goods, is voluminous and essentially begins with M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* Harvard Economic Studies vol. 124 (1965). A simple example shows its applicability to the shareholder context. Assume that the expenditure of \$200,000 by shareholders could force management to halt its resistance to a takeover and thereby secure a gain of \$1,000,000 for all shareholders. Collectively, it would be rational for shareholders to spend up to \$999,999 to secure the \$1,000,000 premium (if it were certain), but this amount can be raised only if all shareholders can be assessed pro-rata. A hypothetical shareholder who owns 5% of the target firm would find it uneconomic to expend \$200,000 himself in order to secure only 5% of \$1,000,000 (or \$20,000). Thus, unless a sufficient number of shareholders can coordinate their activities and share expenses, the expenditure will not occur. Each individual shareholder, however, believes that others will pay and that the gain will be received whether he pays or not. Such attempts to obtain a free ride may result in a failure to raise the \$200,000 and the much greater premium will be lost.

130. Interestingly, corporate law has successfully developed an answer to the free-riding problem in other contexts. For example, the plaintiff shareholder who maintains a successful

that shareholder resistance will be systematically underfunded in the case of publicly held corporations.

In the last analysis, Professor Carney's thesis that shark repellants represent a socially desirable mechanism for shareholder coordination contains a sound diagnosis, but a flawed prescription. The recent history of stock repurchases by target corporations in order to buy off potential bidders at a substantial premium over the market price shows that management has the practical ability to use stockholder funds to prevent a control contest from developing.¹³¹ Typically, the stock market reaction to these repurchases is strongly negative.¹³² Thus, if rational shareholders were capable of coordinated action, the first supermajority provision that they would be likely to adopt would be one designed to chill or prevent such corporate stock repurchases from potential bidders. That they have not been able to do so in turn suggests that this theory of shark repellants as a desirable form of shareholder coordination must be viewed with considerable skepticism. In the face of partial bids, shareholders may well desire some form of coordinated protection, but the end result is likely to be biased upward by management's own self-interest. The simpler, safer answer may be to attack the problem at its source by eliminating partial bids.¹³³

Still, Professors Carney and Gilson have each made valid points that must lead us to a highly equivocal conclusion. The former has shown that rational shareholders could intelligently decide to adopt some form of supermajority provision even though it would reduce the probability of a tender offer. But the latter's analysis indicates that target managements can bias the charter amendment process and use shark repellants to obtain excessive insulation. Neither position refutes the other. Thus, governmental oversight of the market for corporate control appears necessary, but sweeping prophylactic rules do not seem clearly justified as in the best interest of shareholders. Perhaps the best way to resolve the tension is to recognize that the auction market and shark repellants are competing solutions to the same problem.

derivative action has his costs and attorneys' fees paid by the corporation, which in effect taxes all shareholders pro-rata. See, e.g., Del. Code Ann. tit. 8, § 326 (1983).

131. For a survey of such repurchases, see Kirkland, *When Paying Off a Raider Benefits the Shareholders*, *Fortune*, Apr. 30, 1984, at 152.

132. See Bradley & Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 *J. Fin. Econ.* 301 (1983); Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 *J. Fin. Econ.* 275 (1983). Both these studies found that repurchases from a potential bidder result in a wealth loss for the remaining shareholders; Dann and DeAngelo found the magnitude of this wealth loss to be 6%, and Bradley and Wakeman place it at 13% "for repurchases that mark the termination of a take-over bid." Bradley & Wakeman, *supra*, at 327. For other recent data that find that the share price does not decline all the way to its prior level before the insurgent began its purchasing program, see Kirkland, *supra* note 131, at 154. This is probably best explained as reflecting the market's belief that once a firm is identified as a takeover target, it remains a target, even if the initial bidder is "bribed" to abandon its bid.

133. This proposal is advanced in more detail *infra* notes 431-54 and accompanying text.

Both raise premiums but reduce frequency. Thus, while shark repellents may be defended in isolation, it is more difficult to justify them as an additional protection in a competitive auction environment where partial bids are restricted and where bidders must at least anticipate a rival bid and so will initially offer high premiums to discourage potential rival bidders. The auction market thus yields the desired result and avoids the potential for managerial manipulation inherent in shark repellent provisions. This does not mean that shark repellents are never justified, but it does suggest that from a regulatory perspective, highly restrictive limits should be placed on their use.

D. The General Deterrent Effect of the Hostile Takeover

To this point, this Article has focused only on the interests of shareholders in receiving a direct gain in the form of a premium for their shares as the result of an actual or threatened corporate contest. That interest can be defined as the product of the probability of a hostile bid being made times the size of the expected premium. Still, such a definition of the shareholders' self-interest fails to account for all the interests of shareholders in corporate control contests, because it ignores the benefits received by shareholders in the vast majority of corporations for which a hostile bid is never made. To the extent that hostile takeovers produce a desirable general deterrent effect, which constrains managerial self-dealing and inefficiency, these shareholders also benefit. In this light, probably the strongest argument in favor of the Easterbrook-Fischel position that auctions should be discouraged is that a zero premium policy will maximize the general deterrent effect of the hostile takeover by increasing the frequency of hostile bids.

To understand the impact of this deterrent effect on shareholder wealth, it is useful to think of the value of a share of stock as being the sum of two components: (1) the price that would prevail in the market under current management if no takeover bid were forthcoming multiplied by the probability that no offer will be made, and (2) the premium that would be paid over this price in a hostile tender offer multiplied by the probability of such an offer.¹³⁴ Because the probability that a hostile tender offer will be made for any specific corporation is relatively small, the second component—the expected takeover premium—is likely to be the smaller of the two.¹³⁵ Indeed, these two components of value may at times even have an inverse relationship.¹³⁶ As a result, legal rules that discouraged competitive bidding, thereby

134. This statement is only a rephrasing of a point originally made by Professors Easterbrook and Fischel. See Easterbrook & Fischel I, *supra* note 1, at 1164 & 1178 n.44. But see *infra* notes 140, 145-54 and accompanying text.

135. The highest number of cash tender offers between 1965 and 1982 was 205 in 1981, while 1982 saw only 117. See *supra* note 95.

136. This would be the case if the demand for corporate control were inelastic as considerable evidence suggests, see *supra* notes 104 & 116, but a higher frequency of takeovers generated

increasing the frequency of takeovers, could in theory produce a net benefit for shareholders by maximizing the size of the first component of value, even if they minimized the size of the second component.¹³⁷ Accordingly, even if the demand for corporate control is inelastic and even if auctions and shark repellent provisions do maximize the size of the expected takeover premium, it is still possible that the higher frequency of takeovers under the Easterbrook/Fischel position would produce a greater gain in the first component (the value under current management) than it would a loss in the second component (the expected takeover premium). Yet, the trade-off between these two components must remain indeterminate because we cannot reliably estimate (a) their relative size, (b) the incremental, general deterrent effect of increased capital market discipline, or (c) the possibility that over-deterrence might result because of "excessive" capital market discipline.

Still, the traditional theory of criminology provides a useful analogy that tends to confirm the view that there should be increased deterrence under a regime of more frequent takeovers. In general, criminologists have placed greater emphasis on the likelihood of detection than on the severity of the sanction in estimating the impact of deterrence.¹³⁸ Indeed, not only is the probability of a takeover higher under the Easterbrook/Fischel position, but the severity of the sanction is also greater. Dismissal of incumbent management is likely to occur more quickly and with less face-saving diplomacy in the wake of a hostile takeover than in the aftermath of an arranged marriage with a white knight. In addition, the executives who are dismissed probably will be shareholders as well, and they stand to receive a lower premium for their shares under the Easterbrook/Fischel rule of passivity than under a system that facilitates an auction market.¹³⁹ Thus, the two standard variables criminology uses to analyze the deterrent effect of a sanction—probability of apprehension and severity of sanction—both point in favor of a policy of high frequency and low premiums.

additional deterrence (as it may), thereby reducing managerial inefficiency and raising the market price. In such an environment, a policy of encouraging auctions would maximize the second component—the expected premium over the price that would prevail under the incumbent management—but might reduce this first component by a greater margin.

137. See generally Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 *Bell J. Econ.* 42 (1980). Thus, in terms of Diagram A (see text *supra* note 96), even if the Easterbrook-Fischel position failed to maximize the expected takeover premium because the demand curve for corporate control was relatively inelastic, it might still maximize the value of the firm because the enhancement of this first component of value more than offsets the relative loss in the second.

138. For a balanced summary of the current evidence on deterrence, see generally Panel on Research on Deterrent and Incapacitative Effects, *Nat'l Academy of Sciences, Deterrence and Incapacitation: Estimating the Effects of Criminal Sanctions on Crime Rates* (1978).

139. In addition, in a "two-tier" bid, target executives who resist the takeover bid and fail to tender will lose their share of the takeover premium and may have their shares cancelled at a low price in a takeover merger. Thus, they tend to incur a greater economic penalty in a hostile bid than if a white knight negotiates a merger with them.

Because deterrence is the wildcard in this debate, it is interesting to consider whether the increased frequency of takeovers in recent years has resulted in changed managerial behavior or in increased sensitivity to the market's judgment. In two respects, the answer appears to be yes. First, survey evidence suggests that takeovers and takeover defenses are currently very much on the minds of corporate management. According to one study, nearly half of American corporate managements already believe their corporation is vulnerable to a takeover; of the remainder, thirty-eight percent have adopted some form of anti-takeover plan to thwart such a bid.¹⁴⁰ This evidence suggests that, even now, we may be operating close to (or beyond) the point of diminishing returns in terms of the ability of a higher frequency of takeovers to yield greater managerial attentiveness or zeal. Indirect evidence is even more probative: by all available accounts, the rate of "asset redeployment" has increased significantly in recent years.¹⁴¹ Although reliable statistics are lacking, the consensus among investment bankers and market professionals is that corporate managers now sell marginal divisions and investments, where as such divisions were once retained even though they lowered the corporation's overall return on shareholder equity. Such a shift in the direction of faster redeployment increases the corporation's return on equity, while correspondingly decreasing the incentive for a hostile bidder to initiate a takeover in order to realize the higher liquidation value inherent in such excess or marginal assets. At least in part, this trend appears to be the anticipatory response of target managements to a new trend in the bidder's motivation for undertaking a hostile tender offer. Increasingly, bidders are announcing that they plan a "bust-up" of the target—that is, a planned liquidation of the target to realize the liquidation value on some or all of its assets. In response, apprehensive managements of potential targets have begun to preempt the bidder by undertaking their own programs of asset redeployment.¹⁴² In overview, these preemptive responses show a heightened sensi-

140. A 1981 survey of chief financial officers at the 480 largest U.S. industrial firms found that 49% believed their company was vulnerable to a takeover; of the remaining group, 38% reported having developed a formal antitakeover plan to thwart such a bid. See R. Reich, *supra* note 5, at 148 (citing survey by Mark Kaplan reported in *High, Necessary Cost of the Takeover Game*, *Financier*, June 1981, at 44-48.

141. For an overview of this trend, see Arieff, *Firms Reverse Field, Start Selling Subsidiaries*, *Legal Times*, Oct. 31, 1983, at 2 (citing TWA's recent spin-off of its airline subsidiary as a response to investor pressure and a proxy contest initiated by Odyssey Partners). Data gathered by W.T. Grimm & Co. shows that 694 divestitures took place during the first three quarters of 1983, and that divestitures accounted for 39% of all acquisition activity during the third quarter of 1983. Divestitures also rose 12% over their level in the third quarter of 1982. For a summary of this data, see *Legal Times*, Nov. 7, 1983, at 8. These divestitures have occurred even within the largest corporations. For a list of 16 major corporate divisions sold in leveraged buy-outs since 1978, see Meyer & McGough, *Where the Smart Money Wants to Go*, *Forbes*, Dec. 19, 1983, at 38; see also *infra* note 150.

142. See Cole, *Proxy War Tacticians*, *N.Y. Times*, May 17, 1982, at D8, col. 3.

tivity to the market's judgment, which tends to confirm the general deterrent effect of the hostile takeover.

Although this pattern suggests that the current impact of the hostile takeover may prune overgrown corporate empires more frequently than it builds new ones,¹⁴³ it also raises the prospect that a still higher rate of takeover activity might compel potential target managements to view their firm's assets in much the same manner as a professional securities trader does his current portfolio. Increased deterrence may well make the manager more sensitive to the market's judgment, but this is a mixed blessing to the extent that the manager may have either better judgment or better information. Although this example of a possible diseconomy will be postponed until Part III, another probable consequence of an increased deterrent threat will be considered next because it involves not a diseconomy as such,¹⁴⁴ but rather an adaptive response by management to the increased risk of a low premium takeover that could deprive management of what it sees as its legitimate entrepreneurial interest in its firm. This response seems likely to offset the benefits to shareholders of the additional deterrence generated by a low takeover premium policy.

E. Management's Response to a Rule of Passivity: The Leveraged Buy-out as a Preemptive Strike

How would management of potential target corporations behave in a world of very low tender offer premiums where defensive tactics were wholly barred and competing bids discouraged? A simple picture has been painted by Professors Easterbrook and Fischel that management would work harder and otherwise be more faithful to the interests of shareholders.¹⁴⁵ But such a

143. An interesting example is supplied by Beatrice Foods. Beatrice Foods has been cited as an example of an empire building corporation which acquired small companies without regard to profitability. See *The Bigness Cult's Grip on Beatrice Foods*, *Fortune*, Sept. 20, 1982, at 122. Yet, in 1983, Beatrice began a divestiture program under which the disposition of 52 companies was planned, 26 of which had been sold as of the end of 1983. See *Beatrice's Stock Buy*, *Fortune*, Jan. 9, 1984, at 111.

144. As the term is used in this Article, a diseconomy has the effect of reducing the aggregate value of the entity or entities involved. Leveraged buy-outs by management are not likely to do this, but may transfer wealth from shareholders to management to the extent that management through its possession of inside information can outpredict the stock market.

145. Easterbrook & Fischel I, *supra* note 1, I at 1169-70 ("Corporate managers . . . , like all other people, work harder if they can enjoy all of the benefits of their efforts. . . . Because no single manager receives the full benefit of his work, he may find that, at the margin, developing new ventures and supervising old ones takes too much effort to be worthwhile No manager will be completely vigilant. So some managers will find it advantageous to shirk responsibilities, consume perquisites, or otherwise take more than the corporation promised to give them. . . . As a result, many firms will have some employees less than completely dedicated to their jobs and other employees who, although fully dedicated, ought not to be in the positions they hold.'). Although it must be conceded that some managers will shirk, the critical issue is whether the threat of a takeover can reduce agency costs sufficiently to deter such shirking.

picture is seriously misleading. Rather than seeing itself as the shareholders' agent, management very likely views itself as a joint venturer with its shareholders in an enterprise that is substantially dependent upon management's skill and judgment for its success.¹⁴⁶ The enhanced danger of ouster under a regime of frequent takeovers threatens the senior management group with the potential loss of what they predictably see as their legitimate entitlement to share in the future earnings and stock appreciation of the firm. The problem is most acute for a management group that is successfully turning around a previously failing or marginal firm. Even in an efficient market, abundant empirical evidence shows that insiders can outperform the stock market with respect to investments in their own corporation's stock.¹⁴⁷ This means that a turnaround management can know well ahead of the market that its firm's stock should rise significantly in the near future. Meanwhile, the firm's stock price may remain depressed in the market, because general skepticism still exists as to whether the firm's performance will improve. In this setting, a hostile tender offer at a low premium threatens to deprive managers of a gain they expect and believe they have earned.

What could management do about this if defensive tactics were forbidden? The simple answer is that management could do a great deal to protect itself through anticipatory measures initiated well before a specific control contest was in view. Apprehensive managers who believe their firm's stock price will shortly improve can always buy the firm themselves. Even under a strict rule of passivity, target management could still preempt the potential control contest by taking the firm private. Thus, an important failing of the *ex ante* perspective adopted by Professors Easterbrook and Fischel is that it is simply not *ex ante* enough. From a truly before-the-fact vantage point, one must balance the shareholders' interest in a tender offer at a premium against their vulnerability to a managerial buy-out in a transaction where management has the benefit of favorable inside information.

One predictable response to this argument is that, even when a takeover is not threatened, management always has an incentive to exploit its superior information and thus purchase its own firm at a bargain price. However,

146. Professor Klein sees the managerial employee as having typically traded a reduced level of fixed compensation in return for a contingent claim to share in the enterprise's profits, thus making such an employee as much a residual claimant as the stockholder. See Klein, *supra* note 20, at 1528-29, 1532. Professor Klein concludes that management's interest in "continued employment has a significant impact on managerial behavior and attitudes and, consequently, on the interests of other claimants." *Id.* at 1541. This effect will be considered in more detail in the text in Part III, *infra* notes 265-75, 309-15 and accompanying text.

147. See, e.g., Finnerty, *Insiders and Market Efficiency*, 31 *J. Fin.* 1141 (1976); Jaffe, *Special Information and Insider Trading*, 47 *J. Bus.* 410 (1974); Lorie & Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 *J. L. & Econ.* 35 (1968). This ability of insiders to outperform the market is conceded by Professors Easterbrook and Fischel. See Easterbrook & Fischel I, *supra* note 1, at 1168.

absent the threat of a hostile takeover, management is restrained from engaging in such a buy-out by the considerable economic risk associated with holding an undiversified portfolio that is "over-invested" in a single investment (that is, the management's own firm).¹⁴⁸ In a world of very low takeover premiums, management may feel compelled to accept this risk, because the alternative is exposure to the countervailing risk of a hostile bid that divests it of its expected gain from its firm. On the other hand, in a competitive auction market characterized by higher premiums and lower frequency, management is both less subject to this risk and receives a higher premium on its own shares should the hostile bid come. In short, a low premium policy forces managers to accept an undesired level of risk and forces other shareholders to accept buy-outs that essentially represent a form of insider trading.

Empirical support is available for the prediction that managerial buy-outs will increase in direct proportion to the rate of takeover activity. Leveraged buy-outs by management now account for a significant percentage of all acquisitions, and, by some estimates, they may have accounted for as much as fifty percent of all acquisitions completed in 1983.¹⁴⁹ Clearly, the proportion they represent of all acquisitions is rising at a dramatic rate, and one study by W.T. Grimm & Co. indicates that the number of such management buy-outs more than doubled between 1980 and 1982.¹⁵⁰ This statistic suggests both that the threat of takeovers may already have induced a substantial increase in the rate of buy-outs and that the frequency of buy-outs should increase further if a zero premium policy were pursued.

The point here is not that buy-outs are bad. Indeed, leveraged buy-outs help ensure that there will be an auction. If bidders are permitted to make a "two-tiered" bids at low premiums, managements should be permitted and encouraged to make their own higher counter-bids. This counter-move in fact

148. Others have suggested that because management effectively holds an undiversified portfolio in its own firm, it may wish to make diversifying acquisitions that are not in its shareholders' best interests. See Note, *supra* note 48, at 1241-44. Here, this idea explains why management would not exploit every opportunity to acquire all the stock in its own firm though it possesses material nonpublic information of a forthcoming profit turnaround. The recent increase in "buy-outs" in direct correspondence to the increased takeover threat implies that managements had not previously exploited every opportunity to "go private" based on material inside information, and supplies some confirmation of this hypothesis.

149. W.T. Grimm & Co. has reported that of the 694 divestitures that took place during the first three quarters of 1983, 104—or 15%—were leveraged buy-outs. See *supra* note 141. The managing director of Merrill Lynch Capital Markets predicted that leveraged buy-outs would account "for up to 50% of all corporate acquisitions in 1983, compared with 15% to 20% in 1982." See Hill & Williams, *Buyout Boom: Leveraged Purchases of Firms Keep Gaining Despite Rising Risks*, *Wall St. J.*, Dec. 29, 1983, at 1, col. 6; cf. Lederman, Citron & Macris, *Leveraged Buyouts—An Update* (outline for 15th Annual Institute on Securities Regulation).

150. As computed by W.T. Grimm & Co., leveraged buy-outs rose from under 50 in 1980 to over 110 in 1982. See *Leaning on the Levers*, *Fortune*, July 11, 1983, at 112. In addition, as the preceding footnote indicates, 104 were completed within the first three quarters of 1983. For a list of recent leveraged buy-outs, see Meyer & McGough, *supra* note 141, at 38.

suggests that a zero premium policy is an illusory goal, because target management will be likely to seek to outbid a takeover made at only a nominal premium. Still, the anticipatory leveraged buy-out that precedes a hostile offer is a more disquieting phenomenon. Although leveraged buy-outs have a variety of justifications in the abstract,¹⁵¹ there is a fundamental inequality of bargaining power between management, which has access to inside information, and its shareholders, who do not. In addition, there is the problem of the high degree of leverage associated with such buy-outs, which increases the risk of bankruptcy and thereby affects nonshareholder classes as well.¹⁵² For both of these reasons, a policy which sought to reduce takeover premiums to benefit shareholders could result in a Pyrrhic victory, even if we assume that a policy of low premiums and high frequency was more profitable for shareholders than the converse policy of an auction market.¹⁵³ Ultimately, the attempt to institutionalize a rule of absolute passivity seems likely to place the interests of management and its shareholders so firmly in opposition as to encourage both buy-outs and other questionable practices still unforeseen. Conversely, a policy of facilitating auctions can accommodate the leveraged buy-out as simply another competing bid, while also reducing the frequency with which such buy-outs occur as the initial bid.¹⁵⁴

F. Summary

The conclusions that emerge from the analysis to this point are principally negative ones. Neither the Easterbrook and Fischel position that competitive bids are undesirable nor the converse position of Gilson and Bebchuk

151. Most obviously, a managerial buy-out reduces agency costs. Because management now retains the greater portion of the firm's earnings (along with the equity investors who financed the buy-out), there is a reduced incentive to shirk or to consume perquisites. See note 145 *supra*.

152. See *infra* notes 301-15 and accompanying text. Managerial buy-outs probably tend to be highly leveraged because individuals lack the resources of corporate bidders and so must rely on their firm's debt capacity to effect the acquisition and because managerial buy-outs in response to a potential hostile takeover obviously are time constrained, thus denying management a full opportunity to seek large equity investors.

153. The normative and legal issues in leveraged buy-outs are beyond the scope of this Article, as is the reach of SEC Rule 13e-3, which regulates "going private" generally. Suffice it to say here, however, that SEC Commissioner Beavis Longstreth struck a responsive chord when he recently concluded that:

In management buyouts, the current rules of the game—both federal and state—fail adequately to assure to public shareholders a fair deal—that is, the highest price currently obtainable

See Longstreth, *Fairness of Management Buyouts Needs Evaluation*, *Legal Times*, Oct. 10, 1983, at 14, 21; cf. Brody, *Controversial Issue: A Leveraged Buy-Out Touches Off a Bitter Dispute*, *Barron's*, Sept. 19, 1983, at 12, 15 (describing one recent dispute at Empire, Inc.).

154. In a competitive auction market, management would realize that any proposal to take the firm private would be likely to touch off a bidding contest that it was likely to lose. For example, the attempt by Norton Simon's management to take that firm private eventually resulted in its acquisition by Esmark. See Tracy, *David Mahoney's Two Hats*, *Fortune*, July 11, 1983, at

convincingly demonstrate a way to maximize shareholder wealth or economic efficiency. Professor Carney appears to have overstated the case for shark repellents, principally because of their redundancy given the *ex ante* effect of an auction market on takeover premiums.

On balance it seems more likely today that competitive bidding benefits shareholders, but this conclusion rests on inferential data, and it must be conceded that an auction market implies a decreased frequency of takeovers.¹⁵⁵ Thus, Professors Easterbrook and Fischel are probably correct in their claim that a rule of passivity would maximize deterrence. Yet, this increased deterrence may come at too high a price—either because it may encourage wealth transferring acquisitions, such as managerial buy-outs, or because the magnitude of the incremental gain in deterring shirking may be too slight to justify the costs. We may already be operating close to, or beyond, the point of diminishing returns in terms of the disciplinary capacity of the hostile takeover. Finally, the disciplinary capacity of the hostile takeover may have been exaggerated by its proponents. Part II will next survey this question.

II. THE HOSTILE TAKEOVER AS THE ENGINE OF CORPORATE ACCOUNTABILITY: A CRITICAL ANALYSIS

Since Henry Manne first coined the phrase “market for corporate control” nearly twenty years ago,¹⁵⁶ it has approached the status of a truism within the “law and economics” community that hostile takeovers serve as the primary disciplinary mechanism by which corporate managements are held accountable.¹⁵⁷ Proponents of this view tend to minimize the importance of other techniques of ensuring accountability—such as independent boards, shareholder voting, derivative litigation, or mandatory disclosure statutes.¹⁵⁸ Such alternative modes are seen as confounded by a free rider problem, which

109. In this light, competitive bidding seems the optimal remedy for the problems associated with managerial buy-outs; it is relatively costless to society, should deter many undervalued buy-outs and increases target shareholder wealth.

155. The proposition that demand curves tend to slope downward to the right is a fundamental one in economics and cannot be distinguished away by narrow arguments about the specific motivations of bidders in takeovers. The historical evidence is certainly consistent with this view, because it shows that the number of takeovers declined once the Williams Act encouraged competitive bidding. See *supra* note 95. Moreover, even within the takeover context, there are persuasive reasons to believe that the initial bidder will frequently incur a loss on his search activities and investment (at least in terms of his opportunity costs) if he is outbid in an auction. See *supra* notes 88–95 and accompanying text. Thus, the disincentives created by permitting an auction market appear quite real.

156. See Manne, *supra* note 14.

157. See *supra* note 15.

158. For a representative statement of this perspective, see Fischel, *The Corporate Governance Movement*, 35 *Vand. L. Rev.* 1259 (1982).

prevents shareholders from serving as effective monitors of management. The implications of this hypothesis are obviously significant. If capital market discipline alone were adequate to monitor and replace corporate managements, then much of existing corporate law—such as the legal rules governing self-dealing and fiduciary duties—should either wither away as obsolete or be viewed as simply nonmandatory provisions, which the parties to the corporation may modify as they choose.¹⁵⁹

Seldom, however, has this thesis been critically examined. In particular, two basic difficulties with the thesis have not been adequately faced by the existing literature. First, severe limits appear to exist on the degree to which takeover premiums can be minimized; this implies that the utility of the hostile tender offer is likely to be limited to instances of gross managerial failure. Second, there is also considerable evidence that takeovers do not focus on the worst-managed companies, but rather operate only within an intermediate range where the expectation of a short-term turnaround profit exists.¹⁶⁰ These assertions neither deny that a substantial disciplinary capacity still exists nor challenge the premise that corporate control contests should serve the interests of allocative efficiency. They do suggest, however, that the utility of the hostile takeover is bounded. Accordingly, because it is at best a partial remedy and cannot be seen as a substitute for other modes of accountability, it is necessary to consider where the hostile takeover fits within our overall scheme of corporate governance.

A. *The Limits of Market Discipline*

Early in one of their provocative articles, Professors Easterbrook and Fischel state the case for the disciplinary effect of hostile takeovers in bald and unqualified terms: "The tender bidding process polices managers . . . and disciplines or replaces them if they stray too far from the service of the shareholders."¹⁶¹ But how far is "too far"? Most instances of managerial inefficiency or self-dealing will not result in a significant enough discount in the corporation's shares to justify the substantial tender offer premiums that have recently prevailed. Surveys have reported that the average premium in

159. This is close to the position already taken by Professors Easterbrook and Fischel. They argue that the principal value of fiduciary duties is that "[t]he existence of such 'off-the-rack' rules reduces the costs of transacting and of enforcing restrictions on the agent's powers." Easterbrook & Fischel II, *supra* note 1, at 702.

160. See text *infra* accompanying notes 172, 198–207. Business executives have so stated on numerous occasions. For example, the chief executive officer of Northwest Industries, Benjamin Heineman, has claimed his own company looks for targets "earning at least 12% on capital and whose markets are growing by 10% a year or more." According to Heineman, "It always takes longer than anyone believes to turn a company around." See *The Great Takeover Binge*, *Bus. Wk.*, Nov. 14, 1977, at 179.

161. Easterbrook & Fischel I, *supra* note 1, at 1169.

cash tender offers during some recent periods has exceeded the stock market price of the target's stock prior to the announcement of the offer by as much as seventy percent.¹⁶² A rational bidder will offer such a premium over the market price (and incur notoriously high transaction costs as well) only if it believes that the future value of the target's stock under different management will exceed the price it offered the target's shareholders within a relatively brief period. Accordingly, before a takeover would be cost-justified, the management of a target corporation would either have to have dissipated the greater portion of the company's value through inefficient performance or self-dealing or have convinced the market that recurrent substantial deviations from the goal of shareholder profit maximization were likely for the foreseeable future.¹⁶³

Whatever the plausibility of this scenario as it might apply to simply inept or overly risk-averse managements, it clearly has limited relevance to the problem of self-dealing. To believe that the tender offer can discipline self-dealing when the typical tender offer premium exceeds fifty percent requires one also to believe that management had first misappropriated a sufficiently large proportion of the corporation's value to cause the market to discount the corporation's shares by more than half. No matter how venal or self-interested the management, such a thorough-going looting seems highly unlikely today in the case of a public corporation living in an environment of constant disclosure and subject to both public and private enforcement. Not only are the numbers involved simply too immense and case histories of abuse on such a scale extraordinarily rare, but there is also a timing problem that makes hostile takeovers largely irrelevant to the problem of self-dealing. The discount in the target corporation's shares should attract a bidder only if the damage to the target is reversible. Yet, the losses caused by a self-dealing management can seldom be restored.¹⁶⁴ Once the horse is stolen, it does little good to buy the empty barn at a premium.

162. See Jarrell & Bradley, *supra* note 56, at 373 (finding that average takeover premium rose to 73% after passage of state antitakeover statutes).

163. If the misappropriation or other loss is perceived by the market as likely to recur, then it need not approach a significant portion of the company's value to produce a significant decline in share value. If repetition were likely, a rational market would in effect capitalize the instant loss and subtract it from what otherwise would be the aggregate value of the firm's shares. Yet, except with respect to the possibility of excessive compensation (where recurrence is likely, but where the aggregate impact on earnings is likely to be modest), this scenario is not plausible. Opportunities for significant self-dealing transactions in large, publicly held corporations arise only occasionally and in a random, generally unpredictable fashion. Also, the truly predatory management which seeks such profits repeatedly may be disciplined by other means, including derivative litigation. From an "ex ante" perspective, this means that an efficient market would not anticipate that a given instance of self-dealing was likely to be repeated with sufficient regularity to justify capitalizing it and subtracting it from the firm's "going concern" value.

164. Professor Lowenstein, a former chief executive officer of a New York Stock Exchange listed corporation, has argued that the damage done by poor management has often proven

If the disciplinary capacity of the takeover thus seems irrelevant to the context of self-dealing transactions, its ability to remedy inefficiency is more realistic. Here, it is not implausible that the market might discount the target corporation's shares by a margin greater than the tender offer premium because of managerial ineptitude. Yet, even within this more limited context, two problems remain with the Disciplinary Hypothesis.

First, the hostile bidder, as an external monitor, is unlikely to be the first to detect or respond to managerial inefficiency. Generally, there should be an earlier tripwire—namely, internal monitoring within the firm, leading in the case of inefficiency by senior managements to their removal by increasingly independent boards of directors, who may have been pressured into action by dissatisfied shareholders or, ultimately, apprehensive creditors.¹⁶⁵ So long as the takeover premium necessary to acquire control is high, one must ask why a minimally independent board would not first detect the inadequacy of the incumbent managers and intervene at a point well before a takeover at a substantial premium became cost-justified. To be sure, one may be justly skeptical about the independence of outside directors in many instances.¹⁶⁶ But even those most critical of the board's performance have acknowledged that the board has consistently performed one essential function—that of crisis intervention, once management's inability to continue has become evident.¹⁶⁷ Particularly within recent years, board-initiated coup d'états have become increasingly common, even in cases where management had seemed entrenched.¹⁶⁸ In principle, the board has far better access to confidential

"irreparable" (citing examples of Montgomery Ward, Marshall Field, A & P, and First National Stores). Lowenstein, *supra* note 1, at 305 n.223. In addition, the disruptive impact of the hostile takeover and associated executive turnover may aggravate the managerial problem at the height of the crisis.

165. The limited empirical data available suggest that the rate of turnover among chief executives and chief operating officers has increased significantly in recent years. In particular, the number of such resignations during 1980-1983 was three times the rate it was in 1960-1964 and more than twice the rate of 1970-1974. See *Turnover at the Top*, *Bus. Wk.*, Dec. 19, 1983, at 104 (citing study of 100 of the largest U.S. corporations by Professor Eugene Jennings). Although much of this turnover is the product of takeovers, a list of major executive firings in 1981-1983 shows more executives departing as the result of pressure from creditors or in the wake of large losses than as a result of takeovers. *Id.* at 105. More theoretically oriented studies have found executive turnover to be "positively related in a quite responsive way to profit variations." See Crain, Deaton & Tollison, *On the Survival of Corporate Executives*, *So. Econ. J.*, Jan. 1977, at 1372, 1274.

166. For such a view, see Brudney, *The Independent Director: Heavenly City or Potemkin Village?*, 95 *Harv. L. Rev.* 597 (1982); accord S. Vance, *The Corporate Director: A Critical Evaluation* 45-46 (1968).

167. See M. Mace, *Directors: Myth and Reality* 47-48 (1971). For a summary of Professor Mace's views on the performance of directors, see Conard, Mace, Blough & Gibson, *Functions of Directors Under the Existing System*, 27 *Bus. Law.* 23, 32-37 (Special Issue Feb. 1972).

168. See *supra* note 165. Citing recent palace coups, Professor Reich finds that the rate of corporate firings has doubled since 1976. See Reich, *supra* note 5, at 161-62.

information about the company than does a hostile bidder, and thus it should be aware of managerial inadequacies well before the market has sufficient evidence of them to discount the corporation's shares by a margin sufficient to trigger a takeover. In addition, the palace revolution should be less costly than the full scale attack launched by outsiders.¹⁶⁹

Phrased more generally, it seems likely that a truly independent board would not tolerate suboptimal performance by management resulting in a share discount large enough to elicit a takeover at any historically prevailing premium level. Of course, some boards are neither independent nor adequately informed, nor do most boards have the same economic incentives to search for mismanagement.¹⁷⁰ Thus, they may passively tolerate substantial inefficiency. This possibility aside, however, the critical point remains that the hostile takeover is at best a failsafe remedy that should come into play only when the board, as the first tripwire, fails to act. This raises a further problem: What happens when internal reform begins to revitalize a company? Even an efficient market's reaction could be slow and hesitant, because the market simply lacks enough information to know if prior errors can be reversed under new management. Not infrequently, a takeover follows such palace coups,¹⁷¹ and in these instances it may be a superfluous remedy that can actually retard the pace at which the target corporation can be revitalized.

The second basic problem with the Disciplinary Hypothesis is its failure to deal adequately with the problem of risk. Because the bidder pays a premium to acquire the target and, after the acquisition may hold a less diversified portfolio, it incurs a higher level of risk than the ordinary investor. Given that risk aversion is a fact of life, it is not surprising that takeovers of

169. No investment bankers need be hired, few legal fees need be incurred and no premium paid. Only an employment contract, if it exists, must be settled. Thus, to a shareholder who owns securities of both bidder and target, this technique of reducing agency costs through close board monitoring is preferable to a hostile takeover.

170. In contrast to a hostile bidder, the director has only weak economic incentives to contest a decision recommended to the board by management. If the decision is reversed, and the corporation's stock price rises as a result, the director gains only to the extent of his investment in the firm, while the bidder who acquires 100% would reap the entire gain. Thus, the director's efforts are constrained by the same "free rider" problem that confounds the shareholder as monitor. However, although the director may have less economic motivation to search and monitor than does the bidder, the director, as an *internal* monitor having access to non-public data, has lower search costs than the bidder, an *external* monitor. Thus, the director could still be a superior monitor.

171. For a possible example, see Berry, *The Bruising Battle for a Harlem Bank*, *Fortune*, Sept. 20, 1982, at 76-77 (describing how the target's "management pulled the tiny bank from the brink of failure," only to face a takeover attempt). Although in such instances the interests of shareholders may be better served if they are able to obtain the takeover premium, it does not follow that economic efficiency is being promoted or that public policy should seek to lower takeover premiums to encourage such changes in control. In addition, the new management will more frequently seek to go private after a successful palace coup.

insolvent or nearly insolvent companies seldom occur. No bidder has yet tendered for (or even approached) Chrysler, International Harvester, or any of the nearly insolvent firms in the troubled nuclear power industry. Financially distressed firms appear relatively immune to takeovers, either because no turnaround seems likely or because the level of risk associated with these companies makes them unattractive candidates for acquisition.¹⁷² Ironically, truly sick companies—or at least those whose problems do not appear to be easily remedied—become indigestible and survive, immune from attack precisely because of their pervasive inefficiency.

This conclusion suggests that the discipline of the capital market operates only within a limited range. Basically, this range is bounded, on one end, by the bidder's level of risk aversion and, on the other, by the minimum premium necessary to acquire control. Companies in which the level of inefficiency is either not extreme enough to justify the necessary premium or so extreme as to surpass the bidder's level of risk aversion fall outside this range and may therefore be only weakly disciplined by the market for corporate control.

Proponents of low takeover premiums would likely contend that today's high premiums shelter managerial inefficiency and constrain the effectiveness of the contemporary market for corporate control. These deficiencies, they would argue, can be attributed to government overregulation, which in effect facilitates competing bids and hence high premiums.¹⁷³ Under this theory, the Williams Act has enhanced the possibility of competitive bids by creating a mandatory minimum period during which the offer must remain open and has thus increased the size of the takeover premium. Absent the Williams Act, the process would be quicker, the premium lower, and the margin for error smaller before a corrective takeover bid would be launched.¹⁷⁴ Thus, this argument runs, if only the Williams Act were repealed, "lightning fast" raids could be launched, auctions would be discouraged, and it would become possible to consummate a tender offer at only a nominal premium, thus enabling takeovers to deter practices, such as ordinary self-dealing, which today seem beyond its effective reach.

If the Williams Act were repealed, however, it is questionable that takeover premiums would drop to nominal levels. First, the size of pre-Williams

172. Not only is there a risk of further decline, but the damage done may simply be irreparable. See *supra* note 164. In the case of these firms, one suspects that few bidders would be spurned and a friendly acquisition could easily be arranged; yet, bidders shy away. Only a foreign bidder eager to acquire a foothold in U.S. markets was willing to buy control of long-unprofitable A & P, and it has publicly proclaimed that it made a mistake in doing so. See Kinkead, *The Executive-Suite Struggle Behind A & P's Profits*, *Fortune*, Nov. 1, 1982, at 89, 90.

173. See Easterbrook & Fischel III, *supra* note 1, at 16-17; see also Fischel, *supra* note 13, at 13-14, 26-27 (discussing negative effects of state regulation of takeovers).

174. Professors Easterbrook and Fischel conclude: "The optimal level of regulation of tender offers . . . is zero. Private and social wealth is greatest when bidders choose their own time periods and disclosures, subject to a prohibition of fraud." Easterbrook & Fischel III, *supra* note 1, at 17.

Act tender offer premiums are estimated to have averaged around thirty percent.¹⁷⁵ Second, when bidders could simply have purchased in the open market before the Williams Act, the fact that they employed the tender offer device needs explanation. The most logical answer to the popularity of the tender offer is that it reduced the bidder's costs, probably because it carried an element of compulsion. As noted earlier, a tender offer, even at a low premium, can create a prisoner's dilemma. Shareholders may feel compelled to tender because they fear an eventual takeover merger at an even lower price.¹⁷⁶ If, absent this coercive element, shareholders would have insisted on a higher price, then the supply curve for target corporation shares may slope upward even more sharply than the pre-Williams Act average premium implies.¹⁷⁷ Third, shareholders have by now learned a variety of means by which to prevent the erosion of takeover premiums, even if the Williams Act were repealed. Most obviously, they could block partial bids and other coercive tactics by adopting shark repellent amendments.

Indeed, this is precisely what shareholders have done: 388 such amendments were adopted between 1960 and 1980.¹⁷⁸ Because the fine art of devising these shark repellents developed largely after the passage of the Williams Act, the level of takeover premiums prior to the Act's passage was in all likelihood artificially low. The decade of the Sixties represents not a stable market but a learning period in which the balance of advantage remained radically tilted in favor of the bidder. Moreover, in the absence of protective regulation such as that supplied by the Williams Act, shareholders would likely be even more prepared to accept excessively restrictive shark repellents, which they would not approve if they were assured of a competitive auction market.

Finally, the market for control has become more competitive because there are today more potential bidders. The first hostile tender offer by one New York Stock Exchange listed corporation for another is generally dated back to only a decade ago—a date well after the passage of the Williams Act.¹⁷⁹ Prior to that point, the population of potential bidders was restricted

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175. See Jarrell & Bradley, *supra* note 56, at 373 (32% for pre-Williams Act average).

176. See *supra* note 111 (estimating a 72% likelihood of a takeover merger within five years of a tender offer).

177. Of course, in the absence of any coercion, some shareholders might seek to gain the special "nuisance value" advantages that hold-outs possess. See, e.g., Grossman & Hart, *supra* note 137, at 45. But rational shareholders would recognize that if too many held out the tender offer would not be consummated and all would lose the premium. As a result, rational shareholders would not adopt overly restrictive supermajority provisions that gave a tiny minority the ability to veto a takeover merger.

178. The great wave of shark repellent charter amendments appear to have come over the last five years. See *supra* notes 99–101.

179. The folklore of the business community identifies Inco's hostile (and ultimately successful) bid for the Electric Storage Battery Company in July 1974 as "the first time a conservative blue chip company had fired its cannon at a peaceable target." See Metz, *Aiding Hostile Takeover Bids*, N.Y. Times, Dec. 28, 1981, at D6, col. 3 (Market Place column). Prior to that

by the then dominant social convention among businessmen that one public corporation did not raid another. Today, the obviously increased number of bidders in turn implies competition and a higher premium level. Equally important is the recent emergence of risk arbitrageurs, who make speculation on takeovers a major aspect of their business. These market professionals typically invest either immediately before or after the commencement of the tender offer and have a strong interest in encouraging a competitive bid by a white knight. In addition, another potential competitor is target management itself. If competing bids are allowed, there seems no valid reason why management should not be permitted to make its own competitive bid in the form of a leveraged buyout proposal. Given the availability of the leveraged buyout, it should be anticipated that target management has every incentive to resist a low premium takeover. Indeed, the recent wave of such buyouts is probably both an anticipatory response to the hostile takeover and evidence of the inherent competitiveness of the market for corporate control.

Thus, even in the absence of regulation, there exist market forces that can be expected to resist any erosion of takeover premiums and are capable of coordinated action to prevent the bidder from forcing an immediate tender. The countervailing power of these investors—the arbitrageurs as well as the institutions that increasingly dominate the stock market—makes it unlikely that a bidder could force the tender of a controlling interest in the target within a very short period, even if no legal obligation existed to keep the offer open for a mandatory minimum period. Through coordinated action, institutional investors may be able to play the role of auctioneer almost as well as the target's own management.¹⁸⁰

In sum, substantial takeover premiums would persist, even if current regulatory constraints were relaxed. On balance, this likely persistence of high premiums implies a severe limitation on the theory of the takeover as a comprehensive corrective for managerial inefficiency.

B. *The Efficient Market and Inefficient Management: The Inconsistent Evidence*

To this point, the core premise advanced by the proponents of the market for corporate control—namely, that efficiently managed corporations will

time, "raids . . . simply were not done by establishment companies" and few investment bankers would represent the raider. *Id.*

180. At least one such instance has already occurred. In 1980, arbitrageurs and institutional investors agreed among themselves not to tender their shares of Crouse-Hinds below a stipulated price in excess of the tender offer price. The strategy worked and lured into the fray another bidder (Cooper Industries) which made a substantially higher bid. See Lowenstein, *supra* note 1, at 307 n.236. Of course, investors cannot grant lock-ups or crown jewel options as can the target's management, but they can arrange with a possible second bidder to tender to it at a higher price, thereby giving the second bidder a fairly certain victory.

seek to acquire inefficiently managed ones—has been only obliquely questioned. On closer examination, however, this premise also seems to be more a partial truth than an iron law. In theory, the Disciplinary Hypothesis predicts that bidders will search constantly and evenly throughout the economy to find mismanaged targets from whose assets they can obtain greater value. Yet, this prediction seems to conflict with the available evidence in three important respects: First, takeover activity has not been constant, but cyclical, and has followed a wavelike pattern as it concentrates on first one industry and then another. Second, bidders seem to pursue companies with strong operating managements at least as often as they pursue companies that have been clearly mismanaged. Third, the search undertaken by bidders for potential targets seems to be a restricted one that is strongly skewed by internal organizational considerations. To the extent these conclusions are accepted, they suggest a more institutionally sophisticated theory of how the takeover functions than that which neo-classical economic theory has given us. This section will propose a synthesis that incorporates some of the insights of organizational theory into a fuller account of the disciplinary reach (and shortfalls) of the hostile takeover.

1. *The Stock Price Studies and the Contrary Evidence.* — The strongest evidence for the proposition that the tender offer monitors and disciplines inefficient managements is well-known: a series of studies has shown that target corporations as a class have underperformed the stock market prior to the tender offer.¹⁸¹ These studies have focused on the stock prices of the target companies net of movements in the market generally and have demonstrated that on average the stock price of target companies was declining against the general market trend for a period dating well before the commencement of the offer. Professors Easterbrook and Fischel rely principally on this data to corroborate their thesis that hostile takeovers “rescue” firms that have experienced substandard performance.¹⁸²

In rebuttal, the skeptic can respond in one of three ways. First, he can contest the premise of these studies that the stock market is efficient and thus challenge their relevance. Second, he can argue that greater weight should be placed on other evidence, such as financial and accounting profiles of target companies, which has not generally found acquired corporations to be financially weaker or less profitable than their acquirers. Finally, even assuming that target companies do on average appear less efficient than bidding firms, he can suggest that bidders tend to limit their search for potential acquisitions by fairly severe criteria, which implies that the reach of the hostile takeover as

181. These studies are summarized in Easterbrook & Fischel I, *supra* note 1, at 1187–88; see also Jensen & Ruback, *supra* note 34, (full review of recent studies).

182. Easterbrook & Fischel I, *supra* note 1, at 1186–88. In their view, it also refutes the Empire Building thesis that takeovers are motivated by managers' desires to increase corporate size.

a mechanism for purging inefficient management will be uneven and erratic at best.

Others have already taken the first option and have attacked the premise that the stock price of a company is the best measure of its value.¹⁸³ The result has been a provocative, but only partially persuasive, challenge to the Disciplinary Hypothesis. Even if the market is thought to be less than fully efficient, it is not irrational, and the consistent finding that target companies lag behind the market as a whole still supports the inference that their managements have performed poorly.

The second option reveals a striking contrast between the results of stock price studies and the results of financial and accounting surveys. In terms of internal rates of return and other accounting data, target corporations do not clearly seem to have been less profitable as a class than their acquirers.¹⁸⁴ Although accounting data can to some extent be manipulated by the incumbent target management, attempts to identify the characteristics of target corporations through statistical techniques based on their financial attributes have had similarly little success.¹⁸⁵ The most important finding of these statistical studies has been that "only a small portion of the factors contributing to acquisition is captured by the statistical models based only upon acquired-firm characteristics."¹⁸⁶ This suggests that synergy may be a stronger motive. In any event, the stock price studies seemingly stand alone; their picture of target corporations as lackluster companies that underperform the market is not corroborated by either statistical or financial studies of the typical target corporation.

Still, the stock price studies cannot be lightly dismissed. Not only do a number of such studies all point in the same direction, but case histories can

183. See Lowenstein, *supra* note 1. As indicated *supra* notes 65-72 and accompanying text, this author has his reservations about this argument.

184. Professor Lowenstein has calculated the return on equity of the 11 industrial corporations that were targets of major hostile tender offers in 1981. Of the 10 that failed to survive as independent companies, five had a higher average return on equity than their ultimate acquirers, and five did not. But, eight had a higher return on equity than the original bidder that initiated the contest. See Lowenstein, *supra* note 1, at 289 n.165. A British study in the 1970's also found that in 19 of 41 cases studied the acquired firm was more profitable than the acquirer. See Singh, *Take-Over, Economic Natural Selection, and the Theory of the Firm: Evidence from the Postwar United Kingdom Experience*, *Econ. J.*, Sept. 1975, at 512 (discussed in Herman, *supra* note 47, at 100).

185. See Harris, Stewart & Carleton, *Financial Characteristics of Acquired Firms, in Mergers and Acquisitions: Current Problems in Perspective* 223, 249 (M. Keenan & L. White eds. 1982) (discussing earlier studies as well). According to this study, price-earnings ratios, liquidity, firm size and indebtedness level all had a statistically significant correlation with the probability of being acquired, but the model as a whole had only weak predictive power.

186. *Id.* at 224. This study concludes that "no strong generalizations can be made from" acquired-firm characteristics alone, but that "matching phenomena between acquired and acquiring firms" offers the best possibilities for predicting "merger behavior." *Id.* at 239.

also be identified in which the target corporations were clearly viewed as the laggards within their industry. Even a cursory review of recent control contests yields a list of target corporations that were widely so perceived: Marshall Field, Kennecott, Pabst, Pullman, GAF, Grumman, Cities Service. Each of these recent target corporations has been objectively described as an industry laggard.¹⁸⁷

If the evidence thus seems in conflict, one interpretation may reconcile much of it and also help explain the limits on the disciplinary capacity of the takeover. To understand this interpretation, it is first necessary to remind ourselves what the stock price studies do and do not compare. Essentially, they measure the performance of the target corporation's stock against the movement of the market as a whole.¹⁸⁸ What they do not measure is the movement of the same corporation's stock against an industry average or a selected control group. This leaves open the possibility that some extrinsic factor, having a unique impact on an industry or a group of firms within that industry, has caused the stock of the target corporation to underperform the market as a whole. For example, an oil embargo or an increase in interest rates may have a particularly adverse impact on the auto or housing industries, respectively. Measuring the performance of a firm only against the standard of the market and ignoring the benchmark of the relevant industry particularly biases the investigation if the intent is to prove the inefficiency of the subject firm. Such an evaluation process would conclude that a firm was inefficient if its stock price rose less than the market average even though it outperformed every other firm in its industry.

Apparently only one study has yet undertaken to examine acquisitions against such multiple benchmarks. In a 1978 paper, Professor Terence Lange-
tieg of the University of Southern California employed three performance

187. Pabst Brewing Co., for example, has beaten back no fewer than seven takeover attempts in recent years, and it reported a net loss in 1982. See Metz, *Back to Brewing: After Takeover Truce, Pabst Battles to Regain its Lost Market Shares*, *Wall St. J.*, June 14, 1983, at 1. Similarly, Marshall Field & Co., which ranks behind its major competitors in terms of return on equity, return on assets, earnings as a percentage of sales and related measures, was the subject of a takeover bid in 1977 before it was acquired in 1982 by B.A.T. Industries. See Curley, *B.A.T Vows to Turn Field into a Success*, *Wall St. J.*, July 30, 1982, at 21, col. 3. GAF has also had a long history of declining stock prices and earnings losses. See Smith, *In Bitter GAF Proxy War, Dissident Gains from Management's Errors*, *Wall St. J.*, Apr. 28, 1983, at 33, col. 4. With respect to Grumman's problems, see Smith, *The Bogged-Down Bus Business*, *Fortune*, Mar. 9, 1981, at 58; see also Gallese, *Big Bite: Wheelabrator Digests Larger Pullman Inc. by Dismembering It*, *Wall St. J.*, Mar. 5, 1981, at 1 (Pullman suffered \$18.5 million loss in first nine months of year in which acquired by smaller bidder); Nulty, *Treasure Hunt at Cities Service*, *Fortune*, June 28, 1982, at 53 (explaining that Cities Service had the highest exploration cost per barrel of oil discovered between 1977 and 1981); Shao, *Tarnished Image: Kennecott, for Years King of Copper Mines, Suffers String of Crises*, *Wall St. J.*, Mar. 5, 1981, at 1, col. 6 (discussing Kennecott's repeated takeover battles and managerial errors).

188. The measure of such price movement net of the general market movement is called the stock's cumulative average residual (or CAR). See Easterbrook & Fischel I, *supra* note 1, at 1186.

indexes to measure stockholder gains from mergers.¹⁸⁹ Examining some 149 mergers, Langetieg measured the gains to the acquired corporation's shareholders against (1) the stock market, using the standard methods employed by other studies, (2) an industry factor obtained by computing the average return to all other firms in the merging firms's industry, and (3) a specially selected control firm within the same industry, whose own residuals (that is, returns net of market influence) most closely matched the subject corporation.¹⁹⁰ Significant discrepancies were found to exist between these different indexes. As with the other studies of stock price performance, the acquired firm exhibited negative cumulative average residuals over a period ending just prior to the merger—a result consistent with the Disciplinary Hypothesis.¹⁹¹ But, surprisingly, so also did the nonmerging control firm, and to the same degree. Langetieg concluded: "We can infer that some external influence has affected both the merging firms and the control firms in a similar way, but we cannot infer that the influence is managerial inefficiency . . ." ¹⁹²

Although the acquisitions examined by Langetieg involved mergers, not hostile tender offers, his findings nonetheless call into question the critical leap in the logic of the Disciplinary Hypothesis—namely, that poor stock market performance implies poor management. Put simply, something else may be occurring on an industry-wide basis, or on a narrower basis within a portion of that industry, that precludes an inference of managerial failure based solely on below average stock performance.

What this "something else" is can reasonably be debated, but a possibility suggested by this data is that the targets of tender offers are disproportionately within depressed industries in which external events have caused stock prices within the industry, or some segment of it, to fall. Several different factors support such a generalization. First, the targets of takeovers have not been randomly distributed across different industries; rather, the takeover movement has successively focused in a series of waves on different industries. An obvious recent example has been the prevalence of natural resource companies as targets of hostile takeovers. In such cases, cyclical price movements in the underlying natural resource may provide a better explanation for the target's depressed stock price than does poor management.¹⁹³ Another example is the semiconductor industry, which, unlike the natural resource industry, has been characterized by high technology and high growth. Yet, in the late

189. See Langetieg, *An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Merger*, 6 *J. Fin. Econ.* 365 (1978).

190. *Id.* at 371. This third factor was intended to test whether the nonmerging "matched" firm's stock also behaved similarly during the pre-acquisition period as the result of some "external influence other than the market and industry influence."

191. *Id.* at 379.

192. *Id.*

193. See *supra* note 63.

1970's twenty-one semiconductor companies—virtually this entire infant industry—were acquired in rapid succession as larger firms decided to gain a toehold in the burgeoning market.¹⁹⁴ Similar waves of acquisitions have hit the publishing, telecommunications equipment, brewing, banking, and casualty insurance industries.¹⁹⁵

The follow-the-leader character of this pattern is inconsistent with the disciplinary rationale of takeovers. Incompetence is not a cyclical characteristic, and thus, if inferior management fueled the takeover movement, one would expect a fairly constant rate of takeovers. Instead, there has been a dramatic boom-and-bust cycle to the modern history of the tender offer.¹⁹⁶ This cyclical character of the process cannot be easily explained by the theory that bidders are simply replacing poor managements with good ones, but it does reinforce the “industry wave” theory under which bidders focus selectively on a particular industry they consider to be undervalued.¹⁹⁷

2. *The Bidder's Motivations: The Survey Evidence.* — Another perspective on bidders' motivation is gained by the refreshingly direct approach of asking them. Surveys that have asked bidders to explain the characteristics that they sought in a potential acquisition have reported that weak companies

194. For an overview of this takeover wave, see Schuyten, *Semiconductor Buying Fever*, N.Y. Times, Oct. 11, 1979, at D2, col. 1 (listing 21 such acquisitions); see also *Can Semiconductors Survive Big Business?*, Bus. Wk., Dec. 3, 1979, at 66 (finding that majority of companies in the field had been acquired in this wave).

195. See Bailey, *Bottom Line: Profitability Makes Book Publishers Tempting Takeover Targets*, Barron's, July 2, 1979, at 11 (in the decade through 1977 there were 215 mergers in book publishing); Bleeke, *Bankers, This Bud's for You*, Wall St. J., Jan. 13, 1984, at 22, col. 4 (describing acquisition waves in brewing industry and noting that between 1980 and 1983 such major firms as Schlitz, Schaefer, Olympia and Pabst were acquired); Gibson, *Suddenly Everybody Wants Small Phone Companies*, Forbes, July 9, 1979, at 114, 117 (reporting also that a prior acquisition wave in the 1960's reduced the number of independents by two-thirds, and that one holding company consummated no fewer than 500 mergers); *Insurance: A Good Buy*, Bus. Wk., July 30, 1979, at 66 (“the wave of takeovers among life companies will continue”).

196. See *supra* note 95 for an annual chart. Although the sudden decline in 1969 can be ascribed to the impact of the Williams Act, which became effective that year, the abrupt changes between 1980, 1981 and 1982 are not so easily explained. Moreover, the history of business acquisitions generally in the United States has been similarly characterized by cyclical volatility. A great burst of acquisitions occurred from 1898–1902, during which more than 3,000 industrial firms were acquired. A second peak occurred from 1926 to 1930. Subsequent high volume periods were 1946–1947 and 1954–1956. See R. Nelson, *Merger Movements in American Industry 1895–1956*, at 5, 37 (1959).

197. Other factors also corroborate this picture of a takeover movement that advances on an industry-specific basis. As noted earlier, see *supra* notes 185–86 and accompanying text, statistical studies have found some evidence that the probability of acquisition is most dependent upon “areas of complementarity between the two firms.” Harris, Stewart & Charleton, *supra* note 185, at 224. Thus, bidders will not search randomly for targets, but will concentrate on firms that “fit” with their own operations. As one sector of the economy becomes more profitable, bidders in this area, having ample cash resources from profits, will seek acquisitions, but will search only within a limited sector of the economy, thereby producing an industry-wave effect. See also *infra* note 199.

are avoided and strong management seems to be the first thing bidders say they are looking for. A 1981 nationwide survey by Touche Ross & Co. asked corporate directors to rate from a list of specified factors the characteristics that made a potential target company attractive. It found that "excellent management" was listed as either a "major attraction" or a "minor attraction" by ninety-eight percent, while the vast majority of responses denied that the perceived inefficiency of the target made it an attractive takeover prospect.¹⁹⁸ By a wide margin, the quality of management outranked other common explanations for acquisitions, such as synergy, high liquidity, unused debt capacity, high cash flow and low price-to-earnings ratios.¹⁹⁹

One can, of course, easily be skeptical about the value of such subjective and even self-serving data. Still, this collective expression of concern over the importance of strong management in the target company is consistent with earlier findings about the replacement of management in the aftermath of an acquisition. Studying the conglomerate mergers of the 1960's, Harvard Business School Professor Jesse Markham found that "two-thirds of the large acquirer companies grant virtual autonomy to the acquired companies in respect to operating decisions; in by far the most typical case, the acquiring company management confines itself to an advisory role."²⁰⁰ Only in one-fifth of the acquisitions that he surveyed was there "more than incidental reorganization" of the management structure.²⁰¹ A similar study also found little integration of the operations of the acquired firm with that of the acquirer and concluded that the acquirer exhibited "a strong preference for capable management which can be retained after the acquisition."²⁰² These earlier findings both reinforce the Touche Ross study and contrast sharply with the inept management thesis.

3. *A Behavioral Analysis: Organizational Dynamics and Bidder Motivations.* — One interpretation can reconcile much of the seeming inconsistency between the stock price studies and the other empirical evidence. From a behavioral perspective, it has long been argued that an important motive for expansion is to increase the opportunities for promotion available to senior

198. Touche Ross & Co., *The Effect of Mergers, Acquisitions, and Tender Offers on American Business: A Touche Ross Survey of Corporate Directors' Opinions* 12 (1981). Eighty-four percent listed excellent management as a major attraction, 14% as a minor attraction; poor management was listed as a major attraction by 9%, a minor attraction by 22%, and no attraction by 69%. *Id.* at 12.

199. *Id.* The most highly rated characteristic was a "major product line in a rapidly growing market," which 91% listed as major, 8% as minor, and only 1% as no attraction. In contrast, synergy received only a 52% response as a major attraction and "substantial excess cash or underutilized debt capacity" was listed as a major attraction by only 43%. *Id.* This focus on product lines and growth markets is likely to fuel the industry wave pattern noted *supra* note 197.

200. J. Markham, *Conglomerate Enterprise and Public Policy* 85 (1973).

201. *Id.* at 85-86.

202. H. Lynch, *Financial Performance of Conglomerates* 282 (1971).

and middle-level executives within the acquiring firm.²⁰³ Yet, an acquisition candidate that is likely to survive as an independent division within a conglomerate bidder will provide few opportunities for internal promotion for the pre-existing managerial staff of the bidder. Such a candidate may well arouse opposition from existing division heads because, if acquired, it will become in essence a competitor for internal funds and corporate resources and thus may interfere with these pre-existing divisions' ability to undertake desired plans or projects.²⁰⁴ If we recognize that decisionmaking within large firms is often collegial and that a process of consensus building frequently precedes the most significant corporate decisions in order to preserve organizational harmony, then it is not surprising to learn that the operating heads of the largest divisions typically are consulted in advance of a critical acquisition.²⁰⁵ Other things being equal, the self-interest of these officials should lead them to prefer a target that can be subdivided among their divisions or at least subjected to their organizational control. This factor tends to bias the target selection process. Growth maximization is a goal of division chiefs as well as of chief executives, and this compromise satisfies their needs—although it may not best enhance overall corporate efficiency.

A more traditional economic analysis also suggests that the bidder's search will be biased in favor of industries in which it already operates. Arguably, greater operating synergy can be realized between two firms that share similar markets and have overlapping product lines and related technical orientations. The recent series of consolidating mergers in the oil industry tends to bear this out, as nearly all the bidders have been other oil industry firms.²⁰⁶ Even if this generalization is not always valid, it remains true that

203. See Marris, *supra* note 24, at 103 ("with transfers inhibited, management members can improve their position only by expansion, which, as it were, pushes them up from below . . .").

204. In the modern multi-divisional (or "M-form") firm described by Oliver Williamson, the central executive office serves principally as a miniature capital market allocating the firm's funds between contending divisions. Williamson, *The Modern Corporation: Origins, Evolutions, Attributes* 19 *J. Econ. Lit.* 1537, 1555-60 (1981). Although Professor Williamson focuses on the efficiency-enhancing potential in the development of the "M-firm," this organizational structure must also necessarily create rivalry and tension within the firm among the contending divisions. Coalitions in particular might form to oppose future acquisitions (or at least those likely to result in the appearance of a new contender for limited resources). This process of coalition formation would produce a predictable outcome: less internal opposition would exist when the target could be dismembered and subdivided among existing divisions than when it would survive as an autonomous division.

205. Martin Lipton, a noted acquisition specialist, has told this author that in his experience the CEO of a bidder generally has to engage in a certain amount of negotiation with his senior operating division chiefs, who are often concerned about the diversion of corporate funds from internal growth. He added that it is not unusual for an understanding to have been reached within the bidder as to the allocation of the target's assets among various divisions before the takeover bid is made.

206. The three recent "mega-transactions" in this industry have been *Socal's* acquisition of *Gulf*, *Texaco's* acquisition of *Getty Oil*, and *Mobil's* acquisition of *Superior Oil*. See Lueck, *Benefits for New Oil Giants*, *N.Y. Times*, Mar. 21, 1984, at D1, col. 3. Although *DuPont's*

firms within the same industry have greater knowledge about each other's properties, products and prospects. Particularly given the time constraints within which the potential white knight must decide whether to make a counteroffer, this factor implies that white knights are most likely to emerge from the population of firms that already are knowledgeable about the target firm's industry. More generally, this greater certainty also enables the bidder to pay a higher premium for the same expected return and hence to emerge as the winning bidder in an auction contest. Other bidders, facing greater uncertainty about the target's future earnings or asset value, should behave in a more risk averse fashion and, other things again being equal, should drop out of the bidding at an earlier stage.

The implications from this line of analysis are two-fold. First, the bidder's search for potential targets will be a limited one in which the bidder will exhibit a strong preference toward those targets whose assets and organizational structure "fit" with its own. Second, competent management of the target may be displaced as a result of the acquisition. This may occur not because the bidder has superior management in its field, but because the internal politics within the bidder have already foreclosed the possibility that the target would remain an autonomous division within the bidder. In this light, the bidder's interest in acquiring firms with strong management may seem anomalous, but this fact can also be explained: the bidder needs strong operating management at middle management levels, precisely because the senior executive responsibilities are likely to be transferred to executives of the bidder having little familiarity with the technical side of the acquired business.²⁰⁷

Although the apparent importance of a "close fit" between the operations of bidder and target may suggest that the Synergy Hypothesis has greater explanatory power than the Disciplinary Hypothesis, the motive for any particular takeover may often be a combination of both. Probably the best answer to the seeming tension between the stock price studies and the other evidence is a compromise of both theories: the bidder expects to realize synergy and thus has a specific profile for its acquisition candidates. This would explain the industry-specific character of the takeover movement. At the same time, within this limited universe, the bidder tends to select the best bargain available. The industry laggard, of course, is the company most likely

acquisition of Conoco in an exception to this generalization, the market penalized DuPont shareholders heavily for making such an unpromising acquisition. See Ruback, *supra* note 56.

207. As Professor Williamson has emphasized, a special strength of the "M-form" corporation is its ability to acquire and manage efficiently dissimilar assets, including unrelated businesses. Williamson, *supra* note 204, at 1558. But there are limits to this ability. A bidder's management may have expertise in consumer products or micro-computers, but not understand the marketing of home video games. It thus seeks targets with a strong operating management, precisely because that operating management will have to survive the likely decapitation of its senior level in the wake of the takeover. But see *infra* notes 277-92 as to the transition difficulties.

to be available at a discount. Accordingly, an acquirer intent on achieving synergy may still displace inferior management, even without consciously so intending.

To sum up, under this suggested synthesis the market for control has a disciplinary effect, but the scope of that effect tends to be more limited than neo-classical theory has admitted. The important distinction of this hybrid theory as opposed to the simpler model advanced by proponents of the Disciplinary Hypothesis is that under it the disciplinary impact of the takeover will be uneven. In industries that are in the midst of a takeover wave, all companies within the industry may be potential targets. Within such an industry, the omnipresent threat of a takeover may produce not optimal deterrence, but only fatalistic resignation. Indeed, the probability of a takeover and ouster could even encourage shirking or predatory misbehavior as managers sought to pursue their own self-interests in the brief time left before the inevitable takeover.²⁰⁸ Conversely, in other industries, there could be too few bidders to generate sufficient deterrence. The structurally depressed domestic steel industry may today supply an example of such a case.²⁰⁹ The possibility that there could be simultaneously too few and too many bidders, depending on the industry, shows once again the difference in conclusions that follows from taking a disaggregated perspective on the takeover phenomenon as opposed to one that focuses only on the aggregate data.

This pattern of restricted search by bidders also raises traditional anti-trust concerns. If bidders do tend on average to search for acquisitions within their own basic field of operational competence, then takeovers should be viewed somewhat more skeptically than if they consisted principally of conglomerate acquisitions. In consequence, a public policy toward takeovers that seek to increase their frequency in the interests of economic efficiency does legitimately raise the danger of increased industry consolidation.²¹⁰ Although horizontal acquisitions can be challenged and tested in each individual case, such a policy may nonetheless work at cross-purposes with the policies underlying the antitrust laws. No claim is made here that recent acquisitions have yet produced, or even threatened, an undesirable level of industry concentration. Yet, recent experience has been within the context of a highly competitive auction market, where high takeover premiums imply lower frequency.

208. If ouster is inevitable, the manager has an incentive to maximize his own income in the short-run, even at the expense of the shareholders' welfare. See *infra* text accompanying notes 297-98.

209. No hostile tender offer has recently occurred in this industry, although a number of major firms are selling at prices below their book value. Because no bidder anticipates a turnaround profit, in this industry the hostile takeover may have little deterrent capacity.

210. But see Goldberg, *The Effect of Conglomerate Mergers on Competition*, 16 *J. L. & Econ.* 137 (1973) (arguing that the effect has been to reduce the level of industry concentration). The real question here is whether takeovers tend to produce conglomerate acquisitions, or horizontal or vertical combinations. At least within the natural resource industry, the current

C. *The Doctrinal Issues: Are Fiduciary Duties Owed to the Market?*

In possibly their most provocative assertion about corporate control contests, Professors Easterbrook and Fischel argue that corporate fiduciaries should seek not to maximize the returns to their specific shareholders, but rather should act so as to maximize shareholder wealth generally.²¹¹ Thus, even if their proposed rule of managerial passivity would not maximize the gains to the target shareholders, target management should still not be permitted to challenge a takeover bid or seek competing bids, so long as passivity would maximize value for the universal class of shareholders that includes both target and bidder shareholders. In this view, it is irrelevant whether the gains accrue to bidder or target shareholders; all that is important is that the gains be maximized.

The logic underlying this proposed radical reformulation of fiduciary duties is both stimulating and flawed. Because the fiduciary responsibility of target management is the most unresolved doctrinal issue of contemporary corporate law, it is useful to see how far afield such a revolutionary redefinition leads us.

In assessing this proposal, its redistributive impact stands out above all else. According to the most recent summary of empirical research on hostile takeovers, takeovers produce abnormal gains of approximately thirty percent for target shareholders and four percent for bidder shareholders.²¹² This implies that nearly ninety percent of the total gains that result from takeovers currently accrue to shareholders of the target. A policy of low takeover premiums in effect amounts to an attempt to reverse this allocation and direct the benefits to the bidder. Indeed, Professors Easterbrook and Fischel have explicitly endorsed the idea that the bidder should be permitted to capture virtually all the gains.²¹³

Their rationale for focusing on the bidder is that some of the gains that target shareholders may realize in a tender offer come at the expense of bidder shareholders. That is, competitive bidding and auction contests simply increase the wealth transfer that bidder shareholders make to target shareholders.²¹⁴ Thus, such gains in their view constitute only "trading gains," representing mere transfer payments that do not increase aggregate shareholder wealth. Because the bidding process involves transaction costs and consumes

trend has been toward horizontal combinations. Little accurate data is available, however, because most bidders would prefer to characterize their transaction as a conglomerate one.

211. Easterbrook & Fischel II, *supra* note 1, at 698, 708-15; Easterbrook & Fischel III, *supra* note 1, at 7-9.

212. See Jensen & Ruback, *supra* note 34, at 7. These gains are measured in terms of "abnormal percentage [of] stock price changes" (that is, net of general market movement).

213. Easterbrook & Fischel II, *supra* note 1, at 698, 708-15.

214. Easterbrook & Fischel I, *supra* note 1, at 1175.

real resources, the net effect, they claim, is socially wasteful.²¹⁵ Society should even be willing, they argue, to pay shareholders not to seek such trading gains by the target shareholder.²¹⁶

This assertion can be disputed, of course, by arguing that competitive bidding does not produce simply wasteful "trading gains," but instead creates value, because the highest bidder typically expects to achieve greater synergistic gains than do the other bidders who drop out of the auction at a lower price.²¹⁷ However, the more basic question is why directors should not pursue even "wasteful" gains for their shareholders. After all, even if the game is a zero-sum one, the participants are still intensely interested in who wins and who loses. Moreover, if management is to be viewed as the agent of the shareholders, one would ordinarily prefer one's agent to be faithful to one's own interests and not the higher goal of economic efficiency.

Here, the basic rationale offered by Professors Easterbrook and Fischel comes into clear focus. Their fundamental claim is that because shareholders can diversify their securities portfolios, they should be expected to own both bidder and target securities, probably in equal proportions. Thus, shareholders should prefer all managements to follow the policy that produces the greatest gains, without regard to the sharing of these gains between the bidder and the target.²¹⁸ There is some plausibility to this contention. Shareholders do not start out as either target or bidder shareholders; arguably, they have an equal chance of being one or the other.

Nevertheless, this thesis is still a classic case of an argument that seeks to prove too much. By arguing that an "'externality' arises when a target's management resists a tender offer,"²¹⁹ Professors Easterbrook and Fischel come dangerously close to claiming that directors cannot pursue a gain whenever its realization would also impose greater costs on society. Such a rule, if intended, might also deny directors the ability to close or relocate an industrial plant if the private gains were less than the social loss.²²⁰ This line of argument quickly converts the corporate director into an unelected and unaccountable public servant.

215. *Id.* at 1175 n.38 ("As a general matter, expenditures that influence the distribution of trading gains but do not generate better performance are simple waste."). This is a noncontroversial statement of economic logic. See Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 *Am. Econ. Rev.* 561, 573 (1971).

216. Easterbrook & Fischel I, *supra* note 1, at 1175.

217. See Bebchuk II, *supra* note 1, at 39-44.

218. See Easterbrook & Fischel III, *supra* note 1, at 7-9. But see Bebchuk II, *supra* note 1, at 27-30.

219. Easterbrook & Fischel I, *supra* note 1, at 1176. But see Easterbrook & Fischel II, *supra* note 1, at 702-03 (arguing that the fiduciary principle exists exclusively to maximize "the welfare of investors").

220. Others, of course, have advocated such an expanded view of fiduciary duty. See, e.g., Dodd, *For Whom Are Corporate Managers Trustees?*, 45 *Harv. L. Rev.* 1145 (1932). But see Engel, *An Approach to Corporate Social Responsibility*, 32 *Stan. L. Rev.* 1 (1979).

Understandably, Professors Easterbrook and Fischel have attempted to draw back from such a broad thesis and have adopted only a narrower variant of it under which directors should act to enhance the position of the diversified shareholder. But it is not clear that they can avoid the full implications of their claim. Their rule means that a potential gain should be foregone when it would come simply from another class of shareholders. From this, it follows that the target's board should allow the bidder to capture the entire gain because this minimizes wasteful transaction costs and so best serves the interests of the diversified shareholder.²²¹ There may be many other contexts, however, in which trading gains that do not increase total wealth arise and are pursued by competing corporations at each other's expense.

Of course, one response to Professors Easterbrook and Fischel is that even casual observation makes clear that many—and perhaps most—shareholders are not fully diversified. They would answer this argument by replying that shareholders could achieve efficient diversification at low cost.²²² But this response begs the question: Why have they not done so? If we assume that shareholders are rational, sensible answers must be expected to this question, and a number of plausible answers suggest themselves.²²³ Thus, their claim that shareholders *can* diversify is relevant only if taken as a normative statement that shareholders *should* diversify—or forfeit any claim to the specific loyalties of their fiduciaries if they do not. This normative theory views corporate law not as a private ordering process, in which the law intervenes chiefly when there is a possibility of market failure, but rather as an instrument for achieving economic efficiency. No evidence exists that shareholders wish to risk sacrificing themselves on this altar.

More importantly, the implications of this view that the fiduciary duty of the board of directors is to the diversified shareholder (or, more generally, to the equity marketplace) are much broader than their discussion indicates. Logically, this rule would apply equally to the bidder. Potentially, a bidder may today achieve a “trading gain” by making an exploitative two-tier tender

221. Easterbrook & Fischel III, *supra* note 1, at 7–9; accord Easterbrook & Fischel II, *supra* note 1, at 711–15. But see Bebchuk II, *supra* note 1, at 29–30 (arguing that this perspective incorrectly treats the interests of shareholders as if they were identical to social wealth maximization).

222. Easterbrook & Fischel III, *supra* note 1, at 8–9. Even if an investor is not diversified, they claim he will still prefer a policy that maximizes gains because he cannot know *ex ante* whether his corporation is more likely to be a bidder or a target. *Id.* at 9. This is unpersuasive, because the shareholder in a financially distressed firm or a relatively small firm knows that his firm is more likely to be a target than a bidder. See Bebchuk II, *supra* note 1, at 28–29.

223. For example, rational investors are interested in diversifying their total investment portfolios, not merely their stock portfolios. Thus, if a significant percentage of their wealth is locked up in illiquid investments (real estate, stock options or other investments in their own firm), they should seek not a perfectly balanced stock portfolio but one that counterbalances their other investments. In addition, the costs of diversifying a portfolio may be significant where it contains one (or more) substantial investments that cannot be liquidated.

offer that enables it to capture a target at below its prior market value. Because such a transaction would not create wealth, but only transfer it, it too would be socially wasteful because unproductive transaction costs would be incurred.

Ultimately, the rationale underlying this view of fiduciary duty cannot be intelligently confined to an operating rule that simply instructs the fiduciary to maximize wealth for the diversified shareholder. Rather, its logic extends much further. To begin with, the underlying rationale also requires that the fiduciary seek to maximize the economic position of the fully diversified investor who holds both debt and equity securities in his portfolio. Typically, full diversification requires a blending of debt and equity securities, and the rational investor is as likely to be a holder of the debt securities as the equity securities of a given corporation. But at this point, the position of the director of the corporation becomes hopelessly conflicted. For example, should the director approve an acquisition that will enhance the value of the corporation's equity securities, but reduce the value of its debt securities? Apart from the takeover context, should the director vote to refinance an outstanding loan in order to obtain a lower interest rate for the corporation, when the effect will be to injure the holders of the outstanding debt securities?²²⁴ In these and other cases that can easily be imagined, the gain realized by one class comes at the expense of another. It is thus similar to a "trading gain" in that it does not benefit the fully diversified investor.

In short, if we define the concept of fiduciary duty to require such a broad definition of the interests that are to be protected, the resulting definition collapses under its own weight. Indeed, one could even plausibly argue that because investors are also consumers, employees and citizens, their interests must be even more broadly defined, because rational investors basically would want to maximize their overall economic position. If so, should the corporation accept a takeover or merger proposal that will result in substantial dismissals of employee shareholders?²²⁵ At this point, we again confront a

224. Of course, the refinancing would be allocatively efficient, but as long as one side's gain matches the other side's loss, this effect on third parties is not clearly relevant to the definition of fiduciary duty. After all, the fiduciary can pursue private gains for his investors even if the course chosen imposes externalities on society. Another argument in favor of the refinancing is that because the debt investors had not bargained for call protection against refinancing, they had assumed the specific risk of its occurrence. This argument would be highly relevant to a traditional analysis, but it is less so here once the underlying question has become: what course of action maximizes wealth for a diversified investor? If the refinancing decision involved a "zero-sum game"—that is, if the creditors' loss precisely equalled the shareholders' gain—then the logic underlying the Easterbrook-Fischel position should make the decision depend on whether a diversified portfolio would contain more debt than equity securities, or vice versa. If it were equally split, the director would receive no guidance.

225. Because not all shareholders are employees, it could be argued that the shareholders' gains as a group would exceed the losses of the employees who were shareholders. But it is also possible that the gain is not a zero sum one; that is, the losses to employee-shareholders may

standard that can expand the corporate fiduciary's responsibilities into meaninglessness or convert him into an unelected public servant. A coherent standard therefore requires that we focus the concept of fiduciary duty so that it basically applies only to the shareholders of a single corporation; that is, the director should not be permitted to ignore the undiversified shareholder on the dubious argument that he chose his own fate. Once this is said, any legitimate gain—whether a “trading gain” or not—should be pursued.

What limits then should exist on the discretion of managers and directors when private and social interests diverge? If there is any consensus on the nature of the corporate fiduciary's responsibilities, it is probably that stated in the American Law Institute's Tentative Draft No. 1, Principles of Corporate Governance and Structure, which states that directors *may* consider ethical limitations on the pursuit of shareholder gain, but are not generally obligated to do so, except to the extent such limitations are embodied in mandatory law.²²⁶ As applied to the takeover context, such an authorization of permissive departures from the goal of profit maximization when ethical limits would otherwise be transgressed does not significantly restrain target management if such a management sees an opportunity to increase the premium offered to its shareholders by seeking a rival bidder.²²⁷ As fiduciaries to their shareholders, rather than civil servants responsible to the broader society, target management should be entitled to seek to maximize the takeover premium, even if this results in inefficiency on the macroeconomic level.

So long as fiduciary duties essentially depend upon the existence of a principal-agent relationship, it is a conceptual self-contradiction to define the fiduciary's duty so that the principal cannot instruct his agent to seek a higher premium. Nor, should the agent be permitted to ignore his principal's instructions because more enlightened shareholders would decide otherwise. The fabric of existing doctrine tears when it is asked to justify legal rules that treat the principal as unable to determine its own best interest. To be sure, this is a

exceed the gains to all shareholders. A similar quandary arises if one poses the case of a director of A.T. & T. who knows that its break-up will maximize shareholder gains but will also produce greater losses to these same shareholders in the form of more costly and less efficient phone service. Once one expands one's focus to include the interests of all investors, it seems myopic to look only at the asset side of their personal balance sheets and ignore the actual or contingent liabilities that a given course of conduct would create. But if one expands the focus this broadly, the director once more approaches the status of an unelected civil servant who is being asked to make public policy determinations beyond his limited competence as a business director.

226. See Principles of Corporate Governance and Structure: Restatement and Recommendations § 2.01 (Tent. Draft No. 1 1982) (“The Objective and Conduct of the Business Corporation”). This section provides that the corporate objective is to maximize shareholder gain, except that “the corporation . . . *may* properly take into account ethical principles that are generally recognized as relevant to the conduct of business . . . “ (emphasis added). Clearly, this language is permissive. It should be noted that this author is serving as Associate Reporter to this project.

227. This author at least sees no ethical principle that is transgressed by the lawful pursuit of a “trading gain,” even though it may be socially wasteful.

conservative position that views corporate law as a governance structure rather than a mechanism for attaining efficiency. But precisely because private ordering cannot satisfactorily deal with the problem of externalities, it is essential to ask next how public policy can and should address these problems.

III. THE DISECONOMIES IN TAKEOVERS: A LOOK AT THE COST SIDE OF THE LEDGER

Private and social wealth can diverge. Even if a policy of increasing the frequency of takeovers should maximize the private wealth of shareholders, Part III will argue that such a policy should fail to maximize social wealth. This argument, however, travels a well-worn, but treacherous, path. Popular commentary has frequently warned that dire social consequences may follow in the wake of hostile takeovers. Typically, these prophecies have tended toward an essentially populist critique, in which some variation of the following arguments predominates: (1) takeovers increase corporate consolidation and the likelihood of an oligopolistic industry structure;²²⁸ (2) scarce credit is diverted from socially "productive" uses to "nonproductive" uses;²²⁹ and (3) takeovers divert managerial time and attention, result in layoffs, plant closings and socially harmful industrial relocation, and also discourage target management from fulfilling its obligations to noninvestor groups.²³⁰ Whatever

228. Though this claim is heard frequently, one study has concluded that takeovers tend to reduce the level of concentration in the target firm's markets. See Goldberg, *The Effect of Conglomerate Mergers on Competition*, 16 J. L. & Econ. 137 (1973); White, *Mergers and Aggregate Concentration*, in M. Keenan & L. White, *supra* note 44, at 97-111.

229. For a full discussion of both sides of this debate, see *To Extend the Credit Control Act: Hearings Before the Subcomm. on Consumer Affairs and Coinage of the Comm. on Banking, Finance and Urban Affairs, 97th Cong., 2d Sess. (1982) (hearings on H.R. 6124)*. H.R. 6124 sought to amend the Credit Control Act of 1969 to authorize regulatory authorities to deny bank credit for "unproductive" takeover loans. To demonstrate this problem, the sponsors of the legislation adduced evidence that loan commitments for mergers exceeded \$73.5 billion in 1981. *Id.* at 4. Subcommittee Chairman Annunzio described these loans as unproductive on the grounds that they "did not build any new plants or cars or houses," and asked "what would happen if instead of using the \$70 billion to satisfy corporate egos, that money was used for solving unemployment?" *Id.* at 2.

Despite its political appeal, this rhetoric has attracted no support among economists. Representatives of both the Federal Reserve System and the Department of the Treasury testified in opposition to the bill. Interestingly, however, the Federal Reserve System representative acknowledged that "some distortions in the distribution of credit and the structure of rates in different markets" might result from takeover loans, and that the Federal Reserve had on occasion "asked banks to limit loans for takeovers or speculation." *Id.* at 195 (statement of Preston Martin, Vice Chairman, Board of Governors, Federal Reserve System). Manuel H. Johnson, Acting Assistant Secretary for Economic Policy, Department of the Treasury, essentially denied that takeover loans were unproductive and argued that "[m]ergers are a means of efficiently reorganizing and strengthening failing enterprises and saving jobs by providing new capital and management expertise." *Id.* at 219.

230. See Mintz, *Community Dislocations: A Painful Side Effect of Merger*, *Washington Post*, Apr. 20, 1980, at A2, col.1 (decrying "painful side effects" of takeovers of local companies

the merits of these criticisms,²³¹ they seem to be equally applicable to friendly acquisitions. Moreover, even if these arguments were given credence, they would not justify a policy of dramatically chilling takeover activity. Other means exist to deal with these problems that would neither interfere as overbroadly with the capital market's processes nor risk the even greater danger of creating a stagnant economy.²³² Thus, the appropriate question on which public policy needs to focus is less the validity of these already much debated arguments than whether other diseconomies can be posed that uniquely apply to the hostile takeover and that would be exacerbated by a shift in the direction of a higher frequency of takeovers.

Part III examines three general types of diseconomies that might result from a policy aimed at maximizing the frequency of takeovers. First, the problem of empire building must be confronted. Although the harshest critics of the takeover have painted a picture in which frequent takeovers lead to a gradual bureaucratization of American industry, with a consequent loss in its ability to respond to new stimuli or challenges,²³³ this seems a grossly overdrawn portrait. Takeovers can prune empires as well as build them. The real danger is that of inefficient transfers of control. Although several reasons why inefficient control transfers occur will be examined, it must be recognized that the bidder's decision to make a takeover bid is based on information about the

by "distant corporate holding companies"). Proponents of this view have recommended a "social impact analysis" before a merger is permitted. *Id.* (describing recommendation of William C. Norris, chief executive officer of Control Data Corp.). Similarly, a recently introduced bill seeks to amend the Clayton Act with respect to certain large acquisitions to authorize the Assistant Attorney General or the Federal Trade Commission to determine if the acquisition "would, if consummated, serve the public interest." H.R. 3561, 98th Cong., 1st Sess., 129 Cong. Rec. H5135 (daily ed. July 13, 1983). Both agencies would be authorized to attempt to enjoin those acquisitions that did not. This author would not support such a "politicization" of the acquisition process.

231. Probably the greatest fear of organized labor (and others) about takeovers is that they increase the likelihood of plant closings and relocations, since local firms lack the mobility of capital of larger firms. See Mintz, *supra* note 230. Yet, the preliminary evidence seems mixed. A study undertaken in connection with the Conference on the Impact of the Modern Corporation, sponsored by the Center for Law and Economic Studies of Columbia University School of Law, found that plant closings appear to be more prevalent in smaller companies than in large ones. Schmenner, *Aspects of Industrial Plant Openings and Closings* 7 (1981) (unpublished manuscript). Professor Schmenner also focused on the behavior of conglomerates in opening and closing plants. He found them involved in relatively more plant closings than other companies, although the plants closed tended to be smaller in size. *Id.* at 19. Yet conglomerates were also more likely to expand employment through plant openings. *Id.* at 20. He concluded that conglomerates were more active in their production capacity decisions, thus accounting for the relatively higher rate of closings. *Id.*

232. For example, if industrial relocation visits substantial losses on the employees left, that are not matched by the gains to new employees elsewhere, the less drastic means of mitigating these losses is to legislate special relocation benefits to be paid by employers to employees so terminated.

233. See R. Reich, *supra* note 5, at 141-45.

target generally inferior to that possessed by the target's own management. Rather than presume that the bidder has greater business acumen, policy planning needs to compare the relative efficiency of external monitoring through the capital market as against internal monitoring through a managerial hierarchy.²³⁴

Second, a higher frequency of takeovers should have an adverse impact both on the labor market for executive services and on employee performance generally. In particular, as the threat of a hostile takeover increases, logic suggests both that increased executive compensation will be necessary to compensate managers for their increased risk and that the mobility of executive talent will be reduced, as marginal firms find it more difficult to attract executives who are risk-averse about the prospect of dismissal in the aftermath of a takeover. In addition, excessive deterrence may result in both demoralization costs and increased opportunistic behavior by employees who come to see their tenure in office as no longer predictably related to their own performance.

A final diseconomy, though more speculative, deserves serious consideration because it involves a serious risk. An increased frequency of hostile takeovers may induce a substantial shift in both bidder and target managerial behavior in the direction of risk preference and in particular toward an increased degree of leverage in corporate financial structures. On the target's side, the pervasive threat of a takeover may cause potential target managements to take riskier gambles to preserve their independence. Although a variant of this point has been made by those who decry the alleged preoccupation of management with short-run profit maximization,²³⁵ this thesis of a myopic fixation on the short-run fails to explain coherently why the stock market would not penalize such behavior or why investors should not choose the discount rate at which future earnings are discounted to present value. A better formulation is that takeovers may produce not an excessive focus on the short run, but an excessive willingness to accept high risks. On the bidders' side, because leveraged takeovers can be used as a means by which shareholders of the acquirer transfer value from debt holders in their corporation to themselves, bidders will have an incentive under a low premium policy to execute higher risk takeovers. The cost of these wealth transfers may be a potentially undesirable increase in risk that will not be penalized by the stock market.

Each of these potential diseconomies may also result from a friendly acquisition, but their probability and intensity seem likely to be greater in the

234. A developing economic literature has advanced the theory that over a considerable range of decisions, internal decisionmaking processes are superior to the market's capability as an external judge. See, e.g., O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975).

235. See *supra* note 5.

case of a hostile takeover for reasons hereafter explained. None of the negative effects next assessed can be quantified with precision, nor is it asserted that their collective impact necessarily justifies additional legislative or administrative restrictions on the takeover process. The more modest claim made is that the threat of these diseconomies provides sufficient reason to prefer a policy of maintaining a substantial takeover premium and a stable auction market. By moderating the frequency of takeovers, a competitive, high-premium auction market should mitigate these diseconomies.

A. Empire Building: Defining the Diseconomy

A considerable literature has argued that corporate acquisitions are substantially motivated by bidder management's desire to maximize corporate size and growth, even at the expense of shareholder welfare.²³⁶ Several plausible reasons explain why management would pursue growth through acquisitions and pay an economically unjustified premium to achieve increased size: (1) executive compensation and associated perquisites tend to be a function of firm size; (2) increased size in turn implies increased immunity from a hostile takeover; (3) acquisitions dilute the stockholdings of existing large shareholders and thereby confer increased autonomy on the management of the bidder; and (4) expansion both provides an opportunity for advancement within the corporate hierarchy for younger managers and justifies the continued employment of those who are acquisition specialists.²³⁷ Still, bidder overpayment is not itself a diseconomy, but only a wealth transfer which has no necessary effect on aggregate shareholder wealth.²³⁸

Where then in the diseconomy is empire building? Several plausible answers can be given to this question, but in each case the evidence is mixed. Ultimately, a judgment either way must be based as much on inference and a due regard for the gravity of the risks involved as on hard proof. First, Professor Reich argues that growth-maximizing acquisitions are socially undesirable because they produce "bureaucratic layering," which in turn implies that corporate decisionmaking will become more sluggish and less able to adjust to external stimuli.²³⁹ Yet, this "Corporate Brontosaurus" thesis encounters a number of problems when examined closely. Most importantly, it

236. See sources cited *supra* notes 48-57. For a comprehensive statement of this thesis, see Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 *J. Econ. Lit.* 32 (1980).

237. See *supra* notes 48-57 and accompanying text.

238. Overpayment only creates a decline in aggregate shareholder wealth (and hence a diseconomy) if the bidder's securities decline in value by an amount greater than the sum paid the target shareholders. See *supra* note 6. Such a decline might occur if the bidder's solvency were threatened as a result of the acquisition.

239. See R. Reich, *supra* note 5, at 140-45 (discussing growth in size of staff and hierarchical levels in American corporations as compared to Japanese corporations).

seems contradicted by the modern literature on the evolution of the American corporation. This literature has viewed the appearance of the conglomerate form as an efficient response to a series of internal crises that occurred within large corporations earlier in this century.²⁴⁰ Economists have suggested that the actual cause and effect relationship may be the reverse of that suggested by this "layering" thesis: takeovers may do less to increase "bureaucratic layering" than this earlier evolution of managerial structure did to make possible the takeover movement.²⁴¹

A related argument reformulates this theme of corporate bureaucratization to suggest that empire building may slow the pace of product innovation and technological progress. As large firms swallow smaller ones, they are argued to become more bureaucratic and less willing to accept the entrepreneurial risks inherent in the development of a new generation of products.²⁴² Again, the available evidence is ambiguous. Although some evidence suggests that smaller firms produce technological innovations at a higher rate, larger firms seem to allocate a disproportionately larger share of their budgets to research and development.²⁴³ In addition, there is also a competing theory that acquisitions by diversified firms may spur, rather than retard, the pace of technological change because of those firms' superior access to capital and the economies of scale that appear to be associated with research and development.²⁴⁴

1. *Inefficient Transfers of Control.* — A simpler theory of the diseconomies associated with empire building emerges if we place less emphasis on the size of the combined entity and instead focus on the potential for an inefficient bidder to acquire an efficient target for entirely rational reasons that are in the best interests of the bidder's shareholders. This scenario is plausible

240. For a concise account, see Williamson, *supra* note 204, at 1555-60.

241. Professor Williamson argues that the rise of the modern decentralized conglomerate form made the tender offer possible. Only this structure makes the acquisition of unrelated businesses feasible by providing a monitoring mechanism capable of supervising diverse lines of business. *Id.* at 156. See Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 *J. L. & Econ.* 351, 361-63 (1983).

242. This is a central theme in the argument made by Professors Hayes and Abernathy. See Hayes & Abernathy, *supra* note 5, at 74-76. They claim that because the energies of American managers have been devoted to the pursuit of acquisitions and diversification, such managers have "forsworn long-term technological superiority." *Id.* at 70.

243. See Scherer, *Technological Change and the Modern Corporation* (1984) (paper presented at the Conference of the Impact of the Modern Corporation, see *supra* note 231). For an overview of these issues, see generally M. Kamien & N. Schwartz, *Market Structure and Innovation* (1982).

244. See Nelson, *The Simple Economics of Basic Scientific Research*, 67 *J. Pol. Econ.* 297, 302 (1959). Nelson argues that conglomerate firms obtain economies of scale when conducting basic research, because technological innovation resulting from such research is often unpredictable, and hence the diversified firm with more product lines stands a greater chance of benefiting from an unexpected innovation.

because bidders with below average performance could improve their own rates of return by acquiring more efficient targets. In such a case, the result is that the assets of the more efficiently managed firm are acquired by a less efficient one, and the superior, rather than inferior, management is replaced or superseded.

For example, assume that Big Corp. has mediocre management, which is achieving only a ten percent rate of return. However, Big Corp., which is in the oil business, has accumulated large cash reserves. It might reasonably decide to tender for Little Corp., which earns a twenty percent rate of return. So long as the premium Big Corp. has to pay does not dilute the rate of return of Little Corp.'s assets in Big Corp.'s hands to ten percent (or below), Big Corp. would improve its own rate of return through this transaction. Thus, if the aggregate market value of Big Corp.'s and Little Corp.'s shares were \$100 million and \$10 million, respectively, and the much larger Big Corp. paid a premium of twenty-five percent (or a total price of \$12.5 million) for all the shares of Little Corp., the result would be to dilute Little Corp.'s rate of return in Big Corp.'s hands from twenty percent to sixteen percent.²⁴⁵ This acquisition would still be attractive to Big Corp., which was earning only ten percent on its own. But the reverse acquisition (Little Corp. acquiring Big Corp. at the same premium) would not be attractive to Little Corp., because it would reduce Little Corp.'s return on its capital. Thus, the result of Big Corp.'s acquisition of Little Corp. is that Big Corp.'s excess capital has moved to a more productive use, but one could hardly conclude here that a superior management team has replaced an inferior one.

In theory, in an efficient market, events should rarely work this way, either because Little Corp. would be trading at a price well in excess of \$12.5 million or because the premium Big Corp. would have to pay for Little Corp. would be large enough to equalize the rate of return on Little Corp.'s assets with its own and thereby remove the incentive to take over Little Corp.²⁴⁶ Yet, there exists an important and much investigated anomaly in the empirical evidence concerning the efficient market thesis, which is known as the "small firm effect." Empirical studies have repeatedly found that smaller, publicly held corporations seem to trade at an undervalued price that cannot be accounted for simply by the higher risk associated with such companies.²⁴⁷

245. Little Corp. is earning \$2,000,000, which is 20% of its aggregate value of \$10 million. This same \$2,000,000 figure is 16% of \$12.5 million.

246. In effect, Little Corp. was trading at a price-earnings ratio of 5:1, while the less efficient Big Corp. was trading at 10:1. This could be explained by Little Corp.'s higher level of risk or its lack of exposure in the market. For another explanation see *infra* note 251.

247. For an overview of recent research on the "small firm effect," see Symposium on Size and Stock Returns, and Other Empirical Regularities, 12 *J. Fin. Econ.* 3 (1983). For a more accessible treatment, see Seligman, *Can You Beat the Stock Market?*, *Fortune*, Dec. 26, 1983, at 82, 94 ("The news on the small-firm effect is that even after adjusting for risk, small-company stocks yield outsize returns."); see also Rosett, *Chicago School Bets on Inefficiency*, *N.Y. Times*,

This finding suggests that bargain purchases of such companies may often be possible and that the foregoing scenario of Big Corp. acquiring Little Corp. is plausible. Indeed, the empirical data suggest that "acquisitions of small privately held companies remain the focal point" of merger and acquisition activity.²⁴⁸ As a result, the danger exists that inefficient (but large) firms may cannibalize efficient (but small) firms.

This danger is exacerbated by a zero premium policy, which reduces the margin of protection that shelters the more efficient firm from the larger, less efficient firm. In an auction market, a Big Corp. seeking a Little Corp. might be outbid by a rival bidder that perceived even greater synergy or that was more confident about its managerial ability to improve the performance of Little Corp. If auctions were discouraged, the likelihood would fade that a more efficient bidder would intervene and prevent an inefficient transfer by making a higher bid. Thus, in a capital market characterized by low takeover premiums, there is likely to be an even higher proportion of inefficient bidders with internal rates of return below those of their targets than would be the case under competitive bidding for corporate control.

The problem of inefficient control transfers is not limited to the special case of small firms. Some evidence suggests that even in the case of considerably larger target firms, the target has generally had a higher internal rate of return than its bidder.²⁴⁹ Such data seemingly conflict with the stock price

Dec. 11, 1983, at F10, col. 3 (smallest 20% of publicly traded companies in terms of total market value earned abnormally high returns, even after adjustment for risk). Thus, the Little Corp. hypothetical is not only realistic, but logical, since a rational bidder such as Big Corp. can increase its own return by buying Little Corp. at what is seemingly a bargain price. Both the shareholders of Little Corp. and Big Corp. benefit, but it does not follow that the control transfer furthers allocative efficiency, because assets are here moving into the hands of less successful managers. In short, because of this stock market anomaly that smaller firms are undervalued, the data on bidder share performance in the wake of a tender offer announcement may be a misleading proxy for economic efficiency.

One rebuttal to this claim is that the market is efficient, but better techniques for measuring risk need to be developed. Small firms may be "undervalued" simply because they are riskier investments. Yet, because large firms are less risk-averse than the individual investor and are more diversified, they may be willing to pay more than the price that a marketplace of individual investors would pay.

248. See Economics Div., Cong. Research Serv., 97th Cong., 2d Sess., *Merger Tactics and Public Policy 15* (Comm. Print 1982) (study prepared for the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce) (quoting press release of W.T. Grimm & Co. dated January 2, 1982). Even though public attention has been focused on recent "megatransactions," the typical target has been much smaller. This study reports that of the 2,395 transactions tabulated for 1981, 56% "involved the sale of a closely held firm." *Id.* at 16.

249. See Lowenstein, *supra* note 1, at 289 n.165 (finding that the return on equity of the public corporations that were targets in 1981 was no lower than that of their bidders). Although Professor Lowenstein's sample was quite small, his findings are consistent with those of others who have compared the relative profitability of bidders and targets in terms of their reported earnings. For a review of earlier studies, see Herman, *supra* note 49, at 100. A study of the British "takeover wave" that occurred from 1967 to 1970 found that in 19 out of 41 acquisitions studied,

studies, which generally have shown a slight rise in the acquiring firm's stock as a result of the acquisition.²⁵⁰ A number of plausible hypotheses can be advanced for this discrepancy: (1) the proper methodology for computing the return to the acquiring firm's shareholders is disputed and one study using the latest methodology has found that acquiring firms suffered a significant loss;²⁵¹ (2) the market may have a bias toward over-optimism about acquisitions, thus anticipating synergy and bidding up the value of the acquiring firm's stock, even though the evidence shows that the expected synergy generally fails to materialize;²⁵² (3) weaker firms in high growth industries may have low internal rates of return, but such firms may seek diversification through acquisitions as a means of gaining protection from the competitive pressures of their superior rivals; or (4) the target's higher internal rate of return may not have been an accurate measure of its then current value, possibly because of new developments not yet reflected in these basically historical data.²⁵³

the acquired firm was more profitable than the acquirer. See Singh, *Take-Overs, Economic Natural Selection and the Theory of the Firm: Evidence from the Postwar United Kingdom Experience*, 85 *Econ. J.* 497, 512 n.1 (1975).

250. See Jensen & Ruback, *supra* note 34, at 16-17.

251. See Malatesta, *supra* note 30, at 169 (finding acquiring corporations incur significant losses that more than offset gains to target shareholders). The Malatesta study estimated the abnormal dollar gain or loss, unlike the studies summarized in the Jensen and Ruback survey, which examined percentage change in stock price. Jensen and Ruback found the abnormal returns for bidders in successful tender offers to have a weighted average of 3.8%. Jensen & Ruback, *supra* note 34, at 16-17. The Malatesta study, however, found an average dollar loss of \$28 million to bidders between 1969-1974. Malatesta, *supra* note 30, at 169. Jensen and Ruback appear to concede the difficulty of measuring the returns to bidders and to accept Malatesta's methodological critique of the prior studies. Jensen & Ruback, *supra* note 34, at 18. As a result, the empirical issue of the returns to bidding firms in takeovers still seems unresolved. Studies focusing on specific industries have also found that the bidder's stock declines after a takeover. See *supra* note 56.

252. Follow-up studies have generally discounted the ability of business combinations to produce significant operating or financial synergies. See *supra* note 45. Although this seems inconsistent with the stock price studies, none of the stock price studies have followed the securities of the bidder firm for a period longer than twelve months (usually from the date of the announcement of the offer). See Jensen & Ruback, *supra* note 34, at 21. This period may be too brief to judge the wisdom of the bidder's decision. Significant managerial or other reforms are unlikely to be accomplished so quickly (although their advent may often be signaled).

Thus the market's response, while indicative, is not necessarily dispositive of the wisdom of the acquisition. This point is two-sided: Dupont's acquisition of Conoco, which elicited a dramatically negative market response, see *supra* note 54, may yet prove wise, whereas other acquisitions, where the bidder's stock rose, may prove unwise. Those who argue that the stock market is dominated by the excessively short-range focus of institutional investors, see Lowenstein, *supra* note 1, at 297-306, can therefore argue that this bias toward a short-term profit leads institutional investors to overreact to the possibility of synergy and so bid up slightly the shares of most bidders. This behavior would not be irrational so long as some bidders, even infrequently, secured large synergistic gains.

253. Return on equity is an historical measure of past performance, which ignores new problems or competitive challenges that the firm is currently expected to face. For example, the

Whatever the explanation that best reconciles the conflicting data, the more important point is that there is no reason to expect that the current pattern, under which the bidder's stock typically rises upon the announcement of a tender offer, would continue under the very different market structure that low takeover premiums would imply. If, as just argued, a low premium policy would invite a higher percentage of inefficient control transfers, it is no answer to reply that at present there is little evidence that inefficient transfers are occurring when the present market is a highly competitive one. Ultimately, one cannot quantify the seriousness of this risk of inefficient control transfers in a noncompetitive market, but the risk seems real.

2. *The Relative Error Rate: A Comparison of Internal and External Monitoring Controls.* — All modes of corporate accountability involve real costs, and takeovers involve notoriously expensive transaction costs. To the extent various modes overlap superfluously, some costs are wastefully incurred;²⁵⁴ to the extent various modes interfere with each other, these costs result in a negative utility. This axiomatic point has relevance here because any program designed to minimize takeover premiums in order to enhance the takeover's utility as a monitoring force is essentially overlaying an additional system of monitoring (by external bidders) on top of the system of internal monitoring that already exists within most public corporations. Two questions therefore arise. First, what function can this additional layer perform—that is, can it reduce the agency costs of corporate governance significantly? Second, will it render less effective the existing system of internal controls?

This Article has already given its answer to the first of these questions: the existence of significant takeover premiums prior to the Williams Act and the evidence that the shareholders' supply curve slopes upward strongly suggest that the disciplinary reach of the takeover is limited.²⁵⁵ If one accepts either this premise or the premise that high transaction costs necessarily accompany takeovers, it follows that the takeover cannot curb minor managerial departures from the goal of shareholder wealth maximization.

return on equity of most home computer manufacturers would remain high, even as their stock fell, upon the announcement of a new line of personal computers by IBM.

254. External monitoring through takeovers involves transaction costs to investment bankers, lawyers and other advisers, which in the aggregate probably exceed the costs applicable to internal monitoring or external monitoring through litigation. These are real costs, not simply transfer payments between classes of shareholders, as the takeover premium may be. In comparison, internal monitoring involves the costs of directors' salaries and expenses and those of the managerial staff specializing in monitoring, while corporate expenses in derivative litigation include the plaintiff's attorney's fee (paid by the corporation if the attorney is successful), and possibly indemnification payments. From a cost-minimization perspective, redundant costs should be eliminated. Thus, if takeovers can monitor small departures from shareholder wealth maximization (a premise this article does not accept, see *supra* notes 161-64 and accompanying text), there is still a question as to which rival technique involves the lowest cost.

255. See *supra* notes 114-23, 175-80 and accompanying text.

The importance of the second question, however, overshadows the first one. As already noted, there is a broad consensus that the internal structure of the American corporation has evolved over the last sixty years in response to internal crises and that, as a result, the internal monitoring capacity of the modern multidivisional corporation is vastly enhanced over that of its predecessors.²⁵⁶ The basic picture, agreed upon by both historians and economists, is that a senior executive staff typically no longer makes operating decisions, but instead concentrates on monitoring the effectiveness of decentralized and partially autonomous management teams at the division level. It replaces those divisional teams that prove inferior and allocates the firm's internal cash flow in favor of more successful or high growth divisions and away from declining or low growth divisions. In so doing, the firm's central executive office performs the function of a miniature capital market. This gradual evolution in the role played by senior management suggests that, at least over some range, hierarchical supervision within the firm may be superior to the disciplinary capacity of the capital market.²⁵⁷ Indeed, the simplest explanation for the conglomerate structure of modern corporations is that a senior managerial staff, specializing in financial controls and strategic planning, can better monitor and discipline its portfolio of companies than can the capital market. Otherwise, such an evolution in managerial structure should not have occurred. In this light, a zero premium policy can be seen as a flawed attempt to turn back the clock and replace internal monitoring with the external discipline of the capital market.

More importantly, a low premium policy relies upon a particularly error-prone form of capital market discipline. To understand this contention, one must begin with the simple truth that a bidder's decision to offer a premium means only that the bidder *thinks* it can do better than the incumbent management. The premium offered by a bidder does not represent the same collective market consensus that the target stock's recent performance in the market does. Although the market reflects the collective judgment of many traders and is potentially capable of digesting far more information than any single decisionmaker can analyze, a bidder's decision to offer a premium inherently represents only an individual and potentially idiosyncratic judgment. Moreover, because target management possesses information not known to the bidder, there is an inherent and substantial possibility of error when the bidder

256. See *supra* notes 240-41 and accompanying text.

257. Professor Williamson has offered the general conclusion that internal monitors have relative advantages over external monitors in their superior access to information. See O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* 145-48 (1975). He has concluded that the problems posed by the separation of ownership and control in corporate governance that arose early in this century have "been alleviated more by internal than by external . . . organizational reforms." Williamson, *supra* note 241, at 364; accord Williamson, *supra* note 204, at 1559-60.

seeks to substitute its judgment for that of the target. Indeed, few things are clearer about stock market performance than that insiders characteristically have better information than the market generally (including the bidder) and normally are able to outperform the market.²⁵⁸ Thus, when the bidder wishes to pursue a different business policy than the incumbent management, there is good reason to believe that the judgment of the incumbent management, supported by better information, normally has a lower risk of error. For example, the bidder's reluctance to sell a particular subsidiary whose prospects or line of business the stock market regards as static or unpromising may be based on the target's superior information about the subsidiary's prospects, which information the target may have withheld for proprietary reasons. Admittedly, the same decision to retain a seemingly low growth division may instead be based on a managerial bias toward empire building and growth maximization. Which factor is dominant is difficult to detect. Yet, the consistent behavior of institutional investors in following the "Wall Street Rule" (under which they backed incumbent management or sold their stock, but never supported insurgents) may represent some empirical confirmation that institutional investors believe the internal monitor has an overall lower error rate.²⁵⁹ Of course, this suggestion that "management knows best" has its obvious limits: a given management may be sufficiently inferior or conflict-ridden that it is unable to exploit its superior informational resources in order to maximize value for shareholders. But this possibility should not be confused with the systematic tendency: other things being equal, when bidder and target management disagree on questions of policy, the latter has a higher probability of being right, even in a securities market that is highly efficient.

This observation has obvious contemporary relevance. In a recent series of much-publicized cases, potential bidders have sought to initiate a control contest over specific business policies—for example, Mesa Petroleum's efforts to convince Gulf to place its oil producing properties in a royalty trust.²⁶⁰

258. See *supra* note 147. This point again underlines the limited relevance of the issue of market efficiency. See *supra* text accompanying notes 66-72. Because insiders have informational advantages even in an efficient market, market efficiency does not imply that the bidder in a low premium takeover is likely to enhance efficiency.

259. A recent survey of 96 proxy contests between 1962 and 1978 found that in approximately 75% the incumbents retained control of a majority of the seats on the board; however, in 58% dissidents won at least one seat. See Dodd & Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 *J. Fin. Econ.* 401, 409 (1983). In a majority of the cases (37 out of 71) involving a pure control contest for control of the board (as opposed to merely an effort to obtain representation), the insurgents were former managers or directors of the firm. *Id.* at 410. This suggests that institutional investors are reluctant to displace incumbent management with outsiders but on occasion will back a challenge by a former insider. By this author's count, in the most recent round of proxy contests, only in the cases of GAF Corp. and Gulf Resources & Chemical Corp. have "true" outsiders having no prior position within the firm been able to dislodge the incumbent management and obtain working control of the firm.

260. For an overview of this contest over business policy, see Nulty, Boone Pickens, Company Hunter, *Fortune*, Dec. 26, 1983, at 54. Although the stock market significantly bid up the

Traditionally, to force such a change in business policy upon an unwilling board of directors, the insurgents would have had to undertake a proxy contest with relatively little chance of success. But if a hostile tender offer could be successfully accomplished at a low premium, this would change the odds by reducing the protective restraint of requiring the insurgent to convince a majority of its frequently skeptical fellow stockholders. Thus, it is an oversimplification to say that the threat of a takeover necessarily enforces greater sensitivity on the part of management to the market's judgment. The bidder is not the market, but rather a lone (and potentially even reckless) entity who is pressuring the firm. Nor does the apparent fact that the target's market price often goes up in response to the bidder's campaign resolve all questions by implying that the market agrees with the bidder's judgment. This response may only reflect the market's anticipation of a short-term control contest, which will end with a hostile tender offer, a white knight merger, or a leveraged buy-out at a premium—all of which represent profitable outcomes to a market focused more on trading gains than allocative efficiency. From this perspective, a policy aimed at reducing takeover premiums may subject management to increased pressure to accede to business policies in conflict with its judgment and having a higher possibility of error.

In contrast, when the bidder offers a large premium over the market price of the target's stock, it is in effect manifesting considerable confidence in its judgment. Although it is still possible that the bidder is acting irrationally, its willingness to exceed the market price by a significant margin suggests either that significant synergy can be realized from the combination of the two firms, or that the incumbent management has so clearly and palpably mis-handled a business decision or judgment (which decision can still be reversed) that a significant premium can be justified. In short, the more a party is willing to invest in its own judgment, the greater the confidence that society can also place in it.

Against this backdrop, two critical advantages of encouraging auctions (and thereby fostering high premiums) come into sharper focus. First, when takeover premiums are high, there is less reason to fear that erroneous business judgments by bidders will be imposed upon target corporations. Conversely, when takeover premiums are low, it becomes easier for an ill-informed bidder to substitute its judgment at a nominal premium for that reached by the incumbent management. Given the possibility that the bidder may simply have misunderstood or oversimplified the target's problems, there is little reason for public policy to encourage costless substitutions of a less-informed judgment for that of the incumbent management.

Phrased more generally, internal monitoring should ordinarily outperform external monitoring. Thus, the appropriate role of the external monitor should be to intervene only in cases of egregious managerial failure; the takeover is the remedy of last resort. The soundest technique by which to limit external interventions to such cases of significant failure, therefore, is to encourage auctions that in effect require the bidder to offer a substantial takeover premium. Although supermajorities and other "shark repellents"

tend also to minimize external interventions, they are more vulnerable to managerial bias and may be used to preclude all takeover attempts, regardless of the size of the premium offered. In contrast, a policy of low takeover premiums makes the hostile tender offer the remedy of first resort. Such a policy puts the cart before the horse and ignores modern business history. It places unrealistic expectations on the capabilities of external monitors, who have inferior information and are themselves subject to conflicts of interest.²⁶¹

A second reason for preferring an auction market as a means of reducing erroneous business judgments is that it tends to tilt a competitive control contest in favor of the party with more information. Other things being equal, it is axiomatic that the contestant who will pay the highest price for an expected return is the contestant who sees the least risk associated with the return. If the target can find a white knight and convince it to enter the contest, the odds are high that the white knight will win.²⁶² One explanation for this phenomenon is the asymmetry between the two bidders in terms of the information they possess about the target. The hostile bidder will typically be denied access to nonpublic data, while the white knight, who is often lured into the contest by the target, can obtain access to whatever it wants in terms of the target's internal reports and projections. Having more information, it faces less uncertainty about the target's future earnings stream, and is less likely to make an ill-informed strategic blunder.

The most important point to be made with respect to any comparison of monitoring techniques is not simply that internal monitoring should outperform external monitoring over the broader range of cases, but rather that close external monitoring is inconsistent with effective internal monitoring. All managements are fallible; eventually, any management will make a strategic blunder. Thus, some irreducible error rate is inevitable. Accordingly, if any significant decline in share value invites a hostile takeover, excellent managements may be replaced pointlessly. To illustrate, consider two similar corporations, each facing five major strategic decisions over a period of years. Assume that each decision, if successfully made, will increase that corporation's share price by twenty-five percent; conversely, a wrong decision will result in a twenty-five percent price decline. If Corporation *A* makes four out of five correct decisions, it has done excellently; if Corporation *B* makes only two out of five correctly, it has done poorly and probably deserves to be

value of Gulf Oil stock as a result of the Pickens challenge to Gulf's management, a majority of the shareholders (52.7%) voted in favor of a reincorporation proposal advanced by Gulf management in order to deny board representation to the insurgent group. See *A Victory for Gulf's Management*, *Bus. Wk.*, Jan. 16, 1984, at 34. For similar contests, see Wallace, *The New Activists: Big Investors*, *N.Y. Times*, June 12, 1983, at F4, col. 3 (detailing contests at Superior Oil, Trans World Corp. and MacMillan).

261. On the conflict of interest within the bidder firm, see Note, *supra* note 46.

262. See Ruback, *supra* note 20, at 147 (the first bidder is unsuccessful in 75% of the cases where there is a competing bid).

replaced. But the sequence of outcomes here becomes critical. If Corporation *A*'s first decision is its one erroneous decision, its share price will decline by twenty-five percent, while if Corporation *B*'s first decision is one of its two correct decisions, its price will rise by a corresponding amount. At this point, Corporation *B* is in a position to acquire Corporation *A*, even though with perfect hindsight this appears a perverse result. Now, expand this simplified example to a real world setting in which there is a much larger supply of potential bidders, and at this point management has no significant margin for error, even though some error rate is inevitable.

In rebuttal, one might argue that, on balance, the superior managements will acquire the weaker ones, even if sometimes the reverse occurs.²⁶³ This is probably true, but the rate of inefficient control transfers would be lower under a high premium policy. Moreover, in a world where any significant error invited a takeover, the effect on managerial behavior should be to deter the acceptance of avoidable, but desirable, risks when failure could cause a decline in share value sufficient to trigger a takeover.²⁶⁴ In sum, reality requires that management be given a reasonable margin for error, and this is what a policy of encouraging high takeover premiums tends to accomplish.

B. The Impact on the Managerial Labor Market

Corporations compete in three markets: (1) in the product market, where price and quality determine the outcome; (2) in the capital market, where a poor return on the investor's equity may elicit a tender offer; and (3) in the market for executive services, where competent managers sell their services in return for both high compensation and job security. Since Henry Manne first pointed out that corporations are disciplined by capital market competition,

263. To be sure, the probability is higher that events will occur in a different sequence, with the result that Corporation *A* will acquire Corporation *B*. Still, the key point is that if the margin of protection were higher (as it would be under a high takeover premium policy), there would be very little prospect of the inferior management replacing the superior one. A high premium policy also conserves on the supply of potential bidders, which is far from inexhaustible.

264. Professor Herman has raised a similar argument; he claims that in a very efficient capital market "managers may be pressed toward a focus on quick gains at the expense of risk-taking and longer-term investments that more stable tenure might allow." E. Herman, *supra* note 49, at 100. There is a tension between this claim and the argument later made in this Part that management might tolerate excessive risk under the pressure of more frequent takeovers. A reconciliation of these two claims is possible, however. A potential target management whose stock price lagged behind that of its rivals would indeed feel pressure to accept high risk gambles and to divest itself of liquidity. Conversely, a management that was performing at or above the medium level for its industry might be unwilling to accept a large entrepreneurial risk if a single failure would threaten its displacement. Because the market cannot realistically know most of the business decisions that management considered and rejected, it has only a limited capacity to monitor or discipline this refusal to accept desirable risks. In effect, the synthesis here suggested is that weak firms will tend to accept undesirable risks in order to catch up, while stronger firms will refuse desirable risks that might imperil executive tenure.

economists have focused their attention on the market for corporate control and given considerably less attention to the very different competition that occurs for executive talent.²⁶⁵ Yet, even a moment's reflection should remind one that the simplest and most direct way for a corporation to improve its management is to hire superior executives. Clearly, this happens on a regular basis, as corporate boards either fire an incumbent chief executive or, on his retirement, hire an outside successor. By most accounts, the pace of turnover in the executive suite appears to have accelerated in recent years,²⁶⁶ for a variety of reasons. Nor is this high rate of mobility limited to the uppermost echelons of the executive suite. When faced with a problem division or a lack of managerial depth, chief executives commonly bring in executive vice-presidents or division heads from firms whose management has long been highly regarded within their industry. At the other end of the scale, corporations compete for the graduates of leading business schools. Overall, the rate of executive mobility in the United States vastly exceeds that in Western Europe or Japan. By some estimates, one third to one half of all United States managerial and office workers leave their jobs each year.²⁶⁷

Although the market for executive services has not been extensively studied,²⁶⁸ several of its features suggest that it is an imperfect market which is vulnerable to periodic failure. First, because most executive vacancies are filled internally, this market is not a continuous auction, but rather a sporadic search process.²⁶⁹ Second, the transferring executive faces a considerably

265. But see Fama, *Agency Problems and the Theory of the Firm*, 88 *J. Pol. Econ.* 288 (1980) (arguing that competition in the market for executive services is one of the principal mechanisms explaining "the survival of the modern large corporation."). Fama asserts that the managerial labor market is more important than the market for corporate control.

266. Earlier data suggested "that managers, particularly top managers, seldom change jobs." W. McEachern, *supra* note 24, at 30-31. Yet, in his recent work, Professor Jennings has estimated that the turnover rate at the highest corporate levels during 1980-1983 was three times the rate during 1960-1964 and twice the rate of 1970-1974. See *supra* note 165. More recent studies of individual industries have also reported a more active market for executives and particularly for chief executives. See Barmash, *Looking for Company Presidents is Now a Deadly Serious "Game,"* *N.Y. Times*, May 13, 1978, at 29, col. 5.

267. See R. Reich, *supra* note 5, at 163. Professor Reich cites data indicating that the average corporate chief executive in the United States has been in office for less than five years and that each year 15% to 25% of all American executives leave their jobs. At any given time, 30% of American managers are seeking new employment. *Id.* at 161.

268. For an excellent overview, see Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 *J. Corp. L.* 232, 236-38, 272-74 (1983).

269. *Id.* at 237. Still, lateral hiring of chief executives is far from uncommon. Professor Vagts cites a 1981 *Forbes* survey which shows that 121 out of 818 chief executives had become chief executive at their present firm without prior service at that firm. *Id.* at 237 n.27 (citing *Forbes*, June 18, 1981, at 114). Another study has estimated that lateral transfers between firms accounted for 13% of changes in senior management (based on a survey of Wall Street Journal announcements). See Roche, *Compensation and the Senior Executive*, *Harv. Bus. Rev.*, Nov.-Dec. 1975, at 33.

higher level of risk than one accepting an internal promotion; consequently, to induce him to accept this risk, the compensation offered must be significantly higher.²⁷⁰ Third, those who have studied executive recruiting most closely report that the monetary rewards are often of secondary importance to the executive considering a transfer. More important were the increased responsibility, challenge and opportunity for "self-actualization."²⁷¹ In particular, the "fast track" executive seeking to become a future chief executive is likely to place primary emphasis on these intangible factors.

What would be the impact of an increased frequency of hostile takeovers on this labor market? First, to the extent that job security is reduced, the executive should demand much higher compensation for his services. Viewed as an entrepreneur, the senior executive will rationally appraise any opportunity in terms of its expected return and the degree of risk associated with it. If the risk increases, so must the return, to hold his overall benefit constant. Greater risk is associated with a regime of more frequent takeovers because job security would be imperilled in several respects. In the aftermath of a hostile bid, the tendency is to replace the entire senior management team rather than selectively evaluate each executive's utility to the bidder.²⁷² In addition, many positions simply become redundant: the bidder will have its own general counsel, senior vice-president for finance and other specialists and will not need to retain those occupying similar positions in the target. Middle management officials working for the bidder are also likely to view the target as conquered territory within which they will move into the major executive positions. In general, to the extent that the target's operations and product lines are divided among the operating divisions of the bidder, most senior executives of the target will become superfluous, and predictably will leave within a brief period after the acquisition.

If higher compensation does result because of the greater uncertainty associated with executive status, the impact on shareholders is also obvious: net profits will decline. This increase in executive compensation may well prove to be immaterial for the average firm.²⁷³ However, from a disaggregated perspective, job security would be especially threatened in inefficiently man-

270. Professor Vagts cites a "rule of thumb that an executive must be given a 25-40% increase in compensation to move to another company." Vagts, *supra* note 268, at 237 n.28.

271. See Roche, *supra* note 269, at 53-54 ("Executives who change employers report that the opportunity for more responsibility and greater challenge is more important to them than increase in compensation.").

272. Professors Easterbrook and Fischel suggest that this is because the individual contribution of each manager to the enterprise cannot be separately evaluated, at least by an external monitor; thus, each manager bears a vicarious responsibility for his fellows and they are replaced as a group. Easterbrook & Fischel I, *supra* note 1, at 1172; see Fama, *supra* note 265, at 295-306.

273. Professor Roberts has estimated that the total compensation received by senior executive officers represents on average about 5% of firm profits (with the range being between 1% and 10%). See Roberts, *supra* note 48, at 54 (cited in Marris, *supra* note 24, at 67). Since Professor Roberts' study in the 1950's, executive compensation has increased substantially—arguably in response to less secure executive tenure—and thus his figures may be somewhat understated.

aged companies because such companies would be particularly vulnerable to a takeover. As a result, the ability of the marginally inefficient corporation to rehabilitate itself through an infusion of new management could be seriously impeded. Not only would it have to outbid all rivals by a substantial margin, but there might exist no risk premium sufficiently large to compensate the risk-averse manager who feared the loss of status, career interruption and reputational injury that might follow from dismissal in the wake of a tender offer. To the extent that nonmonetary rewards are decisive for the "fast track" executive, a transfer to a highly vulnerable firm that is an obvious takeover candidate makes little sense.

An even greater danger looms. Not only might it be hard to attract competent new managers, but it might also be difficult to retain existing management, as the best of them might transfer to more secure positions with less vulnerable firms. Such a migration of capable executives to less vulnerable firms would be a perverse result, which would aggravate the difficulties of the inefficient firm by both reducing its access to the executive labor market and inducing an increased flow of departures just as the firm fell to a level that rendered it a takeover target.

If this premise is accepted, it is an insufficient answer to these dangers to reply that special employment contracts would give adequate security to the superior manager. If the dynamic "fast track" manager most fears the career interruption and loss of opportunity for advancement that flows in the wake of a hostile takeover, he is not easily compensated. Moreover, contractual attempts to guarantee job security to the target's employees undercut the one clear comparative advantage of a zero-premium policy: namely, its greater deterrent threat. Indeed, a form of "moral hazard" problem arises once a manager obtains a long-term contract, particularly one that entitles him to substantial lump-sum payments if he is terminated or otherwise departs, because his incentive not to "shirk" is thereby reduced.²⁷⁴ This does not mean that some measure of contractual security should not be given, but it does indicate that a basic tension exists between the twin goals of capital market discipline through hostile takeovers and an efficiently functioning market for executive services.

Thus, an ironic symmetry emerges: the cost of attaining perfect competition in the market for corporate control is substantial impairment of the efficiency of the executive labor market. The critical question is therefore which market is more important. This question certainly can be debated, but

274. Frequently, the triggering condition for "golden parachutes" is only that some potential bidder acquire a specified percentage of the target's stock. On occasion, the threshold has been put as low as 15%. See Morrison, *Those Executive Bailout Deals*, *Fortune*, Dec. 13, 1982, at 82, 85. As a result, an executive may resign in order to obtain a lump sum settlement, even though no takeover has occurred. Several such instances have been reported. *Id.* at 85-87. Indeed, even if the contract provides for such a payment only if a takeover is completed, the executive will now have an incentive to encourage a low-premium takeover, or even an exploitative partial bid, which may not be in the best interests of shareholders.

the labor market has several obvious comparative advantages. First, its use involves considerably lower transaction costs. Second, there is less likelihood that incumbent management can block resort to it through "shark repellent" or similar devices. Indeed, incumbent management does not have a collective self-interest in opposing resort to this market. Finally, replacement of inferior executives can be made on a more selective basis, without the need for mass dismissals. For these reasons, the labor market is logically the superior remedy for a corporation having only modest deficiencies in its managerial resources, while the hostile takeover seems best consigned to the role of a remedy of last resort.

C. Excess Deterrence and the Problem of Demoralization

A takeover is a traumatic event for target management. In its aftermath, dismissals are almost inevitable, and in some cases they decimate the executive staff of the target.²⁷⁵ Those who wish to maximize the frequency of takeovers tend to see the often dramatic staff reductions, dismissals and uncertainty that follow a takeover as simply the inevitable by-products of capital market discipline, as the bidder disposes of the excess assets and personnel of the target.²⁷⁶ However, an alternative interpretation is that the high rate of executive turnover following a takeover is often undesired by the bidder and instead is but one example of a "demoralization cost." These costs arise to the extent that employee performance and loyalty deteriorate in an environment characterized by a high rate of changes in corporate control. Although the magnitude of these costs is debatable, a higher rate of takeover frequency may increase them to a level where they negate or exceed the gains arising from the supposed greater deterrence that was earlier seen as the unique advantage of the Easterbrook/Fischel position. This section will examine first the specific problem of assimilation difficulties and then turn to the more general topic of the relationship between the deterrent threat of the takeover and the firm's ability to maximize employee motivation.

1. *Post-Acquisition Assimilation Problems.* — Both survey and reportorial data show that the quality of the target's management is a leading criterion in the selection of the target.²⁷⁷ Although this finding initially seems inconsistent with the disciplinary theory of takeovers, it can be partially reconciled with the theory of capital market discipline if we assume that by "quality of management," the bidder primarily means the strength of middle management—namely, those at the operating and technical levels whose expertise cannot easily be replaced.²⁷⁸ During the conglomerate acquisition wave

275. See, e.g., Tomasson, *The Trauma in a Takeover*, N.Y. Times, Jan. 9, 1982, at 31, col. 3.

276. See Easterbrook & Fischel I, *supra* note 1, at 1190 n.83 ("Managers should not be allowed to consider whether creditors, suppliers, or employees will be displaced in deciding whether to oppose a tender offer.").

277. See *supra* notes 198-99 and accompanying text.

278. See *supra* note 207 and accompanying text.

of the 1960's, personnel at these levels were rarely replaced following an acquisition.²⁷⁹ But today a new pattern has become evident: operating personnel are leaving the acquired company in substantial numbers following a takeover, apparently of their own volition. Moreover, those leaving often are those having the highest mobility in the labor market. Peter Drucker, the management theorist, has generalized that an acquiring company must be prepared to supply replacement management for the acquired corporation within two years of the acquisition.²⁸⁰ Empirical data, although limited, seem to bear him out. One survey on executive turnover in the wake of an acquisition has reported that 20% of the target's senior executives leave in the first year, a total of 36% leave by the second year, and 52% are gone at the end of the third year.²⁸¹ Approximately half of this number appear to have left for reasons other than the elimination of their jobs by the acquiring corporation, and the departures occurred disproportionately in the case of hostile takeovers.²⁸² Another study of 200 acquisitions made by a group of Fortune 500 companies found that only forty-two percent of the top management remained as long as five years.²⁸³ There are obvious problems with the nature of this data: critical terms such as "top management" are undefined and a satisfactory control group is lacking for meaningful comparison.²⁸⁴ Still, this high rate of voluntary departure suggests that the hostile bidder may not get what it paid for. To the extent that the acquired firm is valued because of its human capital, it may be left with only a corporate shell depleted of much of its human assets. Case histories can be cited in which the departure rate following an acquisition by an acquiring firm characterized by a different operating style has seriously compromised the acquired firm's efficiency.²⁸⁵

279. See *supra* notes 200-02 and accompanying text.

280. See *Why Some Mergers Work and Many More Don't*, *Forbes*, Jan. 18, 1982, at 34, 36.

281. This survey was conducted by Lamalie Associates, Inc., an executive search firm, and involved 260 "senior executives who were involved in the major corporate takeovers of the past three years." *The Lamalie Letter*, Third Quarter, 1981, at 1 (copy on file at the offices of the Columbia Law Review).

282. *Id.* at 2. Fifty percent of those surveyed explained that their jobs were eliminated in a reorganization, and 50% gave other reasons. Interestingly, all of the executives surveyed who remained with their company reported that their acquisition had been a "friendly" one. Although such self-reported data is open to serious question and some methodological laxness seems evident, this study suggests that when executives view the takeover as "hostile" they are more likely to leave voluntarily.

283. See Hayes, *The Human Side of Acquisitions*, *Mgmt. Rev.*, Nov. 1979, at 41. This study surveyed personnel managers, rather than departed employees, and its findings from the employer's point of view dovetail with, and reinforce, the Lamalie study, *supra* note 281.

284. This point is important because the overall rate of executive turnover is sufficiently high (by some estimates) to produce a similar level of departures after five years. See *supra* notes 268-69. Cross comparisons between studies are difficult to make because each study defines its terms differently. Thus, the data cited in notes 266-67 include junior personnel, such as clerical workers, whose turnover rate is likely to be very high.

285. For example, shortly after Morton-Norwich Products, Inc., a white knight bidder, acquired Thiokol Corp., the majority of Thiokol's managers who had "golden parachute" employment contracts resigned, reportedly in part because they "felt uncomfortable working for

To be sure, the bidder is entitled to take risks, and only a foolish paternalism would deny it that right. However, this pattern may explain the tendency for takeovers to focus on natural resource companies, where presumably the role of human capital is less important than it is in service or high technology industries, where takeovers appear to have been less frequent.

From a managerial perspective, two points have been made repeatedly by virtually every careful student of acquisitions. First, assimilation problems are likely in the aftermath of mergers and takeovers, and often they produce problems far more serious than the bidder anticipated.²⁸⁶ Indeed, this may be one reason why relatively few bidders make repeated hostile acquisitions.²⁸⁷ Second, departed executives cannot be easily replaced by personnel recruited from outside the organization. This latter observation is a commonplace among business school academics, who have repeatedly stressed that managers acclimated to one corporate culture face significant problems of adaptation when transferred to another.²⁸⁸ Because of this limitation, Peter Drucker has estimated that "three out of four managers from outside do not prove out."²⁸⁹

The concept of corporate culture has increasingly been the focus of much behavioral literature.²⁹⁰ Proponents of this perspective have argued that a manager trained at G.E. is likely to be a flop at Xerox, and vice versa, because both firms have strong but differing cultures that shape the attitudes toward risk-taking, managerial practices and professional styles of those trained and socialized within them.²⁹¹ Even if such claims sometimes sound overstated, it should be obvious that no context presents more difficult problems of adapta-

Morton." Dorfman, *The Thiokol Defections*, *Forbes*, Mar. 28, 1983, at 110; see also Mufson, *Schlumberger's Slip: Oil-Fields Highflier Finds Turbulent Skies in the Chip Business*, *Wall St. J.*, Aug. 26, 1983, at 1, col. 6 (reporting Fairchild Camera's top management was "leaving in droves" as a result of operating style conflicts with new parent).

286. The literature on this point includes the following representative examples: Gill & Fouldner, *Managing a Merger: The Acquisition and Aftermath*, 10 *Personnel Mgmt.* 14 (1978); Hayes, *supra* note 283; Levinson, *A Psychologist Diagnoses Merger Failures*, *Harv. Bus. Rev.*, Mar.-Apr. 1970, at 139; Marks, *Merging Human Resources*, 17 *Mergers & Acquisitions* 38 (1982); Sinetar, *Mergers, Morale and Productivity*, 60 *Personnel J.* 863 (1981); see also *infra* notes 291-92.

287. Although a number of corporations—such as Mobil, Occidental Petroleum and Seagrams—have made repetitive hostile bids, only a very few—United Technologies being the prime example—have made a successful hostile bid, digested the target corporation and then sought other targets in hostile bids. The more common experience is one of acute organizational difficulties surrounding the integration of a large target corporation with the bidder's own operations. Cf. Louis, *The Bottom Line on Ten Big Mergers*, *Fortune*, May 3, 1982, at 84 (discussing integration difficulties in ten of the largest "friendly" acquisitions).

288. See, e.g., T. Deal & A. Kennedy, *Corporate Cultures: The Rites and Rituals of Corporate Life* 16-18, 83-84 (1982); C. Handy, *Understanding Organizations* (1976); W. Ouchi, *Theory Z: How American Business Can Meet the Japanese Challenge* (1981); see also *infra* note 292.

289. *Why Some Mergers Work and Many More Don't*, *supra* note 280, at 36.

290. See, e.g., T. Deal & A. Kennedy, *supra* note 288; W. Ouchi, *supra* note 288; R. Roy, *The Cultures of Management* (1970).

291. T. Deal & A. Kennedy, *supra* note 288, at 16-17.

tion and assimilation than the post-acquisition stage. Focusing on this stage, Harvard Business Professors Paul Lawrence and Jay Lorsch have concluded:

The assimilation of new acquisitions is at present very uneven, marked by notable failures as well as successes. While there is little hard evidence on this matter, it would appear from anecdotal accounts that many failures result from too little attention to the organizational issues connected with acquisitions Too often the conversion process results in dissipating the most important asset acquired—a strong, viable organization.²⁹²

The rebuttal of the neoclassical economist to these contentions is predictable: if assimilation problems were indeed serious, the stock market would penalize bidders that attempted unpromising acquisitions. At present, no evidence suggests that this is happening.²⁹³ Yet, this lack of response is not dispositive, for at least two reasons. First, the contemporary market for corporate control is a competitive one in which the initial hostile bidder loses in the vast majority of the cases to a white knight. Second, bidders may anticipate the problem and focus disproportionately on asset or cash-laden companies where human capital is a less important factor. Although “friendly” acquisitions by “white knights” also produce assimilation difficulties, it seems a fair premise that the level of suspicion and paranoia will be higher in a hostile takeover than in one that is at least marginally more amicable. In this light, the problem of assimilation difficulties is less a current diseconomy than a potential one, which would be exacerbated if we sought to maximize the frequency of hostile takeovers by discouraging auctions and the search for a white knight.²⁹⁴

2. *Deterrence and Employee Motivation: Toward a Broader Theory.* — Ultimately, demoralization costs raise the danger of overdeterrence. The very possibility of excess deterrence has been ignored by the neoclassical approach to corporate accountability. Its premises are simple and stark: employees tend to shirk and avoid additional effort; they therefore must be closely supervised and subjected to the threat of dismissal through the medium of the hostile takeover.²⁹⁵ In all likelihood, John D. Rockefeller, Henry Ford and even John Calvin would concur with this assessment of the need for stern discipline to prevent inefficiency. Yet, both the behavioralist and the modern manager have long since progressed to a more balanced view of motivation and the

292. P. Lawrence & J. Lorsch, *Organization and Environment: Managing Differentiation and Integration* 231-32 (1967).

293. As noted earlier, bidders appear to experience a small increase in their stock prices on the announcement of a takeover; however, the methodology surrounding these studies is open to some dispute and there are inconsistent findings. See *supra* note 253 and accompanying text.

294. One study has found that in competitive bidding contests, the first bidder (typically the hostile black knight) is unsuccessful in acquiring control in 75% of the cases. See Ruback, *supra* note 20.

295. Easterbrook & Fischel I, *supra* note 1, at 1169-70.

problematic impact of threats. Probably the most influential book in recent times on motivating and managing human resources has been Douglas McGregor's *The Human Side of Enterprise*, which outlined two general theories of motivation, Theory *X* and Theory *Y*.²⁹⁶ Rare is the experienced senior executive who does not know that the authoritarian, coercive theory outlined above is basically Theory *X*. In contrast, Theory *Y* postulates that individuals need and desire to work and perform best within a participative, open framework; under it, management will be more effective if it creates an environment that stresses support and encouragement rather than constant threats of dismissal.

Although others have refined and sharpened McGregor's analysis and most would today agree that the truth lies somewhere in between the stereotypical concepts of Theory *X* and Theory *Y*, professionals in the allied fields of psychology and labor relations generally believe that Theory *Y* (in a variety of modified forms) is a better generalization than Theory *X*.²⁹⁷ Thus, if McGregor and a legion of other social scientists are correct, maximizing the threat of dismissal may be a very counterproductive policy, particularly in an economy dominated by service and high technology industries where human capital is of increasing importance and decisionmaking is more collegial than hierarchical.

In short, the view of employee motivation underlying the concept of capital market discipline through hostile takeovers is an archaic and simplistic one. The constructive disciplinary reach of the hostile takeover is probably limited to the senior-most echelons of a potential target's management, where the threat of a takeover may cause the management to sell or otherwise dispose of assets whose value cannot be maximized in the corporation's own hands. But, beyond encouraging a higher rate of asset disposition, which probably is in the best interests of shareholders, the takeover's deterrent impact otherwise may be more negative than positive. The divisional or more senior manager who has performed diligently but who knows that management tends to be replaced as a team following a takeover has little motivation to perform, and every incentive to shirk, once a takeover appears imminent. He also has an increased incentive to engage in predatory self-dealing that reduces shareholder wealth. Although this problem may arise whenever a takeover occurs, under a zero-premium policy the pervasive threat of a take-

296. D. McGregor, *The Human Side of Enterprise* (1960). McGregor's work has much in common with the theories of the psychologist Abraham Maslow, who also analyzed management styles. See A. Maslow, *Eupsychian Management: A Journal* (1965). For two other important works in this area, see C. Argyris, *Integrating the Individual and the Organization* (1964); R. Likert, *New Patterns of Management* (1961).

297. Deal and Kennedy suggest that since McGregor's seminal writings, organizational styles have "continued to gravitate more and more in the 'Theory Y' direction." T. Deal & A. Kennedy, *supra* note 288, at 180; see also P. Lawrence & J. Lorsch, *supra* note 292, at 234-45 (discussing nonhierarchical organizational structures); M. Maccoby, *The Gamesman: The New Corporate Leaders* 210-17 (1976) (analyzing the influence of McGregor and citing it as "still one of the works most quoted by managers").

over should increase the magnitude of these demoralization costs and cause them to arise well before a specific takeover threat is in view. In this view, the constructive deterrent value of the takeover lies more in its ability to function as the corporate guillotine, amputating swiftly and finally an inefficient management, and less in its general deterrent effect as a motivating force by which marginal managements are spurred to greater effort.

D. *The Shift Toward Risk Preference*

Although it has repeatedly been asserted that the threat of a takeover is producing an unfortunate managerial preoccupation with short-run profit maximization,²⁹⁸ the more coherent scenario and the greater danger involves a likely shift in managerial attitudes toward greater tolerance for risk. This assertion will next be analyzed from the differing perspectives of the bidder and the target.

1. *The Target's Perspective.* — Considerable reason exists to believe that the threat of takeovers has already altered business decisionmaking within target corporations. Potential target firms now seek to reduce their vulnerability by divesting themselves of cash or other assets desired by the bidder.²⁹⁹ General agreement exists that high liquidity is a leading characteristic in the profile of target companies, as is a low level of indebtedness.³⁰⁰ From a conservative, balance-sheet-oriented perspective, this means that an undesirable incentive arises for potential targets to rid themselves of liquidity and to increase indebtedness. At least over the short run, the result is that an arbitrary element has been added to the calculus of business planning, as cash depletion and illiquidity become managerial objectives. A related consequence is that the takeover process begins to feed on itself as threatened managements execute highly leveraged buyouts and as targets stalk other targets in order to grow in size and deplete cash reserves, thereby reducing their own likelihood of being taken over. In overview, such a shift toward increased risk is simply another consequence of excess detrence. Whatever the magnitude of this shift today (and, overall, it may still be relatively small), it should logically

298. See *supra* note 5.

299. For recent examples of this defensive tactic, see R. Reich, *supra* note 5, at 148 (citing J. Ray McDermott Company's \$758 million acquisition of Babcock & Wilson and Kennecott Copper Corporation's \$567 million acquisition purchase of Carborundum).

There has also been much speculation that the managements of target corporations are willing to take high-risk gambles, which they would otherwise disdain, in order to obtain an earnings increase that will enable them to defeat insurgents in a corporate control contest. For one recent example that may bear out this prediction, see Levin, *Gulf Oil Is Pressing Hunt for Big Finds in Alaska as Way to Win Proxy Battle*, *Wall St. J.*, Nov. 21, 1983, at 8, col. 1.

300. Statistical studies have found both liquidity and a low debt ratio to have a positive correlation with being acquired, although the strength of this correlation was for some years statistically significant and for some years not. See Harris, Stewart & Carleton, *Financial Characteristics of Acquired Firms, in Mergers and Aquisitions: Current Problems in Perspective* 235 (M. Keene & L. White eds 1982).

accelerate if management were otherwise barred from engaging in defensive tactics. Indeed, from a truly *ex ante* perspective, such perverse tactics as the anticipatory depletion of cash or the sale of "crown jewel" divisions at bargain prices become the logical counter-moves by target managements to a rule of managerial passivity in the face of a hostile bid.

2. *The Bidder's Perspective.* — A bidder may profit from a takeover either by creating wealth or by transferring it. The transferred wealth, however, need not come from target shareholders; alternatively, it can come from creditors or other fixed-interest claimants in the bidding firm. In general, once a creditor has acquired its debt security, any subsequent shift by the debtor toward increased leverage injures the creditor by subjecting it to additional risk. Yet, such a shift toward increased leverage may well benefit the holders of the equity securities of the debtor, because some or most of the risk is being borne by the firm's creditors. As a result, debt-financed takeovers can be used to effect a wealth transfer from creditors of the bidder to its equity security holders, with the result that a potentially dangerous incentive may arise for increased leverage in corporate financial structures. History has taught once already in this century that overly leveraged capital structures are a legitimate cause for social concern.³⁰¹

An example is useful to illustrate why a rational management might increase leverage to a level that was undesirable from a social perspective. Let us suppose that a corporate manager can choose between two alternative investments: Investment *A* will yield an expected return of \$50 million with minimal risk, and Investment *B* will yield a return of \$80 million, if it succeeds, but it has only a fifty percent chance of this outcome and a fifty percent chance of a zero outcome. Normally, Investment *A*, which has an expected value of nearly \$50 million, would be considered superior to Investment *B*, which has an expected value of \$40 million.³⁰² But now assume that

301. The most obvious historical precedent is that of the public utility holding companies of the 1920's, which attained an extreme degree of leverage through a technique known as "pyramiding." Their financial failure during the Depression as a result of such leverage led to the Public Utility Holding Company Act of 1935, the only federal securities statute that directly regulates corporate financial structure. For an overview of this episode in financial history, see V. Brudney & M. Chirelstein, *Corporate Finance: Cases and Materials*, 331-61 (2d ed. 1979). Leverage is not irrational but the interests of social wealth maximization and shareholder wealth maximization can diverge, particularly to the extent that bankruptcy involves substantial social costs.

For recent examples taken from the front page of the *Wall Street Journal* during 1983 in which bidders appear to have encountered serious financial crises or bankruptcy as a result of excessively risky acquisitions, see Bayless, *The Morning After: Canadian Firms Find Their Binge of Buying is Causing Hangovers*, *Wall St. J.*, Nov. 15, 1983, at 1; Ingrassia & Hertzberg, *Sour Notes: How Baldwin-United Expanded from Pianos to Finance to Trouble*, *Wall St. J.*, Mar. 28, 1983, at 1; Waterloo, *Bitter Harvest: Expanding Too Fast, A Major Grain Co-op Fell into Big Trouble*, *Wall St. J.*, July 18, 1983, at 1.

302. Expected return is simply the weighted average of all possible returns, each discounted by its probability. See W. Klein, *Business Organization and Finance: Legal and Economic Principles* 145-46 (1980). Here, Investment *A* has an expected return of \$50 million with no discount for risk, while Investment *B* has an expected return of \$40 million, the weighted average

the corporation about to undertake this investment has a high debt to equity ratio and has outstanding debt securities of \$40 million, which must be repaid out of the proceeds of either investment. Now, from the standpoint of the equity stockholder, the first project offers him only \$10 million (after debt repayment), while the second project offers him \$40 million if it succeeds, or an expected value of \$20 million given its fifty percent chance-of success.³⁰³ Particularly if failure does not threaten immediate insolvency, the risk-neutral equity shareholder, who will not be liable for the corporation's debt if it goes unpaid, should rationally prefer Investment *B*, although from the overall perspective of the corporate entity or that of society, Investment *A* seems superior.³⁰⁴ In effect, the equity shareholder is here altering the risks imposed on other claimants on the corporation to improve his own position. Next, add to this example the fact that Investment *B* is a risky takeover, which will either increase the degree of leverage in the corporation's financial structure or otherwise result in an increased level of risk. The result realistically demonstrates why managements, which are chiefly responsible to the equity shareholders, may adopt a risk-preferring strategy that is not desirable from the perspective of the firm's investors. Highly leveraged takeovers can thus be understood as a means for shifting risks to creditor classes in order to increase the expected return to shareholders.

Although the foregoing transaction as a whole may be inefficient in terms of its aggregate impact, there is no necessary reason why the stock market should penalize such conduct, because the transaction benefits shareholders at the expense of creditors. The possibility of these wealth transfers from creditors to shareholders calls into question the relevance of the stock price studies of bidder performance in the wake of a tender offer announcement. Although these studies have tended to show slight gains in the bidder's stock price following the takeover's announcement,³⁰⁵ such a finding cannot serve as a proxy for the overall economic efficiency of the transaction because of the possibility that the source of these gains lies in wealth transfers to shareholders. In any event, it is clear that some bidders have borrowed amounts that

of \$80 million and zero, each outcome being equally likely. There is no question that Investment *A* would be preferable if a single investor supplied all the firm's capital, both debt and equity.

303. For a similar analysis, see Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 *Yale L.J.* 49, 67 n.84 (1982). In Professor Levmore's terms, the example in the text is an illustration of "risk alteration," in which equity holders seek to impose additional risks upon pre-existing debt holders. As a result they may prefer an investment that is not rational from the combined perspective of the debt and equity.

304. From the viewpoint of efficient allocation of resources, however, Investment *A* has the higher expected value and hence creates greater social wealth. Thus, private and social wealth diverge, and to the extent that the equity class elects management, the firm has an incentive to undertake investments that are not socially desirable.

305. Bidder stock prices appear to have increased 3.8% on weighted average and net of overall market movement in the period surrounding a takeover announcement. See *supra* note 251.

significantly reshaped their capital structure in order to finance a takeover.³⁰⁶ Instances can be identified as well where the outstanding debt securities of the bidder went down in value as a result of the transaction at the same time as the bidder's common stock went up.³⁰⁷ Still, little aggregate evidence is available as to the effect of takeovers on bondholders, and some analysts have concluded that their impact has been slight.³⁰⁸ Yet, conclusions about the current impact of takeovers on bondholders do not resolve the issue of what their impact would be under a regime of much more frequent takeovers. Nor does it dispose of the possibility there may be other creditor classes besides bondholders who are less able to protect themselves.

306. When DuPont acquired Conoco, it borrowed \$3.9 billion. With the prime interest rate then at 20%, in one quarter alone its interest expense rose from \$35 million to \$201 million. See Chavez, *DuPont's Unconvincing Merger*, N.Y. Times, Nov. 14, 1982, at F1. An even better example is Fluor Corporation's acquisition in 1981 of the much larger St. Joe Minerals for \$2.7 billion, \$1 billion of which was borrowed. As a result, Fluor "poured virtually its entire cash flow for the first half of 1981 into interest payments." R. Reich, *supra* note 5, at 148. Similarly, Occidental Petroleum financed its much criticized acquisition of Cities Service for \$4 billion in part by borrowing \$1.9 billion from banks and issuing notes valued at \$533 million. As a result, Occidental "has not been earning enough to cover its own \$240 million annual common stock dividend, let alone the new debt from the Cities acquisition." Wayne, *A Costly Merger for Occidental*, N.Y. Times, Jan. 23, 1983, at F1. Most recently, it has been estimated that Texaco's record-breaking acquisition of Getty Oil would cause the percentage of debt in its capital structure to rise from 11% to 39%, unless other means of financing the acquisition besides debt are found. See Nulty, *supra* note 54, at 108. Other recent takeovers, including Allied's purchase of Bendix and U.S. Steel's merger with Marathon Oil, also resulted in a radically leveraged capital structure. Although it would be rash to predict that any of the foregoing companies will ever face insolvency, other large corporations have gone into bankruptcy apparently in large measure because of debt-financed takeovers. See Fisher, *The Decade's Worst Mergers*, Fortune, Apr. 30, 1982 at 262, 270 (discussing failures of Baldwin-United and Wickes).

307. A good example is Esmark's acquisition of Norton Simon in 1983. The acquisition doubled Esmark's size, but plunged it deeply into debt. See Williams, *Acquisition Strains at Esmark*, N.Y. Times, Oct. 7, 1983, at D1, col. 3. As a result of the acquisition, Esmark's debt went from \$355 million to \$1.5 billion—a 425% increase in one transaction. *Id.* at D3, col. 4. The debt and equity markets responded (rationally, it must be presumed) in dramatically divergent manners: Esmark's shares rose from \$68.25 to \$83.50 per share, but both of the major bond rating agencies lowered their credit ratings (Moody's reduced its rating from A3 to Baa1, while Standard & Poor's placed Esmark on its Creditwatch list). *Id.* Thus, outstanding debentureholders lost while stockholders won, and the result was essentially a value transfer from creditors to equity holders.

308. For a brief discussion, see Schipper & Smith, *Effects of Recontracting on Shareholder Wealth: The Case of Voluntary Spin-offs*, 12 J. Fin. Econ. 437, 438 (1983) (reporting most studies to show small gains or no gains to bondholders of both bidder and target firms). However, enormous methodological difficulties confront any attempt to measure the impact of any corporate action on bondholders, both because trading in senior securities is relatively infrequent and because the impact will vary depending on the particular class of bondholder, with the severest impact being felt by the subordinated debentureholder. See Hite & Owers, *Security Price Reactions Around Corporate Spin-off Announcements*, 12 J. Fin. Econ. 409, 422-24 (1983) (describing methodological problems). Also, the proxy typically used to measure an adverse impact—a decline in the bond rating given the security—is a questionable one because bond rating agencies lack incentive to investigate closely.

In fairness, it must be observed that the operative force here is not the takeover itself but the attractiveness to stockholders of higher risk investments financed through high corporate leverage which place a major share of their cost on other pre-existing classes of corporate security holders. This inherent conflict between debt and equity holders is a longstanding problem in corporate finance,³⁰⁹ and it also has been long recognized that one motive for mergers is that they may substantially increase the debt capacity of the surviving entity.³¹⁰ What is new here is only that the hostile takeover presents a unique vehicle for allowing shareholders to increase the degree of leverage previously accepted by creditors and others having fixed, nonresidual claims in the corporation. Takeovers differ from other forms of acquisitions in one significant respect which exacerbates this problem: hostile tender offers tend to be for cash, while mergers more typically involve an exchange of equity securities in order to secure favorable tax treatment.³¹¹

In response, proponents of a high frequency of takeovers will predictably claim that creditors are fully capable of protecting their own interests. Clearly, they are right to a considerable extent, and it is only an unanticipated increase in risk that unfairly prejudices the bondholder. Substantial creditors, such as banks, have the capacity to protect themselves through negative covenants, and typically they will obtain higher interest payments as the price of their consent. However, smaller creditors—such as public purchasers of debentures and trade creditors—may have less adequate protections and thus may have unanticipated risks imposed on them for which they have not been compensated. Indeed, the very concept of “agency costs” implies that a small consortium of large banks should be better able to monitor their debtor than a much larger network of loosely organized debenture holders.³¹² Arguably, even

309. Studies have reported that stockholders may sometimes “steal” value from bondholders through spin-offs and divestitures. See Hite & Owers, *supra* note 307, at 412 (discussing research of others on use of spin-offs and special finance subsidiaries to outflank contractual arrangements protecting bondholders’ priority and collateral).

310. With respect to the basic problem, endemic to corporate finance, that common shareholders can adopt high-risk strategies in order to cause the market value of their shares to gain at the expense of the market value of the fixed claims held by creditors, see W. Klein, *supra* note 301, at 167–69, 189–90. With respect to the specific motive for acquisitions, that they can increase debt capacity, see Stapleton, *Mergers, Debt Capacity, and the Valuation of Corporate Loans*, in *Mergers and Acquisitions: Current Problems in Perspective* (M. Kcenan & L. White eds. 1982). Cash tender offers are unlike mergers in that they typically involve a much more significant issuance of debt.

311. In addition, in a merger effected exclusively through an exchange of equity securities, it is likely, other things being equal, that debentureholders should gain wealth, since the combined corporation is likely to have a lower risk of default.

312. The position of the debentureholder is different from that of the commercial lender for two distinct reasons. First, the original drafting of the loan instrument is supervised on behalf of the purchasers by the underwriter of the debentures, who typically is subject to a conflict of interest because he wishes to retain the issuer’s future business; also, the prospect of securities liability is low in the context of debt issues. Second, there is a problem in monitoring compliance with the negative covenants contained in the trust indenture. Typically, the indenture trustee can

these smaller creditors should, over time, become more sensitive to the risks that debt-financed takeovers impose on them and will negotiate tighter covenants or demand higher interest. Thus, the adverse impact on their interests may be only marginal and temporary.

Nevertheless, there are other classes having an economic interest in the corporation—for example, employees, suppliers, pensioners and lower level managers—who are adversely affected by an increase in leverage or any other substantial shift in the direction of risk preference.³¹³ Although these claimants are not typically seen as creditors, they have an interest that resembles the fixed nonresidual interest held by creditors. However, while they hold relatively fixed claims and do not share substantially in increased profits, they tend to lack contractual or other mechanisms by which to protect themselves. Only a minority of the workforce is unionized, and it is a rarity for a middle manager to have any contract, much less one that constrains corporate decisionmaking in any way. To some extent, these fixed interest claimants may free ride on protections secured by senior creditors, but because senior creditors will willingly accept increased risk for an increased return, this protection is imperfect and uneven. In overview, a basic conflict exists between those who profit from acceptance of increased risk and those who do not. Because of stock options and other forms of incentive compensation, the position of senior management is most closely aligned with the shareholder who benefits from increased leverage. In contrast, employees and middle management are more aligned with creditors but lack the protections possessed by them. Add to this the behavioral explanation for empire building—that senior management's compensation and relative immunity from a hostile takeover should increase with increased growth—and the conflict intensifies.

In sum, the real potential losers from the pursuit of empire building through higher leverage may be less the shareholders or bondholders than the true subjects of the empire—employees and middle managers. To say this is neither to claim (as others have) that management owes a fiduciary duty to all who have an interest in the corporation³¹⁴ nor to urge that inefficient or excess plants or resources not be disposed of. Management's fiduciary duty is to its shareholders and it is basically entitled to pursue any legal strategy for enhancing shareholder gain. But public policy planning must consider the same issues from a broader angle of vision and must ask what strategies for increasing

grant waivers and may also be a commercial lender to the borrower, with the result that it will be reluctant to declare a default. For a brief review of these problems, see Levmore, *supra* note 303.

313. Modern institutional economics tends to see the corporation as a "set of contracts" entered into by managers, investors and other necessary participants who accept either residual or fixed claims depending upon their attitude toward risk. See Klein, *supra* note 20. Professor Klein sees management as the holder of a residual claim—that is, the right to whatever is left over after the fixed interest claimants are paid. This view accurately describes the position of senior management, whose interests are directly tied to current profitability through stock options and incentive compensation. Other managerial officials, however, receive only a salary and thus are in a position analogous to that of fixed interest claimants, such as creditors or suppliers.

314. See Dodd, *supra* note 220.

shareholder wealth at the expense of that of other classes it wishes to encourage. This social cost accounting has not yet been adequately conducted and, before the frequency of takeovers is deliberately increased, this possibility of hidden losses to employees and middle management that involve no compensating increase in economic efficiency deserves closer attention.³¹⁵

3. *Summary.*—“Who shall guard the guardian?” is the most enduring question of constitutional law—both public constitutional law and the private constitutional law of corporate governance. No simple solution exists to this perplexing issue. Proponents of the “market for corporate control” thesis assumed that this problem would be solved by the use of the market as an external monitor, because a market is by definition neutral, unbiased and objective. But, as the foregoing analysis has sought to show, this solution is imperfect for several reasons. First, the disciplinary mechanism is ultimately not the market, but rather the individual bidder who, having imperfect information, is more error-prone than are internal monitoring mechanisms within modern decentralized firms. Second, a tension exists between the prerequisites of efficiency in the market for corporate control and those applicable to the market for executive services. Third, the stock market reflects only the interests of those who participate in it. Because some interests are not represented, it is an imperfect (if still highly relevant) proxy for economic efficiency. As a result, the market for corporate control may work less well than other capital market incentives (such as the use of stock options and similar contractual arrangements), which can align the manager’s interest with those of the shareholders and are not as likely to produce the foregoing diseconomies.³¹⁶ These assertions do not imply that hostile takeovers cannot perform a disciplinary function. Rather, they suggest the flaw in attempting to rely chiefly on this market. As we attempt to facilitate takeovers by reducing the requisite takeover premium, adverse consequences become more predictable: less efficient bidders will increasingly enter the market and the proportion of inefficient control transfers will rise; demoralization costs will become more significant; takeover gains may come to a greater extent at the cost of increased risks imposed on fixed interest claimants in the firm, chiefly employees; and antici-

315. A number of scenarios can be described in which the interests of employees are adversely affected by both bidder and target firm behavior in takeovers. One such example is the use by both bidders and targets of employee pension funds to finance takeovers or takeover resistance. See, e.g., *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982) (involving use of pension plan assets by target to make defensive purchases of target corporation’s stock at premium over usual trading price); District 65, *UAW v. Harper & Row Publishers*, [1983–84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,608 (S.D.N.Y. Dec. 30, 1983) (permitting termination of pension plan so as to enable target to use excess plan assets to finance buyback of large block of its stock).

316. The use of such contractual incentives as a means of better aligning the manager’s self-interest with that of shareholders has been repeatedly suggested by those economists—such as Fama, Jensen and Meckling—who have focused on the impact of the separation of ownership and control within the public corporation. See *supra* note 20.

patory responses by target management, including an increased rate of leveraged buy-outs and executive migration toward less vulnerable firms, will increase with corresponding frequency.

Where then does this leave us? This Article would caution against regulatory interventions—either by means of redefinition of fiduciary duties or otherwise—that deliberately seek to maximize the frequency of takeovers. Essentially, this is a *laissez-faire* position, whose premise is that the market for corporate control works best when competitive auctions (or simply the prospect thereof) discourage the less efficient bidder and provide a margin for managerial error that does not discourage entrepreneurial risk-taking. Such a stance assigns to the market for control a residual position as the remedy of last resort and places primary reliance on other forms of monitoring.

Still, this *laissez-faire* response is not sufficient. Market failure is a clear and present danger, both because target companies can preempt the possibility of a hostile takeover in a variety of ways and because bidders can utilize tactics that erode the takeover premium. A minimal degree of regulation is therefore necessary, and the available options will next be considered in Part IV.

IV. IMPLEMENTATION: STEERING A MIDDLE COURSE

Proposals for regulation of tender offers abound.³¹⁷ If one's only object were to chill takeovers, any number of stratagems could be devised. But, if

317. Recent legislative proposals can be grouped under four basic headings: (1) those that seek to restrict the credit available to finance takeovers; (2) those that seek to extend the minimum period that the tender offer may remain open; (3) those that seek to restrict partial bids or related tactics, such as open market purchasing; and (4) those that seek to establish greater regulatory authority or a veto power. For a discussion of the first category, see *supra* note 236. An example of the second variety is Professor Lowenstein's carefully elaborated proposal under which any takeover bid would have to remain open "at least six months from the date it is first published or sent to security holders." See Lowenstein, *supra* note 1, at 317. As an example of the third category, three states have recently enacted supermajority legislation which seeks to restrict or more closely regulate partial bids and open market purchasing. A 1983 special session of the Maryland legislature enacted H.B. 1, which basically requires a supermajority of 80% of the outstanding shares (plus 66 2/3% of the voting shares not held by the bidder) to approve a merger between and any beneficial holder owning 10% or more of its voting stock, unless a statutory "fair price" formula is satisfied. Similarly, Pennsylvania has amended Section 910 of the Pennsylvania Business Corporation Law to trigger an appraisal remedy whenever a shareholder acquires 30% or more of the voting stock of a Pennsylvania corporation. Pa. S. 1144, P.N. 1597 (1983). Pennsylvania corporations were permitted to opt out of this statute by adopting a charter provision prior to March 22, 1984, and some did. See Sun Co. Shuns an Antitakeover Law, N.Y. Times, Mar. 22, 1984, at D13, col. 1. Under a 1982 Ohio statute, a shareholder vote of the target corporation's shareholders must precede any "control share acquisition," and the bidder must prepare an "acquiring person statement." The acquisition may then proceed only if a majority of the disinterested shareholders approve the proposed share acquisition. See Ohio Rev. Code Ann., tit. 17, § 1701.831 (Baldwin 1983).

Finally, a bill now pending before the U.S. Congress and introduced by Representative Rodino would establish a public interest test for acquisitions resulting in the acquirer having more than \$5 billion in assets and more than 25,000 employees, and would permit "independent

one wishes instead to preserve an auction market, the problem of implementation becomes more complex. Constitutional limitations and high corporate mobility between jurisdictions of incorporation are likely to confound any effort at state regulation. Similarly, although federal legislation is a possible answer, Congress seems reluctant to invade the state's authority over substantive corporate law and the SEC's pending legislative proposals attempt to do no more than plug a few egregious loopholes through which targets have frustrated recent takeover attempts.³¹⁸ In addition, no simple legislative statement can respond adequately to the complex variety of situations that must be faced. A more flexible tool is necessary. To foster an auction market, public policy must steer a careful course, restricting defensive tactics, but still granting management the discretion it needs to solicit competing bids and extend the bidding process.

To date, proponents of an auction market have given little attention to how to fashion a more flexible instrument of regulation. Too facilely, they have assumed that their aims could be achieved either through (1) a stricter redefinition of fiduciary duties, or (2) the exercise by the SEC of its rule-making authority under the Williams Act in order to proscribe specific practices. Problems with both strategies, however, are immediately evident. First, easy as it is to argue that fiduciary duties should be redefined, no movement in the case law in this direction is discernible,³¹⁹ and in fact no decision appears

directors" to reject and block any unwanted takeover. See *Legislation to Curb Hostile Takeovers is Planned* by Rodino, *Wall St. J.*, Mar. 14, 1984, at 4. For a predecessor of this bill, see H.R. 3561, 98th Cong., 1st Sess. (1983).

Symptomatically, none of these recent proposals have sought to require shareholder approval by the bidder's shareholders—a policy that would give bidder shareholders an opportunity to veto a significant wealth transfer to target shareholders. See *supra* note 54 (discussing loss by Dupont shareholders in Conoco acquisition). However, § 1701.83 ("Procedures upon combination or majority share acquisition") of the Ohio General Corporation Law has since 1970 required a two-thirds shareholder vote by the bidder's shareholders if the bidder will issue voting shares equal to one-sixth or more of its outstanding voting stock. Ohio Rev. Code Ann., tit. 17, § 1701.83 (Baldwin 1983). This provision thus restricts significant exchange offers, but not cash tender offers. See *infra* notes 379–85 and accompanying text.

318. Following the report of the SEC Advisory Committee on Tender Offers, *supra* note 13, the SEC has proposed legislation to curb some defensive tactics. See *Ingersoll, SEC Seeks to Prohibit Many of the Tactics Used by Firms to Avert Hostile Takeovers*, *Wall St. J.*, May 10, 1984, at 7, cols. 1–2. Essentially, the package submitted to Congress would restrict defensive self-tenders and stock repurchases over 3% of the shares outstanding, and would restrict stock lock-ups to a 5% level (unless shareholder ratification of the lock-up or repurchase were secured). See H.R. 5693, 98th Cong., 2d Sess. (1984) (The Tender Offer Act of 1984). However, these restrictions on self-tenders and lock-ups would apply only once a tender offer had begun. Thus, they would not apply to anticipatory defense measures, apparently even if undertaken on the eve of a hostile takeover. This narrow scope may reflect a desire not to invade the states' domain over corporate governance, but as a result these proposals, if adopted, would not eclipse the need for the stock exchange rules proposed herein.

319. See cases cited *supra* note 2. For more recent holdings to the same effect that a broad array of defensive tactics will be protected by the business judgment rule, see *Data Probe Acquisition Corp. v. Datatab Inc.*, 722 F.2d 1 (2d Cir. 1983) (lock-up of shares totaling 200% of

yet to have imposed actual financial liability on directors for resisting a tender offer.³²⁰ On balance, few prospects appear more utopian than the idea that well-established common law principles according broad discretion to management in corporate control contests will be reversed on a sufficiently national scale to block corporate migration toward those jurisdictions that are more protective of target managements. All the signs are to the contrary, as the majority of states have raced to out do each other in enacting highly protective antitakeover statutes over the last fifteen years.³²¹ Even if fiduciary restrictions were adopted, the problem of judicial nullification would remain; courts appear reluctant to impose financial liability on directors who have not personally profited,³²² and this is the profile of the outside director who votes to authorize resistance to a takeover.

Similar problems confound the use of the SEC's rulemaking powers. For example, some decisions have already approved the use of the "two-tier" bid,³²³ and the Williams Act seems expressly to contemplate the legitimacy of

outstanding shares permitted), cert. denied, 52 U.S.L.W. 3612 (U.S. Feb. 21, 1984); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983) (lock-up of treasury stock approved); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982) (counter tender offer permitted); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982) (sale of crown jewel asset permitted); *American General Co. v. NLT Corp.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,808 at 94,125 (S.D. Tex. July 1, 1982) (counter tender offer permitted); *National Educ. Corp. v. Bell & Howell Co.*, Civ. A. No. 7278 (Del. Ch. Aug. 25, 1983) (court declines to enjoin "poison pill" convertible preferred stock dividend without passing on merits).

320. Several decisions have enjoined specific defensive tactics. See *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981) (crown jewel option enjoined); *Joseph E. Seagram & Sons v. Abrams*, 510 F. Supp. 860 (S.D.N.Y. 1981) (crown jewel asset sale); *Telvest, Inc. v. Olson*, Civ. A. No. 5798 (Del. Ch. Mar. 8, 1979) (available on LEXIS, States Library, Del. file) (issuance of piggyback stock dividend enjoined); see also *Crane Co. v. Harsco Corp.*, 511 F. Supp. 294 (D. Del. 1981) (tender offer has private right of action under § 13(e) to enjoin target company's purchase of its own shares); *Applied Digital Data Sys., Inc. v. Milgo Electronic Corp.*, 425 F. Supp. 1145 (S.D.N.Y. 1977) (preliminary injunction to prevent a white knight sale available under the Williams Act); *Royal Indus., Inc. v. Monogram Indus.*, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863 at 91,131 (C.D. Cal. Nov. 29, 1976) (defensive acquisition enjoined). In addition, the liability of pension fund trustees who use their fund's assets to resist a takeover may be considerable. See *Donovan v. Bierwirth*, 680 F.2d 263 (2d Cir. 1982). Nonetheless, although injunctive and other "bloodless" relief is possible, this author is aware of no case imposing actual damages for defensive action taken as a corporate director.

321. Some 36 state antitakeover statutes were enacted prior to the decision in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). For a list, see Note, *Securities Law and the Constitution: State Tender Offer Statutes Reconsidered*, 88 *Yale L. J.* 510 n.28 & 29 (1979). If nothing else, this indicates the predisposition of state legislatures to chill takeovers and suggests that they will also seek to protect defensive tactics. A recently enacted Pennsylvania bill authorizes corporate directors to consider "the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments are located and all other pertinent factors." See Pa. S. 1144 (1983). Such language clearly signals that the state legislature's most basic concern in tender offer regulation is with the prospect of plant closings and layoffs, not fairness to shareholders.

322. See *supra* note 9.

323. See *Jacobs v. G. Heileman Brewing Co., Inc.*, 551 F. Supp. 639 (D. Del. 1982) *Radol v. Thomas*, 534 F. Supp. 1302 (S.D. Ohio 1982); cf. Note, *Front-End Loaded Tender Offers*, 131 *U. Pa. L. Rev.* 389 (1982).

partial bids.³²⁴ Recent decisions have also declined to find “lock-ups” and similar tactics to be “manipulative” within the meaning of the anti-fraud section of the Williams Act.³²⁵ Above all, any attempt to breathe substantive life into the Williams Act’s provisions is constrained by the logic of the Supreme Court’s decision in *Santa Fe Industries*,³²⁶ which insisted that federal courts not override state corporate law when it allegedly conflicts with federal policies, unless “a clear indication of congressional intent” is evident.³²⁷ Thus, it seems doubtful that major substantive restrictions—including those recently proposed by the SEC’s Advisory Committee on Tender Offers³²⁸—can be adopted pursuant to the SEC’s rule-making authority under the Williams Act.³²⁹

The problem lies not only in the lack of legal authority, but also in the need for flexibility and specificity. If one accepts the argument made in Part I that the shareholder’s supply curve bends upward, it follows that some forms of supermajority “fair price” provisions may benefit shareholders. Similarly, if the demand curve for corporate control is inelastic, competitive bidding

324. Section 14(d)(6) of the Securities Exchange Act of 1934, acknowledges the possibility of partial bids by establishing a proration rule under which all shares so tendered within the first ten days of the offer must be accepted proportionately. 15 U.S.C. § 78n(d)(6) (1983).

325. See *Buffalo Forge Co. v. Ogen Corp.*, 717 F.2d 757 (2d Cir. 1983); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), cert denied 52 U.S.L.W. 3612 (U.S. Feb. 21, 1984); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 628 (D. Md. 1982); *Marshall Field & Co. v. Icahn*, 537 F. Supp. 413 (S.D.N.Y. 1982). For a differing view, see Note, Target Defensive Tactics as Manipulative Under Section 14(e), 84 Colum. L. Rev. 228 (1984).

326. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977).

327. *Id.* at 479. It can, of course, be argued that the principles enunciated in *Santa Fe* should not apply, or should be applied less forcefully, to § 14(e) than to § 10(b). This argument was made by Judge Sofaer in *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538, 1543-55 (S.D.N.Y. 1983), rev’d, 722 F.2d 1 (2d Cir. 1983), cert denied 52 U.S.L.W. 3612 (U.S. Feb. 21, 1984); However, other decisions have also concluded that the nearly identical phrasing of § 10(b) and § 14(e) implies the “same limitations would apply to § 14(e) given the similarity of purpose of the two sections.” See *Altman v. Knight*, 431 F. Supp. 309, 314 (S.D.N.Y. 1977). This is a highly debatable contention. For the opposing view, see Note, supra note 323.

328. SEC Tender Offer Report, supra note 3. Although the SEC Advisory Committee on Tender Offers did not challenge the applicability of the business judgment rule to defensive tactics, see *id.* recommendation 33, it did propose the following substantive restrictions on defensive tactics: (1) Supermajority provisions should be adopted by the same level of shareholder support as they would require to approve a transaction and should be renewed every three years, *id.* recommendation 36; (2) Advisory votes should be required on all “change of control” related policies of a corporation, *id.* recommendation 37; (3) Counter tender offers should not be permitted when the bidder makes a cash tender offer for 100% of the target company, *id.* recommendation 40; (4) Stock lock-ups in excess of 15% should require shareholder approval, *id.* recommendation 41; and (5) Block repurchases by the target of its own stock from a prospective bidder or insurgent at a premium should require shareholder approval, *id.* recommendation 43.

329. The decisions which assume that *Santa Fe Industries* constrains the scope of § 14(e) as much as it does § 10(b), make it highly questionable that the array of foregoing provisions (other than recommendation 36 on “advisory votes”) could be adopted as an exercise of the SEC’s rule-making authority under § 14(e). See supra note 327.

should maximize shareholder wealth, and thus it may be in the shareholders' best interests that management issue a large block of authorized, but unissued, shares to a potential second bidder (even at below market price) in order to lure it into the auction. Prophylactic restrictions are not therefore easily justified, particularly when the critical issue depends on the slope of a curve that may shift from time to time in the future. Yet, there is undoubtedly a point at which supermajority and similar provisions become injurious to shareholders, even though shareholders may ratify them. Sensible regulation therefore involves line drawing, and this is not easily done based only upon the authority conferred by a vaguely phrased anti-fraud statute.

Those in search of a workable model for regulation have recently turned their attention to the English system for regulating takeovers, which appears to function smoothly.³³⁰ Yet, surprisingly, little attention has been given to the most visible institution in the English regulatory structure: the self-regulatory panel which enforces and administers its system.³³¹ The most obviously analogous institution within our own system would be the stock exchanges. Against this backdrop, section A will explore the potential utility of stock exchange listing rules as a self-regulatory technique for the adoption of specific "bright line" rules which avoid many of the problems that vaguer fiduciary standards inherently involve. Such an approach is intended not as a substitute for legislative reform, but as a supplement to fill the inevitable interstices that legislation leaves behind. To a largely unrecognized extent, our existing system already relies heavily on stock exchange rules to preserve a healthy auction market. The most important substantive parameters on managerial tactics are today established by the New York and American Stock Exchange rules on "lock-ups."³³² Section A will argue not only that such a regulatory system has

330. For example, Professor Lowenstein examines the British model in proposing his suggested reforms. Lowenstein, *supra* note 1, at 264, 320-21, 327, 330-33. The SEC Advisory Committee on Tender Offers also considered the British approach, particularly to the regulation of partial bids. See SEC Tender Offer Report, *supra* note 3, at 26. For a recent overview of the British experience under The City Code on Take-overs and Mergers (the "City Code"), see De Mott, *Current Issues in Tender Offer Regulation: Lessons from the British*, 58 N.Y.U. L. Rev. 945 (1983).

331. The Panel on Take-overs and Mergers administers the City Code. The Panel, a non-governmental entity functioning under the auspices of the Council for the Securities Industry, was established in 1968 by the London Stock Exchange, the Bank of England and the private banking community. The Panel includes representatives of the London Stock Exchange, the Confederation of British Industry and the principal financial institutions. See A. Johnson, *The City Take-Over Code* 30-31, 37 (1980); DeMott, *supra* note 330, at 954-55. Great Britain has no body analogous to the Securities and Exchange Commission.

332. For a number of years, the New York Stock Exchange has had a "shareholder approval policy" pursuant to which listed companies may not take certain measures without first securing a favorable shareholder vote. This policy is now set forth in the New York Stock Exchange Listed Company Manual (1983) at § 312.00. Section 312.00 provides that

[s]hareholder approval is a prerequisite to . . . [t]he acquisition, direct or indirect, of . .

tangible or intangible assets or property or securities representing any such interests . . .
[w]here the present or potential issuance of common stock or securities convertible into

important comparative advantages over the use of a fiduciary duty approach, but that such a program can be adopted under current law without legislative action.

Section B will focus on possible means to discourage "empire building" without chilling efficiency-enhancing takeovers. Although the evidence that bidders sometimes overpay seems clear, the aggregate impact of takeovers on bidder shareholders is uncertain and may be positive. Accordingly, the least restrictive alternative seems preferable, and section B will consider two possible reforms: first, a requirement that bidder shareholders ratify a proposed tender offer before the shares are accepted for payment, at least in the case of tender offers that are substantial in relation to the bidder's assets, and second, the use of accounting inducements that would uniquely penalize growth-maximizing acquisitions. Section B does not give an unqualified endorsement to either proposal, but concludes that each has the potential to chill disproportionately takeovers unlikely to enhance economic efficiency.

Finally, because this article has argued that an auction market is likely both to maximize shareholder wealth and minimize diseconomies, section C will address the practical issue of how the law can encourage a stable auction market in which substantial takeover premiums will persist.

A. Stock Exchange Rules As a Vehicle for Balanced Regulation

1. *An Overview and Evaluation.* — At present, the most significant limitation on defensive tactics by target corporations is contained neither in the common law of fiduciary duties nor the anti-fraud rules adopted by the SEC under the Williams Act, but rather is set forth in the New York Stock Exchange's policy that effectively limits the magnitude of any stock lock-up the target's board may issue. This policy restricts the number of treasury shares or limits the authorized, but unissued, shares that a listed corporation may issue without shareholder approval to a number equal to 18.5% of the issuer's outstanding shares.³³³ Because there is rarely time to obtain shareholder ratification of a lock-up in the hurly-burly of a control contest (and

common stock could result in an increase in outstanding common shares approximating 18 1/2% or more

Subparagraph 3(c) of § 312.00 then adds that this 18 1/2% rule is also violated where "the present or potential issuance of common stock or any other consideration has a combined fair value approximating 18 1/2% or more of the market value of the outstanding common shares." Thus, the issuance by a target of its own stock, or stock plus any option to purchase its stock, is permitted only up to this 18 1/2% threshold. If assets are sold or transferred the total value of the property plus securities may not exceed 18 1/2% of the target's stock market value, unless shareholder approval is secured. The American Stock Exchange has a similar policy which precludes stock issuances in excess of 19.5%. See AMEX, *Company Guides*, §§ 713, 714. For brief overviews, see M. Eisenberg, *The Structure of the Corporation: A Legal Analysis* 232-36 (1976); Securities & Exchange Comm'n, *Staff Report on Corporate Accountability* 628-31 (1980) (printed for Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess.) [hereinafter cited as *Staff Report*].

333. See supra note 332.

because shareholders might decline to approve such an issuance), this rule places a *de facto* ceiling on the number of shares that can be issued to a white knight. Absent such a limitation, the target corporation could typically respond to a hostile bid by issuing sufficient shares to a white knight to give the latter bidder an absolute voting majority, thereby preempting the control contest.³³⁴

Although there are a host of interpretive and other problems surrounding the New York and American Stock Exchange's rules on shareholder approval of stock issuances,³³⁵ all indications are that these rules are enforced and are not significantly evaded or challenged.³³⁶ They thus stand in contrast to the vaguer statements in the New York Stock Exchange Listed Company Manual, that frown on defensive tactics but do not establish bright-line tests.³³⁷ In the

334. This is precisely what happened in *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538 (S.D.N.Y.), rev'd, 722 F.2d 1 (2d Cir. 1983), cert. denied, 52 U.S.L.W. 3612 (U.S. Feb. 21, 1984) (No. 83-1023), where the target corporation, Datatab, responded to Data Probe's tender offer for all its shares by granting an option to a subsidiary of CRC Information Systems, Inc. to purchase shares equal to 200% of its then outstanding shares. 568 F. Supp. 1538, 1542. Datatab was not listed on any securities exchange, but was traded over the counter.

335. Section 312.00 of the New York Stock Exchange Listed Company Manual provides that "shareholder approval is a prerequisite to listing securities" in certain defined circumstances, including when the 18 1/2% threshold is to be surpassed. See *supra* note 330. Read literally, this language is inapplicable if the securities have already been listed and are reacquired by the target company through open market purchases or a self-tender. Similarly, how is this rule to be interpreted when the issuer does not seek to list the securities (possibly because the white knight does not care if the securities are listed or not, because it contemplates a merger)? It is the author's understanding that the New York Stock Exchange has policies that require shareholder ratification in both these circumstances, even though listing is not sought, since the issuer must list all newly issued securities.

336. For example, in the recent takeover campaign by The Limited, Inc. to acquire Carter Hawley Hale Stores, Inc., the New York Stock Exchange appears to have rebuffed Carter Hawley Hale's attempt to issue a 22% lock-up to General Cinema. Published reports have indicated that the lock-up was "under study by the New York Stock Exchange . . . [which] is concerned that the deal may violate its rule that listed companies cannot sell 18 percent or more of their voting rights without shareholder approval." See Barmash, *supra* note 127, at D4, col. 3. However, individuals involved on both sides of this transaction have informed this author that the Exchange blocked the transaction as originally formulated. Moreover, the Exchange did so even though its rule technically applied only to a lock-up that exceeded 18.5% of the outstanding shares: the stratagem employed by Carter Hawley Hale was to issue a lesser number of shares, each of which carried 11.1 votes. See *Limited's Bid Rejected*, N.Y. Times, Apr. 30, 1984, at D2, col. 5.

337. By way of contrast with the 18 1/2% rule, consider § 308.00 of the New York Stock Exchange Listed Company Manual. Section 308.00 deals with "defensive tactics" and states in part:

The Exchange has an ongoing concern as to the possible implications of certain so-called "defensive tactics" which would in effect discriminate among shareholders.

Generally speaking, an arrangement which could be applied uniformly to all transactions of similar nature and without regard to the parties involved normally would not be viewed as objectionable. On the other hand, any proposal which results in either discrimination against an existing shareholder or discouragement of anyone seeking to make a substantial investment would appear to raise substantial questions as to whether or not it constitutes an infringement upon the voting philosophy of the Exchange.

latter case, the New York Stock Exchange's enforcement practices appear to have been less certain or visible.³³⁸ This disparity suggests the preferability of bright line rules to more generalized statements of fiduciary duty. Still, before this approach can be recommended, several basic obstacles must be overcome.

First, there is a problem with the underlying sanction. Not only has the sanction of delisting been rarely employed,³³⁹ but the threat may be irrelevant to a target corporation that is seeking a merger with a white knight in preference to a takeover by a hostile bidder. In this recurring context, the target knows that its existence as an independent company is at an end and that the only real question is the identity of the company that will acquire it. As a result, the threat of delisting is academic because the target will shortly cease to exist in any event.

Second, and even more important, enforcement by the exchanges is confounded by the recurring problem of a race to the bottom. Increasingly, the stock exchanges are in competition with the over-the-counter market, where the emergence of a computerized inter-dealer quotation system gives issuers an inviting alternative to the exchanges.³⁴⁰ There are at present a

In this author's judgment, this is a vague statement, which invites companies either to ignore it or to seek to test its limits by threatening to delist.

338. For example, neither the American nor the New York Stock Exchange has yet taken a public position on the "poison pill" convertible security dividend. Nor have they commented on Pac-Man counter tender offers. See *supra* note 3 for a description of these tactics. The former could be read as violative of the philosophy announced in §§ 313.00 and 308.00 of the New York Stock Exchange Listed Company Manual, which bar issuances of securities to block changes in control. Yet, in a recent case *Bell & Howell Co.*, a New York Stock Exchange-listed company, utilized the "poison pill" device to block a takeover, and it remains a NYSE-listed company. See *National Educ. Corp. v. Bell & Howell Co.*, no. C.A. 7278, slip op. (Del. Ch. Aug. 25, 1983).

339. In 1962 *Cannon Mills Co.* suffered the delisting of its common stock for its failure to comply with a requirement that all listed firms solicit proxies. See Staff Report, *supra* note 332, at 629. However, no instances of delisting involving the failure of a listed company to comply with a substantive policy adopted by the Exchange to protect shareholders appear to have occurred. This could imply either a high rate of compliance or a reluctance to use the sanction of delisting except in extreme cases of outright defiance.

340. See *Big Board Seeks Shifts in Stock-Listing Rules*, *N.Y. Times*, Aug. 22, 1983, at D1, col. 4. This increased competition is also reflected in the sharp rise in the number of equity listings on NASDAQ (the National Association of Securities Dealers Automated Quotations), while equity listings on both the New York and American Stock Exchanges have declined at a steady pace since 1978. See *Blumstein, Amex Carving a New Niche*, *N.Y. Times*, Sept. 8, 1983, at D1, col. 4 (chart showing relative change). See also *Lee, Off the Boards: Why OTC Is Favored Over NYSE*, *Barron's*, Sept. 12, 1983, at 42, col. 1.

NASDAQ today transmits current price quotations over a computerized network for more than 4,000 domestic and foreign securities. Typically, seven or eight market makers compete with each other to buy and sell the same NASDAQ security. See *How NASD Runs the OTC Market*, *Barron's*, Sept. 12, 1983, at 44, col. 5. This may result in greater price competition than under the single specialist system used by the major exchanges. On several days during 1983, the volume on NASDAQ surpassed the NYSE, and "in every year since 1978, NASDAQ volume has swamped the numbers of the Amex." *Lee, supra*, at 42, col. 2. Even more importantly, NASD has recently developed a special listing—known as its "National Market System"—consisting of some 500 actively traded securities. To a potential target corporation faced with New York Stock Exchange

substantial number of companies eligible for listing on the New York and American Stock Exchanges which have remained on NASDAQ.³⁴¹ In some cases, the motive would appear to be the corporation's distaste for the rules of the exchanges that constrain takeover defense techniques.³⁴² Hence, any regulatory initiative by the exchanges could be countered by voluntary delistings by potential targets in advance of any takeover contest. In short, the stock exchanges are at best uncertain champions of reform at a time when their very viability against automated inter-dealer networks is open to doubt.

Finally, there is the danger of bias. Stock exchanges are private organizations, not regulatory agencies; as such, they tend to support the interests of their constituencies, and overwhelmingly corporate America is suspicious of the takeover. For every corporation which sees itself as a potential bidder, many more suspect and fear that they are takeover targets. Thus, even apart from an exchange's fears of corporate delistings, self-regulatory rules might tend to legitimize, rather than constrain, defense tactics that preempt auction markets.

Nonetheless, satisfactory answers seem possible to each of the foregoing problems. First, the limited utility of the delisting sanction is best corrected by making the stock exchange's rules equally applicable to listed companies that are bidders as well as those that are targets. An impermissible lock-up issued by a target to a listed bidder would then threaten both the bidder and the soon-to-disappear target with delisting. Although the basic rationale for such an extension is the traditional rule of joint and several liability among coconspirators, there is also some precedent in the New York Stock Exchange's own

restrictions on takeover defenses, a transfer to NASDAQ's National Market System can look very attractive, and to this author's knowledge some attorneys who specialize in takeover defenses have recommended such a move.

341. Professor Joel Seligman has informed me that figures given him by NASD showed that as of September 1983, there were approximately 1600 securities eligible for trading on the American Stock Exchange and approximately 600 eligible for listing on the New York Stock Exchange that were then traded solely on the NASDAQ system. Although this number includes multiple classes of securities issued by one issuer, it still indicates that a NASDAQ listing remains sufficient for a much larger class of issuers than is generally realized.

342. Apple Computer, MCI Communications Corp., and Intel have not listed on any major exchange, even though they would easily qualify. See *Big Board Seeks Shift in Stock Listing Rules*, N.Y. Times, Aug. 22, 1983, at D1, col. 4. In 1981, MCI Communications Corp. amended its certificate of incorporation expressly to "discourage any attempted takeover of control of the Company" by restricting the voting rights of any shareholder who owns, legally or beneficially, more than 10% of the shares of any class. See *MCI Communications Corp., Notice of Annual Meeting and Proxy Statement*, (June 5, 1981). (notice of annual meeting of stockholders); Bancroft, *MCI Limits Shareholder Powers in the British Fashion*, Legal Times of Wash., Feb. 28, 1983, at 14, col. 1. In effect, the new provision gave such a shareholder only 1/100th of one vote for each share owned over 10% and thus limited him to a maximum voting power of 15%. Cf. *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977) (charter provision which limited number of shares any one holder could vote held valid on grounds it was a restriction applicable to shareholders and not to shares). The adoption of this charter amendment would appear to have required delisting under § 313 of the New York Stock Exchange Listed Company Manual, if MCI had been listed.

rules.³⁴³ In any event, joint liability seems appropriate to the context of control contests, where the white knight is seldom an arm's-length purchaser of the shares issued in the lock-up, but rather has probably jointly conceived and negotiated the particular tactic which violated the rule.

Second, the race to the bottom can be curtailed, without interfering with the desirable competition among exchanges and the over-the-counter market. As a stopgap measure, the SEC has the legal authority to deny listed companies the ability to delist.³⁴⁴ More importantly, the SEC can eliminate the regulatory disparity that now exists between the exchanges and NASDAQ, the principal interdealer network. Under Section 19(c) of the Securities Exchange Act of 1934, the SEC has authority over the National Association of Securities Dealers (which administers NASDAQ) as well as over the exchanges.³⁴⁵ It thus is in a position to equalize the rules restricting takeover defense tactics by requiring NASDAQ to adopt rules essentially similar to those of the exchanges, or at least to justify any deviations. At a minimum, for example, the listing criteria for NASDAQ's National Market System should incorporate rules substantially duplicating the shareholder approval rules which both the New York and American Stock Exchanges have long enforced so as to limit lock-ups; similarly, NASDAQ should deny listing in this system to corporations whose certificates of incorporation restrict the voting rights of common stock.³⁴⁶

343. Section 311.03 ("Tender Offers") of the New York Stock Exchange Listed Company Manual establishes a duty to give shareholders "an opportunity to participate on equal terms" in a tender offer. It then adds: "The same considerations apply when a company invites its shareholders or shareholders of another company to tender their shares for purchase even though such tender offers are not covered by a listing agreement" (emphasis added). Once duties are imposed on a listed company to provide an equal opportunity to shareholders other than its own, it is only a marginally more ambitious step to limit a listed company's ability to accept a lock-up which was in violation of the New York Stock Exchange's shareholder approval policy.

344. Section 12(d) of the Securities Exchange Act of 1934 provides in part that "[a] security registered with a national securities exchange may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and, upon such terms as the Commission may deem necessary to impose for the protection of investors, upon application by the issuer or the exchange to the Commission . . ." 15 U.S.C. § 78l(d) (1982) (emphasis added). This language would seem clearly to authorize the Commission to deny the issuer's application for delisting if it believed this were necessary to protect target shareholders. Such a denial would then raise the issue of the Exchange's ability (or that of a shareholder) to seek injunctive relief to enforce the listing agreement in those circumstances where the issuer wished to delist. See *infra* note 366.

345. Added in 1975, § 19(c) authorizes the Commission to "abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter . . . , or otherwise in furtherance of the purposes of this chapter . . ." 15 U.S.C. § 78s(c) (1982). The Senate Committee Report indicated that this authority was to be broadly construed and the "SEC would be granted the power to change the rules of a self-regulatory organization in any respect, not just with respect to certain enumerated areas." See S. Rep. No. 75, 94th Cong., 1st Sess. 131 (1975).

346. NASDAQ's National Market System today consists of 500 actively traded securities, whose issuers could in most instances qualify for listing on at least the American Stock Exchange.

In the past, the SEC has deferred to the claim that NASDAQ issuers were smaller and could less afford arguably costly requirements. Thus, when the SEC pushed the major exchanges to require independent audit committees as a condition of eligibility for listing, it declined to do the same with respect to NASDAQ's listing criteria,³⁴⁷ largely on the grounds that a mandatory requirement of independent directors might prove too expensive for smaller issuers. Yet, as interdealer quotations systems mature in importance and as a National Market System develops within NASDAQ, these arguments about excessive cost become overbroad and need to be viewed more skeptically. In particular, they have no application to the context of takeover defense tactics, because a rule limiting lock-ups involves no cost to the issuer. In short, no topic deserves a higher priority on the SEC's agenda with respect to takeovers than that of reducing the disparity in listing criteria as they apply to the takeover context. Here, the burden should be on NASDAQ to justify any substantial difference in treatment.

To sum up, the SEC should exercise its supervisory powers under Section 19(c) in order to prod the exchanges toward a reexamination and reformulation of their rules with a view to achieving greater specificity. The interpretation and enforcement of these rules has been a low visibility process, which invites a negotiation process of threat and counterthreat, as issuers imply that an aggressive interpretation of exchange rules would force them to delist.³⁴⁸ More specifically, the formulation of the exchange's rules in this area needs exactly the sort of close critical examination that the SEC Advisory Committee on Tender Offers has recently given to the SEC's own policies. Although it is unlikely that a body with the free-ranging authority accorded Britain's Panel on Take-overs and Mergers would ever be accepted within our institutional and legal structure, a blue ribbon advisory committee could seek to develop bright line standards whose enforcement could then be safely entrusted to the exchanges.³⁴⁹ Such a body could make judgment calls in those

See *supra* note 339. The issue of whether significantly smaller companies should similarly be made subject to the shareholder approval policy of the New York or American Stock Exchanges is not here addressed.

347. See Staff Report, *supra* note 332, at 631 (noting that while the NYSE and the AMEX have adopted audit committee requirements to varying degrees, the NASD's Board of Governors has only "strongly recommended to all NASDAQ companies" that they establish an audit committee) (quoting NASD Memorandum to NASDAQ companies, NASDAQ Notice No. 4-80 (Aug. 5, 1980)). However, NASD did advise all "NASDAQ companies that the Board will consider making an audit committee mandatory for quotation on NASDAQ at some time in the future." *Id.* Such a statement concedes the critical point that the NASD considers that it has the power to impose corporate governance provisions on its quoted companies as a condition of eligibility.

348. Vague policies invite such threats, while highly visible bright line standards—such as the NYSE's 18 1/2% rule—reduce the prospect of such threats. They may in time, however, result in some voluntary delistings, unless NASDAQ's rules are brought into reasonable conformity. See *supra* notes 337-42 and accompanying text.

349. An exchange that did not enforce a clearly applicable rule could itself incur liability to those injured by nonenforcement. See *infra* note 364.

areas where clear distinctions do not exist. In contrast, such precise line drawing, even when done by the SEC, seems inappropriate when based only on the vague authority of anti-fraud rules. Controversial as stricter exchange rules would be, the only sensible alternative to self-regulatory reform is close and direct SEC supervision of defensive tactics, and this alternative should prove even more unpopular.

2. *Some Proposed Stock Exchange Rules.* — The following defensive tactics stand out as obvious candidates for regulation through stock exchange rules.

a. *“Crown Jewel” Options.* — The sale of a prize division or asset to the preferred bidder is a well-known tactic for discouraging a hostile bidder.³⁵⁰ Because the present exchange rules place a percentage ceiling on the number of shares that may be issued without shareholder approval, consistency requires that an equivalent restriction be placed on the sale of assets without shareholder approval.³⁵¹ Such an expanded shareholder approval rule would apply only once a tender offer had been made or communicated to management; thus it would not interfere with normal arm’s-length dispositions of assets in the ordinary course of business.

b. *Standstill Agreements.* — A standstill agreement pledges a bidder to cease acquiring further shares of the target, typically for a defined period unless further acquisitions are approved by the target’s management. In return, the bidder is typically given access to confidential information from the target.³⁵² Although sensible justifications often may exist for such agreements,

350. For cases involving this tactic, see *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982); *Joseph E. Seagram & Sons, Inc. v. Abrams*, 510 F. Supp. 860 (S.D.N.Y. 1981). In *Mobil Corp.* and *Joseph E. Seagram & Sons, Inc.*, the sale was enjoined.

351. See *supra* note 330. Read literally, under subparagraph 3(c) of § 312.00 of the New York Stock Exchange Listed Company Manual, the issuance of one share plus the transfer of an asset equal in value to 18.5% of the market value of outstanding shares would require approval, but approval would not be required if 30% of the assets, but no shares, were transferred. The appropriate focus, however, should be on the relative magnitude of the transaction, not the nature of the consideration. The SEC has indicated, however, that it would not favor such a restriction on asset options. See Hearings of the House Subcomm. on Telecommunications, Consumer Protection, and Finance [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,511, at 86,683 (Mar. 28, 1984) (“The Commission supports the general proposition that state corporate law, subject to revised application of the business judgment rule in takeovers, should govern disposition of assets during a tender offer.”) (statement of John S.R. Shad, Chairman of the SEC). This expressed hope for a more restrictive business judgment rule, as opposed to the formulation of clear prophylactic rules, strikes this author as “buck-passing” by the SEC.

352. A recent example of such an agreement arose in connection with the control contest over Gulf Oil. After an unwelcome bid was made by Boone Pickens, a Texas oilman, Gulf invited other companies to make offers and agreed to provide confidential information, provided that they signed a three-year pledge not to try to take over the company without Gulf’s approval. Eight corporations, including the Atlantic Richfield Company, the Standard Oil Company of California, and the Allied Corporation, signed such a pledge, but the Mobil Corporation would not. See Cole, *Arco Nears Expected Bid for Gulf*, N.Y. Times, Mar. 2, 1984, at D1, col. 6.

they can be used to preclude control contests.³⁵³ Moreover, there may in the background exist a covert agreement that the target will repurchase the bidder's shares at a premium over the market price. Again, a rule of thumb seems best formulated through self-regulatory rule making. Such a rule might permit an agreement of short duration—for example, one year—but would otherwise prohibit agreements of longer duration unless specifically approved by shareholders.³⁵⁴

c. Supermajority Provisions. — Rather than prohibit all supermajority provisions, it would be less paternalistic and more in keeping with the rationale of shareholder democracy to place outer limits on the permissible supermajority that might be required. Such a premise seemingly underlies existing policies of the New York Stock Exchange.³⁵⁵ In addition, procedures for the adoption of such provisions should be formulated. One suggestion is that any supermajority level could only be adopted if approved by an equivalent

Little case law or other authority exists concerning the validity or enforceability of standstill agreements, and it can be argued that they lack a valid corporate purpose. See Bialkin, *The Use of Standstill Agreements in Corporate Transactions*, in *Thirteenth Annual Institute on Securities Regulation* 33, 52 (A. Fleisher, M. Lipton, R. Mundheim & R. Santoni eds. 1982). In this author's view, the assimilation difficulties incident to control changes and organizational adjustments frequently make a slower paced takeover desirable, and this consideration should legitimize the standstill agreement, if it is properly constrained.

353. A standstill agreement is typically entered into by the target and the former insurgent group when the target repurchases the latter group's shares at a premium over the market price (a practice commonly called "greenmail"). Otherwise, the target would have no assurance that the same group would not repeat the same tactic. Thus, limiting standstill agreements also has a collateral chilling effect on greenmail. On other occasions, the standstill agreement may give management a long-term captive ally. Thus, General Cinema is required to vote its 22% of Carter Hawley Hale as directed by the majority of the latter's board. See Barmash, *supra* note 127, at D4, col. 5. Even of selective repurchases were prohibited without shareholder approval, see e.g., H.R. 5693, 98th Cong., 2d Sess. (1984), standstill agreements could be used to block control contests, because the target could still "bribe" the bidder (or a white knight) by agreeing to sell a "crown jewel" at a bargain price (as some believe happened in the Carter Hawley Hale control contest).

354. In its recommendation 36, the SEC Advisory Committee on Tender Offers proposed that current standstill agreements having a remaining life of over one year be subjected to an advisory vote of shareholders. See SEC Tender Offer Report, *supra* note 3, at 38. This is a curious recommendation, because such a vote apparently would have only precatory significance and would come only after the action was taken. In order to maintain consistency with its other proposals, the Committee should have subjected such agreements to the same requirements of shareholder approval and three-year renewal that recommendation 36 specifies for supermajority provisions. *Id.* at 37. The Committee's rationale probably was that such agreements would have little power to prevent a control transfer if, as the Committee proposed, lock-ups were more closely regulated. See *supra* note 318.

355. The New York Stock Exchange will not list nonvoting common stock or common stock subject to voting trusts, irrevocable proxies or "disproportionate voting powers"; nor will it list shares "when unusual voting provisions are created which tend to nullify or restrict the voting of a class of stock . . ." See New York Stock Exchange Listed Company Manual, §§ 308.00, 313.00. The common thread behind these provisions is a concern for shareholder democracy. Thus, although the New York Stock Exchange does not expressly establish limits on supermajority provisions, it is doubtful that it would tolerate a 90% supermajority provision.

supermajority.³⁵⁶ Even more desirable would be durational limits under which a supermajority provision would remain operative after a specified period (say, three years) only if renewed by a shareholder vote of a similar magnitude.³⁵⁷ The specifics of these proposals need not be debated here, because the basic contention is only that a highly specific rule is best and can be most feasibly adopted through the vehicle of self-regulatory rules.

d. *Disenfranchisement Provisions*. — One gambit for insulating management is to limit the voting power of any single shareholder by a formula which limits the number of shares any one holder may vote.³⁵⁸ Although case law may uphold such a restriction,³⁵⁹ it should not be available to publicly traded corporations, and it is here that the NASDAQ listing eligibility criteria most need revision.³⁶⁰

e. *“Golden Parachutes”*. — A final obvious category for self-regulatory rules to address are employment severance agreements that entitle senior

356. In its recommendation 36, the SEC Advisory Committee on Tender Offers proposed both that supermajority provisions require a shareholder vote of the same level for adoption and that they be ratified every three years. See SEC Tender Offer Report, *supra* note 3, at 36–37.

357. See *id.* The SEC Advisory Committee did not indicate, however, whether the ratification vote after three years would also have to be adopted by the same supermajority as it specified.

358. For example, a charter provision might give each share one vote, but deny any shareholder the ability to vote more than 50 shares. See *supra* note 342 for a discussion of the use of such a formula by MCI Communications Corporation. Similar techniques have long been utilized in Europe. See Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of ‘One Share, One Vote,’* 56 *Corn. L. Rev.* 1, 11–15 (1970); cf. Arnold, *Defenses to Takeovers: Switzerland*, 8 *Int’l Bus. Law.* 41 (1980).

359. See *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 124 (Del. 1977). It should not be lightly assumed, however, that the *Providence & Worcester* precedent protects a midstream restriction of voting rights, because the *Providence & Worcester* limitation was adopted when the corporation was formed. Subsequent efforts to restrict voting rights could run afoul of the well known line of Delaware cases finding a fiduciary breach when management uses the corporate machinery to seek to perpetuate its own control. See *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 362–66, 230 A.2d 769, 775–77 (1967). Also, such a limitation presumably can only apply prospectively and should not reduce existing voting rights held by a shareholder who already holds more shares than the charter amendment would permit him to vote. See *Keller v. Wilson & Co.*, 190 A. 115, 124 (Del. 1936) (right of holder of cumulative preferred stock, issued at time when law did not permit cancellation of accrued and unpaid dividends, constitutes a vested right of property secured against destruction). But see *Bove v. Community Hotel Corp.*, 105 R.I. 36, 41–46, 249 A.2d 89, 93–95 (R.I. Sup. Ct. 1969) (right of holder of cumulative preferred stock to dividend arrearages may be cancelled by a statutory merger, provided that state law has reserved power of repeal or amendment of corporate charter at time of incorporation).

360. It seems clear that the New York Stock Exchange will not tolerate a provision which denies a shareholder the ability to vote additional shares because of the shares he already owns. See New York Stock Exchange Listed Company Manual, § 308.00 (finding objectionable “any proposal which results in either discrimination against an existing substantial shareholder or discouragement of anyone seeking to make a substantial investment”) and § 313.00. Yet, MCI Communications Corp. was able to evade this restriction by trading instead on NASDAQ’s “National Market System.”

management to compensation or other benefits above a specified level.³⁶¹ Again, neither the legitimacy of some form of severance compensation nor the potential for abuse need be discussed here. The more relevant point is that the New York Stock Exchange's own shareholder approval policy grew out of an attempt to limit the stock options that management could award to itself without shareholder ratification. This history suggests a similar proposal for dealing with "golden parachutes": above some reasonable level (say, one year's compensation) and subject to various possible exceptions, the corporate issuer would agree in the listing agreement to condition any award of severance compensation upon shareholder approval.

Each of the foregoing examples illustrates the desirability of a bright line test as opposed to either a universal proscription of the behavior being regulated or a vague fiduciary standard.³⁶² Among the advantages of such an approach, two stand out. First, it creates a safe harbor for behavior that may be socially desirable. Although the case for some forms of employment severance agreements and shark repellent provisions may be strong, a vague fiduciary standard would leave considerable uncertainty surrounding their validity; such a standard seems likely to produce much litigation and doubt, but little clear guidance or constraint. In this light, however arbitrary the line may seem

361. In its recommendation 38, the SEC Advisory Committee on Tender Offers proposed that the board of directors "not adopt contracts or other arrangements with change of control compensation once a tender offer for the company has commenced." SEC Tender Offer Report, *supra* note 3, at 40. It did not otherwise seek to restrict employment severance agreements, but recommended that they be made the subject of "advisory" votes at each annual shareholders meeting. *Id.* at 41. In H.R. 5693, 98th Cong., 2d Sess. (1984), the SEC has proposed legislation that would deny the issuer the power "to enter into or amend, directly or indirectly, agreements containing provisions . . . that increase directly or indirectly, the current or future compensation of any officer or director." However, this provision becomes applicable only "during a tender offer" and thus would not affect an overly generous golden parachute entered into on the eve of a hostile takeover.

362. A different view has been expressed by Professor Gilson, who argues that a more general standard is preferable to specific rules. See Gilson I, *supra* note 1, at 881-87. He recognizes that economists have argued that "the more specific the prohibition, the less likely it is to deter socially desirable behavior not intended to be prohibited." *Id.* at 883 (citing Ehrlich and Posner, *An Economic Analysis of Legal Rulemaking*, 3 *J. Legal Stud.* 257, 268-69 (1974)). Professor Gilson's response to this argument is that management, assisted by able counsel, "will be able to restructure defensive transactions and tactics to fall outside the form prohibited by the rule without changing the substantive result." *Id.* at 886. This result, however, could be reached just as easily under a general rule premised on fiduciary duties, because the elements critical to the evaluation of a director's fiduciary performance—that is, good faith, due care, reliance on experts—are even more manipulable than the elements of a specific rule. Moreover, Professor Gilson's comparison of specific and general rules assumes that the specific rule is static and cannot be extended or interpreted to reach new cases. Yet, this is where the British system has been most successful in the discretion it gives its Panel on Takeovers and Mergers to apply its policy precepts and appraise each new tactical maneuver as it arises. The real need then is for a body authorized to formulate rules on a prospective basis in order to check new evasions. This power could be given either to the SEC's staff or to an appropriately constituted watchdog committee formed under the auspices of the Exchanges and modelled after the British Panel.

between permitting, for example, a seventy percent supermajority provision and prohibiting a seventy-one percent provision, such a rule facilitates planning, and the certainty it provides should in the end outweigh its possible overbreadth in a given case.

Second, while self-regulatory exchange rules do not necessitate the use of Draconian financial penalties, they may not be prudently ignored. Although the threatened sanction of delisting, if used, might harm target shareholders, resort to this sanction should seldom be necessary. The successful enforcement of the New York Stock Exchange's 18.5% ceiling on lock-ups illustrates this. In addition, although it is unlikely that any implied cause of action will lie against corporate officials for the violation of a stock exchange rule,³⁶³ there is potential liability on the part of the exchange to investors if they fail to enforce their own rules.³⁶⁴ Alternatively, a derivative action should lie if a shareholder can allege that the board and senior management are threatening the corporation with irreparable injury in order to perpetuate themselves in office.³⁶⁵ This latter action would not assert that a violation of stock exchange rules is, itself, an actionable wrong, but rather would focus on the consequences of such a violation—the delisting—to assert that the board, unless enjoined, will cause serious harm to the corporation.³⁶⁶ The importance of this distinction arises from the fact that it preserves a measure of prosecutorial discretion in the self-regulatory body, because the alleged harm is typically

363. No evidence exists of a general congressional intent to authorize suits for breach of the rules of a self-regulating organization. Recent cases have generally denied the investor a cause of action based upon the violation of a stock exchange or NASD rule, at least absent a finding of fraud. See *State Teachers Retirement Bd v. Fluor Corp.*, 654 F.2d 843, 852-53 (2d Cir. 1981); *Utah State Univ. of Agriculture and Applied Science v. Bear, Stearns & Co.*, 549 F.2d 164, 167-69 (10th Cir. 1977), cert. denied, 434 U.S. 890. However, in *Leist v. Simplot*, 638 F.2d 283 (2d Cir. 1980), *aff'd sub nom. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 395 (1982), Judge Friendly indicated that there may still be circumstances in which a private action will lie as a result of the violation of a stock exchange rule, if that rule is a substitute for direct federal regulation. *Id.* at 296 n.11 (citing *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966)).

364. The Supreme Court clearly so held in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 395 (1982); see also *Baird v. Franklin*, 141 F.2d 238 (2d Cir.) (action maintainable against New York Stock Exchange for failure to enforce its rules), cert. denied, 323 U.S. 737 (1944).

365. Again, a series of Delaware cases have held that actions taken primarily to perpetuate management in control amount to a breach of fiduciary duty and can be enjoined. See *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 362-66, 230 A.2d 769, 775-77 (Del. Ch. 1967).

366. One court has enjoined a corporation from taking an action (the issuance of nonvoting shares) which the New York Stock Exchange had announced would result in the firm's delisting. See *United Funds, Inc. v. Carter Prods., Inc.*, [1961-64 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 91,288 (Md. Cir. Ct. May 16, 1963). The Maryland court enjoined the contemplated action on a mixture of fiduciary and contract law theories, holding both that the exchange listing was a valuable corporate asset and that there was an implicit contractual representation to shareholders that it would be maintained. For a discussion of the case, see L. Loss, *Fundamentals of Securities Regulation* 493-94 n.9 (1983).

within its control. For example, if a stock exchange were to announce publicly that some defensive tactic contemplated by a target corporation would, if taken, result in its delisting, this public threat would likely trigger a derivative action for an injunction against the contemplated defensive maneuver. Conversely, if no threat were made or some other compromise were reached, the same potential plaintiffs would find it considerably more difficult to maintain an action. In short, private enforcement is made largely subject to the discretion of the self-regulatory body. In contrast, the concept of "manipulation" under Section 14(e) of the Williams Act threatens corporate officials with substantial liability, while the behavior prohibited remains uncertain. This approach involves the worst of both worlds and could result both in a far greater volume of litigation brought by private plaintiffs and in less certainty about the meaning of the substantive standard.³⁶⁷ Accordingly, if one wishes to minimize the volume of litigation against independent directors, relying on stock exchange rules seems preferable, both because it would utilize comparatively precise standards and because it does not itself give rise to a private cause of action. In addition, because the object of the litigation would typically be to secure an injunction in advance and not to seek damages after the fact, the prospect of judicial nullification of the law's substantive standards because of a reluctance to impose high damages should be significantly reduced.

3. *The Scope of SEC Authority.* — One predictable reply to the foregoing arguments is that they assume a far greater authority on the part of the SEC to revise stock exchange rules than the SEC actually possesses. If reforms such as these can be so easily imposed, then arguably the SEC could also amend stock exchange rules to achieve any of a host of other worthy objectives—ending pollution, requiring non-discrimination, or inducing social activism. This *reductio ad absurdum* argument can quickly be dismissed, however. Limits on the scope of the SEC's power are discernible, although they should permit the mandating of rules intended to preserve a fair balance of advantage in corporate control contests. Section 19(c) of the Securities Exchange Act of 1934 authorizes the Commission to "abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization . . . or otherwise in furtherance of the purposes of this chapter."³⁶⁸ Because the Williams Act is also incorporated within the Securities Exchange Act of 1934, Section 19(c) on its face appears to authorize the Commission to mandate revisions of stock exchange rules in order to help

367. Also, as Professor Gilson has noted, a vague general prohibition may inhibit more socially desirable behavior, particularly if we assume that directors are likely to be risk averse. See *supra* note 362.

368. Securities Exchange Act of 1934 § 19(c), 15 U.S.C. § 78s(c) (1982); see also *supra* note 345.

realize the Williams Act's goals of neutrality between the contestants and protection of investors.³⁶⁹

Although counter-arguments can be raised,³⁷⁰ only one need here be examined in any detail. In *Sante Fe Industries, Inc. v. Green*,³⁷¹ the Supreme Court declared that corporations are creatures of state law, and implied that courts will not lightly infer congressional intent to invade this domain.³⁷² If this deference to federalism still dominates the Supreme Court's current thinking about the reach of the federal securities laws, it cannot be trivialized by the simple expedient of using stock exchange rules to do what cannot be done under Rule 10b-5. Otherwise, federal chartering of corporations could arrive tomorrow based only on SEC manipulation of stock exchange rules.

Where then should the watershed lie between permissible and impermissible SEC revisions of stock exchange rules? For three distinct reasons, amendment of the listing agreement to effect a fair balance of advantage in the contest between the bidder and the target should fall on the permissible side of this line. First, to the extent that modifications of the listing agreement seek to implement a policy of neutrality and investor protection that is truly imbedded in the Williams Act, these reforms stand on stronger statutory ground than does any program to reform corporate governance generally through the mandating of independent directors or requisite board committees. While probably desirable, the latter program of corporate reform has no foundation

369. See *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 29 (1977) ("Congress was . . . committed to a policy of neutrality in contests for control, but its policy of evenhandedness does not go . . . to the purpose of the legislation Neutrality is, rather, but one characteristic of legislation directed toward a different purpose—the protection of investors."). That Congress intended to strike a careful balance between bidder and target in order to improve the position of investors has been frequently emphasized. See Langevoort, *State Tender-Offer Legislation: Interests, Effects and Political Competency*, 62 *Cornell L. Rev.* 213, 249 (1977); Note, *Commerce Clause Limitations upon State Regulation of Tender Offers*, 47 *S. Cal. L. Rev.* 1133, 1168-70 (1974). Stock exchange rules that permit, but limit, supermajority provisions or similar shark repellent devices would seem to implement this purpose and so should be within the permissible scope of § 19(c).

370. One such counter-argument is that the listing agreement is not itself a stock exchange rule, but only a private contract, which is not therefore subject to SEC review. For a critique of this claim, see Note, *Stock Exchange Listing Agreements as a Vehicle for Corporate Governance*, 129 *U. Pa. L. Rev.* 1427, 1436 (1981); see also *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1380 (2d Cir.) (describing the Listing Agreement and the Company Manual as "'instruments corresponding' to rules of the Exchange"), cert. denied, 423 U.S. 947 (1975). This interpretation is strengthened by the fact that § 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78s (1982), specifies that the same procedures be observed in the modification of listing agreements as in rule changes applicable to broker or dealer members of the Exchange; thus, procedurally, listing agreement modifications are effectively given equal dignity with rule changes.

371. 430 U.S. 462 (1977).

372. *Id.* at 479 (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975), that "[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding 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.") (emphasis in original).

in the disclosure-oriented philosophy of the Securities Exchange Act of 1934, whereas the Williams Act does contemplate that investors will have the opportunity to decide the contest themselves³⁷³—an opportunity that some forms of shark repellent provisions would deny them. In short, although Section 19(c) should be read to authorize only amendments that seek to realize a policy of the Act, this scope includes the regulation of takeover contests to preserve neutrality and investor autonomy.

Second, the federalism theme in *Santa Fe Industries* did not motivate the Supreme Court when it invalidated Illinois' anti-takeover statute in *Edgar v. MITE Corp.*,³⁷⁴ even though the claim there made was that takeover regulation was a fundamental aspect of corporate governance.³⁷⁵ The Court appears to see little value in state regulation of takeover contests and is likely to be unpersuaded by appeals to the value of federalism in this context.

A final justification proceeds from historical premises. The New York Stock Exchange's policy of shareholder approval has a long tradition and grows out of a general policy that shareholders should approve fundamental corporate transactions, even if such approval is not required by state law.³⁷⁶ Whatever one thinks about this concept of shareholder democracy, it clearly has not been imposed on the Exchanges by the SEC. If SEC-mandated amendments extend that established policy to the arena of the takeover contest, the SEC is not so much forcing a new and unwanted initiative upon the exchanges as it is requiring consistency in the application of an existing policy. This concept of generalizing an established policy so that it applies to new contexts arguably falls within the scope of Section 19(c), which authorizes the SEC to mandate amendments as "necessary or appropriate to insure the fair administration of the self-regulatory organization."³⁷⁷ At a minimum, "fair administration" should require that the rules promulgated by an exchange not have arbitrarily limited boundaries, but rather must possess a reasonable generality of application. Thus, for example, a mandated revision which extended the existing New York Stock Exchange rule on stock lock-ups to extend to asset lock-ups as well could be defended on this premise that "fair administration" required a reasonable generality.

373. Securities Exchange Act of 1934 § 19(c), 15 U.S.C. § 78s(c) (1982).

374. See *Edgar v. MITE Corp.*, 457 U.S. 624, 633-34 (1982).

375. *Id.* at 645 ("Tender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company.").

376.

For many years, the Exchange has encouraged the broadening of share ownership in a climate of corporate democracy and has endeavored to preserve the basic right of shareholders to participate in the corporate affairs of the companies which they own . . .

. . . Since 1926 the Exchange has refused to list non-voting common stock

New York Stock Exchange Listed Company Manual § 308.00; see Note, *supra* note 370, at 1430-34.

377. Securities Exchange Act of 1934 § 19(c), 15 U.S.C. § 78s(c) (1982).

Although gray areas as to the scope of this authority certainly remain, these ambiguities should not obscure the simple truth that the most dubious tactics which have been used in recent takeover battles—namely, counter-tender offers, “crown jewel” options and asset lock-ups, and the selective repurchase at a premium of shares held by the potential bidder—all seem clearly within the permissible scope of stock exchange rules and thus could be restricted without the necessity of legislative action.

B. *Penalizing the Empire Builder*

To rely on the takeover as a mechanism of corporate accountability, it is essential to create some form of disincentive by which to discourage empire building. Two means to this end will next be considered: a requirement that the bidder secure shareholder approval for its tender offer from its own shareholders, and the use of an accounting penalty in the form of an accelerated amortization period for goodwill.

1. *Bidder Ratification.* — The most direct means of preventing overpayment by bidders would be to give bidder shareholders a right to veto a proposed tender offer.³⁷⁸ Some have already suggested that such a shareholder vote be required,³⁷⁹ but both the SEC and its Advisory Committee on Tender Offers have rejected this idea principally on the doctrinal grounds that corporate law does not require shareholder approval as a precondition to significant purchases of assets.³⁸⁰ Nonetheless, the existence of such a requirement might well have prevented some recent takeovers where the impact on the purchase price of the bidder's stock was devastating to bidder shareholders.³⁸¹

If such a vote were required after the tender offer was publicly announced, bidder shareholders would be voting on a transaction with the market's judgment largely in front of them and would understand that a rejection would restore the discount in share value which an adverse market reaction had already subtracted from their shares. In such a context, the usual obstacles to shareholder activism would be minimized, and indeed one could

378. A few statutes do require approval by a supermajority of the bidder's shareholders if the acquisition will involve the issuance of shares in excess of a specified percentage of the outstanding shares. See Ohio Rev. Code Ann. § 1701.83 (Baldwin 1979) (two-thirds vote required if bidder will issue shares equal to or in excess of one-sixth of those outstanding).

379. See Nordhaus, *The Vanity of the Takeover Game*, N.Y. Times, Oct. 3, 1982, at C3, col. 1. Professor Nordhaus's proposal has been endorsed by another economist. See S. Loescher, *Bureaucratic Measurement, Shuttling Stock Shares and Shortened Time Horizons: Implications for Economic Growth 18-19* (April 6, 1984) (unpublished paper presented at Midwest Economics Ass'n, Chicago, Ill.).

380. In its recommendation 31, the SEC Advisory Committee stated: “Approval by shareholders of a bidder with respect to an acquisition should continue to be an internal matter between shareholders and management, subject only to applicable state law.” SEC Tender Offer Report, *supra* note 3, at 33. The SEC has agreed without further explaining its position. See Hearings of the House Subcomm. on Telecommunications, Consumer Protection, and Finance, *supra* note 351, at 86,681.

381. See *supra* note 56.

expect arbitrageurs and institutional investors to seek to organize shareholder resistance to a pending takeover that the market perceived as unpromising for the bidder.

Still, the problems with this approach are substantial. First, it permits a backdoor attack by the target corporation, which could purchase a few shares of the bidder in order to contest the adequacy of the bidder's disclosures about the proposed acquisition.³⁸² Second, and more seriously, adequate disclosure under the usual federal proxy rules standards seems difficult to provide because the terms of most takeovers change repeatedly, as the initial bidder is compelled to raise its bid in response to a competitor or in anticipation of a second bid.³⁸³ If a resolicitation of proxies were required everytime the offered price was increased or other terms were changed, the feasibility of the proposal seems doubtful. Yet, the logic of shareholder approval seems to require such a resolution, because shareholder approval of a specific proposed transaction hardly implies that shareholders would approve a different and more expensive transaction. Finally, the potential liability that the proxy rules would create might significantly chill the bidder's incentive to make desirable acquisitions. If the acquisition later proved disadvantageous, shareholders might seek damages, claiming that material information was not disclosed to them.

Notwithstanding these problems, it still seems possible to design a sensible ratification rule which could not be manipulated to harass the bidder or delay the takeover interminably. If the bidder were required to secure shareholder approval of the specific terms of a proposed offer, and also permitted at the same time to obtain ratification of a right to increase its bid in response to any counter-bid made by a rival bidder, the necessity for multiple resolicitations would fade. This alternative, under which shareholders would ratify a right to respond to a higher counter-bid, seems preferable to either of the two

382. If a shareholder vote were authorized, most bidders would be obliged either to solicit proxies or at a minimum to distribute an information statement under § 14(c) of the Securities Exchange Act of 1934. 15 U.S.C. § 78n(c) (1982). Either way, recent decisions would hold both the bidder and its directors to a negligence standard of liability. For recent decisions which have so held in connection with mergers, see *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973). But see *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), cert. denied, 449 U.S. 1067 (1980) (scienter standard applied to accountants in connection with proxy statement prepared for a merger); *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195 (2d Cir. 1978). The problem of full disclosure is particularly complicated in this context because the critical factual and financial information about the value of the target's assets are not within the possession of the bidder in a hostile takeover contest.

383. In the great majority of recent takeover bids, the initial bidder has either lost to a second bidder or been forced to raise its initial offer. See Ruback, *supra* note 10. Thus, the original proxy solicitation would only be a prelude to multiple solicitations each time the bidder was forced to raise its price. Of course, the bidder could seek to obtain advance approval of further price increases by specifying a range within which it would make its offer, but this tactic would have the counterproductive effect of enabling the target to attack any price below the maximum so specified as inadequate.

obvious alternatives: prior approval by shareholders of board authority to make an offer within a specific range of prices, or approval of a right to increase the specific offer up to a designated ceiling. The former option would typically amount to a "blank check" approval, because shareholders would not have the terms of any specific offer before them and would not be able to gauge the market's reaction to it. The latter option would give the target a stronger justification for resistance until the highest price authorized by shareholders was in fact offered. In response, the bidder would have an incentive to minimize the ceiling submitted to its shareholders for ratification, because *any* such ceiling would likely be interpreted by the market as an advertisement of the eventual price to be paid. In turn, this would confer a tactical advantage on rival bidders, which would know that even a nominal increase of its offer over the maximum price authorized by the first bidder's shareholders could not be matched by the first bidder without a time-consuming resolicitation of proxies.

Although the proposed procedure of a retrospective ratification coupled with a defined right to respond to a counter-bid would give a tactical advantage to bidders that are not subject to the federal proxy rules and might encourage some bidders to use alternative takeover techniques to the tender offer,³⁸⁴ the marginal delay incident to use of such a procedure, even for those subject to the rules, would not need to be extensive. There is no reason that the offer could not be commenced prior to the shareholder vote and made conditional on shareholder approval. This would add an element of uncertainty to the bidding process, as target shareholders would not know if the offer was firm, but various means can minimize the period of this uncertainty. For example, both the cost and delay incident to a proxy solicitation could be greatly reduced if the requirement for ratification were made contingent upon the filing of an objection to the tender offer by the holders of a specified number of the bidder's shares (for example, one percent) within a specified period (say, ten calendar days) after announcement of the offer. Only those holding stock before the offer was made would be permitted to file objections, to prevent the target from acquiring shares in order to force such a vote as a delaying tactic. Tender offers that were small in proportion to the bidder's size could also be exempted.

More importantly, any delay that did result might well be desirable, because it would afford the target's own management a greater opportunity to

384. For example, bidders might acquire control through open market purchasing or they could launch a proxy fight. Alternatively, control might be purchased in privately negotiated transactions with a few sellers. However, if this bidder ratification rule is combined with this Article's suggestion of a mandatory tender offer requirement once the bidder crosses a specified ownership threshold, see *infra* notes 431-53 and accompanying text, then the bidder would be compelled to make a bid and could not escape the ratification requirement. This, in turn, presents the issue of what happens when a mandatory bid is required, but shareholders of the bidder vote to reject it. Here, the simplest answer is to require the bidder to sell promptly the shares it already holds in the target.

structure a leveraged buyout as a counter-proposal.³⁸⁵ In an optimally designed auction market, there is every reason to encourage target management to make such a counter-bid; both because it has more information about the firm's prospects and more to lose if the hostile bid is successful, it should frequently prove to be the highest bidder. Thus, the delay should help foster an improved auction market.

Implementation of a bidder ratification rule could be achieved through state legislative action, amendment of the Williams Act, or possibly a stock exchange rule. Admittedly, the case for such a reform is a marginal one, because the evidence is inconclusive as to the frequency with which bidders overpay. Still, on balance, a bidder ratification requirement could play a useful role in an integrated system of regulation that sought to encourage an auction between the bidder, other rival bidders and target management.

2. *The Utility of Accounting Inducements.* — Curiously, little attention has yet been given to the impact of accounting policies and conventions on cash tender offers. Nonetheless, two factors make accounting rules an attractive vehicle for regulation.

First, use of accounting inducements involves a less heavy-handed form of regulation; such incentives encourage, but they do not prohibit. Accounting incentives in effect change the scoring system and then rely on the bidder's own self-interest to lead it to focus on the preferred form of transaction. To use a simple analogy, if one changed the scoring system for football so that a field goal counted six points and a touchdown only three, one could reasonably anticipate that, without more, the relative salaries of quarterbacks and place kickers would flipflop and, in time, that high school athletes would spend more hours practicing place kicks than perfecting their spiral passes.

Second, there exists an accounting measure which has the capability of distinguishing those acquisitions most likely to be only growth maximizing ones from those in which the bidder is truly acquiring a troubled firm—namely, the treatment accorded to the "goodwill" that may arise as the result of an acquisition.³⁸⁶ To understand the significance of goodwill, one must understand that acquisitions of unprofitable or inefficient firms will tend in general to give rise to relatively smaller amounts of goodwill on the bidder's balance sheet than will acquisitions of profitable firms, which are typically acquired at a premium well over the fair market value of their assets. Once this is recognized, it implies that the more we penalize the creation of goodwill by requiring its rapid amortization, the more we place a penalty on empire

385. Structuring a leveraged buy-out is a time-consuming proposition, which is closely regulated by SEC Rule 13e-3. See *supra* note 153. Target management, therefore, cannot now compete effectively as a rival bidder against hostile bidders and other white knights. Yet, if the time period were extended, leveraged buy-outs would become a realistic option.

386. The treatment of goodwill is regulated by APB Op. Nos. 16, 17 (1970). For an accessible overview, see Ffilis, *Accounting for Mergers, Acquisitions and Investments*, in a Nutshell: The Interrelationships of, and Criteria for, Purchase or Pooling, the Equity Method, and Parent-Company-Only and Consolidated Statements, 37 *Bus. Law* 89 (1981).

building that does not interfere with the more socially desirable aspects of capital market discipline.

This proposal requires that the accounting concept of goodwill be explained in more detail. In any acquisition accounted for as a purchase (as any cash tender offer must be), generally accepted accounting principles require that the excess of the consideration paid by the acquirer over the fair market value of the acquired company's assets, as valued on the date of acquisition, be assigned to a category called "goodwill," which is a residual account reflecting the value of nonidentifiable intangible assets.³⁸⁷ For example, if the target corporation's assets have a book value of \$10 million, but a fair market value of \$20 million, and the bidder pays \$25 million, the bidder will be required to write up the acquired assets to \$20 million (their fair market value), but the balance of its purchase price (that is, \$5 million) must be assigned to goodwill. Under Accounting Principles Board Opinion No. 17, goodwill must be amortized over a period not to exceed forty years.³⁸⁸ The effect of this amortization charge is doubly serious to the purchasing company because it not only reduces income, but also fails to give rise to a tax deduction.³⁸⁹ As a result, acquirers generally elect the longest amortization period permissible under generally accepted accounting principles (that is, forty years), with the consequence that only 2.5% of the goodwill so created will be deducted from the purchaser's earnings in any one year. In effect, this trivializes the accounting requirement that goodwill be amortized and thereby frames a public policy issue: Should the amortization period be shortened and the penalty thereby increased?

From our perspective, the significance of goodwill lies in the higher probability that it will arise in significant amounts in those acquisitions in which an excessive premium is paid; conversely, there is a much lower likelihood of a substantial amount of goodwill arising in an acquisition of a financially distressed corporation. Because the weaker firms in an industry (plus most firms in some stagnant industries) often trade at an aggregate stock market capitalization that is below (or at least close to) their book value, little or no penalty is implied for such socially desirable acquisitions if a faster write-off of goodwill were required. Even where a substantial premium over such an acquired firm's stock market value is paid, goodwill would still not necessarily result, because the acquirer may write up the purchased assets to

387. There is considerable literature on the meaning of the term "goodwill." For two of the best known studies, see G. Catlett & N. Olson, *Accounting for Goodwill* (Accounting Research Study No. 10) (1968); A. Wyatt, *A Critical Study of Accounting for Business Combinations* (Accounting Research Study No. 5) (1963); Fiflis, *supra* note 386, at 100-01.

388. See APB Op. No. 17 ¶ 9,334 (1970). This means that periodic charges to expenses must be made over the amortization period chosen to account for the addition of goodwill.

389. See Treas. Reg. § 1.167(a)-3 (1960) (goodwill not subject to depreciation for federal income tax purposes). For some of the technical refinements on this point, see Fiflis, *supra* note 386, at 99 n.23.

their fair market value. As a practical matter, the acquirer has considerable latitude in determining the fair market value of the acquired firm's assets.³⁰⁰ Accordingly, significant amounts of goodwill are likely to arise only when the purchase price greatly exceeds the estimated fair market value of the purchased assets. From our perspective, such a circumstance is also highly probative of an "empire-building" acquisition.

An example will show the impact of the proposed revision in amortization periods. Professor Abraham Briloff, a highly respected academic accountant, has catalogued a number of examples of acquisitions in which the amount of goodwill created has been disturbingly large,³⁰¹ and his discussion of United Technologies Corporation has special relevance for our purposes. Between 1976 and 1979, United Technologies engaged in a string of acquisitions that more than doubled its size, buying Otis Elevator in 1976, AMBAC in 1978, and Carrier Corporation and Mostek in 1979.³⁰² The premiums paid in these acquisitions were substantial: for example, the total cost incurred to acquire AMBAC was \$220 million for a company having a book value of around \$100 million.³⁰³ Although Professor Briloff implies that United Technologies strained accounting principles to write up the acquired assets to a value that minimized the creation of goodwill, it was still compelled, even after doing so, to charge \$87.5 million, \$270 million and \$214 million, respectively, to goodwill as a result of these last three acquisitions—in short, a total of \$571 million.³⁰⁴ Although Professor Briloff focused on whether any goodwill, much less a half billion dollars, should have arisen in these transactions, the more striking fact here is that United Technologies was only able to create and carry an intangible asset exceeding one half billion dollars on its balance sheet because current accounting principles gave it an extraordinarily long period to account for the costs it incurred. Using a forty year life, United

390. See A. Briloff, *The Truth About Corporate Accounting* 97 (1981) ("There is a traditional accountants' axiom to the effect that: Those who might well show goodwill on their balance sheets do not; those who should not do so, will."). Professor Briloff points to R.J. Reynolds Industries, Inc.'s acquisition of Del Monte Corporation as an example of asset inflation in order to avoid showing a positive goodwill account. *Id.* at 96-97. His treatment of Gelco's acquisition of CTI also reveals the ease with which goodwill can be created or avoided as desired. *Id.* at 117-28.

391. *Id.* at 90-128.

392. *Id.* at 97-101.

393. United Technology's cost was \$220 million; this exceeded AMBAC's book value by \$122 million. Of this amount, some \$87.5 million was assigned to goodwill. Because AMBAC already had a \$5.1 million goodwill account, Professor Brillof computes the total goodwill in this acquisition at \$92.6 million. This implies that the fair market value of the purchased assets was under \$130 million. *Id.* at 97-98.

394. Carrier Corp. was purchased for slightly in excess of \$1 billion, of which United Technologies assigned "a whopping \$270 million to goodwill." *Id.* at 99. United Technologies paid \$314 million for 91% of Mostek Corporation, of which it assigned \$214 million to goodwill. Another \$25 million was to be assigned to goodwill when the final 9% was acquired, thus making the total goodwill account \$239 million. *Id.* at 100-01. At the end of 1979, when United Technology's equity was \$1,639 million, goodwill amounted to \$530 million, or 32.3%. *Id.* at 101.

Technologies would have had only to charge \$14.3 million per year against current income in order to amortize the \$571 million it assigned to goodwill from these three acquisitions.³⁹⁵

But consider what would happen if the maximum period were shortened. To use an admittedly extreme example, if the permissible period were reduced to five years, the result would be a non-deductible charge against income of \$114 million each year. Under such an accounting convention, it is doubtful that United Technologies would have acquired Carrier (in a hostile tender offer) when the resulting annual amortization charge of \$54 million for that acquisition would alone have exceeded Carrier's average annual earnings over the previous five years of \$43 million.³⁹⁶ Similarly, in the Mostek acquisition, United Technologies allocated roughly two-thirds of the total purchase price to goodwill³⁹⁷—a result that seems unthinkable if this account must be amortized over any realistic period. Even more certainly, even if United Technologies had made any one of these acquisitions, it could not have made them all. The empire would have been too expensive to build at such a price.

In contrast, this telescoping of the maximum amortization period would have much less of an effect on acquisitions of corporations selling at below their book value because goodwill would not typically arise in such cases. This is the profile of the troubled corporation and also the context where the takeover performs its most socially desirable role in transferring productive assets to a superior management. Nor is goodwill likely to be as significant a factor in certain other classes of acquisitions—such as those of natural resource companies, where the value of the company's reserves in the ground is the primary motive for takeovers—because the acquired assets tend to be written up to their estimated fair market value in order to cover the full purchase price. Indeed, what Professor Briloff believes is a vice—namely, that acquiring companies can usually write up the assets of the acquired company to a fair market value that equals the purchase price—may here instead be a virtue, because it reduces the possibility that such an accounting change would have an overbroad effect, chilling socially desirable acquisitions.

Still, any reform has its costs, and here the cost is that acquisitions having a high potential for synergy may be deterred. Empire building and synergistic acquisitions are difficult to distinguish *ex ante*. In both, the premium paid for the target's assets is likely to seem excessive in relation to the current fair market value of those assets. Indeed, the earlier discussed acquisitions by United Technologies provide ironic evidence of this, because those acqui-

395. In fact, United Technologies decided to amortize the goodwill arising from the largest of these acquisitions (Mostek) over a twenty-five year period. *Id.* at 100. This decision may have been affected by the fact that Mostek lost \$19 million in 1979 prior to the acquisition—a factor that cast considerable doubt on whether any goodwill should have been booked. *Id.* at 101.

396. *Id.* at 100. The three year average was \$63.9 million. Professor Briloff concludes that these earnings levels were insufficient to justify the conclusion that Carrier had any “excess earnings potential” sufficient to justify the creation of goodwill. *Id.* at 99-100.

397. See *supra* note 394.

tions, even though at very high premiums, have been cited by Fortune as among the best of the last decade.³⁹⁸ Conversely, a study of acquisitions of high technology companies—although in a context where the prospect of synergy is particularly high—found that bidder shareholders were essentially making wealth transfers to target shareholders.³⁹⁹ Against this backdrop of mixed evidence, the prudent course would be to begin with only a modest change in the current rules by reducing only marginally the current mandatory amortization period of forty years. If a five or ten year write-off is too brief, this same objection cannot be as easily made to a reduction from forty to thirty years. This Article's thesis is not that any specific period is appropriate, but that the accounting rules applicable to the amortization of goodwill represent a feasible lever by which to deter empire building. Thus, this Article will suggest only that the SEC broaden its range of vision and evaluate the accounting inducements it has available to it by which to influence the pace and amount of takeover activity.

Still, even this modest suggestion that accounting incentives might be used to influence takeover activity will be met with two counter-arguments. First, the purpose of accounting, it will be argued, is not to pursue socially desirable ends or ulterior goals, but only to inform investors and provide a neutral, unbiased presentation of a company's financial position and earnings. Second, others will contend that the form of accounting presentation has little effect in an efficient market. In an efficient market, it will be argued, stock value cannot be created or destroyed by manipulative changes in accounting terminology.⁴⁰⁰ These two objections proceed, of course, from inconsistent premises; the first sees the language of accounting as critical (and hence, the proposed change is seen as an illegitimate attempt at its corruption), whereas the second sees it as irrelevant (and hence, the reform is trivial). Both objections express partial truths, but neither undermines the logic of the proposal made here.

The first argument, that a reduced amortization period would distort the financial information given the investor, ignores the fact that the current forty year period is also arbitrary.⁴⁰¹ Indeed, it is an unprincipled compromise that

398. See Fisher, *Mergers that Worked*, *Fortune*, Apr. 30, 1984, at 270.

399. One study of tender offers for high technology firms conducted for the Securities and Exchange Commission found that shareholders of the acquiring firms experienced negative abnormal returns from the takeover, while shareholders of the target incurred positive abnormal returns. See A. Osborne, *Returns to Shareholders of Acquiring and Acquired Companies: The Case of Acquisitions of Technology-Based Firms in the Over-the-Counter Market 20* (SEC Capital Market Working Paper No. 3 December 1980). This tends to suggest that overpayment and a consequent wealth transfer is occurring.

400. A variety of studies of the stock market's response to accounting changes have collectively reached the conclusion "that shifts in market values have not accompanied accounting policy changes." See P. Griffin, *Usefulness to Investors and Creditors of Information Provided by Financial Reporting: A Review of Empirical Accounting Research 15* (FASB Research Report, 1982). For a review of these studies, see *id.* at 196-207.

401. See Miller, *Miller's Comprehensive Guide to GAAP* (1983), at § 21.03.

has no defensible basis in accounting theory. Goodwill is itself a concept upon which accounting theoreticians have long disagreed.⁴⁰² To some, it is simply the residue of the valuation process—that which remains when the purchase price is allocated to all specific assets (tangible assets and identifiable non-tangible ones).⁴⁰³ As Professor Fiflis has accurately noted, this definition is a “nonconcept,” in effect more “a description of the accounting process” than a serious effort at explanation.⁴⁰⁴ To others, goodwill is the value of “superior earning power” that the assets possess.⁴⁰⁵ Still other views of goodwill exist, and some doubt whether the very concept should be retained.⁴⁰⁶ In any event, the relevant point is that a forty year period is not logically related to any of these views. If one sees goodwill as representing “superior earning power,” one might define goodwill as a nonamortizable asset which need never be charged off against income. But such a definition would require accountants to define what superior earning power means—a task from which they understandably shrink. At the other extreme, one could charge the excess of the purchase price over the fair market value of the assets against stockholders’ equity and reduce income in the year of acquisition by the amount of such excess.⁴⁰⁷ This approach would depress the acquirer’s earnings in the year of acquisition but would have no further dampening effect; as a result, it would tend to distort period to period comparisons. Between these two extremes— infinite life and immediate write-off—the forty year maximum is best understood as simply a compromise which was at some bygone moment politically acceptable to both sides.

Yet, this compromise is increasingly anachronistic. Accounting theory has undergone a conceptual revolution during the last decade and moved in the direction of “current value” accounting.⁴⁰⁸ At the core of the transition

402. See Fiflis, *supra* note 386, at 100-01.

403. *Id.*

404. *Id.*

405. *Id.* This is the view that Professor Briloff appears to adopt. See Briloff, *supra* note 390, at 99.

406. Professor Briloff takes the position that it should not. *Id.* at 93. However, his primary objection is to the forty-year deferral period. The Financial Accounting Standards Board has indicated that it will in time reconsider this issue, but it has not rushed to do so. See Fiflis, *supra* note 386, at 100 n.24.

407. In effect, this “current value” approach would treat the excess of the purchase price over the asset’s fair market value as irretrievably lost—much as if the acquiring firm’s management burned this money. Yet, this approach gives too little attention to the possibility that there may be intangible assets (such as managerial know-how and trade secrets) that exist but cannot otherwise be characterized on the balance sheet. It also ignores that some firms may truly have superior earning power with the same assets.

408. The Financial Accounting Standards Board has undertaken a re-examination of the “conceptual framework” of accounting. See FASB, *Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises* (1978). For an overview of the issues that are being re-examined, see H. Kripke, *The SEC and Corporate Disclosure 159-231* (1979). As Professor Kripke notes, under the new theory, which focuses on “the change in net equity of the corporation” from period to period, it becomes highly questionable “whether goodwill, research and development, and other ‘intangibles’ that are not ‘resources’ are to be considered assets” at all. *Id.* at 171-72.

toward "current value" has been a reduced emphasis on the "matching" concept of accrual accounting, under which the recognition of costs was often deferred until the related item of income was recognized.⁴⁰⁹ Instead, the current value approach emphasizes the discounted cash flow to the enterprise, which the matching concept tended to ignore. As modern accounting has become more sensitive to the importance of cash flow and less anxious about the proper matching of items of income and expense that relate to each other, the continued deferral of goodwill for a forty year period seems an increasingly unjustified anomaly. Peaks and valleys in the recognition of income are no longer viewed as necessarily misleading, nor is the suppression of such fluctuations seen as a major policy objective of accounting.⁴¹⁰ Thus, a faster write-off of goodwill is fundamentally consistent with this new direction because it removes a largely fictitious asset from the balance sheet, whose presence there had been justified by the asserted need to smooth the fluctuations that would otherwise result from a quicker write-off.⁴¹¹ Equally important, the present discretion given acquiring corporations to choose an amortization period of up to forty years invites manipulation and creates disparities among similarly situated companies. Because of the nondeductibility of amortization payments, some concerns may seek to write up acquired assets and avoid the creation of goodwill; other companies, less concerned about tax deductions and seeking to report higher earnings, may allocate more to goodwill and less to depreciable assets in order to achieve the opposite effect. As a result, like cases are not treated alike. Thus, the accountant's interest in a comparable, unbiased presentation of financial information would be furthered, rather than hindered, by a curtailment of the discretion currently enjoyed by management to choose any amortization period it wishes within the forty year maximum ceiling.⁴¹²

The second objection noted above, that the market pays little attention to attempts to manipulate accounting data, makes a point that is essentially valid, but has little relevance to the immediate issue. A number of studies have found that purely cosmetic changes in accounting presentation produce no change in stock market prices.⁴¹³ Because a reduced amortization period will

409. For a critique of the matching concept and a summary of the trend away from it, see H. Kripke, *supra* note 408, at 169-78.

410. Given the new emphasis on discounted cash flow, deferral of costs, as through the use of a lengthy amortization period for intangible assets having no useful life, is seen as a distortion because it ignores the time value of money. See H. Kripke, *supra* note 408, at 215-27.

411. There is evidence that investors will pay a premium for the stock of corporations that adopt the more conservative approach to financial reporting and eschew accounting gimmicks. See P. Griffin, *supra* note 400, at 198-99. Thus, a restriction of management's current discretion to choose any period from zero to forty years seems to be a shift in the direction that investors desire.

412. If the goal is to ensure better comparability of financial statements, one solution would be to require that goodwill be amortized over the average life of the firm's other assets. This topic is, however, beyond the scope of this Article.

413. See P. Griffin, *supra* note 400, at 196-206. The most relevant of these studies for purposes of this Article are probably those that assessed the effect of a FASB-required change

not affect the acquiring company's cash flow, it is likely that the market will not respond significantly to such an accounting change, whose effect could usually be determined today from publicly available information. Although there have been instances of a dramatic market response in cases where an accounting change has been mandated,⁴¹⁴ this issue is largely beside the point, because the critical issue is not the reaction of the market to a changed rule, but rather that of the management of the potential acquirer. The real question is a behavioral one: Will senior executives of acquiring companies be prepared to recommend acquisitions that will seriously erode their companies' reported earnings? To answer this question, one must consider more than the market's reaction. Reported earnings will affect the salary, incentive compensation and other perquisites available to management. Equally important, an increase in reported earnings enables senior executives to argue that they have served their stockholders well; this is important both to their psychic income and their standing with respect to their board of directors. Conversely, a decline in reported earnings may elicit greater activism from their board of directors.

Evidence of the importance of reported earnings to management ironically lies in the very studies cited by proponents of the efficient market hypothesis to demonstrate the irrelevance of accounting conventions to the market. Although these studies reported that SEC or FASB initiated changes in general had little effect on stock values, the changes did have significant impact on managerial policies.⁴¹⁵ For example, although the choice of a LIFO versus a FIFO accounting convention appears to have little effect on the stock market, many managements nonetheless continue to choose FIFO in order to maximize reported earnings, even if this choice reduces possible tax savings.⁴¹⁶

under which research and development expenditures were required to be treated as immediate expenses, rather than deferred and amortized. Several studies found no impact in common stock returns. *Id.* at 201-02.

414. Some studies found that a proposed (but never implemented) attempt by the FASB and the SEC to require oil and gas producing companies to shift to a "successful efforts" method of accounting for drilling expenses did result in a negative movement in the stock of those firms adversely affected, even though the proposals had no effect on cash flow or tax liabilities. P. Griffin, *supra* note 400, at 204-05. Another dramatic example of a negative market response occurred in 1983 when the SEC challenged the accounting procedures utilized by Aetna Life and Casualty. After the SEC told Aetna to restate 1982 earnings so as to eliminate tax benefits amounting to 55% of earnings, the market price of Aetna stock fell from \$43 a share to \$33, and "security analysts attribute[d] the decline largely to the tax controversy." See *Battle over Earnings: The SEC vs. Aetna*, *Fortune*, Mar. 7, 1983, at 6; Loomis, *Behind the Profits Glow at Aetna*, *Fortune*, Nov. 15, 1982, at 54.

415. See P. Griffin, *supra* note 400 at 206. Griffin cites studies of managerial reactions to FASB-initiated changes on foreign currency translation and lease accounting, which both found that management practices changed. *Id.* at 202-04. Particularly in the lease context, "a majority of lessee firms actually wrote new leases" to evade the new rule's effect. *Id.* at 204; Abdel-khalik, Thompson & Taylor, *The Impact of Reporting Leases Off the Balance Sheet on Bond Risk Premiums*, in FASB Research Report, *Economic Consequences of Financial Accounting Standards: Selected Papers 101-58* (1978).

423. Of course, repeal of the Williams Act would reduce the level of competition by making possible "lightening fast" raids. Professors Easterbrook and Jarrell suggested this course in their

In short, while the market may give little weight to management's attempts to manipulate earnings, management continues to seek to maximize reported earnings by all available techniques. In sum, mandated accounting changes that the market may ignore can still produce significant change in managerial behavior.

An important consideration with respect to any proposed reform should be the harm, if any, that it could cause. Here, the downside risk could be minimized by a phased reduction of the permissible amortization period. If the efficient market theorists are correct, the impact will be negligible. At worst, if bidders are excessively deterred, the reduction in the period's length could be halted or restored by the SEC. But the possibility of substantial interference with the market seems much less than in the case of other proposed reforms that would attempt to chill the takeover process in a variety of more intrusive manners.⁴¹⁷

Finally, the legal authority of the SEC to mandate change in this area of accounting conventions seems relatively clear. Although the Commission has long deferred to the accounting profession, the legal grant of authority given the SEC by the Securities Exchange Act of 1934 is broad and seemingly unqualified.⁴¹⁸ Some signs of recent activism do exist, but in general the SEC has been reluctant to do more than prod the profession to reconsider its own conventions. Thus, the primary contention of this section is that intelligent regulation of the takeover process must adopt a wider angle of vision, one that considers more than simply the provisions of the Williams Act. Once this is recognized, the revision of accounting conventions appears a relatively mild form of regulation, which at best may give the acquirer incentives to focus takeovers on inefficient targets and at worst can cause little harm.

C. *Stabilizing the Auction Market*

The case for a competitive auction market is strong. In theory, it should maximize target shareholder wealth,⁴¹⁹ and direct assets to their highest valued use,⁴²⁰ while minimizing empire building, inefficient control transfers,⁴²¹ and

417. See *supra* note 317.

418. Professor Kripke has described this legislative grant of authority in the following terms: "Accounting was Congress' most important charge to the Commission and represented the Commission's greatest opportunity to be of use to the investor." H. Kripke, *supra* note 408, at 142. The statutory authority by which the SEC is authorized to prescribe accounting principles and procedures is found in both the Securities Act of 1933 and the Securities Exchange Act of 1934. See Securities Act of 1933, § 19(a), 15 U.S.C. § 77s(a) (1982); Securities Exchange Act of 1934, § 13(b) § 15 U.S.C. § 78m(b) (1982). For an overview of the Commission's historic posture toward the accounting rule-making agencies (generally one of deference), see L. Loss, *Fundamentals of Securities Regulation 159-65* (1983).

419. See *supra* notes 99-105 and accompanying text.

420. See *supra* notes 10-11, 77 and accompanying text. In the absence of an auction market it does not follow that assets will fail eventually to move to their highest valued use as intermediate owners resell them. However, the inevitable transaction costs and other frictions incident to such transfers are likely to retard both the pace and extent to which this goal is realized.

421. See *supra* notes 77, 244-64 and accompanying text.

interference with the market for executive services.⁴²² Although the contemporary market for control appears to be reasonably competitive, the primary goal of public policy should be to preserve this competitive character. Thus, one needs to ask what factors might reduce the level of competition in this market as it is currently regulated.⁴²³ Three answers can be given to this question. First, if bidders can find techniques by which to reduce the takeover premium—such as using “two tier” or partial bids or making open market purchases in lieu of a tender offer—the foregoing policy objectives would be jeopardized. Second, if in an auction market the second bidder consistently wins, there may be inadequate incentive for the first bidder to make the initial offer that starts the contest; hence, the auction market might collapse—or, at the least, oscillate through a series of peak and valley cycles.⁴²⁴ Third, unless regulated, defensive measures—shark repellents, lock-ups, counter-tender offers, “crown jewel” options—may also block any transfer of control, much less an auction, and hence can insulate an ineffective management.

The recent report of the SEC’s Advisory Committee on Tender Offers has addressed the first and last of these dangers, but only tangentially touched upon the second problem of inadequate incentive. Their recommendations would restrict target management’s ability to resist a tender offer by (1) requiring that a supermajority provision be adopted by the same percentage of the shareholders required to vote in favor of a merger or other transaction with the bidder;⁴²⁵ (2) establishing a renewal requirement under which a supermajority provision would have to be ratified by the shareholders every three years as a condition of its validity;⁴²⁶ (3) extending the stock exchanges’ rules against stock “lock-ups” to all corporations, whether listed or not;⁴²⁷ (4)

422. See *supra* notes 265–75 and accompanying text.

423. Of course, repeal of the Williams Act would reduce the level of competition by making possible “lightening fast” raids. Professors Easterbrook and Jarrell suggested this course in their dissenting statement to the SEC Tender Offer Report. See SEC Tender Offer Study, *supra* note 3, at 106 (Separate Statement of Frank H. Easterbrook and Gregg A. Jarrell). My focus here is limited to the options available if we continue to live in a regulatory world whose parameters are established by the Williams Act.

424. The highly cyclical history of the tender offer since the 1960’s, see *supra* note 95, may be explained in part by the occurrence of periods when bidders had inadequate incentives to make a hostile offer.

425. See SEC Tender Offer Report, *supra* note 3, at 36–37 recommendation 36. New York law has an essentially similar requirement. See N.Y. B.C.L. § 616(b) (consol. 1983) (requiring higher two thirds vote of all outstanding shares to adopt a supermajority provision).

426. *Id.* It is not clear from the phrasing of recommendation 36 whether the same supermajority vote would be required to review the provision after its initial approval.

427. See SEC Tender Offer Report, *supra* note 3, at 44 recommendation 41, (“During a tender offer . . . the issuance of stock representing more than 15% of the fully diluted shares that would be outstanding after issuance should be subject to shareholder approval.”). This proposal in effect reduces the New York Stock Exchange 18 1/2% rule to 15%. See *supra* note 330. The SEC has proposed a further reduction to 5%. See Statement of John S. R. Shad, *supra* note 351, at 83,511; see also H.R. 5693, 98th Cong., 2d Sess. (1984) (proposing 5% ceiling). The Committee did not propose similar treatment for asset lock-ups, although recommendation 42 would permit the “sale of significant assets, even when undertaken during the course of a tender offer . . . to be

prohibiting a counter-tender offer by the target when the bidder makes a cash tender offer for all the target's shares;⁴²⁸ and (5) requiring shareholder ratification as a precondition to most non-pro-rata repurchases of shares.⁴²⁹ These proposed reforms are sensible and in all likelihood would be sufficient to prevent most control contests from being thwarted. All they lack is a feasible means for their implementation, and this Article has already suggested that stock exchange rules and listing agreements provide a vehicle by which they may be adopted without legislative action.⁴³⁰

However, the first two questions listed above remain: How should we regulate the bidder to maintain takeover premiums at a high level? And how can sufficient incentive be created to encourage an initial bidder to make a tender offer if it typically loses to a subsequent bidder? Although an obvious tension exists between these two goals, a balanced public policy toward takeovers must respond to both of them if a stable auction market is to be maintained. Here, the Advisory Committee's answers are less satisfactory, and alternative options are considered below.

1. *Regulation of the Bidder.* — The SEC's Advisory Committee on Tender Offers clearly recognized that the partial tender offer created a potential for coercion and unfairness.⁴³¹ Its proposed response, however, seems likely to be both inadequate and possibly counter-productive. In its controversial Recommendation 14, the Committee urged the following bright-line standard:

No person may acquire voting securities of an issuer, if, immediately following such acquisition, such person would own more than 20% of the voting power of the outstanding voting securities of that issuer unless such purchase were made (i) from the issuer, or (ii) pursuant to a tender offer.⁴³²

tested under the business judgment rule." *Id.* at 45. This seems a curious compromise, given the interchangeability of stock and asset lock-up options and their widespread use as defensive tactics. The Committee's justification was that a piecemeal liquidation through such sales might realize greater value than the tender offer premium. Indeed, it might, but shareholder approval is not impossible in such a context and the option's validity could be conditioned upon subsequent shareholder ratification.

428. See SEC Tender Offer Report, *supra* note 3, at 43 recommendation 40. This restriction on counter-tender offers would not apply, however, when the initial tender offer was a partial one. H.R. 5693, 98th Cong., 2d Sess. (1984) does not, however, contain this restriction.

429. See SEC Tender Offer Report, *supra* note 3, at 46 recommendation 43. H.R. 5693, 98th Cong., 2d Sess. (1984), would prohibit a repurchase at an above market price from any person who both holds more than three percent of the class to be purchased and who has held such stock for less than two years, unless the repurchase is approved by the holders of a majority of the corporation's voting securities.

430. See *supra* notes 333-77 and accompanying text.

431. SEC Tender Offer Report, *supra* note 3, at xxi ("The Committee is concerned with the potentially coercive nature of partial and two-tier bids. However, given that partial bids can serve valid business purposes and that two-tier bids generally have proved more favorable to shareholders than partial offers with no second step, the Committee is not prepared to recommend that such bids be prohibited.").

432. *Id.* at 23. It was also recommended that the SEC be given broad exemptive powers with respect to this rule. *Id.* The Commission has already expressed "misgivings" about this proposal

In effect, this twenty percent benchmark would prevent a bidder from undertaking a "creeping control" acquisition either through steady open market purchasing or through privately negotiated purchases.⁴³³ In addition, Recommendation 14 would lessen the incentive for "greenmail" because target management would know that the insurgent could not cross the twenty percent threshold without making a tender offer. Because the insurgent would represent less of a threat, there would be correspondingly less of an incentive for target management to repurchase his shares at a premium.

Still, Recommendation 14 is curiously both inadequate and overbroad at the same time. On one hand, it would not restrict partial or even "two-tier" tender offers; instead of prohibiting such offers, the Committee recommended only a mild disincentive in the form of a longer minimum offering period applicable to partial offers.⁴³⁴ On the other hand, the proposal would apparently apply to, and proscribe, even the purchase of a controlling interest from a single shareholder. Thus, the prohibition would in effect reverse the virtually uniform common law rule that permits control to be sold at a premium without an equivalent opportunity being given to other shareholders to share in that premium.⁴³⁵

More importantly, such a rule would lock in the incumbent shareholder who holds a control block and is willing to sell at a premium. To state the obvious, the simplest way for a bidder to change management is to buy out the

and decided that it should receive further study. See Ingersoll, SEC Endorses Major Changes in Merger Fights, *Wall St. J.*, Mar. 14, 1984, at 4, col. 1; *infra* note 442.

433. A number of decisions have declined to find substantial open market purchases to constitute a tender offer. See *Macke Co. v. Allegheny Beverage Corp.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,612 (D.D.C. July 18, 1980); *Brascan Ltd. v. Edper Equities, Ltd.*, 477 F. Supp. 773 (S.D.N.Y. 1979) (acquisition of over three million shares in two days on American Stock Exchange); *Chromalloy Am. Corp. v. Sun Chem. Corp.*, 474 F. Supp. 1341 (E.D. Mo.), *aff'd*, 611 F.2d 240 (8th Cir. 1979); *Financial Gen. Bankshares, Inc. v. Lance*, Fed. Sec. L. Rep. (CCH) ¶ 96,403 (D.D.C. April 27, 1978). Conversely, when shareholders are actively solicited at a uniform premium over the market price, such purchases may amount to a tender offer. See *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 103 S. Ct. 1522 (1983).

434. In its recommendation 16, the Committee proposed that the minimum offering period for partial bids "should be approximately two weeks longer than that prescribed for other tender offers." See SEC Tender Offer Report, *supra* note 3, at 26. This may mildly reduce the popularity of partial bids, but it overlooks the possibility that some corporations may be of interest only to one bidder because of a unique synergistic fit. Also, the possibility that some bidders—such as Boone Pickens or Carl Icahn—undertake control contests not to win, but to be outbid by a higher bidder, implies that such a longer period may make the partial bid even more attractive to them, because the increased length of time would allow them to orchestrate a contest that leads the target to seek white knights, who in turn compete to outbid each other. Indeed, taken together, recommendations 14 and 16 leave a gaping hole: they restrict open market purchases, but permit the bidder to purchase equivalent amounts by way of a partial bid.

435. See *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y. 2d 684, 421 N.Y.S.2d 877, 397 N.E.2d 387 (1979); *McDaniel v. Painter*, 418 F.2d 545 (10th Cir. 1969). Although *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955), once encouraged commentators to believe that a duty of equal opportunity in control transactions would be judicially created, no subsequent decision has extended its logic this far.

incumbent control group.⁴³⁶ If, however, we deny the incumbent control group the ability to obtain a disproportionate premium for its shares, it predictably will tend to resist takeover bids when the salary, perquisites and psychic income associated with continued corporate office exceed its share of the lesser premium offered equally to all shareholders. No matter how the law seeks to prevent managerial resistance, some low visibility techniques will remain that might not have been utilized if a control premium could have been paid.

Additionally, a twenty percent ceiling emasculates the ability of dissident shareholders to organize a collective resistance to management—either by waging a proxy fight or by agreeing to act collectively with respect to any disposition of their shares. The Advisory Committee appears to have assumed that a twenty percent to thirty percent noncontrolling shareholder inherently threatened other shareholders with the prospect of a low premium takeover. Yet, it is at least as likely that the presence of such a shareholder would reduce the agency costs of corporate governance by providing a better monitor of the incumbent management, thereby benefitting all shareholders.⁴³⁷ In its practical effect, not only would Recommendation 14 inhibit an individual shareholder's ability to assemble a block of shares large enough to make a proxy fight a realistic option,⁴³⁸ but it would also mean that any attempt on the part of shareholders to coordinate their opposition to management would face the predictable response from management that this group was itself a "person" that had illegally crossed the twenty percent threshold. This theory has considerable precedent under the Williams Act,⁴³⁹ and its consequence here is to interfere with entirely reasonable efforts at shareholder coordination. Careful drafting could alleviate much of this problem by defining the term "group" not to include shareholders organized solely for the purpose of conducting a proxy contest,⁴⁴⁰ but the problem remains that shareholders may wish to agree

436. This is, of course, exactly what the Coase Theorem predicts should happen if one management group thinks it can manage another's assets better. See *supra* notes 36-40 and accompanying text.

437. See Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 *J. Fin. Econ.* 275 (1983) (assembly of middle size blocs results in appreciation of share values for all shareholders in empirical study of stock price performance).

438. Professors Easterbrook and Jarrell argue in their dissenting statement to the SEC Tender Offer Report that normally "insurgents must control 30% to make the proxy fight worth the candle." See SEC Tender Offer Report, *supra* note 3, at 93 (separate Statement of Frank H. Easterbrook and Gregg A. Jarrell).

439. See *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971) (four shareholders who agreed to act together and collectively held in excess of requisite filing level found to constitute a group and obligated to file Schedule 13D under Williams Act before any post-agreement actions were taken or purchases made). Although careful drafting might mitigate this problem, it cannot be eliminated, since some collections of individuals or entities (for example, subsidiaries of the same parent corporation) must be treated as a single person if the rule is not to be a nullity.

440. See *infra* note 443.

to act collectively for other purposes as well—in particular, to ensure that some within this group do not abandon the rest by selling their shares back to the target.

Ultimately, the fallacy in Recommendation 14 is that it focuses on the normative goal of equal opportunity,⁴⁴¹ rather than on the practical problem of coercion. If, instead, the objective of regulatory intervention were defined as the reduction of coercive pressure on the shareholders, then a policy of permitting the existing controlling shareholders to transfer control at a premium would not offend this goal. Such a control transfer would not in itself be coercive because it does not occasion any further loss to the shareholders or place them in a position where they must fear such a loss. If there were a preexisting control group, the market price would likely have already reflected this fact, probably before a majority of the current shareholders had purchased their shares. Unlike transfers of existing control blocks, however, partial and two-tier bids create a controlling shareholder where there was none before and thus may transfer wealth. Yet, curiously, they are not precluded by Recommendation 14.

To date, Recommendation 14 has had a critical reception. Already, the SEC has indicated its “serious reservations” about the impact of the proposal,⁴⁴² and others have proposed that the threshold be lowered even further to ten percent.⁴⁴³ In this light, it is useful to ask if any alternative makes better

441. In theory, the existence of a control group should cause the shares of the minority shareholders to trade at some discount from their potential value in the absence of such a group. In this light, the promulgation of recommendation 14 might cause a relative appreciation in share values for minority shareholders since investors would recognize that controlling shareholders could no longer demand control premiums and control could only be acquired through a tender offer.

442. See Hearings of the House Subcomm. on Telecommunications, Consumer Protection, and Finance, *supra* note 351, at 86,679 (statement of John S. R. Shad, Chairman of the SEC). Chairman Shad added: “Further study of the economic implications for the entire change of control area is required.” Sensible as it may be to move slowly in this area, movement is nonetheless necessary.

443. Martin Lipton has proposed legislation that would restrict “creeping control” acquisitions by imposing a 10% ceiling on the stock that might be acquired by any means, other than a direct issuance by the target corporation, before an obligation arose to make a tender offer for all remaining shares. His bill, which has been introduced as H.R. 5693, 98th Cong., 2d Sess. (1984), would add a new section to Section 14 of the Securities Exchange Act of 1934 to impose such a ceiling. See Testimony of Martin Lipton Before the Subcomm. on Telecommunications, Consumer Protection and Finance of the House Comm. on Energy and Commerce, Mar. 28, 1984 (copy on file at the Columbia Law Review).

The Lipton bill is carefully drafted to avoid any application of its 10% group concept to proxy fights or similar disputes. However, in this author’s judgment, it would tend to immunize very large publicly held corporations from the threat of a takeover, because very few bidders could initiate a control contest for a Gulf Oil without first making a substantial acquisition. In contrast, a 30% ceiling would give a bidder the base from which it could seek control through a proxy fight. Also, if the insurgent had a 10% ceiling, it would be unable to use the “equity method” of accounting—reporting as income its share of the target’s earnings—as this method is generally available only if a corporation owns at least 20% of the target’s voting stock. AICPA, *APB Accounting Principles*, § 5131.17 (1973).

sense than the Committee's proposed twenty percent ceiling. The Advisory Committee considered, but declined for the present to recommend, adoption of the British rule, under which an acquirer who crosses the thirty percent threshold must make a mandatory offer for the remaining shares at the highest price it previously paid within a defined period.⁴⁴⁴ Further, under the British system, partial bids are only permitted in limited circumstances.⁴⁴⁵ The obvious effect of the British system is to raise the takeover premium necessary to obtain control. Thus, this approach fits the general policy prescription suggested by this Article.

Yet, at the same time, it is easy to see why the Advisory Committee would have reservations about endorsing such a rule. Several problems must be satisfactorily solved before any rule requiring a mandatory clean-up bid can be recommended as a remedy that is not worse than the disease. First, the incumbent controlling shareholder may once again be locked in if the bidder would be unable to purchase the controlling shares without being required to make a bid for all remaining shares.⁴⁴⁶ Second, the bidder is exposed to the arguably unjustifiable risk of a general market decline between the time it crosses the thirty percent threshold and the time at which the mandatory offer must be made at the highest price paid earlier.⁴⁴⁷ Third, such a rule may chill the possibility of toehold or "beachhead" acquisitions, which are gradually extended by mutual consent into majority ownership.⁴⁴⁸ These slower paced acquisitions may well be socially desirable because they mitigate assimilation difficulties. Finally, a mandatory offer rule may force the acquiring firm to

444. See SEC Tender Offer Report, *supra* note 3, at 26. The Report concluded: "While the British system has considerable attractions, the Committee determined that a more evolutionary development was appropriate. . . ." However, it added that if its recommendations proved ineffective, it would advise "the Commission [to] reconsider incorporation of some features of the British system." *Id.*

445. Basically, the Panel on Take-overs and Mergers must consent to a partial offer. Consent will normally be given only where the bidder will hold less than 30% after completion of the offer or the target's shareholders consent to the offer. SEC Tender Offer Report, *supra* note 3, at 26 n.22. See also DeMott, *supra* note 328, at 330, at 961-62.

446. That is, the incumbent control group is locked in to the extent it demands a control premium. It may be possible, however, for the incumbent control group to sell less than 30% and give an irrevocable proxy with respect to its remaining shares (which here would be coupled with the requisite interest to sustain such an irrevocable transfer). Finally, an exception could be created from the rule for purchases from "grandfathered" groups who held 30% on the date of its effectiveness. Such an approach is followed in Section 13(d)(6)(B) of the Williams Act, which effectively exempts existing shareholders owning more than the requisite 5% level from having to file a Schedule 13D.

447. Of course, this risk is two-sided: the market may also advance and the controlling shareholder may be able to vote through a merger that is below the price that the shares would then bring in an arms-length sale. In any event, market indexes can be used to mitigate these dangers. See *infra* note 450.

448. The SEC Advisory Committee on Tender Offers defended the desirability of partial bids on the grounds that they allowed "acquirers to get to know a potential acquiree over time with a view to moving to 100% ownership." SEC Tender Offer Report, *supra* note 3, at 25.

concentrate its capital on a single investment, thereby reducing the diversification of its portfolio.⁴⁴⁹

Still, all these problems except the last could be resolved satisfactorily with simple draftsmanship. The first problem could be solved if an exception were added to the British rule, permitting a limited group of shareholders to sell at a premium without triggering the obligation to make a follow-up offer. This would remove the inhibition on sales by controlling shareholders. Second, the problem of a general market decline could be handled in a variety of ways. The mandatory offer price could be adjusted downward to reflect the general change in stock market price levels.⁴⁵⁰ Alternatively, the obligation to make a mandatory offer could terminate if the bidder, having crossed the thirty percent threshold, disposed of all its shares in excess of that level within a defined period, such as a year. This would provide an escape hatch that would eliminate any legal obligation to pay a windfall profit to the remaining shareholders if stock prices declined generally. Similarly, a mandatory offer need not preclude toehold acquisitions or a slower-paced takeover process. One answer would be to delay the timing of the mandatory offer. If the obligation were to make an offer within two years after crossing the thirty percent threshold (unless all shares above that level were disposed of within that period), it would be possible to enter into a longer term corporate courtship, which would preserve the possibility of a quick divorce if the trial marriage proved unsuccessful. Conceivably, the threshold could be placed above the thirty percent level, because the objective here is less to prevent the *de facto* acquisition of control than it is to limit the use of coercive tactics.⁴⁵¹

The final problem—that bidders may wish to diversify their investments in order to reduce risk—requires a compromise solution, but also shows the need for a threshold that does not compel the bidder to be a passive investor. Others have urged that the level on open-market and privately negotiated purchases be placed at ten percent in order to prevent “creeping control” acquisitions.⁴⁵² Lowering the ceiling to this level, however, would present the

449. This objection has long been made to any proposal that shareholders be given an equal opportunity to share in a control premium. See Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. Chi. L. Rev. 420 (1965).

450. At least one decision has adjusted a damage award downward under the federal securities laws in order to reflect such a market movement and avoid giving the plaintiffs a windfall profit. See *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (S.D.N.Y. 1971). An economically sophisticated treatment of this topic would also have to factor in the “beta” value of the particular corporation—that is, the particular company’s stock’s volatility in response to a general market movement. On these questions, which are beyond the scope of this Article, see Fischel, *Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law 1 (1982).

451. Alternatively, the threshold could be specified in terms of a phased sequence (for example, 20% within one year, 30% within two years, 40% within three years). This would encourage a slower paced acquisition process in order to evade the rule and thus might mitigate some of the assimilation difficulties which are incident to many corporate acquisitions. See *supra* notes 277–94 and accompanying text. However, at some level (perhaps as high as 50%), the obligation to make a clean-up tender offer for the remaining shares should become unconditional.

452. See Lipton, *supra* note 443.

potential bidder with an even more unattractive "all or nothing" choice. Either it would have to restrict its purchases to a level that realistically would give it little influence over the target, or it would be compelled to acquire all outstanding shares, which might be either financially impossible for many bidders or economically unattractive, given the increased risk associated with holding an undiversified portfolio.⁴⁵³ The practical result might be to immunize large target corporations—such as Gulf, Getty or Conoco—from the threat of either a takeover or a proxy fight, because the only bidders large enough to make a 100% tender offer for them would either have an antitrust conflict or a reluctance to enter the fray as an initial hostile bidder. If, however, we move the permissible level of ownership to somewhere between twenty and thirty percent, the bidder is less restricted in its ability to choose the optimal level of investment in the target. If it wishes, it can anticipate acquiring a significant, and possibly even a controlling, influence over the target. Certainly, the bidder who decides to acquire shares up to a thirty percent level would then be well positioned to launch a proxy fight by which to secure control.

In response, some will argue that a thirty percent shareholder would be able to dominate the target, with the predictable result that the other shareholders would once again be subjected to coercive pressure. Yet, this rebuttal ignores the availability of narrowly limited charter amendments that could block in advance any self-dealing transactions between the thirty percent shareholder and the target, absent shareholder ratification by a supermajority. The availability of such amendments implies that the thirty percent shareholder could acquire control, but not the capacity to exploit it.

Finally, probably the strongest argument for using some variant of the British rule is that its adoption would undercut most remaining justifications for shark repellents and other defensive tactics. Today, the spectre of the exploitative two-tier bid allows management to justify defensive measures that may block all takeovers uniformly. In this light, a mandatory bid rule should be seen as one side of a basic political compromise. Its adoption should be accompanied by closer regulatory restriction of defensive tactics. Although lock-ups and other auction-inducing tactics should still be allowed, the only form of supermajority charter amendment that should escape close and restrictive regulation would be one intended to preserve the status quo between the time the bidder nears the acquisition of *de facto* control at thirty percent and the time of the mandatory bid.

Of course, that such a compromise may be desirable does not mean that it will result. Still, even in the absence of stricter regulation, it is likely that the restriction of partial bids would lead institutional investors to be far more skeptical of shark repellents and to resist their adoption more firmly than they do today. Because a twenty to thirty percent ceiling would imply that the bidder could not force a low premium takeout merger upon unwilling share-

453. See Javaras, *supra* note 449.

holders, the only legitimate objective to be achieved through shark repellents would be to restrict actions by the target's board, after it came under the bidder's influence, that might otherwise result in a piecemeal transfer of the target's assets to the bidder. Once the mandatory bid was made, these restrictions could lapse, and shareholders who rejected the mandatory bid at the highest price previously paid by the bidder could still oppose any proposed merger, but, if unsuccessful, would be required to rely on their appraisal remedy. In substance, the net result of a twenty percent to thirty percent ceiling coupled with a mandatory bid requirement enables shareholders' to raise takeover premiums. This resulting incentive to hold out would mean that we would move from the current era of front-loaded takeovers, which arguably confuse or panic shareholders, to an era of "back-loaded" offers with higher premiums being paid to those shareholders who do not sell to the bidder in the open market. For those concerned with the asserted short-term trading psychology of the American shareholder, this might be taken as a desirable transition in itself, but, even more importantly, higher premiums mean a lower frequency of takeovers in the aggregate.

2. *The Incentive Problem: Why Should a First Bidder Commence a Hostile Tender Offer?* — The statistical evidence is fairly clear that the first bidder generally loses in a competitive bidding contest.⁴⁵⁴ A variety of reasons can be offered to account for this tendency,⁴⁵⁵ but, whatever the explanation, the more significant point is that, as a result, an inadequate incentive may exist for a bidder to initiate a control contest. Not only are the odds high that it will fail to obtain control, but there is strong empirical evidence that its own share value will fall in the wake of its defeat in a control contest over the target.⁴⁵⁶

454. See Ruback, *supra* note 10, at 147 (noting that the first bidder fails to secure control in 75% of cases where a competing bid is made).

455. The target can to a considerable degree tilt the contest in favor of the preferred bidder through the use of stock and asset lock-ups. Additionally, the first bidder may not be truly seeking control; individuals such as Boone Pickens, Carl Icahn and other arbitrageurs sometimes appear to be "psuedo-bidders," who intend only to start a bidding contest. Also, the preferred bidder typically receives confidential information from the target; it thus faces less uncertainty about the value of the target's assets and thus may be prepared to pay a higher price than a hostile bidder which may fear (with good reason) that it is buying the proverbial "pig in a poke." Finally, the second bidder is in fact the highest bidder out of the often substantial population of potential bidders which the investment bankers survey after the initial bid has been made; thus, the real issue is whether any potential bidder will top the first bidder's offer. This factor plus the asymmetry in the information possessed by the contending bidders seem the most persuasive reasons for the relative success of the second bidder.

456. See Bradley, Desai & Kim, *supra* note 92. The risk is not simply that the successful second bidder will fail to acquire the first bidder's shares, but that the second bidder will acquire control through a front-loaded tender offer in which the second-step takeout is at or near the previous market price before the tender offer. This would mean that the first bidder, who probably paid a premium for its shares, would suffer a net loss. The first bidder typically cannot tender its shares in the initial cash tender offer made by the successful bidder without incurring liability under § 16(b) of the Securities Exchange Act of 1934 for the profit it makes on its shares in excess of 10% of the class. See *supra* cases cited at note 90.

At this point, a paradox becomes apparent: without an adequate supply of black knights, there cannot be any white knights. In principle, the answer to this dilemma is to identify and encourage another class of potential bidders who are prepared to initiate a control contest in return for the expected turnaround profit they can realize by tendering to the winning bidder. The most obvious candidates for this role are the risk arbitrageurs who today operate at the periphery of takeover contests. These smaller operators typically lack the resources to win an auction or even to bid for all the outstanding shares of a moderately large corporation. Yet, when organized in groups, they have repeatedly demonstrated their ability to acquire ten to twenty percent of a target corporation, chiefly through open market purchases.⁴⁵⁷ Ideally, this activity can perform a useful social function—initiating the auction contest—while also gaining a substantial profit for these smaller bidders, to whom the short-term gain from tendering to the winning bidder is far from insignificant.

Yet, the activities of these smaller bidders today do not necessarily result in a control contest. Instead, the more common scenario involves the arbitrageur group selling the shares it purchased in the open market back to the potential target at a substantial premium over the market price.⁴⁵⁸ This practice—known as “greenmail”—in effect short-circuits the control contest that should result; rather, there is a perverse auction in which the competing bidders are the target corporation (whose management plainly suffers from a conflict of interest) and any potential bidder (if there indeed is one) actually interested in acquiring control of the target.

In effect, the arbitrageur group extorts the target's management into repurchasing its shares, lest it continue its threatened creeping acquisition. The typical pattern has an easily recognized sequence of events. First, the

457. In the recent control contest over Gulf Oil Corporation, the group of individual and corporate investors organized by Boone Pickens, the chief executive of Mesa Petroleum, first acquired 13.2% of Gulf and then announced a tender offer for 8.2% more. Thus, they had the capacity to acquire at least 21.4% of the ninth largest U.S. corporation. See Cole, *Mesa Bids to Raise Gulf Stake*, N.Y. Times, Feb. 23, 1984, at D1, col. 6.

458. The two names most closely associated with this practice are Mesa Petroleum and Carl Icahn. On three separate occasions in 1982 and 1983 prior to its Gulf Oil adventure, Mesa sold the stock it acquired in a takeover bid at a handsome profit. In September 1983, Mesa sold four million shares of Superior Oil Company (or 3% of those outstanding) back to Superior at a profit of \$32 million. See Daly, *Mesa Posts Profit on Stock Sale*, N.Y. Times, Sept. 2, 1983, at D1, col. 6. Similarly, Mesa made a profit of \$45 million on its sale of General American Oil Company and \$45 million on its sale of the stock of Cities Service Company. *Id.* at D3, col. 3. Carl Icahn has engaged in similar transactions after taking substantial positions in the stock of Dan River, Gulf & Western Industries, Inc., and American Can Co. See What Carl Icahn Wants, *Bus. Wk.*, Dec. 12, 1983, at 116-17.

All signs are that this tactic is on the rise. Simultaneously with Gulf Oil's surrender, Texaco repurchased for a total price of \$1.28 billion a 9.7% stake in itself which the Bass Brothers Enterprises had acquired and on which they earned a \$250 million profit. See Salpukas, *Texaco to Buy Its Stock Back*, N.Y. Times, Mar. 7, 1984, at D1, col. 6; see also Kirkland, *supra* note 131 (survey of recent selective repurchases).

putative bidder will acquire equity securities of the target just in excess of five percent—at which level the Williams Act requires it to file a Schedule 13D and disclose its intentions.⁴⁵⁹ Typically, in disclosing these intentions, the bidder will indicate a desire for control, but will also hint clearly its readiness to resell its shares to the target at a premium. This disclosure advertises to both the target and other potential bidders that its block of shares is available.

The next step is often to propose a fundamental change in the target corporation's policy or capital structure—typically, the sale of a major subsidiary, the closing of unprofitable operations or even a partial liquidation; a proxy fight may also be threatened if target management refuses to accept these recommendations. Although these proposed changes may at times be sensible, their tactical significance is both to increase the willingness of target management to effect a repurchase at a premium and to enhance their legal entitlement to use corporate funds in this manner. Under existing law, the target is permitted to buy out a dissident shareholder, even at a premium, in order to forestall a change in business policy or operations that the board considers undesirable.⁴⁶⁰ Whether or not so intended, the insurgent's proposal legitimates the target's decision to repurchase. Yet, in consequence, this entire process resembles extortion in the eyes of the business community. The result has been both to stigmatize the concept of capital market discipline and to perpetuate the stereotype of the hostile bidder as a disreputable "raider" who intends a speedy and dubious liquidation of the target's assets.

Still, from a corporate accountability perspective, there is potentially more right than wrong with the recurring scenario of the arbitrageur stalking a target which it cannot itself absorb. In general, the targets of such creeping acquisitions have been companies with lackluster market and financial histories.⁴⁶¹ Although the arbitrageur's threat to sell a division or liquidate the company may be motivated by a desire to intimidate management into repurchasing its shares, this threat often has credibility because the proposed sale or partial liquidation is one which financial analysts think advisable. In short, the arbitrageur has identified a legitimate target for a "bust-up" and has

459. Section 13(d) of the Securities Exchange Act of 1934 requires any person who acquires more than five percent or more of a class of equity securities to file a Schedule 13D. Item 4 of Schedule 13D requires the person filing to disclose "any plans or proposals which the reporting person may have which relate to or would result in: (a) The acquisition . . . of additional securities of the issuer, or the disposition of securities of the issuer; (b) An extraordinary corporate transaction . . . involving the issuer." The net result is that this legal requirement can be used both to threaten further purchases and liquidation of the target *and* to indicate a willingness to sell the stock back at a premium. In effect, the disclosure becomes an advertisement.

460. See, e.g., *Heine v. Signal Companies, Inc.*, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,898 (S.D.N.Y. March 4, 1977); *Kaplan v. Goldsamt*, 380 A.2d 556 (Del. Ch. 1977); *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964). *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (Del. Ch. 1960). There are, of course, a number of qualifications in the scope of these cases, but they are beyond the scope of this Article.

461. Among Carl Icahn's targets have been such companies with lackluster earnings histories as Marshall Field, Dan River and ACF Industries, Inc. See, e.g., *What Carl Icahn Wants*, Bus. Wk., Dec. 12, 1983.

proposed a credible scenario for the realization of its latent value. All that has gone wrong is that the discipline of the takeover has been thwarted by the repurchase.

The socially desirable outcome, then, is that the arbitrage group either should sell its block to a true bidder interested in acquiring corporate control or undertake a proxy contest, as has increasingly also happened. If the arbitrage group did sell to another bidder, it would earn a substantial profit for its search activities, and an acceptable solution would have been achieved to the problem of inadequate incentives for the first bidder to undertake a control contest.

But how do we get to this desired state from the current reality? The answer is simple as a problem of implementation, but more difficult as a matter of legal doctrine. The law should forbid a corporation from repurchasing its own shares, except on a basis that provides an equal opportunity for all shareholders to sell their shares, or as specifically authorized by shareholders. Although some other limited exceptions may be justifiable,⁴⁶² privately negotiated non-pro rata repurchases should generally be barred. If this were the law, the takeover process could not be short-circuited by target managements, nor would the polite extortion of greenmail be possible.

A prophylactic ban on non-pro rata repurchases should also reduce the current level of activity among the risk arbitrageurs, because it would eliminate the target corporation as the purchaser of last resort. Arbitrageurs would then run the risk that no other purchaser would pay a premium for the shares they had acquired. This seems desirable, because the absence of a buyer willing to repurchase the arbitrageur's block would mean that they had not truly identified an attractive takeover candidate which was trading at a discount off its potential value. Over time, the arbitrage community would learn to search more carefully before it initiated an auction. Not only would fewer companies face creeping raids, because the game would not be riskless to the arbitrageur, but the risk of inefficient control transfers would also be reduced. Today, even when the arbitrage group initiating the contest has not truly identified a poorly managed company as its target, the target may still feel compelled to seek out a white knight. Yet, this white knight may be a bidder that is less efficiently managed than the target. Its willingness to outbid the initial bidder may be the product of its own desire to maximize growth instead of profitability.

The basic lesson seems inescapable: the best way to resist extortion is to deny oneself the power to pay it.⁴⁶³ In principle, this protection can be achieved through self-help. For example, a corporation by charter amendment

462. Exceptions may be appropriate for shares repurchased from employees in connection with employment severance agreements or for share repurchases in connection with divisive reorganizations (i.e., spin-offs, split-ups, etc.). These problems of draftsmanship are essentially beyond the scope of this Article.

463. A similar point has been made by the game theorist, Thomas Schelling. Sec T. Schelling, *The Strategy of Conflict* 37-42, 137-39 (1960).

could deny its board the power to repurchase its own shares (other than on a pro-rata basis). This would reduce the prospect of a creeping acquisition motivated by the acquirer's hope for a short-term profit. Yet, the fact that such charter amendments are not adopted today seems evidence of management's conflict of interest. Rather than surrender any discretion, management insists on preserving its vulnerability to extortion in order to "protect" itself in the event that a "raider" does appear on the horizon to threaten its control.

A legal rule proscribing most non-pro rata repurchases could be easily enforced because large purchases are easily detectable. Such a rule would also be virtually costless in terms of economic efficiency, because there is seldom a legitimate reason for selective repurchases when most corporations could issue authorized, but unissued, shares at almost any time. Nonetheless, courts have shown considerable tolerance for substantial share repurchases in the middle of takeover battles and have not subjected such transactions to the rules applicable to self-dealing transactions.⁴⁶⁴ This tolerance may be attributable both to the general reluctance of courts to impose liability on directors who do not personally profit and to a judicial inability to take an *ex ante* perspective. If one perceives the hostile bidder as a potentially sinister raider, then, from an *ex post* perspective, it may seem important to preserve the corporation's flexibility to resist. However, from an *ex ante* perspective, this flexibility is undesirable, because it increases the possibility of the very abuse that it purportedly seeks to prevent.

Although it may still be hoped that courts will tighten the ambiguous rules on non-pro rata share repurchases, other means need to be considered by which to restrict such repurchases. Earlier, this Article suggested that stock exchange rules provide one vehicle for reform, and the SEC has recently proposed legislation to this same end.⁴⁶⁵ Either way, the remedy should be applicable to the bidder whose shares are repurchased as well as to the target corporation, and thus any premium the bidder received could potentially be recaptured directly from it.⁴⁶⁶

In summary, a prohibition on selective share repurchases and adoption of some variant of the British mandatory offer rule both have the effect of decreasing takeover frequency. Barring selective share repurchases would deter the current phenomenon where groups of individuals assemble large blocks through open market purchasing, because these groups could no longer look to the target corporation as a purchaser of last resort. With the frequency of

464. See cases cited *supra* note 460.

465. See *supra* note 318. Even if this legislation were enacted, however, there would also need to be restrictions placed on standstill agreements, because there would remain other ways by which to "bribe" a potential insurgent not to undertake a control contest. See *supra* note 353. Restriction of standstill agreements would make such side payments far more difficult to negotiate, because the target could not be effectively assured of security.

466. This is an important point because it permits the court to recover the premium without imposing financial liability on corporate officials, which courts appear reluctant to do, and it chills the eagerness of the insurgent group to devise evasions of the rule as long as the liability falls on others. See *supra* note 9.

this practice reduced, there would be less need for a lowered ceiling on open market purchases, such as the twenty percent rule proposed by the SEC's Advisory Committee on Tender Offers.⁴⁶⁷ In turn, this limitation on share repurchases would convert the arbitrageur from being a market parasite to a true entrepreneur whose specialty is to search out and identify undervalued or inefficiently managed companies. So converted, the arbitrageur would perform a socially useful "pump priming" function under which it risks its capital in the hopes of either winning an eventual proxy fight to obtain control or initiating an auction that it does not expect to win.

CONCLUSION

The overall impact of the takeover phenomenon on the American economy is still not well understood. On one hand, the claim that hostile takeovers generate a disciplinary force that constrains managerial behavior cannot seriously be disputed. But enforcing greater sensitivity to the market's judgment is not inherently desirable if internal monitoring forces have superior information to that possessed by the market. Thus, what the most zealous proponents of the takeover have overlooked is that there can be too much of even a good thing. Accordingly, if one believes that the current level of takeover activity exerts an influence that is, on balance, desirable (as this Article would tentatively conclude), it does not follow that more is better. All mechanisms of corporate accountability can be carried to excess and can result in over-deterrence. In this respect, the hostile takeover is no different than other punitive techniques of corporate accountability, such as shareholder litigation or criminal enforcement. By analogy, if one were at every available juncture to tilt the balance of advantage in shareholder and derivative litigation in favor of the plaintiff, the result might be to maximize deterrence, but also to chill entrepreneurial risk taking and encourage frivolous litigation. Similarly, a systematic policy of reducing the takeover premium to a minimal level seems likely to produce its own diseconomies.

None of the diseconomies principally discussed in this Article—inefficient control transfers, the distorting impact on the executive labor market, or the shift toward risk preference—can be quantified, nor is it asserted that they justify policies that would seek to reduce substantially the current level of takeover activity. This hesitation about seeking to reduce the pace of takeover activity arises principally because the contemporary market for corporate control is already a competitive one in which the existence of high takeover premiums mitigates the effect of these diseconomies. The central contentions of this Article are then two-fold. First, there are important public policies that require the preservation of a competitive auction market for corporate control. Second, the market for corporate control resembles other markets in that market failure is possible, and thus some forms of regulation are desirable.

467. See *supra* notes 431-53 and accompanying text.

An optimally designed auction market would have several features not present in current law or practice: Partial bids would be severely restricted; greenmail would be prohibited, and most defensive tactics would require specific shareholder approval, but target management would be allowed an effective opportunity to make a counter-bid. Still, the enlightened regulatory objective is a modest one—the preservation of a viable auction market, in which substantial takeover premiums make the hostile tender offer the remedy of last resort and not the first line of defense. Regulation must also be conscious of the need for balance and the danger of any sudden tilt in the direction of either side in corporate control contests. Here, the SEC's pending legislative proposals may be faulted, because they focus disproportionately on the target and do little to restrict creeping control contests or partial bids.⁴⁶⁸ Thus, they will predictably intensify the pace of takeover activity, even if only modestly.

How high should takeover premiums be? True believers—either in the utility of the takeover or the sanctity of management—have ready, if antithetical, answers to this question. In contrast, in favoring an auction market, this Article does not intend that takeover premiums should be either maximized or minimized. All that can be said is that the risks associated with their reduction seem at least as great as those applicable to their enhancement. Even more clearly, these risks fall on different classes and thus raise a legitimate normative question. Still, given the uncertainties, the least restrictive form of regulation seems best. Absent federal legislation, stock exchange rules and listing agreements appear to offer the best vehicle by which to generate reasonable—but specific—parameters instead of the rigid—but vague—prophylactic rules that others have urged. Such a regulatory structure both avoids the necessity of high financial penalties and recognizes that corporate law fundamentally establishes a governance structure within which the participants are entitled to pursue their own legitimate self-interests. In contrast, a policy aimed at either maximizing or minimizing the frequency of takeovers subordinates the private ordering character of corporate law to the attainment of public policy goals.

Given the currently competitive character of the market for corporate control, there is little evidence that public and private interests diverge significantly at present. If the demand for corporate control is inelastic (as it appears to be), then the same policies that maximize shareholder welfare by ensuring that a high premium must be paid to acquire control should also enhance the

468. The SEC's legislative proposals essentially focus only on abuses by the target. They would sensibly seek to restrict self-tenders, selective share repurchases, and golden parachutes and would limit post-tender offer stock lock-ups to five percent of the class of securities. See *supra* note 318. However, they would impose only one modest incremental restriction on the bidder: the 10-day interlude between the moment a bidder crosses the five percent threshold and the day it would be obligated to so notify the target would be sharply reduced. *Id.* While this would eliminate "sneak attacks" and would prevent "cheap" pretender purchases of the target's stock, these proposals would do nothing to restrict partial bids, two-tier pricing or creeping control acquisitions.

welfare of non-shareholder classes by reducing the frequency of hostile takeovers, thereby mitigating the possible diseconomies associated with them. Nonetheless, to the extent one believes that the frequency should be reduced below this current level, the least objectionable way to achieve this end is to set the threshold at which a mandatory tender offer must be made at a progressively lower level, thereby both restricting the "creeping control" acquisition and enhancing equality of treatment among shareholders. But any more radical restructuring of the corporate market place seems undesirable, and this Article has proposed only modest reforms. When the interests of public and private welfare dovetail, as they currently appear to, the course of wisdom is to make haste slowly.