tunity to evaluate proposals of value to themselves, if not to society, and should be prohibited unless compelling reasons exist to reject these benefits.

Section B considers the most persuasive justifications for shark-repellent amendments: 1) shareholder ratification; and 2) management's obligation to protect the interests of the corporation, the shareholders, and (possibly) nonshareholder groups. For reasons to be discussed, these justifications are deficient. The article concludes, in Section C, by proposing a new legal framework for assessing shark-repellent amendments. Amendments whose value arises solely in the takeover context would be barred *per se*. Amendments that can operate under normal business conditions introduce additional justification but ultimately require treatment nearly, and in some cases equally, as strict.

A. *The Benefits of Tender Offers*

In publicly held corporations the separation of ownership and control removes shareholders as a realistic check on managerial inefficiency.[191] Since most shareholders diversify their investments as a means of spreading risk, they often lack a sufficient financial interest to police the management of any given firm. They also lack incentives. Even if a shareholder or group of shareholders could determine that management was inefficient, the cost of acquiring that knowledge might not be offset by the gains from new management, which would be enjoyed by all investors. Moreover, the insurgents would still have to persuade other shareholders to replace incumbent directors. Both the cost of a proxy fight and management's domination of the proxy machinery render internal upheaval unlike-

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fit, since the interests of shareholders who sell may not outweigh the interests of shareholders who retain their stock and discover that the quality of their investment has changed. Courts have been relatively liberal in allowing share transfer restrictions (such as the right of first refusal) in order to preserve shareholder expectations in closely held corporations. *See generally* Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 278-80 (1967). Although that approach is facially at odds with the free transferability argument presented in this article, it is not inconsistent with the analysis upon which the argument is based.

191. *See, e.g.*, Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AMER. ECON. REV. 777, 788 (1972); Easterbrook & Fischel, *supra* note 13, at 1170-71; Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 291 (1980) [hereinafter cited as *Agency Problems*]; Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, (1980). For an early—and pioneering—study of the separation of ownership and control, *see* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968), first published in 1932. *See also* Weiner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388 (1977).

ly.[192] Assuming that management will not perform an effective self-regulatory function,[193] an external monitor is required in order to transfer control.

Unrestricted transferability of shares is the prerequisite for such a monitor.[194] Shareholders who cannot, as individuals, exert direct influence over management have the power—by selling out—to indirectly control their agents.[195] The tender offer, which aggregates the voting power of many shareholders and thereby reunites ownership and control, represents one means of achieving this result. The threat of a tender offer, and the resulting fear of replacement, should induce target management to maximize the value of the firm.[196] It can accomplish this objective by operating the enterprise as efficiently as possible and by distributing to shareholders a portion of the profits (through dividends). If management fails to behave in this manner, either because it is incompetent or because it deliberately ignores shareholder interests, then the corporation is a prime takeover candidate. Presumably outsiders will recognize that corporate earnings could be higher and will wish to take advantage of an attractive investment opportunity. In either scenario—improvement from within or tender offer from without—the corporation benefits, although in the latter situation some of the shareholders will benefit by selling their interest in the gains from improved management.

This model was first introduced by Henry Manne.[197] In Manne's view, control constitutes a valuable asset which is sold in an active market. The sale can occur through mergers, proxy fights, open market purchases of stock, negotiated transactions, and tender offers. To some extent, shifts in control may be attributable to factors unrelated to managerial efficiency: a corporation's desire to 1)

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192. *See* PROXY CONTESTS, *supra* note 43, at 9.

193. *But see infra* text accompanying note 216.

194. *See, e.g.*, Alchian & Demsetz, *supra* note 191.

195. Of course, the shareholders who sell may do so because of the premium they are offered, and not because they are particularly dissatisfied with management. This attitude is consistent with the separation of ownership and control. Regardless of the shareholders' motives, however, the sale may benefit the corporate entity.

196. The maximization argument is not without limits. This article does not argue, for example, that a corporation should never make a charitable contribution because such payments may reduce corporate profits. This issue is beyond the scope of the article and, for simplicity's sake, will not complicate the analysis presented here. It should be noted, however, that the argument favoring management's abandonment of pure profit maximization in favor of a recognition of "social interest" does not compel approval of the use of nonfinancial factors when management determines how to respond to a tender offer.

197. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) [hereinafter cited as *Corporate Control*].

achieve economies of scale (by acquiring another corporation it might be able to increase production and reduce unit costs), 2) earn monopoly profits (resulting from the elimination of a competitor), or 3) merely make a safe investment (not intending to alter corporate practices). These factors may explain the existence of "friendly" tender offers.[198] The corporation seeking control might also anticipate the kinds of rewards that will not be shared with target shareholders: high salaries and other perquisites for top management, as well as access to corporate funds. At its extreme, the last possibility constitutes the "looting" that target management sometimes views as the dominant motive for making a tender offer.[199] Whether this fear is a sufficient basis for defensive action will be explored—and rejected—in Section B.

The presence of several motivating factors in the market for corporate control does not undermine the impact of tender offers and other forms of takeover on target management. Certainly it is not necessary to claim that ineffective management provides the sole reason for a takeover. Yet Manne based his model on the belief that takeovers prompted by managerial inefficiency are a significant, if not the dominant, force in this market.[200] He reached this conclusion because of the ease with which outsiders can determine when management should be removed. In order for any market to function, participants must have information which will enable them to make accurate purchasing decisions. Manne and others have concluded that such information comes from the stock market.

The crux of their analysis is that stock markets (unlike managers) are inherently efficient.[201] The market "responds immediately to relevant information that any trader may have and never attaches the

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198. The number of contested tender offers has dropped sharply since 1972. In 1972, sixty-five percent of all tender offers were opposed by the target. In contrast, less than thirty percent of all tender offers were opposed during 1978 and slightly less than twenty percent were opposed during the first half of 1979. Austin, *supra* note 1, at 17. The reason for the change may be the factors cited in the text or, on a more cynical note, the possibility that bidders are "buying" the acquiescence of target company management.

199. *See, e.g.*, Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979).

200. *See Corporate Control, supra* note 197, at 113.

201. Manne did not discuss this phenomenon in depth. *See id.* at 112 n.10. Other writers have examined the stock market in more detail. Their conclusion is known as the "efficient capital market hypothesis." For the relationship of the hypothesis to tender offers, see Easterbrook & Fischel, *supra* note 13, at 1165-68; Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978). *See also* Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

wrong evidentiary weight to the information." [202] If management is suboptimal and earnings reflect that fact, the corporation's stock will be depressed relative to that of comparable firms with better management. Managerial inefficiency is, in a sense, embedded in the stock. Outsiders will recognize this problem and attempt a takeover.[203] According to the theory, the transfer of control should be encouraged since the bidder's self-interest in enhancing its investment must carry with it at least the expectation of better management and improved performance. Moreover, the premium paid to target shareholders is viewed as an approximation of the extent to which the tender offer improves the allocation of resources by eliminating inefficient management.[204] These investors will therefore share in the

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202. Fischel, *supra* note 201, at 1.

203. The existence of transactions costs will not make a takeover automatic. One study has concluded that transactions costs equal at least thirteen percent of the market price of the target's shares after the offer. This means that management need not worry about the threat of a tender offer until the value of the firm's shares has dropped thirteen percent; alternatively, there is no assurance that the value of any firm is more than eighty-six percent of its potential value were it to be operated in an optimal fashion. Smiley, *Tender Offers, Transactions Costs and the Theory of the Firm*, 58 REV. ECON. & STAT. 22, 30 (1976). Transactions costs include: 1) fixed costs of the tender offer (legal fees, publication expenses, etc.); 2) variable costs (broker's fees and transition costs incurred in improving the firm's performance); 3) an increase in the market price of the stock immediately prior to the announcement of the offer (if news of the imminent offer is leaked); and 4) the premium. *Id.* at 22-23.

204. *E.g.*, Easterbrook & Fischel, *supra* note 13, at 1173. The shareholders will not receive the full amount of the improvement, of course: otherwise, the bidder will not make a profit. Two commentators have argued that some shareholders recognize the divergence between the premium and the anticipated benefits from new management and accordingly fail to tender. Acting as free-riders, they believe that a sufficient number of investors will approve the tender offer, leaving the non-tendering minority in a better position than if it had sold its stock to the bidder. Grossman & Hart, *supra* note 191, at 43. If enough shareholders reason in this manner, their behavior can thwart deals which are socially desirable. Grossman and Hart write that the problem is not as severe if shareholders and bidders have different expectations concerning future benefits (after all, the premium is tangible while expectations are not), or if shareholders allow bidders to create such a divergence by diluting the value of a minority interest in the corporation. Dilution would occur, for example, if the successful bidder paid new management excessive salaries or merged out the minority at a price that did not reflect the value of the assets transferred. *Id.* at 46. Grossman and Hart conclude that dilution is essential in order to ensure the success of tender offers and thereby penalize bad management, since the threat of dilution will induce shareholders to sell their stock. *Id.* at 47, 59-60.

Although the preceding analysis does provide a solution to the free-rider problem, it also distorts shareholder decisions in an undesirable way. Shareholders should not be forced to accept a tender offer solely because they fear unfair treatment in the post-offer period. Free-rider considerations do not constitute the only basis for rejecting a tender offer; the Grossman and Hart argument requires that shareholders approve of the bidder, an assumption that will not always hold true. Moreover, enabling management to receive excessive salaries and cause unfair mergers makes a mockery of the concept of fiduciary duty. In cases where the bidder wants to cause a freezeout, it should be noted that a "neutral" rule would also overcome the free-rider problem. Such a rule requires the bidder to pay the tender offer price in the freeze-

anticipated gains from the transfer of control even as they leave the corporation.

The stock market analysis may appear simplistic in two respects. First, *is it true that stock prices accurately reflect corporate performance?* If the market is wrong, then a tender offer may not increase the value of the firm. Supporters of the "efficient capital market hypothesis" respond that such aberrations are temporary at best. Should the market guess incorrectly about a corporation's performance and future prospects, sophisticated investors will buy the stock and, through their own efforts, help restore the true value.[205] Even without widespread dissemination of the correct information, the market will respond in the proper manner. Indeed, whether they own stock or not, insiders have an obvious incentive to correct the market's misperceptions.[206]

Second, *is it true that corporate performance accurately reflects managerial effectiveness?* If poor performance can be explained by nonmanagerial factors, then, once again, a takeover may not benefit society. Here the response is somewhat complicated. Managerial talent is obviously not the sole determinant of corporate earnings. Earnings may also be low because of unanticipated changes in the supply of inputs or an increase in the intensity of foreign competition. All corporations may be affected by a recession or by government policies adverse to business. Yet, to the extent that these problems are beyond management's control, they are unlikely to provoke takeovers. A rational corporation would not make a tender offer and pay a premium price for an unprofitable situation it could not improve. Thus, as a matter of hindsight, it is probable that takeovers of lagging firms reflect a high correlation between managerial performance and corporate performance. In this context, other explanations for below normal returns lose much of their relevance.

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out and to announce its intentions at the time of the tender offer. In determining their response to the tender offer, shareholders would recognize that they could not receive more than the tender offer price. As a result, a decision to reject the bidder would not reflect a free-rider bias. It may be that fewer offers would succeed than in the dilution model, but the result is certainly more fair.

205. *See, e.g.*, Easterbrook & Fischel, *supra* note 13, at 1165-68.

206. Restrictions on insider trading prevent management from trading in the corporation's stock if material information has not been disclosed. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Thus, if the reason for the market's behavior is its ignorance of favorable information (as opposed to a more generalized pessimism about the firm's future), management cannot correct the market by purchasing the stock until it discloses the information. Yet disclosure will in and of itself perform the corrective function (and eliminate potential trading gains for management).

Stock prices provide a compelling reason for firms to enter the market for corporate control. According to Manne, the stock market represents "the single great protective device for shareholders." [207] What Manne did not explain fully was the reason why a tender offer is the most desirable of the various mechanisms for shifting control. For instance, a corporation which acquires a minority interest in the target should decide that a proxy fight is unappealing for the same reasons that individual shareholders find the technique ineffective.[208] Large open market purchases are expensive when shares are widely dispersed because SEC disclosure requirements [209] will contribute to an increase in the market price when it becomes apparent that the outsider is seeking control.[210] Negotiated transactions are desirable only when there are a few controlling shareholders (and if that is the case, the shareholders are likely to be management).[211] Finally, mergers require management's approval,[212] a factor which may force the outsider to make a tender offer. Manne recognized that management will try to appropriate part of the value of control because of its ability to block the combination: "When we find incumbents recommending a control change, it is generally safe to assume that some side payment is occurring." [213] At least when a hostile tender offer is made, shareholders, not management, receive the full premium.

Since Manne introduced his theory, attempts have been made to empirically assess the performance of target corporations. Evidence exists to support the conclusion that bidders are attracted to firms which are poorly managed.[214] Other writers have expressed skepticism over the efficiency attributes of tender offers and question the importance of shifts in control as a management-checking tech-

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207. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1431 (1964) [hereinafter cited as *Share Voting*].

208. *See supra* text accompanying note 192.

209. *See* 15 U.S.C. § 78m(d)(1) (1976) (disclosure by five percent owner).

210. Fischel, *supra* note 201, at 6.

211. *Id.*

212. *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 75 (1971).

213. *Corporate Control, supra* note 197, at 118. The side payment may be blatant or disguised through lucrative employment contracts, stock options, etc.

214. *See, e.g.*, E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 2-7 (1973); Austin & Fishman, *The Tender Take-Over*, 4 MERG. & ACQ. 4 (May/June 1969); Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV. 135 (March/April 1967); Kummer & Hoffmeister, *Valuation Consequences of Cash Tender Offers*, 33 J. FIN. 505 (1978). The data is not very current, however. The most recent study, conducted by Kummer and Hoffmeister, examined tender offers through 1974. *See also* Brudney, *A Note on Chilling Tender Solicitations*, 21 RUTGERS L. REV. 609, 631 (1967) [hereinafter cited as *Tender Solicitations*]; Fischel, *supra* note 201, at 7-8.

nique. They suggest that target companies are generally well-managed and profitable.[215] Additionally, they claim that a managerial market (composed of outsiders and insiders seeking to displace top executives) is the most significant influence on managerial performance.[216] The implication is that bidders do not care (or do not need to care) about improving performance and merely wish to make a safe investment; accordingly, there is no reason for society to enforce rules protecting their behavior.

This approach is clearly erroneous. Although the criticism will be valid in certain cases, it is inappropriate to generalize and conclude that all tender offers fit a certain pattern. In many instances the availability of a tender offer as a management-checking technique will prove decisive. Moreover, even if bidders do not, *ex post*, improve corporate performance, shareholders who are offered a premium for their shares benefit by being able to sell at a price above the market. Unless opponents of tender offers can point to persuasive evidence that tender offers actually harm society, it is senseless to deny shareholders the right to sell their property to whomever they choose. As Section B reveals, this evidence does not exist.

B. *Justifications for Shark-Repellent Amendments*

1. The Principle of Noninterference

The analysis presented in Section A leads to the conclusion that target company management should not interfere with tender offers. Self-interested directors will not produce a result more desirable than that produced by the market for corporate control, especially since the primary function of the market is to replace inefficient management. In particular, shark-repellent amendments distort the market because they impose a restriction on the free transferability of shares.[217] When tender offers are deterred by shark-repellents, shareholders lose opportunities to sell their stock at an attractive price; indeed, because of the likelihood that management will be en-

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215. *E.g.*, *Corporate Takeovers are Here to Stay*, FORTUNE, May 8, 1978, p. 91; Gelfond & Sebastian, *Re-evaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403, 453-58 (1980); Steinbrink, *supra* note 14, at 887; Troubh, *Characteristics of Target Companies*, 32 BUS. LAW. 1301 (1977) (reasonably successful companies with unaggressive management); Comment, *Economic Realities of Cash Tender Offers*, 20 ME. L. REV. 237 (1968).

216. *E.g.*, *Agency Problems*, *supra* note 191, at 292-95.

217. *Cf.* Mobil Corp. v. Marathon Oil, [1982] 14 SEC. REG. & L. REP. (BNA) No. 1, at 49, 53 (6th Cir. Dec. 23, 1981) (target held to violate Exchange Act on a finding that it had engaged in certain defensive tactics which "artificially affect, [and] for all practical purposes completely block, normal healthy market activity").

trenched, the stock should trade at a lower price than it would under normal conditions.[218]

This Section examines the justifications for permitting charter amendments to undermine the principle of noninterference. These justifications are both procedural and substantive. In neither case do the arguments favoring shark-repellents provide compelling reasons for abandoning the benefits of tender offers.

2. Procedural Justification: Shareholder Ratification

Most shark-repellent cases place strong, and often conclusive, weight on the aspect of shareholder ratification.[219] As one commentator has written, it is currently difficult to attack the validity of an amendment adopted by the shareholders after "full and fair" disclosure, "even though one of the purposes and effects of the provision would be to maintain the present management in control." [220] If shareholders are willing to approve provisions to deter tender offers, why deny them such freedom? We might argue that they have the right to receive tender offers—but don't they have the right to decide how to run the corporation? Indeed, since shareholders commonly approve shark-repellents, perhaps tender offers are less desirable than the analysis in Section A indicates.

A procedural justification for shark-repellent amendments is actually very convenient. It diverts attention from broader issues—societal benefits and managerial self-interest—and imposes a mechanical test. So long as a sufficient number of shareholders approve, the interests of other groups can be discounted, if not discarded. Emphasizing ratification also undermines the argument that shark-repellents restrict shareholder freedom, since voting is itself a part of that freedom. If shareholders were forbidden to enact shark-repellents, then their freedom would be restricted in another way.

These arguments derive support from a long line of cases examining self-interested transactions by management. Self-dealing, a situation where an insider has decision making influence on both sides of a corporate transaction, is analogous to management's position when it proposes charter amendments. In self-dealing cases management may appropriate a tangible part of the corporation's wealth; for

218. Fischel, *supra* note 201, at 31.
219. *See supra* pp. 58-64.
220. Mullaney, *supra* note 21, at 1454.

example, by selling assets to a corporation it controls [221] or by voting itself stock options.[222] When the transaction occurs at an unfair price, the insider receives something at the expense of the shareholders.[223] When management proposes a shark-repellent, it also receives something that the shareholders do not receive: job security. We might conclude that the amendment benefits the corporation (as self-dealing might, if the terms of the transaction are fair), but it cannot be denied that a conflict of interest is present.

Courts have resolved the conflict of interest in self-dealing cases by establishing a dual test. Ordinarily, management must prove the "intrinsic fairness" of the transaction.[224] However, when disinterested shareholders ratify the transaction, the burden shifts to complaining shareholders to show that "no person of ordinary, sound business judgment would be expected to review the consideration as a fair exchange for the value which was given." [225] Less than unanimous ratification will not preclude a lawsuit against directors (alleging fraud or a gift of corporate assets) because an "unconscionable deal between directors personally and the corporation they represent could not become conscionable merely because most of the stockholders were either indifferent or actually in sympathy with the directors' scheme." [226] Yet the practical effect of the allocation of the burden of proof is to insulate many questionable activities from meaningful review. If the same standard is applied to shark-repellent cases, then the business judgment test easily validates these provisions. Shareholders must essentially prove that management has an evil motive; such proof is virtually impossible given the fact that benign justifications (shareholder protection being one of them) are conceivable.

The issue, then, is whether existing legal authority and assertions of shareholder "free will" are sufficient to resolve the policy problems created by shark-repellent amendments. The answer is *no*. To begin with, the significance of tender offers is too important to be bar-

221. *See, e.g.*, State *ex rel.* Hayes Oyster Co. v. Keypoint Oyster, 64 Wash. 2d 375, 391 P.2d 979 (1964).

222. *See, e.g.*, Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 177, 91 A.2d 57 (Del. 1952).

223. The merger of a subsidiary into a parent presents a similar set of problems. *See, e.g.*, David J. Greene & Co. v. Dunhill Int'l, 249 A.2d 427 (Del. Ch. 1968).

224. *E.g.*, Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976).

225. 2 W. FLETCHER, *supra* note 37, § 764, at 121 (Supp. 1980) (footnote omitted). *See also* Cohen v. Ayers, 596 F.2d 733 (7th Cir. 1979); Michelson v. Duncan, 407 A.2d 211 (Del. 1979); Gottlieb v. Heyden Chem. Corp., 32 Del. Ch. 231, 83 A.2d 595 (1951), *rev'd*, 33 Del. Ch. 82, 90 A.2d 660 (Del. 1952), *reh'g granted*, 33 Del. Ch. 177, 91 A.2d 57 (Del. 1952).

226. Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 82, 91, 90 A.2d 660, 665 (Del. 1952).

gained away by shareholders. Once we decide that tender offers are an important mechanism of corporate control, there is no reason why that mechanism should not predominate as a matter of policy. Corporate law imposes many substantive restrictions on corporations and this would be but one more.

Next, the obvious self-interest of management in proposing shark-repellents cuts against ratification as an excuse for weak judicial review. The "free will" argument assumes that shareholders base their decisions on full knowledge. Although corporate proxy statements are generally quite frank in explaining the effect of a shark-repellent, the ramifications of self-interest are less clearly explored.[227] Such behavior is understandable, for rational directors would not disclose improper motivations to their intended victims. It does, however, indicate that shareholders may not have material information when they approve shark-repellents. Indeed, given the limits of disclosure, the traditional treatment of self-dealing is similarly open to attack.

The "free will" approach also assumes that ratification provides an accurate reflection of shareholder desires. This assumption is without merit. Writers have long recognized the infirmities inherent in the corporate voting process.[228] The Exchange Act's orientation towards disclosure does not force shareholders to exercise their voting rights. Under normal conditions, the average shareholder in a publicly held corporation will fail to vote or will automatically return a proxy favoring management's position.[229] His apathy is rational because the costs of self-education are personal while the benefits from informed voting are shared by all investors.[230] Additionally, small

227. *See supra* pp. 52-58.

228. *See, e.g.*, Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 998, 1032-36 (1981); Chayes, *The Modern Corporation and the Rule of Law*, in THE CORPORATION IN MODERN SOCIETY 25 (E. Mason ed. 1959); Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 779-85 (1979); Rostow, *To Whom and for What Ends is Corporate Management Responsible?*, in THE CORPORATION IN MODERN SOCIETY 46 (E. Mason ed. 1959); Manning, *Book Review*, 67 YALE L.J. 1477 (1958) (reviewing J. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958)). *But see* Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1 (1969) (defending shareholder approval of "structural" decisions, such as mergers, sales of assets, liquidations, and certain charter amendments). For a discussion of possible ways of improving the voting process, including increased disclosure and greater reliance on outside directors, see Feis, *Is Shareholder Democracy Attainable?*, 31 BUS. LAW. 621 (1976). This article accepts the existing voting structure as a given and considers neither the value nor feasibility of such reforms.

229. *See, e.g.*, A. FREY, J. CHOPER, N. LEECH & C. MORRIS, CASES AND MATERIALS ON CORPORATIONS 399 (2d ed. 1977). Even if some shareholders take an active interest in corporate policy because of the size of their holdings, the apathy of the majority nevertheless undermines the value of the voting process to shareholders *as a group*.

230. Clark, *supra* note 228, at 779-81.

shareholders, recognizing that their votes carry little weight, may believe that they can rely on other shareholders to make the proper decision. Of course, if enough shareholders lack the foresight to appreciate the implications of such behavior, the "free ride" becomes no ride at all.[231]

The lack of incentive to oppose management is another result of separating ownership and control in publicly held corporations.[232] It pervades most instances of shareholder voting, ranging from the selection of directors, to the ratification of self-dealing and other corporate transactions,[233] and even so far as structural changes, such as mergers, which significantly alter (and may terminate) the shareholders' investment in the corporation.[234] Shark-repellent amendments provide another example. Shareholders will not read proxy materials if the costs of self-education are great in relation to the anticipated decline in share prices produced by the shark-repellents.[235] This factor explains why institutional investors are likely to vote against shark-repellents.[236] The fixed costs of reading the materials are less significant as the variable costs created by the change in share value (the number of shares times the drop in price) increases.

The general ineffectiveness of shareholder involvement in corporate decision making does not mean that voting is *always* worthless. When the separation of ownership and control is attacked or eliminated, voting assumes critical importance. If a major shareholder wages a proxy contest against management, the publicity and recognition of high stakes may induce other shareholders to join in the battle.[237] At the very least, the adversary nature of the contest en-

231. *Id.* at 783-84.

232. *See supra* text accompanying notes 178-80.

233. *See* Brudney & Clark, *supra* note 228.

234. *See, e.g.*, Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 300-04 (1974) [hereinafter cited as *Fair Shares*]; Clark, *supra* note 228, at 780. *But see* Eisenberg, *supra* note 228.

235. Fischel, *supra* note 201, at 31.

236. *Id.* at 31 n.102. *See also* A. FLEISCHER, *supra* note 21, at 8; 1 M. LIPTON & E. STEINBERGER, *supra* note 17, § 6.2.3, at 265. Although the large portfolios of institutional investors suggest that these shareholders could exert continuing control over management, such has not been the case in practice. Because institutions perceive their primary responsibility as running to *their* investors rather than to the shareholders of the corporations in which they invest, they tend to sell their stock if they lose confidence in management. They will not wage a proxy fight against a management they oppose. Institutional investors do, however, play an important role in mergers and tender offers. *See generally SEC Institutional Investors Study Report—Summary*, [Special Studies Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 74,701 (1971).

237. Manne, however, wrote that the free-rider problem applies in this context as well as in uncontested board elections. This is because shareholders may feel that their financial interests are the same as other shareholders; as a result, they can rely on the majority to reach the proper decision. *Share Voting*, *supra* note 207, at 1441-42. A more fundamental problem with the proxy scenario is the infrequency

sures that shareholders will receive continual reminders of the value of their votes. Similarly, voting is the key to a tender offer. The bidder hopes to purchase enough stock to exercise control; it buys the prospect of an appreciated investment along with the votes which help guarantee future appreciation. As for the shareholders, they will pay attention to the tender offer because the premium appeals directly to their interests as investors. Since shareholders can obtain something of value at very little cost, they have an incentive to sell their stock and effectively "vote" for a transfer of control. Thus, it is the tender offer itself, and not the adoption of shark-repellent defenses, which proves the validity of shareholder voting.

3. Substantive Justification: Protection of Affected Interests

The inadequacy of the procedural justification for shark-repellent amendments eliminates a simple reason for approving these provisions. Substantive justifications are more complicated. The general argument favoring shark-repellents is that management has an obligation to uphold the interests of the corporation, its shareholders, and even society in general. As a result, management should have the discretion to block tender offers or, at a minimum, compel bidders to negotiate with it. The argument can be broken down into four related parts: 1) protecting society (by taking nonfinancial factors into account when determining how to respond to a tender offer); 2) protecting the corporate entity (from looters); 3) protecting shareholders prior to a tender offer (by requiring negotiation); and 4) protecting minority shareholders in the event that a tender offer succeeds (through fair price and related provisions). To some extent the justifications overlap: protecting the corporation from looters really protects the minority shareholders who fail to tender and the consumers who purchase the corporation's output; similarly, negotiation may help everyone. And in each case management self-protection may be the overriding motive. Conceptually, however, it is useful to examine the interests of the various groups affected by a tender offer.[238]

a. *Social Interests*

As previously discussed,[239] one type of shark-repellent amendment enables management to rely on nonfinancial factors if it recom-

with which shareholders will overcome the apathy and cost factors and decide to wage a proxy contest in the first place.

238. For a more general "interest analysis" of tender offers, see Bromberg, *supra* note 188.

239. *See supra* pp. 38-39.

mends that shareholders reject a tender offer. These factors include the effects of the tender offer on the target's employees, suppliers, customers, and the communities in which it operates. This technique may also permit management to initiate overt defensive actions upon the announcement of a tender offer when social considerations support such a response.

One case has suggested that the more extreme approach is desirable. In *Herald Co. v. Seawell*,[240] a newspaper repurchased some of its stock for an Employee Stock Option Plan. More than eight years later, suit was brought by shareholders who claimed that the purpose of the transaction was to prevent another publishing company from gaining control. Although additional evidence existed to support the board's action,[241] the court emphasized the newspaper's societal obligations. It stated that the newspaper was a quasi-public institution endowed with an important public interest.[242] Even if the directors had purchased the stock in order to prevent its sale to the other corporation, their belief that the outsider would create employee unrest (it had labor problems with its own employees) and ignore the interests of the community (it owned a chain of newspapers, unlike the Herald Company, which was a local business) justified management's actions.[243]

The public interest approach has also been advocated by commentators who argue that management is "accountable to a broad spectrum of interests." [244] One has written that management's recognition of such interests stands in sharp contrast to the bidder's "myopic focus" on acquiring control at a favorable price.[245] Shareholders entrust their funds to managers "not only to enhance the wealth of the investors, but also to anticipate, probably unwittingly, the furtherance of the economic well-being of other affected persons." [246]

This argument takes too much for granted. It asks us to believe that bidders are less socially responsible than targets. It implies that shareholders are incapable of assessing these interests on their own and

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240. 472 F.2d 1081 (10th Cir. 1972).

241. The court found that the plans for the ESOP were well under way before the prospective bidder entered the picture. Moreover, two of the directors had retired since the plan was adopted and a third was approaching retirement. *Id.* at 1096. The court took this to mean that management entrenchment was not the primary purpose for the transaction.

242. *Id.* at 1094-95.

243. *Id.* at 1092.

244. Steinbrink, *supra* note 14, at 884.

245. *Id.* at 899.

246. *Id.* at 900.

that they want management to do it for them. It presumes that management is qualified to represent nonshareholders. It ignores management's self-interest and willingly accepts positions that are incapable of objective verification.[247]

Most of all, the social interest argument assumes that management's obligation *should* extend beyond the corporation. This attitude may be correct if it is deemed desirable to encourage corporations to contribute funds to charities and universities. Arguably such contributions promote profit maximization by creating a favorable public image for the corporation. The corporation's public image will enhance the directors' public image as well (even if profits are not maximized), although shareholders or outsiders will react if management diverges too far, relative to other corporations, from the profit maximizing norm. The takeover mechanism sets a limit on managerial discretion.

When managerial discretion operates to defuse the takeover mechanism, either completely or by requiring negotiation with management, then the discretion is essentially limitless. For this reason, public interest arguments are inappropriate in the tender offer context. Such a rule should apply even if management's only involvement is to recommend that shareholders reject a tender offer because of social factors. Shareholders can reach this conclusion without management's interference. And if they do not, their decision does not provide an excuse for giving nonshareholders a veto over shifts in corporate control. If the bidder is truly antisocial, then someone will rebel—minority shareholders, employees, consumers, creditors, and perhaps most significantly, other participants in the market for corporate control.

b. *Corporate Interests*

The corporate interest justification proceeds from a fear of looting. This justification is related to, and builds upon, the social interest justification discussed above. Not only do bidders ignore consumer and community interests, they actually harm the corporation. The use of the pejorative term "raider" when describing bidders implies that takeovers are uniformly destructive unless management approves.[248]

As an excuse for shark-repellents, looting fails for its overbreadth. A rule that prohibits controlling shareholders and manage-

247. *See* Easterbrook & Fischel, *supra* note 13, at 1199-1201; Gelfond & Sebastian, *supra* note 215, at 458-59.

248. *See generally* Barnhill, *The Corporate Raider: Contesting Proxy Solicitations and Take Over Offers*, 20 BUS. LAW. 763 (1965).

ment from knowingly or negligently selling control to a looter is desirable.[249] But unless we make the unreasonable assumption that all bidders have improper motives, shark-repellents attack legitimate behavior as well. Moreover, adequate legal mechanisms exist to deter and penalize looting. Of course, shareholders have the burden in such instances of securing representation, bringing a lawsuit, and awaiting recovery. Yet the cost to society is much less than it would be if desirable takeovers were repeatedly thwarted.

A variation of the looting argument focuses on the dissolution of the corporate enterprise. A bidder may decide to liquidate the corporation upon the completion of the tender offer. In *Cheff v. Mathes*,[250] a stock repurchase case, the court suggested that liquidation constitutes a proper basis for defensive action.[251] But is society harmed if the corporation "disappears"? Society will lose the corporation's contribution to the national output of goods and services. The decision to liquidate, however, indicates that the corporation lacks value as a going concern and that its assets may be invested more profitably in other areas.[252] Additionally, a bidder who shares in the proceeds only in proportion to its investment will not treat other investors unfairly.[253] This result should be contrasted with a looting scheme whereby the bidder appropriates assets rightfully belonging to all of the shareholders. Since investors should have no expectation that the corporation will exist in perpetuity, liquidation ought to be viewed as a legitimate business decision properly made by those who control the corporation.

c. *Shareholder Interests: Pre-Tender Offer*

Although tender offers and mergers differ in a critical respect—the former do not require management's approval—some commentators have argued that this distinction should be minimized.[254] In particular, shark-repellent amendments are supported on the ground that they induce bidders to negotiate with management prior to mak-

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249. *See, e.g.*, Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa. 1940).

250. 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964).

251. In *Cheff*, there was no proof, other than management's assertions, that liquidation was imminent. Nevertheless, the court held that management's belief that there would be a material change in sales policies which would threaten the corporation's success provided sufficient justification for the stock repurchase. *Id.* at 507-08, 199 A.2d at 556.

252. *Tender Solicitations*, *supra* note 214, at 626.

253. *Id.* at 627.

254. *See, e.g.*, Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 61 CHI. BAR REC. 152 (1979); Mullaney, *supra* note 21, at 1461; Steinbrink, *supra* note 14.

ing a tender offer.[255] As discussed in Part I,[256] supermajority voting provisions, fair price provisions, and redemption rights commonly contain waivers which enable friendly bidders to proceed without complying with the restrictions applicable to outsiders opposed by management. Even a staggered board may be circumvented by negotiation: the bidder agrees to retain existing management or the old directors resign (presumably for a price). The negotiation argument is facially less objectionable than the looting argument because it admits that some tender offers are beneficial. Upon further reflection it is equally objectionable because it presupposes that bidders need prodding in order to act in the shareholders' interests and that management negotiates solely with those interests in mind.

According to one commentator, "the same policy requiring that a merger be approved by the directors before submission to shareholders would support similar action when a tender offer would have the same effect as a merger." [257] Corporation statutes contemplate that management will negotiate as the shareholders' agent and will exercise its business judgment as to the desirability and terms of a merger or other form of business combination. Ordinarily, management is the best informed group with respect to the factors which determine the value of the corporation. Ordinarily, too, this policy works to the shareholders' advantage. If not, and management approves an unfair merger or attempts to derive "secret profits" as its reward for selling out, it has breached its fiduciary duty to the shareholders and a lawsuit will ensue. Thus, the argument goes, management should always negotiate on behalf of the shareholders, who are unorganized and cannot bargain effectively.[258] Whatever management's motives, negotiation can increase the premium paid to shareholders in a tender offer or facilitate competing offers which are more attractive.[259]

Analogizing tender offers to mergers assumes an identity of interest between management and outsiders. Writers who blur the distinction between the two forms of takeover on the ground that a tender offer is merely an "alternative technique for completing an acquisition" [260] ignore the fact that these techniques operate in different psychological environments. Tender offers are valuable precisely because management's approval is required for a merger. When

255. *E.g.*, Mullaney, *supra* note 21, at 1461.
256. *See supra* pp. 42-48.
257. Mullaney, *supra* note 21, at 1461.
258. Steinbrink, *supra* note 14, at 896; Herzel, Schmidt & Davis, *supra* note 254, at 154.
259. *See* Steinbrink, *supra* note 14, at 893-94.
260. *Id.* at 892.

management rejects a fair merger, a tender offer is the logical (and necessary) next step. Indeed, if mergers and tender offers were identical, then why should both exist? The answer, at least from those writers who find bidders inherently suspect, is that the tender offer should not. "Negotiation" becomes synonymous with "rejection" when an outsider wants to replace existing management but will not pay some type of bribe. No one bargains away a job for nothing. It is therefore unrealistic to support negotiation on agency grounds. The tender offer is a device by which new shareholders discharge the agent and select a new one. The discretion available to an agent in good standing surely cannot be invoked by that agent in order to fend off his ouster.

Similarly, we should reject the rationale that negotiation is beneficial because it increases the consideration paid to target shareholders. As some writers allege, bidders may make tender offers without approaching management because they believe that they can obtain a better price for the target by avoiding negotiation.[261] There is no need to ascribe evil motives to such a strategy. Unless the tender offer price were sufficiently attractive, shareholders would not sell their stock. The market for corporate control replaces negotiation and is far more effective since managerial interests carry no weight. It is also unlikely to have the unfortunate side effect of defeating certain offers. Defensive tactics aimed at provoking a higher bid may serve only to *prevent* desirable transactions from being consummated—particularly if the bidder offers a fair price in the first place. Thus, the advantage of obtaining an increased premium should be viewed in light of the possibility that target shareholders will receive *no* premium at all.

Finally, the negotiation argument implies that existing constraints on tender offers do not adequately protect the interests of target shareholders. There is no reason to believe that such an implication is valid. The Exchange Act imposes substantive restrictions on tender offers,[262] requires extensive disclosure by the bid-

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261. Herzel, Schmidt & Davis, *supra* note 255, at 154.

262. Section 14(d)(5) provides that shareholders who tender their stock may withdraw within the first seven days of the offer or after sixty days have passed. 15 U.S.C. § 78n(d)(5) (1976). Offers must therefore remain open at least that long. SEC rules permit withdrawal during the first fifteen business days, 17 C.F.R. § 240.14d-7(a)(1) (1980), and require that the offer be held open a minimum of twenty business days. *Id.* § 240.14e-1(a). The offer must remain open an additional ten business days after a competing offer is made, *id.* § 240.14d-7(a)(2), or if the consideration is increased. *Id.* § 240.14e-1(b).

Section 14(d)(6) requires proration of shares tendered within the first ten days when an offer for less than all of the target's stock is oversubscribed. 15 U.S.C.

der,[263] and contains an antifraud provision.[264] Additional safeguards arguably conflict with the federal policy of neutrality which is embodied in the statute. Indeed, shark-repellent amendments are analogous to state antitakeover laws which delay, and sometimes prevent, the commencement of a tender offer.[265] In part, the antitakeover statutes are undesirable because they superimpose a pro-management bias on the regulatory scheme created by Congress and the SEC. This criticism also applies to shark-repellents and provides another reason for opposing their adoption.[266]

d. *Shareholder Interests: Post-Tender Offer*

In addition to inducing negotiation, stage three charter amendments focus on the interests of target shareholders upon the completion of a successful tender offer.[267] In this respect they place management in a role it usually does not occupy: representing minority rather than majority shareholders. The role makes sense, however, when we remember that the majority shareholders were the ones who abandoned management and transferred control to the bidder.

The so-called "protective" charter provisions are based, in part, on a fear of freezeout mergers. Once the bidder purchases a majority

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262 (cont.):

§ 78n(d)(6) (1976). *See also* 17 C.F.R. § 240.14d-8 (1980) (longer period if bidder specifies).

Section 14(d)(7) provides that a price increase made by the bidder during the course of the tender offer must be applied retroactively to the stock already tendered. 15 U.S.C. § 78n(d)(7) (1976).

263. Section 14(d)(1) requires disclosure at the time the tender offer commences if the bidder would, upon the successful completion of the offer, be the beneficial owner of more than five percent of the class of stock for which the offer is made. 15 U.S.C. § 78n(d)(1) (1976). For the information required to be disclosed, see 17 C.F.R. § 240.14d-6 (1980).

264. Section 14(e) prohibits untrue statements or misleading omissions of material fact, as well as fraudulent and manipulative acts or practices. 15 U.S.C. § 78n(e) (1976). *See also* 17 C.F.R. § 240.10b-13 (1980) (bidder cannot make purchases outside of offer while bid is outstanding).

265. *See generally* Note, *Securities Law and the Constitution: State Tender Offer Statutes Reconsidered*, 88 YALE L.J. 510 (1979). Some courts have held that the state laws are preempted by the federal regulation of tender offers and also impose an unreasonable burden on interstate commerce. *E.g.*, Great W. United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir.), *rev'd on other grounds sub nom.* Leroy v. Great W. United Corp., 433 U.S. 173 (1979); Dart Indus., Inc. v. Conrad, 462 F. Supp. 1 (N.D. Ind. 1978). Although not discussed in this paper, antitakeover statutes are used as a shark-repellent technique: instead of amending the existing charter, management can reincorporate in a state with an antitakeover statute and adopt a completely new charter. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 56-9 to 56-12.

266. The SEC noted the conflict between shark-repellent amendments and the federal regulation of tender offers when it requested comment on the types of rules that would be desirable in dealing with defensive charter provisions. *See supra* text accompanying notes 144-45.

267. *See supra* pp. 42-48.

of the target's stock, it might decide to merge the target into itself. Supermajority provisions increase the vote required to consummate such a merger, while fair price provisions establish rigid formulas for determining the freezeout price. The right of redemption provision takes the opposite approach. If successful, it will deter a bidder who does *not* want to buy all of the target's stock. By enabling minority shareholders to put their shares to the corporation at a predetermined, and possibly higher-than-tender-offer price, the amendment lets the shareholders decide whether they wish to terminate their interest in the corporation. This procedure is the opposite of a freezeout merger, where the bidder imposes its will on the minority with respect to both the decision to obtain full control and the terms of the transaction. According to one commentator, fair price and redemption provisions represent a "significant step forward in defensive tactics" [268] because the emphasis placed on the consideration received by minority shareholders defuses some of the criticism leveled against management's self-interest.

1) *Supermajority Voting.* Supermajority provisions assume that freezeout mergers are undesirable. The assumption is correct in certain cases; for example, when the controlling shareholder pays an inadequate price. This problem will be discussed in the following subsection, in relation to fair price provisions. For the moment, it should be noted that supermajority voting does not provide the solution. The primary emphasis of the requirement is on procedural rather than substantive aspects of the transaction.[269] Thus, a bidder who buys an overwhelming percentage of a corporation's stock could eliminate minority shareholders regardless of the consideration paid in the merger.

A second type of freezeout, and an equally undesirable one, occurs when a corporation "goes private." [270] In that situation insiders force out public shareholders usually because they believe that the market has undervalued the corporation's stock. The fiduciary status of the controlling shareholders compels close scrutiny of their actions. Indeed, on fairness grounds, the arrangement is objectionable. The insiders take advantage of market swings to eliminate minority shareholders but will presumably go public again when market conditions improve.[271] At that time they will sell the stock at a much

268. Smith, *supra* note 21, at 27.

269. It is true that the waiver option may provide an incentive to consummate the merger at an attractive price. On the other hand, the waiver may also induce bidders to make side payments to target management; in that case, shareholders would not receive any benefit.

270. *See generally Corporate Freezeouts*, *supra* note 61, at 1365-70.

271. *Id.* at 1366.

higher price in order to profit from the transient period of private ownership. Additionally, the freezeout normally lacks a business purpose. Although the usual justification is that private control will enable the corporation to save expenses attributable to SEC and stock exchange disclosure requirements, "[t]he costs of monitoring management's conduct are incurred for the *benefit* of the public stockholders, and it hardly rests with the fiduciary to cite the saving of those costs as a reason for terminating the beneficiaries' interest without their consent." [272] In economic terms, the merger merely shifts stock ownership without producing gains in output or the efficient utilization of resources.

The legal restrictions imposed on going private transactions [273] should not extend to a third type of freezeout—a merger that occurs soon after a bidder makes a successful tender offer. Two factors distinguish the second-step merger from the going-private transaction: the merger can be socially beneficial and there is no self-dealing. "Floating vote" provisions which require that mergers be approved by a majority of shares other than those held by the bidder find a conflict of interest where none exists.[274] Although the acquiring corporation has managed to purchase a majority interest in the target, it is really an outsider. If we view the tender offer and merger as steps in a single plan, then the bidder occupies the same position as a corporation making a straightforward merger or purchase of assets.[275] In that case, bargaining, not a conflict of interest, determines the price paid to shareholders. When a tender offer occurs, the only difference is that the bidder bypasses management and "bargains" with the shareholders directly. It possesses neither the inside information nor the fiduciary relationship to shareholders which justifies stringent regulation.

More significantly, in traditional mergers we have no trouble accepting majority rule as the proper standard for decision mak-

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272. *Id.* (emphasis in original).

273. The holding in *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), presumably applies to going private transactions, although the facts in that case involved a freezeout following a tender offer. The court imposed a dual test of business purpose and fairness in assessing the propriety of a freezeout. *See supra* note 61. Brudney and Chirelstein have argued that going private transactions should be prohibited in all cases. *Corporate Freezeouts*, *supra* note 61, at 1367. They base this conclusion on "the absence of social benefit, the strength of fiduciary obligation, and the danger of unpoliceable abuse. . . . " *Id.* at 1368.

274. *See supra* p. 44.

275. *Corporate Freezeouts*, *supra* note 61, at 1360. The analogy becomes weaker as the lag between merger and tender offer increases.

ing.[276] Advocates of supermajorities do not contend that all mergers should require an extremely high vote of approval. Yet to the extent that these provisions are motivated by a fear that a minority will disapprove of a transaction and deserves protection, there is no distinction. A preferable and less restrictive means of protecting minority interests following a tender offer would be to require equality of treatment at the second stage. By disclosing its intentions at the time of the tender offer and by paying the same price in both transactions, the bidder would indeed achieve the functional equivalent of a staightforward merger.[277]

At present, however, supermajority provisions accomplish much more than the minimal shareholder protection required in the takeover context. Their underlying premise—the impropriety of freezeouts—is inapt. As a result, supermajorities can prevent desirable deals from occurring because bidders who cannot obtain waivers are fifty-one percent rather than eighty or ninety percent shareholders.[278] In effect, the restrictive voting provisions permit the "tyranny of the minority" [279] to rule the corporation long after the majority has "voted" in favor of a transfer of control.[280]

2) *Fair Price Provisions.* Fair price amendments are less restrictive than supermajorities because they do not create a procedural impediment to freezeouts. Fairness is a value that should be encouraged; accordingly, it may seem reasonable to incorporate this principle into the target's governing documents. Further reflection reveals that the arguments favoring fair price provisions are seriously flawed and possibly disingenuous. Since the amendments rely on management's definition of "fairness," the result is not as appealing as the name implies.

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276. Shareholders who are dissatisfied with the transactions are not without recourse. For example, they can attempt to enjoin the merger as unfair. They might also utilize their statutory appraisal rights, *see, e.g.*, ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 80 (1971), although an admitted problem with appraisal is that the remedy focuses on the pre-merger value of the acquired corporation's shares and will generally not reflect the synergistic gains produced by the merger. *See, e.g.*, *Fair Shares*, *supra* note 234, at 305.

277. *See Fair Shares*, *supra* note 234, at 336-40. *See also Corporate Freezeouts*, *supra* note 61, at 1361-62. These procedural rules reject the tests adopted by the Delaware Supreme Court in the *Singer* case. *See supra* note 61.

278. The situation is especially troublesome when management owns a significant block of stock.

279. E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 195 (1977).

280. The same objection applies to other restrictive voting arrangements, such as the "scale voting" provisions upheld in *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977), discussed *supra* pp. 63-64.

Courts can approve a fairness test without deriving their authority from the corporate charter. As Professors Brudney and Chirelstein have proposed,[281] two basic safeguards are necessary in order to ensure fair treatment of target shareholders in a freezeout merger. The bidder should 1) announce its intent to cause a freezeout at the time of the tender offer; and 2) pay the same price per share during the merger as it paid during the tender offer.[282] These requirements eliminate the possibility that shareholders will tender their stock only because they believe that a freezeout merger will occur at a lower price. They are also easy to administer. Fairness can be determined procedurally rather than substantively because the merger price equals the price offered by an outsider immediately prior to the merger.[283]

So long as courts apply these safeguards, fair price provisions are neutral at best.[284] Actually, they are often detrimental. Existing charter provisions create a strong possibility that the merger price must *exceed* the tender offer price. The "premium test" [285] and the "price/earnings test" [286] may distort shareholder decisions as much as the uncertainty of a lower price, albeit in the opposite direction.[287] If shareholders refuse to tender because they prefer to be merged out, then the tender offer will fail and the merger will never take place.

The impropriety of the high-priced formulas is illustrated by a very simple question: why should minority shareholders receive better treatment than tendering shareholders? Unless there is a significant lag between tender offer and merger, there is no change of circumstances that justifies disparate treatment. Unless we believe that the tender offer price ignores the benefits of a shift in control, it makes no sense to devise alternative tests. As Section A revealed,[288] the premium paid by the bidder does reflect those benefits. It represents the bidder's estimate of the extent to which the tender offer improves the allocation of resources by eliminating inefficient management. When minority shareholders receive the tender offer price in a

281. *See supra* note 277.

282. *Fair Shares, supra* note 234, at 337. The authors do acknowledge a case in which the procedural safeguards would not be sufficient. If there is reason to believe that side-payments affected management's approval of a tender offer, the shareholders should be able to challenge the merger price even if it equalled the tender offer price. *Id.* at 341-44.

283. *See supra* pp. 82-85.

284. If the Brudney and Chirelstein view is not widely accepted, then a charter amendment adopting the procedural rules would be desirable.

285. *See supra* text accompanying note 72.

286. *Id.*

287. *See supra* pp. 45-46.

288. *See supra* text accompanying note 204.

freezeout merger, they also share in the gains from improved management. Provisions that enable them to receive a higher price replace the bidder's expectation of benefits with management's self-interested assessment of fairness.[289]

3) *Right of Redemption.* The right of redemption provision is the most extreme of the stage three charter amendments. Unlike supermajority and fair price provisions, the right of redemption may deter a bidder whose only goal is to obtain a control position in the target.[290] There is no need to provide protection against a freezeout. Rather, shareholders are given the power to veto certain offers solely because they object to a transfer of control which will leave them in the minority.

Redemption provisions imply that the mere state of being a minority shareholder is unfair. This concern is unwarranted for two reasons. First, shareholders who object to the change in control are free to sell their shares to other investors. They are not forced to retain their investment; indeed, if the tender offer is desirable, then the market should value those shares more highly once the transfer of control is complete. Second, while it is unreasonable to expect shareholders to contemplate (and thus accept) the possibility of an unfair freezeout when they initially purchase their stock, shareholders should always contemplate a change in control. Certainly there is no right among shareholders in a public corporation to expect the status quo to extend indefinitely. If such were the case, redemption rights should apply whenever the corporation embarks on a policy change or elects different directors. The corporation could not operate under that condition, for it would be tantamount to requiring a shareholder vote on every corporate decision. The separation of ownership and control—which occurs precisely because shareholders are investment-minded and lack an interest in management—would become meaningless.

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289. The increased cost may have an undesirable effect on the consideration received by tendering shareholders. A bidder who wants total control and anticipates paying an inflated price during the freezeout might be tempted to offer the tendering shareholders a lower premium than it would really prefer to pay. Otherwise, the total cost of the takeover process could exceed the bidder's estimate of future benefits. One problem with this reaction is that it may threaten the success of the tender offer; it may also deter the bidder from making the tender offer in the first place. Additionally, it indicates the unfairness of paying tendering and nontendering shareholders on a different basis: not only do minority shareholders receive a windfall, but tendering shareholders are actually harmed. The same objection applies to the price/earnings test and the requirement in some corporate charters that bidders pay minority shareholders an additional premium over and above the amount computed under the applicable fair price formula.

290. *See supra* pp. 46-48.

The protective justification for right of redemption provisions ignores an important distinction between closely held corporations and publicly held corporations. In the former case, courts have permitted restraints on the transferability of shares.[291] The right of first refusal, for example, allows existing shareholders or the corporation to purchase stock from other shareholders before that stock is offered to outsiders. Similarly, preemptive rights enable shareholders to purchase additional stock from the corporation before the stock is sold to third parties. Even if preemptive rights are not specified in the corporate charter, a New York court has held that management must treat all shareholders fairly when selling stock on behalf of the corporation.[292] Selling stock in such a way as to increase the proportionate interest of some shareholders (and thereby reduce that of the rest) requires a showing by management that it could not achieve a legitimate corporate purpose in a manner which would leave proportionate interests unchanged.[293]

The reason for permitting such restrictions on transferability is that shareholders in closely held corporations often take an active interest in management. The quality of their investment is both tangible (the amount of money devoted to the corporation) and intangible (the degree of influence over corporate affairs). Unfettered transferability would undermine the intangible nature of the investment even if the dollar value remained unchanged. Moreover, since there is no market in which to sell the stock, shareholders could be locked into an unfavorable situation if they had no choice but to passively allow changes in control. Shareholders in a publicly held corporation occupy a very different position. For most, the investment is purely tangible.[294] As a result, right of redemption provisions do not pro-

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291. *See* note 190 *supra*. *See generally* Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259 (1966). Courts have also taken a harsher view of certain actions, such as stock issuances to insiders, which entrench the corporation's management. In closely held corporations these actions are likely to be aimed at freezing out another faction already in control; if the corporation needed money, it might just as easily sell the stock to all shareholders pro rata. In publicly held corporations stock issuances will occur for legitimate purposes—for example, as compensation. *Id.* at 266.

292. Schwartz v. Marien, 37 N.Y.2d 487, 373 N.Y.S.2d 122, 335 N.E.2d 334 (1975).

293. *Id.* at 492, 373 N.Y.S.2d at 127, 335 N.E.2d at 338.

294. As Berle and Means wrote in 1932:

> The spiritual values that formerly went with ownership have been separated from it. Physical property capable of being shaped by its owner could bring to him direct satisfaction apart from the income it yielded in more concrete form. It represented an extension of his own personality. With the corporate revolution, this quality has been lost to the property owner much as it has been lost to the worker through the industrial revolution.

A. Berle & G. Means, *supra* note 191, at 64-65.

mote legitimate shareholder expectations but merely enable a minority to dictate the investment decisions of the majority.

C. *Proposals*

The analysis presented thus far supports a simple rule: shark-repellent amendments should be prohibited.[295] A *per se* prohibition is clearly appropriate when the amendments serve no function outside the tender offer context. In those instances, the justifications for shark-repellents fail to outweigh the detrimental effect on the market for corporate control. Thus, at stage one, management should not be allowed to introduce nonfinancial factors into its evaluation of a tender offer. Similarly, at stage three, the "protective" emphasis of supermajority voting, fair price provisions, and redemption rights does not provide a legitimate reason for their adoption.

A simple, *per se* rule creates problems when we examine more complicated charter amendments—those involving the issuance of stock and the composition of the board of directors. These amendments are more complicated because they arguably serve purposes unrelated to tender offers. Stage one stock issuances may provide directors with needed flexibility in managing the corporation's finances. Stage two provisions, particularly the staggered board of directors, may benefit the corporation by precluding abrupt changes in management and, presumably, corporate policy. Financial flexibility and managerial continuity are values which must be considered even after the shark-repellent aspects of the provisions have been rejected.

In the case of stock issuances, it is clear that charter amendments authorizing an increase in the amount of common stock are proper. Many corporations could not exist without such provisions. Since the primary evil surrounding stock distributions is the actual issuance rather than the corporate planning that led to the transaction, challenges at the earlier stage would be counterproductive. Only after the stock is issued can we determine why the charter was amended. At that time, a basic test should be applied to distinguish management-entrenching distributions from those made for legitimate financial purposes. The transaction should be enjoined if it occurred during a tender offer or while management had knowledge

295. Any prohibition must apply to new as well as to existing corporations. Although it might be argued that new corporations should be permitted to adopt shark-repellents, on the ground that shareholders would understand that their rights were restricted at the time they purchased their stock, the policy reasons for rejecting shark-repellents cut against this approach.

of an impending offer, unless management proves that corporate exigencies required such action and that no alternatives were available.[296] This test would presume improper motive from an objective factor—namely, timing—in order to avoid the unsatisfactory subjective inquiry now conducted by most courts.[297] It would also place the burden of rebutting the presumption on management, a second change from current practice.[298]

Preferred stock transactions require more stringent treatment. Management should be able to place preferred stock, subject to the constraints described above. However, preferred stock with "unusual" voting rights should not be issued until shareholders have approved those rights.[299] When shareholders authorize an increase in the amount of common stock, they contemplate a dilution of their investment and can estimate the extent of that dilution. When shareholders authorize a class of "blank check" preferred stock they cannot determine what management will do. This uncertainty also extends to bidders. The interests of both groups would be served best by a simple rule eliminating managerial discretion rather than by a rule requiring an after-the-fact, case-by-case evaluation.

Amendments affecting the board of directors present more problems than stock issuances. These problems lead to the conclusion that the *per se* rule should apply to management-entrenching provisions. First, the theoretical desirability of staggering outside the takeover context has been undermined by critics who argue that, in practice, few corporations experience continuity problems absent a contest for control.[300] If we accept this argument, then a rule which preserves staggering in nontakeover situations merely grants the board of directors a sense of security it normally enjoys. To this extent the rule is meaningless. But once directors have such security, it is impossible to prevent the impact of the amendment from overflowing into the takeover context. Even if the staggered board and related provisions are not enacted because of a shark-repellent motive, a shift in control is still rendered more difficult.

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296. This test is similar to the approach taken in Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975), and Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967), although neither court expressly imposed such a rule. *See also* Karel, *Limitations on Target Management's Use of Indirect Defenses to Oppose a Tender Offer* (Apr. 17, 1980) (unpublished paper by Harvard Law School student).

297. *See supra* p. 66.

298. *Id.*

299. *See* Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979), discussed *supra* pp. 30-51.

300. *See supra* note 41.

Indeed, the "overflow" problem highlights another difference between stock issuances and stage two amendments: the fact that there is no test which readily separates proper from improper behavior. For example, a staggered board might be justified if adopted when the target lacked knowledge of a prospective bidder. However, this rule does not work as well as it does in the stock scenario, since management-entrenching provisions are frequently used as preventative measures.[301] A second test would permit the amendment if management proved that the corporation was experiencing continuity problems.[302] This approach goes to the rationale of the staggered board but also sends a signal to bidders that they should strike before the amendment is adopted. It also assumes that the cure for managerial problems is to protect existing management, an assumption that is not consistent with the thesis of this article. Moreover, neither test is applicable to corporations whose charters have contained management-entrenching provisions for many years. It would be necessary to grandfather existing provisions or to reject them out of hand. In either case, some directors would be treated better than other directors. Rather than distinguish among directors in this manner, we should eliminate stage two provisions entirely. If the amendments are truly useful, their absence will provide evidence supporting their validity.

Although these proposals may appear extreme, they reflect a sensible set of values. The takeover process should not be consumed by self-interest. Instead, tender offers should benefit society by replacing inefficient management. When a corporation adopts shark-repellent amendments, this function is weakened. Management's fear of "sharks" may represent a natural reaction to the threat of job displacement. Yet the predictability of its response does not compel support for its actions.

This article was typeset prior to the United States Supreme Court decision in *Edgar v. Mite Corp.*

301. Of course, stock distributions may also be preventative. The rule advocated in the text admittedly fails to cover these situations. Nevertheless, the extreme interference with corporate policy caused by stringent regulation would outweigh the benefits of such an approach. This is because most stock issuances (unlike stage two provisions) reflect legitimate business purposes unrelated to entrenchment.

302. *Cf.* Rel. No. 15230, *supra* note 136, at 80,988 (requiring disclosure of continuity problems).