JAWS III: THE IMPROPRIETY OF SHARK-REPELLENT AMENDMENTS AS A TAKEOVER DEFENSE

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> "*Shark*!" someone screamed from the entrance. "Goddamn shark's back! There's a *man-eater* out there, somewhere."
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> H. SEARLS, JAWS II, 253 (1978).

In the world of tender offers, bidding corporations are known as "sharks." This metaphor is appropriate if one believes that corporate takeovers are undesirable. If one does not, then the imagery of ravenous corporations scouting for prey along Wall Street will appear extreme, even foolish. Yet it illustrates nicely the emotional upheavel produced by a tender offer. Negative emotions, particularly when expressed by target company management, reflect the development of the tender offer into a popular acquisition technique.[1] Since the bidder can make its offer without obtaining the approval of the target's board of directors, managerial interests are threatened. And unlike most types of sea-life, management can fight back.

The fighting takes many forms. The weakest method of managerial opposition is permitted by the Securities and Exchange Commission ("SEC" or "Commission"). Rule 14e-2,[2] promulgated under section 14(e) of the Securities Exchange Act of 1934 ("Exchange Act"),[3] requires target management to notify shareholders of its position with respect to a tender offer within ten business days from the

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1. The number of inter-firm tender offers has risen sharply since 1975. The following table reveals the extent of this phenomenon:

Year	*Number*
1973	80
1974	68
1975	71
1976	132
1977	181
1978	166
1979 (1/2)	56

Austin, *Tender Offer Update: 1978 - 1979*, 15 MERG. & ACQ. 13, 14 (Summer 1980).

2. 17 C.F.R. § 240.14e-2 (1980).

3. 15 U.S.C. § 78n(e) (1976). Section 14(e) is a general antifraud provision applicable to tender offers.

date the offer commences. The target must recommend acceptance or rejection of the offer, express its neutrality toward the bidder, or indicate that it is unable to take a position. It must also disclose the reasons for its decision. Although some shareholders may decide to retain their stock solely on the basis of management's recommendation to reject the bidder's offer, disclosure enables the target to communicate relevant information about the bidder to investors.[4] Moreover, the board's opinion does not prevent shareholders from selling their stock should they disagree with management. For most shareholders, the tender offer premium will have a greater impact on decision making than management's negative advice.

The limited value of disclosure as a defensive technique has encouraged the use of extreme tactics which undermine the shareholders' right to transfer corporate control. These strategies bypass shareholders entirely (relying on state antitakeover laws; [5] instituting litigation; [6] placing shares of stock in "friendly" hands; [7] acquiring an interest in a corporation that creates antitrust or regulatory problems for the bidder [8]) or make the bidder's offer less attractive by appealing to the shareholders' financial interests (increasing the dividend rate; [9] soliciting a "white knight" to make a competing offer or to merge with the target [10]).

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4. Rule 14e-2 does not specify the proper grounds for management's recommendation that shareholders reject a tender offer. Thus, it is unclear whether disclosure must be limited to an assessment of the financial terms of the offer, or whether management can evaluate nonfinancial interests in reaching its conclusion. That uncertainty presents one of the issues discussed in this article. *See infra* pp. 38-39 & 79-81.

5. *See generally* Note, *Securities Law and the Constitution: State Tender Offer Statutes Reconsidered*, 88 YALE L.J. 510 (1979). The statutes are of dubious constitutionality. *Id.* at 525; *see infra* note 265.

6. Filing for an injunction is commonly the first action taken by target management upon the announcement of a tender offer. According to two observers, "In reading some of the cases, one has the feeling that the complaint may have been drafted in advance with the name of the defendant left blank, to be filled in as the occasion may require." R. JENNINGS & H. MARSH, SECURITIES REGULATION 742 n.25 (4th ed. 1977).

7. *See, e.g.*, Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975); Applied Digital Data Sys. v. Milgo Elec. Corp., 425 F. Supp. 1145 (S.D.N.Y. 1977); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967).

8. *See, e.g.*, Royal Indus., Inc. v. Monogram Indus., Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976) (antitrust).

9. As long as management discloses the reasons for the increase, and indicates whether the new level can be sustained, some writers believe that the tactic is not objectionable because it does not impede the shareholders' ability to consider the merits of the tender offer. *See* Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901, 929 (1979). It will, of course, make the tender offer price less attractive in relation to the value of the shareholders' investment.

10. *See, e.g.*, Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977).

In some cases courts have found such tactics to be improper because their primary purpose was to preserve management's jobs rather than to benefit the shareholders.[11] Overall, the case law is mixed. Courts have applied inconsistent burdens of proof which place one party at a significant, and in many instances conclusive, advantage.[12] Commentators also take divergent positions; some attack managerial self-interest [13] while others argue that target management is in the best position to protect the corporation from unscrupulous "raiders." [14]

This article examines another set of defensive techniques. In contrast to the strategies just discussed, which prove useful after a tender offer has been announced or is clearly imminent, these strategies operate at an earlier point in time; they deter bidders from selecting the corporation as a target. Amending the corporate charter (or by-laws [15]) to prevent shifts in control has become an acceptable and, under most state corporation laws, legal means of rejecting prospective bidders. The so-called "shark-repellent" amendments also contain provisions designed to protect minority shareholders in the event that a tender offer succeeds. Because amendments usually require shareholder approval, it is often assumed that the board of directors occupies a much safer position than when it undertakes defensive tactics on its own initiative.[16] Although questions have been raised

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11. *E.g.*, Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975); Royal Indus., Inc. v. Monogram Indus., Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967).

These cases involved claims of mismanagement brought under state law. Recently, a federal court held that certain defensive tactics constituted "manipulative acts" in violation of Section 14(e) of the Exchange Act. *See* Mobil Corp. v. Marathon Oil Co., [Jan. - June] SEC. REG. & L. REP. (BNA) No. 1, at 49 (6th Cir. Dec. 23, 1981) (options granted to white knight, including option to purchase stock, artificially and significantly discouraged competitive bidding for target).

12. The prevailing test is to apply the business judgement rule and uphold management's actions unless the plaintiff proves that the "primary purpose" of the transaction was to protect managerial interests. *See, e.g.*, Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969).

13. *E.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer* 94 HARV. L. REV. 1161 (1981).

14. *See, e.g.*, Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978).

15. By-law amendments are less common (and less safe) than charter amendments, for reasons to be discussed in Part II. *See infra* note 96 & pp. 50-51. The text therefore focuses on shark-repellent charter amendments.

16. *See, e.g.*, Butler, *Management's Responsibility in Responding to a Takeover*, SEVENTH INST. SEC. REG. 221, 222 (P.L.I. 1976).

about the effectiveness of shark-repellents,[17] and many corporations have chosen not to adopt them,[18] enough support for the practice has developed so as to justify a harder look.[19]

Part I describes the major types of shark-repellent amendments. Part II surveys current legal approaches to the subject and reveals that courts have placed few restrictions on managerial discretion in this area. Such a result is undesirable. It is the premise of this article that management in publicly held corporations should not interfere with sales of control by the shareholders.[20] Setting aside the enabling language in state corporation laws, this premise supports a rule barring shark-repellents. A simple rule is problematic, however, because some shark-repellent amendments may serve useful purposes unrelated to tender offers. Part III analyzes the advantages and disadvantages of the various shark-repellent provisions. The article's conclusion—most provisions should be prohibited, with remaining ones subject to intense judicial scrutiny—would require a reorientation of statutory and common law, but is consistent with management's fiduciary obligation to shareholders.

I. SHARK-REPELLENT TECHNIQUES [21]

Shark-repellent amendments operate at three stages. The *bidder rejection* stage threatens the success of a tender offer. The *man-*

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17. *See, e.g.*, 1 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS §§ 6.2.2-6.2.3 (1978). Overall ineffectiveness does not provide an adequate reason for ignoring shark-repellents. In specific situations the amendments may prove effective. If not, and tender offers are bound to succeed anyway, the amendment process and attempts to utilize the provisions are socially wasteful.

18. A survey of 177 of the 1000 largest industrial corporations has concluded that over two-thirds have failed to adopt shark-repellents. National Association of Accountants, *Takeovers: A Survey of Corporate Defense Strategies*, 15 MERG. & ACQ. 21, 28 (Spring 1980). That figure can be explained, in part, by the fact that about forty percent of the corporations surveyed do not consider themselves vulnerable to a takeover. However, of those corporations that do consider themselves vulnerable, about half have failed to adopt shark-repellents. *Id.*

19. *See* Comment, *A Review of the Literature on Defensive Tactics to Surprise Cash Tender Offers*, 13 CREIGHTON L. REV. 909, 922-24 (1980) [hereinafter cited as *Creighton Comment*].

20. *See infra* Part III. Such an approach may not be appropriate for closely held corporations, however. *See infra* note 190.

21. For more complete descriptions, *see* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 259-62 (1973); E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 194-95 (1977); A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING 6 to 24-4 (1979); 1 M. LIPTON & E. STEINBERGER, *supra* note 17; Hochman & Folger, *Deflecting Takeovers: Charter and By-Law Techniques*, 34 BUS. LAW. 537 (1979); Mullaney, *Guarding Against Takeovers—Defensive Charter Provisions*, 25 BUS. LAW. 1441 (1970); Smith, *Fair Price and Redemption Rights: New Dimensions in Defense Charter Provisions*, 4 DEL. J. CORP. L. 1 (1978). For additional references, *see Creighton Comment*, *supra* note 19.

agement entrenchment stage prevents a rapid shift in the composition of the board of directors if an offer succeeds and the bidder controls a majority of the target's stock. Finally, the *shareholder protection* stage restricts the bidder's freedom of action even after it elects a majority of the board.

The three stages serve as different types of deterrents to tender offers: the first because it provides a direct weapon for managerial opposition, and the last two because they drive a wedge between substantial share ownership and the control of corporate affairs. Although amendments in stages two and three more often delay rather than deny permanently the exercise of policymaking freedom, the theory behind their adoption is that bidders prefer targets with immediate payouts.[22] If nothing else, delay increases the effective cost of a tender offer. Shark-repellents may also induce bidders to negotiate with management in the hope of avoiding this result.[23]

Stage three amendments are supported on the additional ground that they safeguard the interests of minority shareholders in the event of a successful tender offer.[24] The adequacy of this justification will be explored in Part III. For the moment, an additional distinction should be noted. Some shark-repellents are traditional charter provisions the utility of which is not confined to takeover battles, while others (particularly those in stage three) represent the outgrowth of a more recent—and more blatant—antitakeover sentiment.

A. *Stage One: Bidder Rejection*

1. Stock Issuances

One of the most potent takeover defenses employed by target management involves the transfer of the corporation's common stock

22. The theory is simplistic in that it assumes that bidders view targets as fungible investment vehicles with relatively equal rates of return. There are obviously cases where a tender offer will prove extremely profitable to an acquiring corporation willing to discount its return for the delay imposed by shark-repellents. Moreover, to the extent that these provisions are widespread, bidders are forced to choose targets out of a universe including corporations that have adopted shark-repellents and cannot ignore these corporations when they search for an investment. *See* A. FLEISCHER, *supra* note 21, at 11. *But see supra* note 18. It is true, however, that delay may be critical in the case of a financially weak bidder, particularly one who needs access to the corporate treasury in order to finance the tender offer but is prevented from doing so immediately because of stage three provisions. Shark-repellents may also signal that management will act aggressively in the case of an unfriendly tender offer. *See* Hochman & Folger, *supra* note 21, at 537. On the other hand, "there is a growing feeling that . . . these charter provisions are counterproductive in that they call attention to the company as a prospective target." 1 M. LIPTON & E. STEINBERGER, *supra* note 17, § 6.2.3, at 266.

23. *See, e.g.*, Mullaney, *supra* note 21 at 1461.

24. *See, e.g.*, Smith, *supra* note 21.

to "friendly" parties.[25] The transfer threatens the outcome of a tender offer for two reasons. First, it increases the number of shares the bidder must purchase in order to acquire a majority interest in the corporation. Assuming that third parties cannot be persuaded to tender their stock, the bidder must appeal to more of the "disinterested" shareholders than would otherwise be the case. Second, even if enough stock is available, the need to buy a larger block may raise the cost of the tender offer to a prohibitive level, unless the issuance depresses the market price of the target's shares.

Alternatively, the target might issue a new class of preferred stock with multiple votes per share, or the right to vote as a class to elect a specific number of directors or to prohibit mergers and other forms of business combinations.[26] This tactic does not dilute the ownership of the common stock, but renders the purchase of common stock an incomplete means of obtaining control of the corporation. Thus, while a tender offer for the common stock can proceed without difficulty, the bidder will face problems at stages two and three. Should the bidder make a tender offer for the preferred stock, it will encounter stage one problems as well.

Stock issuances occur both in the context of a specific tender offer and as an advance planning technique.[27] If the target's capitalization is adequate, management may be able to sell additional shares of common stock in a private placement without seeking shareholder approval [28] or registering the shares with the SEC.[29] Otherwise, a charter amendment is required in order to increase the company's capitalization. This type of amendment may signify management's anticipation of a tender offer but is more commonly enacted for legitimate financing purposes. Indeed, an obvious reason for enabling management to place securities is that financial issues require a speedy resolution based on informed business judgment—factors which might not be present if shareholders were required to act instead.

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25. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 33-37. Sales to allies or placement in an Employee Stock Option Plan (on the ground that employees are unlikely to sell out to an unknown buyer) are two possibilities.

26. Hochman & Folger, *supra* note 21, at 547.

27. On fiduciary grounds, the former transactions are more problematic because the antitakeover purpose is much clearer.

28. In the case of a company whose stock is listed on the New York Stock Exchange, a shareholder vote may be required if shares are to be issued to officers, directors, or significant shareholders or if the shares exceed approximately twenty percent of the outstanding stock. A. FLEISCHER, *supra* note 21, at 34. The American Stock Exchange has a similar requirement. *Id.* at 34 n.109.

29. For the requirements governing private placements, see section 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2) (1976), and rule 146 thereunder, 17 C.F.R. § 230.146 (1980).

Sometimes charter amendments do more than enlarge the capital stock and deliberately (perhaps dangerously) enhance managerial discretion over corporate finances. For example, the Delaware and New York corporation statutes provide that shareholders can approve the creation of a class of preferred stock and empower the board to fix the rights and preferences of the stock when the charter fails to specify them.[30] Voting is one such right. As a result, management could distribute preferred stock with multiple votes per share or the right to vote as a separate class, without seeking shareholder approval. Although the transaction may pose a fiduciary duty problem, it is not prohibited by the terms of the statutes.

2. Consideration of Nonfinancial Factors in Evaluating a Tender Offer

A potentially less disruptive form of managerial opposition is provided by a charter amendment which authorizes the board of directors to consider certain nonfinancial factors when it evaluates a tender offer.[31] As discussed earlier,[32] management has several options under rule 14e-2: [33] it must either 1) recommend to the shareholders that they accept or reject the offer; 2) express its neutrality; or 3) indicate that it is unable to take a position. The rule does not specify suitable grounds for management's decision, although it does require that management disclose the reasons for its choice. Some corporate charters fill this gap by authorizing management to evaluate the social and economic effects of the tender offer on the company's employees, suppliers, customers, and the communities in which it operates. In addition to proving useful in the disclosure context, such authority may provide the justification for overt defensive actions aimed at thwarting the offer.

The broad issue posed by such a provision—whether management's primary duty is to maximize the value of the shareholder's stock or whether it owes a more general duty to society at large—has long been debated outside the tender offer context.[34] Some com-

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30. DEL. CODE ANN. tit. 8, § 102(a)(4) (1975); N.Y. BUS. CORP. LAW § 502(c) (McKinney 1963). This stock is known as "blank check" preferred stock. Hochman & Folger, *supra* note 21, at 547.

31. *See* A. FLEISCHER, *supra* note 21, at 24-2 to 24-4.

32. *See supra* pp. 32-33.

33. 17 C.F.R. § 240.14e-2 (1980).

34. *Compare* Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (corporate powers exercised for benefit of shareholders) *with* Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) (advocating social duty of corporation). *See also* Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964).

mentators believe that management is always justified in opposing tender offers on societal grounds.[35] If so, a charter amendment condoning such behavior is superfluous. More pragmatically, unless coupled with other defensive practices, the provision may not have a significant impact on shareholder responses to the tender offer. Target shareholders remain free to place their financial interests above those of other groups affected by the offer. Supporters believe, however, that express authorization in the charter is psychologically beneficial because it serves as a vote of confidence in managerial discretion.[36]

B. *Stage Two: Management Entrenchment*

A variety of shark-repellent amendments prevent a rapid turnover in the composition of the board of directors. In contrast to the direct antitakeover effect of stage one, they merely impose a delay between the successful completion of the tender offer and the point at which the bidder can replace target management. Nevertheless, the lag will deter bidders who want to bring about a quick overhaul of corporate policy.

1. Staggered Board of Directors

Probably the most common, and most traditional, means of management entrenchment is the "staggered" (or "classified") board of directors.[37] For example, a corporation with a nine member board of directors could divide the board into three classes of three members each, with members serving three year terms. Instead of electing nine directors each year, shareholders would elect three, the remaining six directors having been elected in prior years.[38] This

35. *E.g.*, Steinbrink, *supra* note 14, at 899-900.

36. *See* A. FLEISCHER, *supra* note 21, at 24-3.

37. *See generally* 2 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 334.1 (rev. perm. ed. 1969); *see also* A. FLEISCHER, *supra* note 21, at 13-14; Hochman & Folger, *supra* note 21, at 538.

38. This is an area where attention to the different state statutes is important. New York permits the board to be divided into two, three, or four classes, provided that no class contains less than three directors and all classes are as nearly equal in number as possible. N.Y. BUS. CORP. LAW § 704 (McKinney 1963). Delaware permits a maximum of three classes, with no requirements as to the size of the board and the number of directors in each class. In addition, the charter may confer upon the holders of any class or series of stock the right to elect one or more directors, whose terms of office and voting powers may be greater or less than those of any other directors or class of directors. DEL. CODE ANN. tit. 8, § 141(d) (Supp. 1980). The Model Business Corporation Act permits up to three classes when the board consists of nine or more members and requires that the classes be as nearly equal in number as possible. ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 37 (1971). Stock exchange requirements are also relevant. The New York Stock Exchange will refuse to list a company's common stock if the board is classified into more than three classes of approximately equal size and tenure. A. FLEISCHER, *supra* note 21, at 13 n.37.

practice has a long history.[39] Like stock issuances, it also has a benign justification: a longer term of office enables directors to acquire greater familiarity with corporate affairs and promotes continuity of management.[40]

Justification for staggering loses much of its force when we realize that corporations rarely experience abrupt changes in management absent a contest for control.[41] Once an outsider has purchased a majority of the target's stock, it seems only fair to allow that individual or entity to control corporate policy. Yet staggering precludes this result for several years. In the case of a nine member board of directors, an unclassified board and straight voting permits a fifty-one percent shareholder to replace all of the directors at one election. With staggering, two elections must occur before control of the board is transferred to the majority shareholder. When shareholders are entitled to cumulate their votes, staggering may produce an even greater lag between formal ownership of a majority of the corporation's stock and the actual power that accompanies such ownership.[42]

A staggered board provides an effective weapon in proxy contests, since it requires insurgents within the corporation to remain organized for an extended period of time.[43] When directed against outsiders, additional safeguards must be adopted in order to ensure that a successful bidder does not repeal or undermine the staggering provision. This purpose is commonly achieved by requiring a "supermajority" (seventy percent or more) vote to repeal the provision [44] and by

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39. Maryland has permitted staggering since 1868, Illinois since 1871, and Pennsylvania since 1887. Adkins, *Corporate Democracy and Classified Directors*, 11 BUS. LAW. 31, 31 (1955).

40. *See, e.g.*, Sell & Fuge, *Impact of Classified Corporate Directorates on the Constitutional Right of Cumulative Voting*, 17 U. PITT. L. REV. 151, 162 (1956).

41. *See* ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 37, ¶ 2 (1971); Adkins, *supra* note 39, at 32.

42. Cumulative voting is problematic in one respect. Although it prevents a bidder with majority ownership from replacing all of the directors in a short period of time, it will enable a minority shareholder (perhaps one who wishes to make a tender offer) to gain a position on the board. Apparently the ambiguity has led a few corporations to combine a staggered board with cumulative voting. *See* Hochman & Folger, *supra* note 21, at 539. However, "[i]f only three directors are to be elected at any time, a minority stockholder would have to control over 25 per cent of the votes cast to be assured of a seat, and with that kind of strength few managements would be inclined to deny him some degree of representation." *Id.*

43. *See generally* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 349-52 (2d ed. 1968) [hereinafter cited as PROXY CONTESTS].

44. *E.g.*, A. FLEISCHER, *supra* note 21, at 18. Such a provision should apply to all shark-repellent amendments. It is especially important in states where shareholders can amend the charter without obtaining the approval of the board of directors. *See, e.g.*, N.Y. BUS. CORP. LAW § 803(a) (McKinney Supp. 1980). *But see* DEL. CODE ANN. tit. 8, § 242(c)(1) (Supp. 1980) (board approval required). In addition, the supermajority provision should itself require a supermajority vote for re-

placing a limit on the size of the board.[45] More significantly, staggering may be worthless if directors decide not to serve out the remainder of their terms upon the completion of a successful tender offer.[46] Nevertheless, the element of uncertainty has not deterred corporations from adopting staggered boards; [47] it merely implies that, at worst, staggering has a neutral effect on tender offers.

2. Removal of Directors

Most corporations combine staggering with restrictions on the removal of directors. The charter may provide that directors can be removed only "for cause" or by a supermajority vote.[48] Delaware corporations need not rely on charter provisions. The General Corporation Law requires cause for the removal of members of a classified board (unless the charter provides otherwise).[49] Similarly, the New York statute provides that directors may be removed without cause only if permitted by the charter or by-laws.[50] Obviously, removal without cause would undermine the rationale for staggered boards (*i.e.*, continuity of management), since directors could be replaced, for no reason, at any time during their tenure in office.

Stringent removal powers represent a retreat from a modern liberalization of the shareholders' removal right.[51] It has long been recognized that "[t]he power to remove a director or an officer for cause inheres in every corporation as a part of its being" [52] and does not require charter or by-law authorization. Common law grounds for removal included such misconduct as malfeasance in office, con-

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peal. Otherwise, a majority shareholder could repeal the provision and then proceed to repeal the shark-repellents. Some state statutes expressly require a greater-than-majority vote for the repeal (and sometimes the adoption) of supermajority provisions. *E.g.*, N.Y. BUS. CORP. LAW § 616(b) (McKinney 1963) (repeal and adoption by two-thirds vote unless charter requires higher vote); DEL. CODE ANN. tit. 8, § 242(c)(4) (Supp. 1980) (repeal only; adoption permitted by simple majority vote under § 242(c)(1)).

45. *E.g.*, A. FLEISCHER, *supra* note 21 at 14-15.

46. Lipton and Steinberger cite this factor in concluding that staggered boards lack any real deterrent effect. 1 M. LIPTON & E. STEINBERGER, *supra* note 17, § 6.2.2, at 265.

47. Perhaps this is so because the problem is not likely to arise during a proxy contest.

48. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 15-16; Hochman & Folger, *supra* note 21, at 541-42.

49. DEL. CODE ANN. tit. 8, § 141(k)(1) (Supp. 1980). However, members of an unclassified board can be removed at any time without cause (subject to certain safeguards in the case of cumulative voting), thereby providing another incentive for staggering. *See id.* § 141(k).

50. N.Y. BUS. CORP. LAW § 706(b) (McKinney 1963).

51. *See* ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 39 ¶ 2 (1971).

52. 2 W. FLETCHER, *supra* note 37, § 351, at 150 (footnote omitted).

viction of a felony, and harassment of employees and officers.[53] The attempt to limit removal to those situations rejects the policy that shareholders should have total freedom in making managerial choices and that removal should accordingly depend upon "the bare question of whether the shareholders desire to retain [a director] as a representative on the board for whatever reason." [54]

3. Other Provisions

Finally, several other management-entrenching techniques have been utilized by corporations fearing takeover bids. These include limiting the right to call special meetings of the shareholders,[55] eliminating the shareholders' right to act by written consent,[56] and vesting the power to fill vacancies solely in the board of directors.[57] Their purpose is to prevent a majority shareholder from changing the composition of the board prior to the annual meeting. As with all shark-repellent provisions, it is necessary to prevent their repeal except by a supermajority vote.[58]

C. *Stage Three: Shareholder Protection*

1. Supermajority Voting

If a bidder succeeds in purchasing a majority of the target's stock, thereby surmounting stage one, and manages to avoid stage two problems by securing majority representation on the board of directors, it might decide to consolidate its position by merging out the remaining minority shareholders. State corporation statutes normally require majority (and sometime two-thirds) approval of mergers and other forms of business combinations submitted to a shareholder vote,[59] un-

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53. *Id.* § 356, at 163-65. The definition of "cause" is sometimes written into corporate charters so that outsiders will have further difficulty in making the allegation. A. FLEISCHER, *supra* note 21, at 16.

54. ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 39 ¶ 2 (1971).

55. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 17; Hochman & Folger, *supra* note 21, at 540.

56. *Id.*

57. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 16; Hochman & Folger, *supra* note 21, at 542.

58. *See supra* note 44.

59. *E.g.*, ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 73 (1971) (majority vote). Some states permit "short-form" mergers (those between parent and subsidiary, where the parent owns at least ninety percent of the subsidiary's stock) to be consummated without a shareholder vote, *id.* § 75, as well as certain other kinds of mergers. *Id.* § 73, ¶ 3.03.

less the charter specifies a greater percentage.[60] Raising the necessary vote increases the uncertainty of a "freezeout" merger.[61] More specifically, the high vote may deter a bidder who intends to finance the tender offer with corporate funds once public shareholders have been eliminated. It will not influence a bidder who desires only to acquire a control position and does not plan a freezeout.

Typical supermajority voting provisions mandate an extremely high favorable vote in transactions between the target and an "interested" shareholder, often one holding as little as five to ten percent of the corporation's stock.[62] The new vote is waived when a majority of the "continuing" directors (*i.e.*, those elected prior to the tender offer) approves the transaction.[63] Supporters of the waiver note that an inflexible supermajority can prevent the consummation of an attractive merger, either with the bidder or with a party unrelated to the tender offer.[64] But since beauty is in the eyes of the beholder—in this case the board of directors—the definition of "attractive" should not be viewed as a process devoid of self-interest. Supporters also argue that the waiver option increases management's bargaining power in negotiations with the bidder.[65] The desirability of that result raises

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60. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(4) (1975); N.Y. BUS. CORP. LAW § 616(a)(2) (McKinney 1963). Apart from the statutes, however, there are some constraints on "unusual" voting provisions. Section 3.07(2) of the WISCONSIN ADMINISTRATIVE CODE, 3 BLUE SKY L. REP. (CCH) ¶ 64,527 (Jan. 1, 1981), states that the Commissioner of Securities may refuse to register a company's securities on the ground that their sale would be unfair and inequitable if the charter or by-laws require a greater than two-thirds vote to approve business combinations (and more than a majority vote to increase or decrease the size of the board of directors, or to remove and replace directors). On the other hand, the WISCONSIN BUSINESS CORPORATION LAW, WISC. STAT. ANN. § 180.25(3) (West Supp. 1980), permits the higher vote. In addition, the New York Stock Exchange has threatened to delist stock with unusual voting provisions, although it has yet to take action in this area. A. FLEISCHER, *supra* note 21, at 24-6.

61. Additional uncertainty, at least for freezeouts involving Delaware corporations, was created by the Delaware Supreme Court's decision in Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977). The court held that a majority shareholder cannot cause a merger for the sole purpose of cashing out the minority; moreover, even if a business purpose exists, the court must examine the terms of the transaction to determine whether they are fair. *See also* Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977) (in merger between parent and subsidiary, business purpose of parent satisfies business purpose requirement). Thus, apart from supermajority charter amendments, there is some doubt as to the viability of freezeouts. Indeed, the merger in *Singer* occurred after the majority shareholder acquired its stock in a tender offer. Nevertheless, strong reasons exist for rejecting the *Singer* result in the tender offer context. *See generally* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter cited as *Corporate Freezeouts*].

62. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 18; Hochman & Folger, *supra* note 21, at 548; Mullaney, *supra* note 21, at 1442.

63. Since the bidder has control of the board at this point, a waiver by a simple majority of the directors would obviously be counterproductive. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 21; Hochman & Folger, *supra* note 21, at 551-52.

64. *See, e.g.*, Hochman & Folger, *supra* note 21, at 551.

65. *See, e.g.*, Smith, *supra* note 21, at 7.

the general issue of management's proper role in the takeover process, which will be discussed in Part III.

A varient of the "contingent supermajority" described above imposes a floating vote requirement which increases with the bidder's stockholdings.[66] In effect, it resembles a class vote, since the merger proposal requires the support of a majority of shares other than those held by the bidder.[67] The rationale here is that the bidder has a conflict of interest and should not be allowed to foist its will on the minority.[68] The flaws in this argument will also be discussed in Part III.

Finally, some controversy exists as to whether the supermajority provisions (and provisions restricting their repeal) must themselves be adopted by an increased vote. New York, but not Delaware, has such a requirement.[69] One commentator has questioned the propriety of a simple majority vote in states where the statutes are silent.[70]

2. Fair Price Provisions

A facially less intrusive shark-repellent amendment is known as the "fair price" provision.[71] Rather than interfering with the majority shareholder's ability to cause a merger, this provision focuses on the substantive terms of the freezeout. It is designed to deter a bidder who is unwilling to pay a "fair price" for the corporation's assets and to make shareholders less fearful of an unfair freezeout when they decide whether to retain their stock. As in the supermajority case, it will not deter a bidder whose sole purpose is to acquire a control position in the target.

Fair price provisions generally require that a supermajority vote be obtained for any merger between a substantial shareholder and the target unless the merger is approved by continuing directors or the price to be paid in the transaction is equal to the greater of:

> (i) the highest price paid by the offeror for any shares of the target during the offer;

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66. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 19-20; Hochman & Folger, *supra* note 21, at 549; Mullaney, *supra* note 21, at 1445-46.

67. One problem with this technique is that class voting provisions in some state corporation statutes do not expressly permit it. *See* Mullaney, *supra* note 21, at 1450.

68. *Id.* at 1446.

69. *See supra* note 44.

70. Cary, *Corporate Devices Used to Insulate Management from Attack*, 25 BUS. LAW. 839, 840 (1970).

71. For a detailed description, see Smith, *supra* note 21, at 13-22. *See also* A. FLEISCHER, *supra* note 21, at 22 to 24-1; Hochman & Folger, *supra* note 21, at 553-54.

(ii) an amount which bears the same or a greater percentage relationship to the then market price of the target's stock as the highest price per share paid by the offeror during the tender offer bears to the market price of the stock immediately prior to the commencement of the tender offer; or

(iii) an amount equal to the earnings per share of the corporation for the four full consecutive fiscal quarters immediately preceding the proposed business combination multiplied by the then price/earnings ratio of the offeror.[72]

Alternative (i) prevents shareholders from tendering because they anticipate an unfair freezeout. At a minimum, minority shareholders receive the same consideration as the shareholders who accepted the tender offer.

Alternative (ii) treats the percentage premium as a benefit which rightfully belongs to the shareholders regardless of the underlying value of their stock. Because the bidder decided to pay a certain premium at the time of the tender offer, it must pay the same percentage above the market at the time of the freezeout. The rationale for such mechanical consistency is not readily apparent. For one thing, the market price of the target's stock probably increased in response to the tender offer; if the price fails to return to the pre-offer level,[73] then the stock market has essentially incorporated the premium into its own valuation of the target. Requiring the bidder to pay an additional markup gives minority shareholders a double premium.

Alternative (iii) is justified on the ground that it reflects the benefit realized by the bidder as the result of the freezeout.[74] In theory, the increase in value of the bidder can be calculated by multiplying the bidder's price/earnings ratio by the additional income it will derive from the merger.[75] One problem with alternative (iii) is that it applies to the entire income of the target, and not merely to the portion of earnings which remains to be controlled by the majority share-

72. A. FLEISCHER, *supra* note 21, at 22-23. If these provisions are so desirable to shareholders, why do directors have the power to waive them? According to Smith, one problem with the regular supermajority waiver is that "there is the potential for abuse on the part of incumbent management which may be persuaded to approve the transaction and 'sell out' the corporation." Smith, *supra* note 21, at 13. In other words, management will use the bargaining process to derive gains for itself. The same problem would seem to apply to fair price provisions, but Smith fails to discuss it in relation to the fair price waiver.

73. If the price subsequently drops to the pre-offer level, then alternative (ii) is no different from alternative (i). Thus, this test will apply only when the market remains at the higher level.

74. Smith, *supra* note 21, at 16.

75. Smith, *supra* note 21, at 16.

holder.[76] The bidder already has the ability to divert a majority of the income to itself in the form of dividends; presumably it paid the tendering shareholders for that benefit. At least in the short run, alternative (iii) overstates the advantages of eliminating minority shareholders.[77]

In addition to the specific problems created by alternatives (ii) and (iii), there exists the broader issue of whether it is desirable to affect shareholder responses to a tender offer by holding out the prospect of a freezeout price which exceeds the tender offer price. Some fair price provisions distort shareholder incentives even more by adding an additional premium to the highest amount computed under the three tests.[78] According to one writer, this is done in order to force a partial liquidation of the target's assets and to guarantee that minority shareholders receive a portion of those assets.[79] At some point, however, the protective justification becomes less important than the anti-takeover function of the provision. If the tender offer fails, the need for protection will never arise.

3. Right of Redemption

The right of redemption provision is the most far-reaching of the shark-repellent amendments discussed in this article.[80] As noted above, supermajority and fair price provisions operate only if the bidder wants to eliminate minority shareholders and obtain full control of the target; they have no effect when the bidder is content with majority ownership. The right of redemption provision fills the void left by these amendments. If effective, it grants a minority of the target shareholders veto power over tender offers made for less than one hundred percent control.

Typically, the amendment provides that if any person owning fifty percent or more of the outstanding common stock of the target has

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76. *Id.*

77. In the long run, this test may actually understate the benefits. Bidders commonly make tender offers because they believe that the target could be more profitable under new management. *See infra* pp. 68-74. If so, a formula which looks to past earnings is inaccurate because the value of minority ownership is potentially much higher. On balance, it is impossible to determine how the conflicting problems with alternative (iii)—the use of *past* earnings and the use of *total* earnings—will resolve themselves in any given case. But the difficulty compounds the impropriety of applying such a formula.

78. Smith, *supra* note 21, at 17. The distortion may provide the reason for management's ability to waive fair price provisions. *See supra* note 72.

79. Smith, *supra* note 21, at 17.

80. For a detailed description, see Smith, *supra* note 21, at 22-27. *See also* A. FLEISCHER, *supra* note 21, at 24-1 to 24-2.

acquired any of the shares pursuant to a tender offer opposed by management, the minority shareholders can have their shares redeemed by the corporation.[81] The redemption price is the greater of:

> (i) the highest price paid by the 50% owner for any shares acquired pursuant to the tender offer or in market and privately negotiated transactions; or
>
> (ii) the highest sales price at which the stock has traded on the market during the 18 months preceding the date of notice of redemption.[82]

As in the fair price situation, the minority shareholders receive no less than the tendering shareholders. They may receive more—for example, if the bidder has purchased stock privately at a price in excess of the tender offer price.[83] The rationale for alternative (ii) is that the right of redemption may accrue several years after the initial tender offer. At that time the tender offer price may not reflect the value of the stock.[84] The rationale is troublesome, however, because the structure of the provision guarantees the shareholders the tender offer price even if the market price of the stock falls during the lag between tender offer and redemption.

One problem with the right of redemption provision is its validity under the state corporation statutes.[85] Most of the statutes provide that a corporation cannot redeem its stock if the redemption would impair the capital of the corporation.[86] Additionally, if the redemption required a reduction in capital or the liquidation of assets, some shareholders might challenge the procedure on the ground that the expenditures constituted waste and failed to serve a valid purpose, despite charter authorization.[87] Assuming these hurdles can be overcome, the Delaware and New York laws contain limitations on redemptions which may, as a matter of statutory construction, preclude their use as a shark-repellent. The Delaware statute provides that preferred stock is redeemable; but the statute is silent as to the re-

81. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 24-1; Smith, *supra* note 21, at 23.
82. Smith, *supra* note 21, at 23.
83. Such purchases are prohibited while the tender offer is outstanding, however. *See* 17 C.F.R. § 240.10b-13 (1980).
84. Smith, *supra* note 21, at 24.
85. *Id.* at 25, n.55.
86. *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 6 (1971).
87. Smith, *supra* note 21, at 26.

demption of common stock.[88] One commentator has suggested that the issuance of redeemable common stock is precluded by the statute.[89] The New York statute expressly states that no redeemable common shares, other than such shares of an investment company or a member of a national securities exchange, shall be issued or redeemed unless the corporation at the time has outstanding a class of common stock not subject to redemption.[90]

II. LEGAL CONSTRAINTS ON THE USE OF SHARK-REPELLENT AMENDMENTS

Constraints on the use of shark-repellent amendments operate at both the state and federal levels. At a minimum, a shark-repellent must derive its substantive justification from enabling provisions in the state corporation laws.[91] Additionally, amendments to the corporate charter or by-laws must comply with state and federal procedural standards. Under state law, charter amendments generally require shareholder approval.[92] In some cases, changes in the by-laws may be approved by the board of directors without a vote of the shareholders.[93] The proxy requirements of the Exchange Act [94] will also apply to those corporations whose securities are registered with the

88. DEL. CODE ANN. tit. 8, § 151(b) (1975). This provision also permits the redemption of stock issued by investment companies and companies having a license or franchise from a government agency or membership on a national securities exchange conditioned upon some or all shareholders possessing prescribed qualifications.

89. Smith, *supra* note 21, at 25 n.55.

90. N.Y. BUS. CORP. LAW § 512(c) (McKinney Supp. 1980).

91. The authorization may be explicit (*e.g.*, supermajorities; staggered boards) or implicit in the general power to adopt rules of corporate governance (*e.g.*, using nonfinancial factors to evaluate a tender offer; fair price provisions). The latitude permitted in the second category means, as a practical matter, that an amendment will probably be valid *on its face* so long as it does not conflict with any of the explicit statutory provisions.

92. *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT ANN. 2d § 59 (1971). The Model Act also provides that a majority of the directors may supply the requisite approval when no shares have been issued. *Id.*

93. The Model Act provides that the power to amend the by-laws shall be vested in the board of directors unless reserved to the shareholders by the charter. *Id.* § 27. Delaware has adopted a slightly different approach: the shareholders have the sole right to amend the by-laws unless the charter confers such power upon the directors; but in no case does directorial power limit the shareholders' right to amend. DEL. CODE ANN. tit. 8, § 109(a) (Supp. 1980). *See also* N.Y. BUS. CORP. LAW § 601(a) (McKinney Supp. 1980). It is considered tactically unwise for directors to place shark-repellents in the by-laws of a Delaware corporation because the "lock-up" amendments that require a supermajority vote to repeal the other shark-repellents could be construed as limiting the shareholders' inherent power to amend. *See* Hochman & Folger, *supra* note 21, at 545. The usual strategy is to utilize the charter as an antitakeover tool.

94. *See* 15 U.S.C. § 78n(a) (1976).

SEC.[95] Finally, fiduciary standards may be applicable to the actions of directors in proposing the amendments even when procedural requirements have been satisfied.

This Part of the article examines cases which allege violations of the constraints described above. The case law is sparse, and consequently the discussion will look beyond the narrow questions posed by defensive charter provisions to consider analogous cases analyzing the broader issues surrounding shifts in corporate control. It concludes that existing constraints on the use of shark-repellent amendments provide (with few exceptions) little protection against managerial decisions to turn the charter into a form of job security.

A. *General Principles*

Three principles emerge from a survey of shark-repellent cases:

1. Shark-repellents adopted without a shareholder vote are vulnerable, especially if the antitakeover intent is clear.[96]

2. In most cases management has not been required to disclose its subjective *purpose* in proposing shark-repellents, although it must reveal the *effect* of the amendments. However, the SEC staff requires extensive—and to some extent subjective—disclosure when proxy materials relating to shark-repellents are filed with the Commission.

3. Shareholder ratification and managerial disclosure are the primary (if not sole) criteria for assessing the validity of a shark-repellent. So long as the amendment complies with the literal language of the state statute, most courts will not scrutinize management's self-interest in proposing the amendment.

From management's perspective, the affirmative obligations created by (1) and (2)—ratification and disclosure—are relatively easy to satisfy. More significantly, they provide a simple way of avoiding an inquiry into purpose under (3).

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95. Corporations whose shares are listed on a national securities exchange or who meet certain tests with respect to assets and number of shareholders must register their stock with the SEC. *Id.* §§ 78l(a) (listed securities), 78l(g) (numerical tests). Most corporations with public shareholders come under one of these provisions.

96. This is another reason for not putting shark-repellents in the by-laws.

B. *Unilateral Action by Management*

A recent decision of the Delaware Chancery Court indicates that certain shark-repellent actions are illegal if based solely on the approval of the board of directors. In *Telvest, Inc. v. Olson,*[97] the plaintiff acquired twenty percent of the outstanding common stock of Outdoor Sports Industries, Inc. ("OSI") through open market purchases. Fearing a takeover attempt, OSI's management called a special meeting of the shareholders for the purpose of adding supermajority provisions to the corporate charter. It cancelled the meeting after Telvest requested a shareholder list and proceeded to enact supermajority provisions on its own initiative as a by-law amendment.

The board planned to issue a class of "blank check" preferred stock [98] as a dividend to the common shareholders. Voting rights set by the board required that eighty percent of the preferred shareholders approve any business combination with a corporation owning twenty percent or more of the outstanding common stock, unless management waived the requirement. Because the dividend was proportionate to common stock ownership, the scheme would allow twenty percent of the common shares to block an eventual freezeout merger by Telvest. The court, however, granted a preliminary injunction against the issuance of the dividend. First, as a matter of statutory construction, it questioned whether OSI's actions complied fully with the relevant provisions in the Delaware corporation law.[99] The court also criticized the argument that the voting change was beneficial because it protected minority shareholders, since the same provision lessened the influence of those shareholders who believed that a merger would be beneficial.[100]

Instead, the court thought it "more logical to conclude that where the holders of the common stock are given the right to approve certain transactions by only the majority vote required by the various applicable statutes, that right cannot be changed short of an amendment to the certificate of incorporation approved by the stock-

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97. No. 5798 (Del. Ch. Mar. 8, 1979) (reported at 5 DEL. J. CORP. L. 378 (1980)). For a summary of the decision, see Gerlitz, *Considerations for the Defense*, ELEVENTH ANN. INST. SEC. REG. 237, 245 (P.L.I. 1979). A more recent case involving unilateral action by target management is Joseph E. Seagram & Sons, Inc. v. Conoco, Inc., 519 F. Supp. 506 (D. Del. 1981), in which the court struck down a by-law limiting the number of shares which could be held by a foreign corporation or individual. The court based its decision on provisions in the Delaware statute which require that such a by-law obtain shareholder approval; the court did not reach the argument that the by-law was intended to entrench target management.

98. *See supra* text accompanying note 30.

99. Telvest, Inc. v. Olson, No. 5798, slip op. at 10-14 (Del. Ch. Mar. 8, 1979).

100. *Id.* at 9.

holders." [101] Moreover, the court speculated that *even if* management could alter voting rights unilaterally, management's motive in this case rendered such behavior improper.[102]

The scope of *Telvest* is unclear. On the one hand, the court did not state that management's designation of voting rights will always be illegal. The court did not place an absolute prohibition on this type of stock issuance; instead it doubted whether OSI's behavior even satisfied the enabling language in the state statute. The fact that the stock was to be given to existing shareholders rather than sold as a financing device probably influenced the decision as well. Similarly, it would be inappropriate to make the broad assertion that defensive by-law amendments approved only by the board are necessarily invalid.

On the other hand, the court's desire to protect shareholder voting rights can be extended to other fact situations. In the takeover context, blank-check·preferred stock is useful precisely because it alters voting rights. The rule announced by the court, if read more generally, suggests that specific shareholder approval must be obtained before such voting rights are set and the shares are distributed. At a minimum, a rigid interpretation of the case would diminish the utility of these transactions as a takeover defense by precluding fast and unsupervised action by management.

Additionally, the court indicated that management's motives could have an effect on the judicial evaluation of its behavior.[103] To this extent the court rejected the conclusion that mere compliance with the statute would have insulated OSI from liability. Of course, the converse—proper motive—would justify defensive actions if this analysis were adopted. And under such an approach the lack of shareholder approval would not be the decisive factor.[104]

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101. *Id.* at 14.

102. *Id.* at 15-16.

103. This approach was consistent with the conclusion reached in an earlier Delaware case involving management's amendment of the by-laws in order to prevent a shift in control. In Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971), management advanced the date of the annual shareholders' meeting so as to preclude a proxy fight by the plaintiffs. This behavior complied with the Delaware corporation statute, but the court held that "inequitable action does not become permissible simply because it is legally possible." *Id.* at 439. A similar situation was presented recently in Lerman v. Diagnostic Data, Inc., 421 A.2d 906 (Del. Ch. 1980). In both *Schnell* and *Lerman*, management acted after it had knowledge of an impending proxy fight, thereby reducing the courts' difficulty in determining the purpose of the amendments.

104. Indeed, courts have permitted management to directly oppose tender offers without obtaining shareholder authorization. *See infra* pp. 58-62.

C. *The Limits of Disclosure*

Unlike the majority of cases arising out of shark-repellent disputes, disclosure cases are primarily federal,[105] alleging violations of section 14(a) of the Exchange Act.[106] Section 14(a) renders it unlawful to violate proxy rules promulgated by the SEC. Rule 14a-9 [107] prohibits false or misleading proxy statements. If the shark-repellent amendment is enacted while a specific tender offer is outstanding, section 14(e),[108] which contains general antifraud language, would also be applicable.

The issue in disclosure cases, whether restricted to shark-repellent situations or not, relates to the amount of disclosure necessary to satisfy the antifraud proscription. Many corporations adopting shark-repellent provisions attempt to avoid the problem by making extensive disclosure of the effects of their actions, including the effect of deterring tender offers.[109] Item 20 of Schedule 14A (which sets forth the information required in a proxy statement) provides that proxy statements containing information about a proposed charter or by-law amendment must disclose "the reasons for and general effect of such amendment." [110] It is unclear, however, whether "reasons and effect" include disclosure of managerial self-interest and job entrenchment, or whether disclosure can be limited to the mechanical aspects of the amendment and the fact that it may deter takeovers. The requirement of "reasons" seems to imply the former, although courts in resolving this problem have not referred to the language in the Schedule.[111] Bidders obviously prefer disclosure of motive, hoping that shareholders will be inclined to reject the amendments and that direc-

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105. Choosing the appropriate forum in which to institute a shark-repellent action is beyond the scope of this article. It should be noted, however, that actions based on violations of management's fiduciary duty will probably not give rise to a claim under the federal securities laws. In Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), the Supreme Court held that a fiduciary duty claim would not satisfy the "manipulative or deceptive" language of § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1976), because the federal statute regulates disclosure rather than corporate mismanagement. *See also* Berman v. Gerber Prods. Co., 454 F. Supp. 1310 (W.D. Mich. 1978) (*Santa Fe* holding applied to tender offer); Altman v. Knight, 431 F. Supp. 309 (S.D.N.Y. 1977) (same). *But see* Lynch & Steinberg, *supra* note 9, at 906-13 (Congress' intent in regulating tender offers was to create a federal fiduciary duty).

106. 15 U.S.C. § 78n(a) (1976).

107. 17 C.F.R. § 240.14a-9 (1980).

108. 15 U.S.C. § 78n(e) (1976).

109. *See* Mullaney, *supra* note 21, at 1454.

110. 3 FED. SEC. L. REP. (CCH) ¶ 24,051 (Dec. 14, 1981).

111. A. FLEISCHER, *supra* note 21, at 24-8 n.94.

tors might decide not to propose them in the first place.[112] At some point, stringent procedural requirements become a substantive regulation of managerial discretion.

The subjective/objective dichotomy is revealed by *Elgin National Industries, Inc. v. Chemetron Corp.*[113] In that case the defendant solicited proxies to amend the charter and provide for a staggered board of directors and supermajority voting. The proxy statement explained that the "reason for the Amendment is to discourage persons from attempting to take over the Company" [114] and admitted that the "general effect" of the staggering provision would make it difficult for a bidder to obtain quick control of the board.[115] Management disclaimed knowledge of an impending tender offer but wanted to "take action at this time to discourage such action and induce a potential acquirer to negotiate with management." [116]

The district court denied the plaintiff's motion for a preliminary injunction to enjoin the voting of proxies and to postpone the annual meeting. It acknowledged that the policy underlying management's position might be wrong (it did not suggest that it was) but found no evidence to support the claim that the statements were false and misleading under rule 14a-9. [117] Nor did it agree that management had made material omissions. The plaintiff alleged that management should have disclosed that the effect of the amendments would be to entrench existing management, not merely to "make it difficult" for an outsider to obtain control. More significantly, management should have stated that its takeover concern was based on self-interest and a desire to enjoy the "continued receipt of substantial emoluments" which flowed from its position.[118] The court took a more benign view

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112. In an analogous context, subjective disclosure has also been used as a means of avoiding the jurisdictional problems described in note 105 *supra*. This theory admits that breach of fiduciary duty does not constitute a federal claim, but argues that *nondisclosure* of a breach of fiduciary duty does. For a successful application of the theory, see Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978) (§ 10(b)). *But see* Selk v. St. Paul Ammonia Prods., Inc., 597 F.2d 635 (8th Cir. 1979) (§ 14(a)); Golub v. PPD Corp., 576 F.2d 759 (8th Cir. 1978) (§§ 10(b), 14(a)). In another proxy case, Podesta v. Calumet Indus., Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,433, at 93,555 (N.D. Ill. 1978), the court stated that the *Santa Fe* case does not stand for the broad proposition that "a claim is insufficient merely because it relates to a breach of duty under state law." Although management need not set out every allegation of misconduct made by any critic, the facts underlying a potential conflict of interest or breach of duty must be disclosed. *Id.*

113. 299 F. Supp. 367 (D. Del. 1969).

114. *Id.* at 370.

115. *Id.*

116. *Id.*

117. *Id.* at 371.

118. *Id.* at 372.

of the situation and concluded that an intelligent shareholder would recognize management's self-interest without disclosure of motive:

> It is self-evident that the advantage which management has in soliciting proxies in favor of incumbent directors is inherent in the control which management possesses over the proxy machinery. But this does not make it wrong for a corporation to solicit proxies which tend to maintain in office incumbent directors without saying as much. Many corporations do this. Some candidates for directorships in some corporations, to be sure, have devious and self-serving purposes in seeking to be reelected. But in other instances the purpose of solicitation of proxies in favor of incumbents is to maintain in office experienced people having intimate familiarity with the corporation's affairs. *In the absence of some intended act of wrongdoing by candidates who seek reelection* there appears to be no reason why the stockholders should be advised that the proposed amendment may tend to facilitate management perpetuating itself in control. Certainly it is not false and misleading for the management to fail to do so. It is an obvious fact which is disclosed whenever management solicits proxies in favor of itself.[119]

The theory of the preceding passage is that management's misconduct will not be presumed. [120] Absent tangible evidence of misconduct (a concept left undefined by the court), the board will not be held liable for its failure to disclose motive. A later case, *Jewelcor, Inc. v. Pearlman*,[121] relied on the *Elgin* analysis but appears to take that case a step further. In *Jewelcor*, the proposal of shark-repellent amendments occurred in the context of a possible takeover by a specific bidder, Jewelcor, which had begun to purchase the stock of Lafayette Radio Electronics Corporation ("Lafayette"). Lafayette's proxy statement disclosed the fact that the amendments would "serve to moderate the pace of any change in control" and would enable the board of directors to protect shareholder interests in the event of a takeover.[122] The court rejected Jewelcor's claim that the proxy statement should have disclosed that the charter amendments were di-

119. *Id.* at 372-73 (emphasis added).
120. *Cf.* Muschel v. Western Union Corp., 310 A.2d 904 (Del. Ch. 1973) (in suit alleging unfair merger, management's conflict of interest would not be presumed absent a specific showing by plaintiffs).
121. 397 F. Supp. 221 (S.D.N.Y. 1975).
122. *Id.* at 248.

rected against Jewelcor and were designed to entrench target management.[123] Even if these allegations were correct, the court thought that omission of motive was probably not material.[124] However, it ultimately granted a preliminary injunction because Lafayette's management had engaged in certain other improper actions to thwart a takeover.[125] Yet, that misconduct did not trigger liability for nondisclosure of motive.

The approach taken in *Jewelcor* is consistent with a number of cases involving direct antitakeover action by target management.[126] What amounts to a presumption in favor of management has a fatal effect on the cases of many plaintiffs who wish to bring a federal action.[127] These plaintiffs would argue that because management has an inherent conflict of interest when it engages in defensive maneuvers (the court in *Elgin* admitted as much [128]), the risk of malfeasance is so high that management must disclose motive and "clear the air." As a practical matter, this solution is problematic. One should recognize that disclosure has obvious psychological limits. Directors whose motives are improper and who have violated state fiduciary principles as a result will not facilitate a second, federal suit by disclosing the unfairness of their behavior. The real problem with shark-repellent amendments lies in the lack of substantive restrictions on their use. As Part III reveals, this problem should be attacked directly, rather than indirectly through disclosure requirements.

At present, however, disclosure is occasionally used as a means of slapping management's wrist and requiring that shareholders have additional information before they are permitted to vote on shark-repellent provisions. A recent case, decided by the same court that de-

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123. *Id.* at 248-49.

124. *Id.* Assuming that Lafayette enacted the amendments in order to prevent a takeover by Jewelcor, the court's conclusion with respect to materiality was incorrect. Such information may well have influenced the reactions of Lafayette's shareholders. The considerations which enter into a decision to adopt a general antitakeover policy may appear weaker (or stronger) when a specific bidder is named.

125. *Id.* at 250-52.

126. *See, e.g.*, Selk v. St. Paul Ammonia Prods., Inc., 597 F.2d 635 (8th Cir. 1979); Golub v. PPD Corp., 576 F.2d 759 (8th Cir. 1978); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). In Altman v. Knight, 431 F. Supp. 309 (S.D.N.Y. 1977), the target made a defensive acquisition which did not require shareholder approval. The court held that any omissions as to motive could not have caused the plaintiff's injury, since shareholders had no voice in the corporation's decision to make the purchase, 431 F. Supp. at 314. *But see* Weber v. Bartle, 272 F. Supp. 201 (S.D.N.Y. 1967) (majority of board has duty to disclose conflict of interest to minority even though disclosure will not prevent majority from taking action).

127. The presumption operates in many state cases as well. *See infra* pp. 58-62.

128. *See supra* text accompanying note 119.

cided *Elgin*, indicates that appropriate disclosure can be rather detailed. In *Blanchette v. Providence & Worcester Co.*,[129] the court found several violations of section 14(e) in connection with an exchange offer between a parent corporation and its wholly-owned subsidiary. The purpose of the exchange was to reinstate voting restrictions which the Delaware Chancery Court had struck from the charter of the parent.[130] The charter of the subsidiary, which had been specially enacted by the Delaware legislature, contained the same restrictions. Both corporations had identical officers and directors; at the time of the exchange offer, the subsidiary was inactive and had no assets other than its capitalized organizational expense. By exchanging their stock for stock in the subsidiary, shareholders affected by the chancery court's decision could readopt the restrictive voting provisions.

The court's analysis may have been influenced by management's obvious attempt to negate the decision of the Delaware Chancery Court. Nevertheless, some broad observations concerning disclosure did emerge. First, the court required that management disclose that it would benefit from the acceptance of the exchange offer because the alteration in voting rights would render its removal more difficult.[131] This much of the opinion did not differ from *Elgin* and *Jewelcor*, since the proxy statements in those cases (although to a much weaker extent in *Jewelcor*) discussed the impact of the proposals on the board of directors.

The court went further, however. Because the shareholders were receiving information from only one party, in contrast to a tender offer in which both target and bidder distribute information to the shareholders, management's disclosure had to be counterbalanced by opposing arguments.[132] This requirement, which applies equally as well to shark-repellent amendments, was not emphasized in *Elgin* and *Jewelcor*. Next, the court criticized management's characterization of the exchange offer as involving "protective voting provisions." [133] Such provisions actually undermined the interests of large shareholders. Moreover, the "assumption that control of a corporation by larger shareholders is generally detrimental to its interest whereas control by small stockholders is advantageous to it is unwarranted in the face of generally accepted principles of corporate

129. 428 F. Supp. 347 (D. Del. 1977).
130. The Delaware Supreme Court ultimately reversed the Delaware Chancery Court. *See* Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1978).
131. 428 F. Supp. at 355.
132. *Id.* at 356.
133. *Id.*

democracy." [134] Finally, management should have disclosed that, in the long run, stock with restrictive voting rights is usually less valuable than stock with full voting rights.[135]

The disclosure required in *Blanchette*, although detailed, would not satisfy advocates of subjective disclosure. The court did not force management to reveal that the *purpose* of the exchange offer was to entrench the board of directors; it merely required the disclosure of facts which would enable shareholders to formulate an opinion about management's purpose. Critics may take comfort, however, in the current attitude of the SEC staff. In 1978, the Commission's Division of Corporation Finance published guidelines to its staff which require extensive—and to some extent subjective—disclosure when a proxy statement containing a shark-repellent amendment is filed with the Commission.[136] Among other things, management must 1) explain the reasons for the shark-repellent and the bases for such reasons; [137] 2) state whether the proposal is the result of management's knowledge of a specific effort to take over the company (and if not, why the measure is being proposed); [138] 3) describe the overall effect of the amendment; [139] and 4) discuss its advantages and disadvantages, for both management and the shareholders.[140] More specifically, supermajority provisions should indicate that management "may obtain a veto power over mergers regardless of whether the transaction is desired by or beneficial to a majority of the shareholders and thereby assists management in retaining their present positions." [141] In the case of a

134. *Id.* at 357.

135. *Id.*

136. Securities Exchange Act Rel. No. 15230, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,748 (Oct. 13, 1978) [hereinafter cited as Rel. No. 15230].

137. The Release stated that the proxy materials "should clearly indicate why management is proposing to amend the corporation's charter or by-laws. The term 'bases' for the reasons means an explanation of the factors and/or principles supporting or serving as a foundation for the reason stated." *Id.* at 80,986. One commentator has criticized the subjective nature of this requirement because "[o]bjective factors can be identified and described in disclosure documents. But why a corporate director or officer decided to . . . propose an amendment to the charter at a particular time, is something that can be argued about endlessly." Leiman, *Recent Developments in Tender Offers: Defensive Tactics*, TENTH ANN. INST. SEC. REG. 289, 292 (P.L.I. 1979). This criticism ignores the fact that Schedule 14A currently requires management to explain the reasons for charter amendments. *See supra* text accompanying note 110.

138. Rel. No. 15230, *supra* note 136, at 80,986.

139. *Id.* at 80,986-87. "A statement that the proposal could make the accomplishment of a given transaction more difficult even if it is favorable to the interests of shareholders may be warranted." *Id.* at 80,987.

140. *Id.* Two commentators consider it "unrealistic to imagine that management will give any stronger emphasis than at present to the disadvantages of anti-takeover proposals." Rose & Collins, *Porcupine Proposals*, 12 REV. SEC. REG. 977, 978 (Feb. 14, 1979).

141. Rel. No. 15230, *supra* note 136, at 80,987.

staggered board, management should disclose whether the amendment is directed at a specific shareholder or group of shareholders; if one reason for staggering is to ensure managerial continuity, the proxy statement should state whether the corporation has experienced continuity problems in the past.[142] And when stock with extraordinary or unspecified voting rights is created, management should state whether a private placement is contemplated and, if so, whether purchasers have an agreement with management to vote the stock a certain way.[143]

The staff instructions have not been reviewed by the full Commission. Nevertheless, in 1979, the Commission announced that it was "becoming increasingly concerned by the effect of defensive corporate charter amendments on the interests of investors, particularly investors who are confronted with a tender offer." [144] It requested comment on the types of rules which would be desirable in this area. The SEC warned that shark-repellent amendments "appear to be inconsistent with the protection of investors and the Congressional purpose underlying the Williams Act." [145] But as of this writing, the Commission has yet to take action directly prohibiting shark-repellents.

C. *A Fiduciary Test?*

Although disclosure is desirable, it may not prevent management from undermining the interests of target company shareholders. Management owes a duty to the shareholders which is more important than procedural regularity, for the "rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest." [146] As this Section reveals, however, many courts view shark-repellent cases as turning on purely mechanical issues—ratification and disclosure. For all intents and purposes, shareholder authorization is final.

1. The Mechanical Approach

a. *Board of Directors*

Challenges to charter and by-law provisions which prevent outsiders from gaining representation on the board of directors have rare-

142. *Id.* at 80,988.
143. *Id.*
144. Securities Exchange Act Rel. No. 16385, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,374, at 82,614 (Nov. 29, 1979).
145. *Id.*
146. Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939).

ly been successful. These cases have dealt primarily with the problem of minority representation on the board rather than the aftermath of a successful tender offer. Whether courts will feel more sympathy for a majority shareholder's inability to control management remains to be seen. The emphasis placed on the procedural aspects of the cases suggests that the treatment of the majority will not differ from that of the minority.

Two cases are illustrative of the courts' deferential attitude toward management. In *McKee & Co. v. First National Bank*,[147] a bank amended its by-laws to impose residency requirements on directors and to prohibit attorneys from serving on the board if they represented other banking institutions. The change precluded the plaintiff, who owned eight percent of the bank's stock, from electing two nonresident directors; one of the nominees also violated the attorney clause. The court held that an inquiry into the bank's motive was unnecessary because the by-laws were reasonable on their face (many banks had similar requirements) and were reasonably applied (all nonresidents, not only the plaintiff's nominees, were affected).[148] The fact that the amendment was specifically directed against a minority shareholder was ignored.

A similar conclusion was reached in *Stockholders Committee for Better Management of Erie Technological Products, Inc. v. Erie Technological Products, Inc.*,[149] a case challenging a by-law amendment which created a staggered board. A majority of the outstanding shares of stock were owned by the officers and directors of the corporation and persons related to them.[150] Immediately prior to the implementation of staggering, the plaintiffs controlled enough stock to elect one member of a seven member board. The staggering provision, which created three classes of directors (two of the classes had two members and the third class had three members), precluded that result.

In considering the defendant's motion for summary judgment, the court assumed the truth of the plaintiffs' allegation that the board proposed the change in order to prevent minority shareholders from electing a director. Nevertheless, the court granted the motion. It stated that "purpose or motives are immaterial," because "[e]ven where a director's motive is suspect, the approval of his action by a majority of the shareholders removes this possible objec-

147. 265 F. Supp. 1 (S.D. Cal. 1967), *aff'd*, 397 F.2d 248 (9th Cir. 1968).
148. *Id.* at 4-13.
149. 248 F. Supp. 380 (W.D. Pa. 1965) [hereinafter cited as Erie Technological Products].
150. *Id.* at 382.

tion." [151] The plaintiffs alleged further that the staggered board would prevent wider trading of the stock and listing on a public exchange, actions which would, in their opinion, enhance the stock's value. To this the court responded that the amendments affected all shareholders equally: "The fact that plaintiffs may have a speculative interest in trading in the stock which is not shared by a majority of the stockholders, or the directors, is no invasion of any legal or equitable rights." [152]

The court also rejected the argument that a staggered board with only two members per class impaired the right of cumulative voting, which was guaranteed by the state constitution.[153] The minority could still obtain representation if it acquired a sufficient number of shares, notwithstanding the fact that the sufficient number had increased significantly. Finally, and perhaps most importantly, the court took the position that the plaintiffs lacked a reasonable expectation that the by-laws would not be changed to their detriment:

> The plaintiffs have of their own free will chosen to join the fortunes of this particular corporate expedition. They are not captive passengers, they can disembark at any time. They anticipated that they might in time garner enough support to secure election of their candidate to the Board of Directors. Nevertheless, they are charged with the knowledge that the By-laws might be amended to make

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151. *Id.* at 389.

152. *Id.* at 384.

153. *Id.* at 386-89. Most of the litigation challenging staggered boards has focused on the conflict between staggering and cumulative voting, which in some states is a right guaranteed by statute or by constitution. *See generally* 2 W. FLETCHER, *supra* note 37, § 334.1, at 126; PROXY CONTESTS, *supra* note 43, at 352-59. Most courts have upheld staggering on the ground that cumulative voting provisions do not guarantee minority shareholders representation on the board; thus, it is possible to undermine the effectiveness of cumulative voting through staggering. *E.g.*, Bohannan v. Corporation Comm'n, 82 Ariz. 299, 313 P.2d 379 (1957); Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780 (1956); Janney v. Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956). Some courts have stated, however, that a scheme which completely denies the effectiveness of cumulative voting must fail, as in the case of a board composed of three directors, elected one each year for a three year term. *E.g.*, *Erie Tech. Prods.*, 248 F. Supp. 380, 386 (W.D. Pa. 1965); Wright v. Central Cal. Colony Water Co., 67 Cal. 532, 8 P. 70 (1885); *cf.* People *ex rel.* Espey v. Deneen, 247 Ill. 289, 93 N.E. 437 (1910) (election of General Assembly). *Contra*, Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780 (1956) (three classes of directors, one director in each). A minority of courts have held staggering illegal merely because it impairs the effectiveness of cumulative voting. *E.g.*, Wolfson v. Avery, 6 Ill. 2d 78, 126 N.E.2d 701 (1955); State *ex rel.* Syphers v. McCune, 143 W. Va. 315, 101 S.E.2d 834 (1958). In *Wolfson*, 6 Ill. 2d at 82, 126 N.E.2d at 704, the court noted that staggering "in fact impairs even majority representation by requiring the majority to wait for two or three years before it can secure representation proportional to its strength."

> that prospect more difficult. That result has come about, but they have not been deprived of any legal right. *Their positions are the same as those of any stockholder in the corporation and they are entitled only to the same legal protection as any other stockholder.*[154]

The "free will" argument is troublesome because it penalized the plaintiffs for their failure to anticipate management's unfairness. It is especially objectionable once one realizes that the plaintiffs did *not* occupy the same position as other shareholders in the corporation, despite the court's assertion to the contrary. Since management and its relatives owned a majority of the outstanding stock, adoption of the staggering provision constituted self-dealing and required strict judicial review. The by-law amendment was not adopted by a large group of independent shareholders with varying interests (as the court seemed to think), but was adopted, instead, by the very interests which had proposed it.

In general, prospective shareholders should recognize that charter and by-law provisions may be amended for legitimate purposes designed to benefit the corporation. This expectation is reasonable even though the impact on individual shareholders can be disparate. Management entrenchment is not a legitimate purpose. Yet the court in *Erie Technological Products* indicated that shareholders have no cause to complain when management proposes charter amendments which undermine their investment. Its conclusion requires a cynical view of management and shareholders alike: management's behavior may well be questionable, but the shareholders are stupid because they did not foresee it! The average shareholder probably lacks such foresight; unless that were the case, why would anyone buy stock? It is therefore improper to charge the shareholder with this knowledge as a means of disposing of claims against management.

Given the judicial acceptance of staggering, it is not surprising that courts have also imposed restrictions on the removal of directors prior to the expiration of their term.[155] Removal would undermine the "continuity of management" rationale upon which staggering de-

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154. 248 F. Supp. at 389 (emphasis added).

155. *See, e.g.*, Essential Enterprises Corp. v. Automatic Steel Prods., 39 Del. Ch. 93, 159 A.2d 288 (1960) (by-law permitting removal without cause inconsistent with purpose of staggering provision).

pends.[156] Furthermore, in defining the type of "cause" which might justify removal, one court has rejected lack of cooperation with fellow directors (as opposed to a calculated scheme of harassment) as a suitable reason.[157] Thus, a bidder who elected a majority of the board could not remove the minority on incompatability grounds.

b. *Voting Restrictions*

Supermajority voting provisions have been upheld by courts in Delaware and Massachusetts. In *Seibert v. Gulton Industries, Inc.*,[158] the Delaware Chancery Court (in an opinion later affirmed by the Delaware Supreme Court) approved a supermajority provision that required an eighty percent majority in order to consummate a merger with a five percent shareholder, unless the provision was waived by the board of directors prior to the acquisition of the five percent interest. The court rejected the plaintiff's claim that the waiver violated section 102(b) (4) of the General Corporation Law,[159] which permits a supermajority vote when required by the charter, because it established a dual voting standard.[160] The statute does not expressly authorize the "shifting vote" created by a supermajority waiver. The plaintiff also argued that the waiver impinged upon the shareholders' right to vote because it enabled directors to determine the vote required for the approval of transactions which could be of financial benefit to the shareholders. Nevertheless, the court found sufficient justification for the board's actions in the general statutory provision which allows shareholders to enact charters containing rules not in contravention of statutory or common law.[161] Since the plain-

156. *See supra* text accompanying note 40. Staggering cases generally do not turn on policy considerations, however. In *Erie Technological Products*, 248 F. Supp. 380, 389 (W.D. Pa. 1965), the court stated that legislatures and regulators, not courts, should assess policy. *See also* Janney v. Philadelphia Transp. Co., 387 Pa. 282, 288, 128 A.2d 76, 79-80 (1956). This attitude is consistent with the courts' willingness to ignore motive and rely on procedural regularity in evaluating charter amendments.

157. Campbell v. Loew's, Inc., 36 Del. Ch. 563, 577, 134 A.2d 852, 860-61 (1957).

158. No. 5631 (Del. Ch. May 25, 1979) (reported at 5 DEL. J. CORP. L. 514 (1980)). The Delaware Supreme Court affirmed. *See* 414 A.2d 822 (Del. 1980) (table of unreported opinions). For a summary of *Seibert*, see Gerlitz, *supra* note 97, at 244. The chancery court had impliedly upheld supermajority provisions in two earlier cases, Young v. Valhi, 383 A.2d 1372 (Del. Ch. 1978), and Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 2 A.2d 108 (1938), but addressed the issue directly for the first time in *Seibert*.

159. DEL. CODE ANN. tit. 8, § 102(b)(4) (1975).

160. The plaintiff admitted that the statute permitted a supermajority provision which did not contain a waiver. *See* Seibert v. Gulton Indus., Inc., No. 5631, slip op. at 3 (Del. Ch. May 25, 1979) *aff'd* 414 A.2d 822 (Del. 1980).

161. Slip op. at 7-8; *see* DEL. CODE ANN. tit. 8, § 102(b)(1) (1975).

tiff could cite no precedents for her action,[162] and could not "point convincingly to any public policy," [163] the court dismissed the complaint.

In *Seibert v. Milton Bradley Co.*,[164] the same plaintiff attacked a by-law amendment which required the approval of seventy-five percent of each class of common stock for mergers and other forms of business combinations, unless the provision was waived by two-thirds of the incumbent directors. The Supreme Judicial Court of Massachusetts relied on the *Gulton* case and similarly dismissed the plaintiff's claim. Among other things, it rejected the argument that supermajority voting unlawfully restricts the shareholders' right to vote, because the shareholders had themselves approved the amendment and could always repeal it.[165]

The Delaware Supreme Court upheld a different kind of voting restriction in *Providence & Worcester Co. v. Baker*,[166] a case which also engendered disclosure litigation in federal court.[167] "Scale voting" provisions, which had been in effect since 1844, based a shareholder's voting power on the size of his or her stockholdings. For the first fifty shares, the shareholder had one vote per share. For every twenty shares above fifty, the shareholder had one vote; however, the shareholder could not vote more than one-fourth of the total number of shares issued and outstanding unless as a proxy for other shareholders.[168] As a result, the plaintiff, which had recently acquired twenty-eight percent of the stock in a merger and was the largest single shareholder, could exercise only three percent of the voting rights.[169]

The court found no statutory prohibition of this practice. Section 212(a) of the General Corporation Law imposes a one vote per share requirement, unless otherwise provided in the charter.[170] The plaintiff relied on this provision and interpreted it to mean that all shares in the same class must have the same voting rights; thus, scale

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162. *Seibert*, slip op. at 8. This was not surprising, since the case was one of first impression!

163. *Id.* at 8-9. The court disposed of plaintiff's allegation of improper delegation to the board by noting that various provisions in the corporation law confer discretion upon a board of directors in connection with mergers and other corporate transactions. *Id.* at 9.

164. 1980 Mass. Adv. Sh. 1235, 405 N.E.2d 131 (1980).

165. *Id.* at 1241, 405 N.E.2d at 135.

166. 378 A.2d 121 (Del. 1977). *See also* Smith, *supra* note 21, at 10-11.

167. *See supra* text accompanying note 129.

168. Also under attack was a charter amendment which increased the corporation's capitalization but retained voting restrictions in the same proportionate ratio as before. *See* Baker v. Providence & Worcester Co., 364 A.2d 838, 841 (Del. Ch. 1976).

169. *See id.* at 840-41.

170. DEL. CODE ANN. tit. 8, § 212(a) (1975).

voting was illegal because it altered the voting rights of large, but not small, shareholders. The court held that the provision was inapplicable because the restrictions attached to the *shareholder* and not to the *stock*.[171] Each share still had one vote, but, depending upon the owner, the vote might not be exercised. The court's formalistic reasoning meant that a majority shareholder could never cast a controlling vote.

The voting cases and their emphasis on statutory formalism are part of a larger body of law permitting corporations to alter voting rights. At one time, many courts assumed that important contractual obligations to shareholders (such as granting common stock the exclusive right to vote) could not be altered.[172] This view is no longer widely held and many statutes expressly authorize such changes.[173] The current tendency to accord management broad discretion in proposing restrictions in voting rights may benefit the corporation in certain contexts (when the corporation needs to sell preferred stock, for example), but it undermines the interests of shareholders when the discretion is used to prevent a takeover. At a minimum, voting restrictions are contrary to the notion of majority rule which dominates corporate law. Yet courts have failed to impose meaningful rules in this area because of their reliance on the statutes.

2. Fiduciary Considerations

The procedural orientation of the cases discussed thus far was rejected by the Court of Appeals for the Seventh Circuit in *Tankersley v. Albright*.[174] The charter amendments in that case provided for a staggered board, supermajority voting, and the creation of a new class of common stock for which the board of directors could determine rights and preferences. Additionally, the board was authorized to determine the rights of the outstanding common stock. The plaintiffs, trustees of a voting trust which controlled the Tribune Company, sought a declaration that they were legally empowered to vote the stock in favor of the amendments. Seven of the eight trustees were members of the Tribune's board. The eighth had resigned from the board and had been replaced by her husband. The district court granted summary judgment for the trustees and the amendments were approved.

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171. 378 A.2d at 123.
172. *See generally* 7A W. FLETCHER, *supra* note 37, §§ 3688-89 (rev. perm. ed. 1978).
173. *Id.*
174. 514 F.2d 956 (7th Cir. 1975).

The Seventh Circuit reversed because the lower court failed to apply fiduciary standards to the trustees' actions. It held that the record was insufficient to support summary judgment as to the good faith of the trustees in proposing the amendments and the related issue of whether the amendments "as a practical matter, will perpetuate the trustees as controlling directors of the company." [175] Although the amendments were prima facie legal, and "it is entirely possible that the plaintiffs had the purest motives in proposing these amendments . . . , it may also be that plaintiffs realized company returns were low and sought to insulate themselves and other board members from removal as a result of poor management." [176]

Tankersley is the only shark-repellent case to expressly hold that a motive-based test is appropriate in assessing the propriety of managerial actions.[177] Its meaning is ambiguous, however. Since the plaintiffs were proposing the amendments as directors and voting on them as trustees—a clear case of self-dealing—the court may have looked to motive because independent shareholder ratification was absent.[178] Nevertheless, it may be argued that shareholder approval generally follows from managerial proposals and that, in effect, directors are the ones who approve the amendments submitted for a shareholder vote.[179] Certainly the conflict of interest does not disappear because of "independent" ratification.

On a broad level, the fiduciary orientation in *Tankersley* is consistent with the approach taken by courts in a number of cases arising out of management's attempts to thwart shifts in corporate control. The tactics in these cases include repurchasing stock held by "dissident" shareholders,[180] allowing directors to retain their stock

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175. *Id.* at 963.

176. *Id.* (footnote omitted).

177. *Cf.* Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979), *supra* note 97, in which the court speaks approvingly of a motive-based test.

178. There was some evidence that the beneficiaries approved. They had received proxy statements and a letter from the trustees, and a mail poll indicated that over ninety percent approved. 514 F.2d at 962. The court held that the record was insufficient to establish the validity of the poll. *Id.* at 963. After the Seventh Circuit's decision, the voting trust expired by its own terms and the stock was distributed to the beneficiaries, who then enacted the amendments themselves; however, it is unclear whether the trustees/directors were significant shareholders. In subsequent litigation the district court dismissed, on procedural grounds, certain of the complaining beneficiaries' counterclaims relating to the trustees' conflict of interest. *See* Tankersley v. Albright, 80 F.R.D. 441 (N.D. Ill. 1978).

179. For a discussion of ratification, see *infra* pp. 75-79.

180. *See, e.g.*, Abramson v. Nytronics, Inc., 312 F. Supp. 519 (S.D.N.Y. 1970); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964); Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (Del. 1962); Kaplam v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977); Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960).

while redeeming stock held by other shareholders,[181] making defensive acquisitions in order to block a tender offer,[182] and issuing common stock to "friendly" parties.[183] In general, courts have assessed the propriety of such actions by considering whether the action was undertaken for a legitimate corporate purpose. Management entrenchment fails this test,[184] but action intended to further corporate policy (a vague standard which sometimes enables targets to oppose tender offers because they are not in the shareholders' "best interests") satisfies it.[185]

Where the courts have split—and where *Tankersley* provides no guidance—is over the question of how to determine management's purpose. Acknowledging a fiduciary duty is meaningless if the standard of review is so weak as to permit management to justify ambiguous actions. Yet many courts are willing to presume legitimate purpose by placing the burden of proving impropriety on the shareholders who oppose the transaction.[186] This is because actions such as stock issuance generally call for the exercise of management's business judgment. Even when courts recognize the element of self-interest, and accordingly place the burden on management to prove the fairness of its behavior, the fact that the cases involve mixed motives can enable defendants to establish that management entrenchment was not the

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181. *See, e.g.*, Petty v. Penntech Papers, Inc., 347 A.2d 140 (Del. Ch. 1975).

182. *See, e.g.*, Royal Indus., Inc. v. Monogram Indus., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976).

183. *See supra* cases cited note 7. *See also* Treadway Cos. v. Care Corp., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,603 (2d Cir. Aug. 12, 1980), *rehearing denied*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,705 (2d Cir. Nov. 17, 1980); Heit v. Baird, 567 F.2d 1157 (1st Cir. 1977); Canada S. Oils, Ltd. v. Manabi Exploration Co., 33 Del. Ch. 537, 96 A.2d 810 (1953). Although the issuance of stock can be a shark-repellent technique, *see supra* pp. 36-38, common stock cases focus on the act of issuance rather than charter amendments which may have increased the capital stock at a prior point in time.

184. *See, e.g.*, A. FLEISCHER, *supra* note 21, at 85.

185. *See id.* Some courts have gone so far as to state that management has an affirmative duty to oppose takeovers not in the best interests of the shareholders. *E.g.*, Treadway Cos. v. Care Corp., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,603, at 98,210 (2d Cir. Aug. 12, 1980), *rehearing denied*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,705 (2d Cir. Nov. 17, 1980); Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712-13 (N.D. Ill. 1969).

186. *E.g.*, Treadway Cos. v. Care Corp., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,603 (2d. Cir. Aug. 12, 1980), *rehearing denied*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,705 (2d Cir. Nov. 17, 1980); Crane Co. v. Anaconda, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,344 (S.D.N.Y. 1975); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969); Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977); Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960).