Delaware Journal of Corporate Law

VOLUME 23 | 1998 | NUMBER 2

A NEW TAKEOVER DEFENSE MECHANISM: USING AN EQUAL TREATMENT AGREEMENT AS AN ALTERNATIVE TO THE POISON PILL

BY GUHAN SUBRAMANIAN*

TABLE OF CONTENTS

*Fellow, Harvard Negotiation Research Project, Harvard Law School. A.B. Harvard College, J.D. Harvard Law School, M.B.A. Harvard Graduate School of Business Administration. I thank Bob Mnookin, David Moss, David Panton, John Pound, and the students in my Mergers & Acquisitions seminar at Harvard College for their helpful comments on earlier drafts of this article. Errors remain my responsibility.

"The reason why the pill was developed was to counter front-end-loaded deals. Until the pill, you couldn't deal with it."[1]

- Martin Lipton of Wachtell, Lipton, Rosen & Katz

"The pill is evolving over time from something different from what it was."[2]

- Investment Banker Central to the Conrail Acquisition

"[D]o you think there is any chance in the world that Conrail wouldn't have sat behind their barriers and the poison pill and just said 'no no no no no'? . . . This is the case of the hostile takeover by a management on its own shareholders. . . . And we said this is wrong; something doesn't look right in this picture."[3]

- Morris Kramer of Skadden, Arps, Slate, Meagher & Flom

I. INTRODUCTION

Fifteen years after their first appearance in corporate boardrooms, poison pills currently provide the centerpiece for more than half of the Fortune 500 companies' takeover defenses.[4] Many of the poison pills that were installed in corporate bylaws in the late 1980s are now coming up for their ten-year renewal.[5] As they do, it is critical for corporate

---

[1]Interview with Martin Lipton, Wachtell, Lipton, Rosen & Katz, in New York, N.Y., 10 (Mar. 14, 1997) (on file with *The Delaware Journal of Corporate Law*). Mr. Lipton was counsel to CSX railroad and created the poison pill.

[2]Interview with an Investment Banker Central to the Conrail Acquisition, in New York, N.Y. 9 (Mar. 14, 1997) (on file with *The Delaware Journal of Corporate Law*).

[3]Interview with Morris Kramer, Skadden, Arps, Slate, Meagher & Flom, in New York, N.Y., 5-7 (Mar. 14, 1997) (on file with *The Delaware Journal of Corporate Law*). Mr. Kramer was counsel to Norfolk Southern railroad.

[4]*See* MARTIN LIPTON & ERICA H. STEINBERGER, 1 TAKEOVERS & FREEZEOUTS § 6.03[4][a], at 6-59 (1997); *see also* Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Poison Pills* (July 18, 1997) (on file with *The Delaware Journal of Corporate Law*) ("[P]oison pills . . . continue to be adopted at a rate of about two a day so that there are more than 2,500 companies that have pills.").

[5]*See* CHARLES E. SIMON & COMPANY, CORPORATE ANTI-TAKEOVER DEFENSES: THE POISON PILL DEVICE (1997) (documenting the expiration dates of the poison pills of all publicly held companies). *See also* Lipton Memorandum, *supra* note 4, at 1 ("[P]oison pills

boards of directors to reevaluate whether the poison pill still serves their shareholders' best interests.[6] This article argues that the usefulness of the poison pill has dissipated since its inception.[7] It proposes a new takeover defense mechanism that better balances the competing interests of acquirers, shareholders, and management.

Part II of this article documents the evolution of the bargaining relationship among acquirers, shareholders, and management in the United States from the turn of the century to the present. Drawing from negotiation analysis perspectives, Part II demonstrates that the "shadow of the law"[8] has had a profound impact on the nature of the deals struck during this period. Part III illustrates the current state of the bargaining relationship through an analysis of the recent contest between CSX and Norfolk Southern to acquire Conrail. In this deal, "[t]he most expensive takeover battle in railroad history,"[9] the pill allowed Conrail management to construct an impenetrable wall which deterred a more lucrative deal than shareholders could have struck with Norfolk Southern.[10]

Part IV proposes an "equal treatment agreement" as a way of reaching an acceptable balance among acquirers, shareholders, and management. Such an agreement would require shareholders to share equally, among themselves, in any takeover premium in the context of a tender offer.[11] An equal treatment agreement in the bylaws would achieve the proper balance because it would eliminate management's unchecked discretion, would restore decision-making power to the shareholders acting as a group, and, indirectly, would construct

---

. . . continue to be renewed by companies that adopted a pill in 1987 and now find the ten-year life about to expire.").

[6]*See* CORPORATE ANTI-TAKEOVER DEFENSES, *supra* note 5 ("In the next several years, as significantly more pills begin to expire, companies will continue to face the question of whether to renew their shareholder rights plans."). Canadian companies will face this issue as well in a couple of years. *See* ROBERT F. BRUNER, THE POISON PILL ANTI-TAKEOVER DEFENSE: THE PRICE OF STRATEGIC DETERRENCE 2 n.1 (1991) (documenting the "surge in poison pill [adopted] in 1989" in Canada).

[7]One commentator has stated that "[t]he pill is evolving over time from something different from what it was." Interview with an Investment Banker Central to the Conrail Acquisition, in New York, N.Y. 9 (Mar. 14, 1997) (on file with *The Delaware Journal of Corporate Law*).

[8]*Cf.* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 951 (1979) (demonstrating how the "shadow of the law" can influence negotiation outcomes).

[9]Daniel Machalaba & Anna Wilde Mathews, *Meeting in the 'Betrayal Suite,'* WALL ST. J., Mar. 4, 1997, at A1.

[10]*See* Kramer Interview, *supra* note 3.

[11]*See* discussion *infra* Part IV.A.

appropriate barriers against acquirers making coercive tender offers.[12] The result would be increased value for shareholders and a more efficient market for corporate control.[13] In view of the record-breaking deal volume over the past few years,[14] this new corporate defense mechanism could create significant value for the economy overall.

II. THE EVOLUTION OF BARGAINING POWER IN THE TENDER OFFER GAME: FROM SHAREHOLDERS TO ACQUIRERS TO MANAGEMENT

Most historical analyses of corporate takeovers have focused on the level of takeover activity in each era.[15] These studies, while interesting, conflate the many factors that influence the market for corporate control.[16] The description that follows focuses solely on the legal relationships among acquirers, shareholders, and management. It asks the question: who has the bargaining power in the takeover negotiation? The answer reveals three distinct eras in corporate takeovers: the era of shareholder power (1800s-1960), the era of acquirer power (1960-1990), and the era of management power (1990-present).

The common goal throughout these three eras has been the quest for an efficient market for corporate control.[17] From a social welfare objective, "efficiency" means that assets should go to their highest-value use.[18] "Value," however, is an amorphous concept in the takeover

---

[12]*See* Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1132 (1983).

[13]*See* discussion *infra* Part IV.A.

[14]The U.S. economy has set a new record in each of the past three years for mergers and acquisitions activity. *See* Steven Lipin, *Murphy's Law Doesn't Apply: The Conditions are Perfect for Continued Growth in Mergers*, WALL ST. J., Jan. 2, 1998, at R6. In 1997, U.S. companies were involved in 10,700 merger transactions valued at $919 billion. *See id.*

[15]*See, e.g.*, PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 18-19 (1996) ("Four periods of high merger activity, often called merger waves, have taken place in the history of the United States."); Devra L. Golbe & Lawrence J. White, *Mergers and Acquisitions in the U.S. Economy: An Aggregate and Historical Overview*, *in* MERGERS & ACQUISITIONS 26 (Alan J. Auerbach ed., 1988) ("[W]e will focus on aggregate numbers . . . of mergers and acquisitions during relatively short time periods . . . and examine the historical patterns of these aggregates.").

[16]These factors include, for example, interest rates, the level of antitrust enforcement, tax factors, accounting rules, Tobin's q, etc.

[17]*See* Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE 321, 342 (Margaret M. Blair ed., 1993) (discussing efficient law with Delaware as an example and stating, "Delaware can provide efficient corporate law by providing stable and clear corporate law").

[18]*See* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 1994

situation for three reasons: First, the inherent value of the shares is not at all clear.[19] Even professional investment banks can produce widely disparate valuations of companies depending on what growth assumptions and operating efficiencies they use.[20] Second, value may be different depending on whether the acquirer or current management ends up controlling the company.[21] Potential synergies are often difficult to value yet they are often the critical factor for an acquirer in determining whether to make a tender offer. Finally, each shareholder may have a different assessment of her shares' inherent value. Therefore, in the tender offer context, value on the seller's side is not a single number but rather is normally distributed around what is most likely "fair" value.

Given these difficulties, a reasonable definition of "efficiency" seems to be as follows: a takeover is efficient if the offer price is greater than the value that a majority of shareholders attach to the shares.[22] Conversely, a tender offer is inefficient if the offer price is less than the inherent value that a majority attach to its shares. Under an optimal rule of law, all efficient tender offers will be successful and all inefficient tender offers will be unsuccessful. The remainder of this Part documents the triangulation of corporate law toward this objective. In doing so, this Part highlights the key problem that plagues takeover law today, namely, the shift in bargaining power too far toward management.

A. *The Era of Minority Shareholder Power (1800s-1960)*

At common law, shareholder rights were deeply rooted in notions of property and contract.[23] From the contract perspective, it was commonly believed that a corporate charter, in addition to being a contract between the corporation and the state, was also a nexus of contracts among all of the shareholders.[24] Therefore, the charter could

---

Q.J. ECON. 957.

[19]*See* Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 304-05 (1974) (suggesting vague nature of "value").

[20]For an illustration of this problem, see *The Old Man and the Tree: A Parable of Valuation*, *in* LEWIS SOLOMON ET AL., CORPORATIONS LAW AND POLICY MATERIALS AND PROBLEMS 143-49 (3d ed. 1994).

[21]*See* Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985).

[22]*See id.*

[23]*See* Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 627 (1981).

[24]*See* William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 77-82.

not be altered except by consent of all of the parties to it.[25] As a result, any single shareholder, regardless of the magnitude of his interest, could block any change to the corporate charter.[26]

While contract doctrine allowed individual shareholders to block changes to a corporate charter, property doctrine allowed individual shareholders to prevent mergers. An unapproved merger with another corporation was a violation of the shareholder's property rights in the company.[27] For example, in *Kean v. Johnson*,[28] the Elizabethtown & Somerville Railroad Company (E&S) was chartered to operate a railroad between those two cities in New Jersey.[29] The majority of shareholders wanted to extend service to Easton.[30] The state legislature granted a charter to the Somerville & Easton Railroad Company (S&E) and the majority of E&S shareholders arranged to sell the assets of their company to S&E.[31] The court enjoined the sale at the request of a minority shareholder in E&S.[32] The court held that majority shareholders were not empowered to force a company to sell its assets simply because they wanted to terminate their current investment and place their funds in a new venture.[33]

Similarly, in *In re Paine*,[34] Copper Range purchased more than 99% of the shares of Trimountain Corporation and attempted to buy out the remaining shareholders.[35] The minority shareholders, holding less than one percent of the stock, refused.[36] Copper Range petitioned the court to dissolve Trimountain, which would force a liquidation of the assets to the shareholders.[37] In denying the petition, the court stated that:

---

[25]*See* 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 376 (2d ed. 1886) ("[N]o majority of the shareholders in a corporation . . . can have any implied authority to agree, on behalf of all the shareholders, to an alteration of [the] charter.").

[26]*See* Mason v. Pewabic Mining Co., 133 U.S. 50, 58 (1890).

[27]*See* MORAWETZ, *supra* note 25 (stating that corporations historically cannot be consolidated "without the unanimous consent" of their shareholders).

[28]9 N.J. Eq. 401 (1853).

[29]*See id.* at 402.

[30]*See id.* at 403.

[31]*See id.* at 402-03.

[32]*See Kean*, 9 N.J. Eq. at 418 ("[Minority shareholders] had the right to retain their investment where it was, and as it was, and . . . their rights are not satisfied by a payment to them of their proportion in the proceeds of such sale.").

[33]*See id.* at 413-14, 423-24.

[34]166 N.W. 1036 (Mich. 1918).

[35]*See id.*

[36]*See id.*

[37]*See id.*

> [i]f counsel's contention is to prevail, . . . [the minority shareholders] may be driven out by a forced sale of their investment for no better reason than that a larger stockholder desires to acquire it in the interest of economy. It is not conceivable that the Legislature ever intended that the statute [allowing the dissolution of a corporation] should be used for such a purpose. . . . Such a construction would be injurious to the public interest and not beneficial to the stockholders as a whole.[38]

This unquestioning protection of minority shareholder rights was a consistent theme in the case law from the inception of the corporate form in the 1800s through the early part of the twentieth century. Courts defended minority shareholders from all forms of take-out transactions, often basing their decisions on notions of morality and justice.[39] Unanimous consent of the shareholders was a nonnegotiable prerequisite for any business combination.[40] Criticism of this structure grew as commentators noted the injustice of allowing "one stupid or obstinate holder of one share [to] tie up the hands of all the rest."[41] State legislatures began to recognize that requiring unanimous consent for fundamental changes in a corporation's organization and barring take-outs of dissenting shareholders created a "tyranny by the minority" that blocked socially desirable transactions. Some states responded by authorizing corporations to engage in fundamental transactions, such as sale of assets, mergers and consolidations, and voluntary liquidations when approved by a corporation's board of directors and a majority or supermajority of its shareholders.[42] Through the turn of the century, however, "no state legislature expressly granted . . . [a majority

---

[38] *In re Paine*, 166 N.W. at 1039.

[39] See, e.g., Mason v. Pewabic Mining Co., 133 U.S. 50 (1890), stating:

> When the proposition is thus presented, in the light of an offer made by a very small minority to a very large majority who object to it, the injustice of the proposition is readily seen; yet we know of no reason or authority why those holding a majority of the stock can place a value upon it at which a dissenting minority must sell or do something else which they think is against their interest, more than a minority can do.

Id. at 59.

[40] *See, e.g.*, Sprague v. Illinois River R.R., 19 Ill. 174, 178 (1857).

[41] *Id.*

[42] *See, e.g.*, Act of May 27, 1896, ch. 932, §§ 57, 58, 1896 N.Y. Laws 994 (voluntary dissolution and merger) .

shareholder] the power to force a minority to relinquish its interest in an ongoing corporate enterprise."[43]

Florida was the first state to step into this breach. In 1925 it revised its general corporation law to provide that a merger or consolidation agreement "may provide for the distribution of *cash*, notes or bonds, in whole or in part, in lieu of stock to stockholders of the constituent corporations or any of them."[44] By 1931, Arkansas, California, Louisiana, and Ohio had followed suit.[45] Although not completely clear, these statutes seemed to authorize the squeeze-out of minority shareholders with the use of cash.[46] The first explicit authorization for cash take-outs occurred in New York in 1936. In that year, New York adopted a provision allowing a gas or electric company to merge with a subsidiary if it owned 95% or more of the subsidiary's stock.[47] In rejecting a minority shareholder's challenge to this statute, the New York Court of Appeals in *Beloff v. Consolidated Edison Co.*[48] held that:

> [h]e [the minority shareholder] has no right to stay in the picture, to go along into the merger, or to share in its future benefits. He has no constitutional right to deliberate, consult or vote on the merger, to have prior notice thereof or prior opportunity to object thereto. . . . In none of this do we see any deprivation of due process, or of contract rights.[49]

The court's language could not have been further from that of the *Paine* court,[50] decided thirty years earlier, yet it was entirely consistent with the evolving consensus on the treatment of minority shareholders. *Beloff* marked a turning point in the bargaining relationship between majority and minority shareholders to the "largely unqualified system of

---

[43]Weiss, *supra* note 23, at 629.

[44]*See* Act of June 1, 1925, ch. 10096, § 36, 1925 Fla. Laws 134 (emphasis added).

[45]*See* Act of Apr. 1, 1931, Act 255, § 61, 1931 Ark. Acts 860; General Corp. Law, ch. 862, § 361, 1931 Cal. Stats. 1809; Act of July 28, 1928, Act 250 § 48, 1928 La. Acts 446; General Corp. Act §§ 8623-8667, 1927 Ohio Laws 35.

[46]*See* Arthur M. Borden, *Going Private — Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987, 1026-27 (1974) ("[T]he social policy reflected in these statutes is a preference for corporate flexibility and corporate democracy over notions of vested shareholder rights. . . . [The legislation] stripped from shareholders . . . well-respected basic rights.").

[47]*See* Act of May 28, 1936, ch. 778, § 1(1), 1936 N.Y. Laws 1658.

[48]87 N.E.2d 561 (N.Y. 1949).

[49]*Id.* at 564-65.

[50]*In re* Paine, 166 N.W. 1036 (Mich. 1918).

majoritarian control" that we have today.[51] This transformation was formalized in state corporate law through the late 1940s and 1950s. In 1949, for example, New York extended its short-form merger statute to all corporations.[52] In 1957, Delaware adopted a short-form merger statute, modeled on the New York law, but applicable to 90%-owned subsidiaries.[53] In view of *Beloff* and analogous cases in other states,[54] it was clear that these new provisions effectively authorized take out mergers.[55]

Minority shareholders challenged the Delaware short-form take out statute in *Stauffer v. Standard Brands Inc.*[56] The Delaware Supreme Court squarely rejected the challenge, stating that:

> [I]t is difficult to imagine a case under the short merger statute in which there could be such actual fraud as would entitle a minority to set aside the merger. This is so because the very purpose of the statute is to provide the parent corporation with a means of eliminating the minority shareholder's interest in the enterprise.[57]

With *Stauffer*, minority shareholders' rights reached their ebb. The appearance of the squeeze-out statutes and their endorsement by state courts provided the critical ingredient for the next era in the market for corporate control.[58]

B. *The Era of Acquirer Power (1960-1990)*

Equipped with the legal toolkit to oust minority shareholders, acquirers quickly abandoned the proxy contest in favor of the tender offer as the acquisition method of choice in the 1960s.[59] In 1960, there were

---

[51]Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 5 (1995).

[52]*See* Act of Apr. 22, 1949, ch. 762 § 1(1), 1949 N.Y. Laws 1707.

[53]*See* Act of June 5, 1957, ch. 121, § 253(a), 51 Del. Laws 188 (1957).

[54]*See, e.g.*, Federal United Corp. v. Havender, 11 A.2d 331 (Del. 1940).

[55]*See* Weiss, *supra* note 23, at 649.

[56]187 A.2d 78 (Del. 1962).

[57]*Id.* at 80.

[58]*See* LEO HERZEL & RICHARD W. SHEPRO, BIDDERS AND TARGETS: MERGERS AND ACQUISITIONS IN THE U.S. 105 (1990) ("Squeeze-outs of minority shareholders play a crucial role in takeovers from the standpoints of both bidders and target shareholders.").

[59]*See* DOUGLAS V. AUSTIN & JAY A. FISHMAN, CORPORATIONS IN CONFLICT — THE TENDER OFFER 32 (1970). The proxy contest, however, did not disappear during this era. *See*

only eight tender offers involving companies listed on the New York Stock Exchange; in 1966 there were 107.[60] This dramatic growth in tender offers caught state and federal regulators by surprise. As a result, acquirers were virtually unchecked in the terms of their tender offer[61] and could operate "in almost complete secrecy."[62] Coincidentally, business theory at the time encouraged acquisitions as a way of reducing a firm's beta and hence its cost of capital.[63] Thus, the legal regime at the time meshed with conventional business wisdom, facilitating the conglomerate wave of the 1960s.[64]

As the legal rules increased acquirers' bargaining power, the demographics of stock market participation weakened shareholders' power. Riding the post-World War II prosperity boom and protected by SEC disclosure rules promulgated in the 1930s, average Americans began to actively participate in the stock market in unprecedented numbers. One study reported a 71% increase in share ownership between 1930 and 1950.[65] By 1967, more than 20 million Americans, almost one-sixth of the U.S. adult population, owned shares.[66] While this remarkable growth in share ownership allowed middle America to participate in the prosperity of American industry at the time, it also led to widely-held companies, a structure that could be exploited by acquirers.

Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 19, 31 (1989) (reporting 141 proxy contests among companies listed on major exchanges as compared with 171 hostile tender offers during the same reporting period).

[60]*See* 113 CONG. REC. 24,664 (1967) (statement of Sen. Williams).

[61]*See* AUSTIN & FISHMAN, *supra* note 59, at 25 ("The cash takeover bid, the most popular form of tender offer, occupied, until July, 1968, a unique position in finance. Until . . . [the Williams Act], the cash tender offer was not formally regulated in any way."); *see generally* John G. Finley & Andrew J. Colao, *Doing Deals: Understanding the Nuts and Bolts of Transactional Practice: Overview of the Williams Act*, 711 PLI/Comm 109 (1995) (discussing the Williams Act), *available in* Westlaw.

[62]S. REP. NO. 90-550, at 2 (1967).

[63]*See* Joel Dean, *Causes and Consequences of Growth by Conglomerate Merger: An Introduction*, *in* CONGLOMERATE MERGERS AND ACQUISITIONS: OPINION & ANALYSIS, 44 ST. JOHN'S L. REV. 15, 22-27 (special ed. 1970). *See also* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 916 (5th ed. 1996) (discussing motives for mergers). Under the capital asset pricing model (CAPM), a firm's cost of equity is directly proportional to its beta, or sensitivity to changes in the stock market overall. *See id.* at 183.

[64]Today the market imposes a "conglomerate discount" on companies that acquire unrelated businesses. *See, e.g.*, Alex Taylor III, *GM: Why They Might Break Up America's Biggest Company*, FORTUNE 78 (Apr. 29, 1996).

[65]*See* Tris Coffin, *Proxy Warfare May Provoke Tighter Government Rules*, NATION'S BUS. 32, 33 (July 1955) (citing a Brookings Institution study).

[66]*See* 113 CONG. REC. 854 (1967) (statement of Sen. Williams).

Instead of having to negotiate with a handful of shareholders who collectively controlled a majority of the shares of the company, for the first time acquirers could negotiate with hundreds or even thousands of small shareholders who could not communicate with each other. An acquirer could exploit this structure in several ways. For example, a typical tactic was to gain a toe-hold in a company, thereby gaining access to a shareholder list, and then to make a tender offer for enough remaining shares to gain control.[67] By leaving the offer open for a short period of time, and by making only a partial bid, acquirers could force shareholders to decide quickly whether or not to tender. The term "Saturday Night Special" entered the takeover vocabulary during this era as a reference to these types of shotgun tender offers.[68] One empirical study calculated that the average tender offer during this period remained open for only seventeen days.[69] In addition, an acquirer could accept shares tendered on a first-come, first-served basis. This feature of a tender offer often created a stampede to tender before the acquirer gained control and could squeeze out the remaining shareholders at a lower price.

Partial, first-come, first-served bids can be analyzed in game theoretical terms.[70] The Added-Value Principle states that no player shall receive more than her added value in any particular game.[71] In the

---

[67]*See* Samuel L. Hayes, III & Russell A. Taussig, *Tactics of Cash Takeover Bids*, HARV. BUS. REV., Mar./Apr. 1967, at 135, 139. The authors advocate a delay between the toe-hold position and the tender offer:

> Knowing when to stop buying . . . is an important element in the bidder's strategy. Investment bankers have suggested to us that at least a month of inactivity should precede a cash tender offer to avoid an undesirable price advance. An even longer period may be warranted to lull the incumbents into a false sense of security.

Id.

[68]The term "Saturday Night Special" was developed as part of a public relations campaign against Colt Industries' hostile tender offer for Garlock in 1975. *See* GAUGHAN, *supra* note 15, at 40.

[69]*See* Hayes & Taussig, *supra* note 67, at 141 (surveying 50 cash tender offers between 1956 and 1966). A histogram appears on page 137 of the article.

[70]Game theory has been used to examine other aspects of corporate law. *See, e.g.*, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153 (1986).

[71]*See* Adam Brandenburger, *Cooperative Game Theory: Conceptual Aspects of Added Value* 1 (Feb. 2, 1997) (unpublished manuscript) (on file with the *Delaware Journal of Corporate Law*). The justification for the Added Value Principle is as follows: if player A received more than her added value, then the agreement would be unstable because the remaining players could do better by excluding A and her added value, and distributing the

context of a 100% bid, an acquirer presumably has a plan to create value through synergies and, therefore, wants to keep as much of the upside for herself as possible. In this situation, each shareholder brings value to the table because the acquirer wants every share. More specifically, the value created is the per share value of the synergies between the acquirer and the target. The shareholder can expect to capture as much as the full value of these synergies.[72] In a partial bid, on the other hand, the acquirer only wants control of the company. Because shares are fungible, if an individual shareholder does not tender she can be replaced by another shareholder who will. Therefore, the value added of each individual shareholder is zero, and the Added Value Principle states that each individual shareholder will capture none of the value created by the acquisition.[73]

Beyond the partial offer, acquirers occasionally pressured a diffuse shareholder base during this era by making a two-tier tender offer. In contrast to a 100% tender offer, also known as an "any and all" offer, a two-tier offer involved two parts: first, a "front-end" offer for part of the stock (e.g., 51%), typically at a premium from the current market price; and second, a "back-end" offer for the remaining stock, inevitably at a lower price than the front-end offer and often in securities that were less attractive than the cash front-end. Two-tier tender offers tilted bargaining power dramatically toward the acquirer and away from the shareholder.

---

remainder among themselves. Therefore, in equilibrium A will receive no more than her added value. *See id.*

[72]The actual distribution of the synergistic gain between minority shareholders and the acquirer will depend on other characteristics of the tender offer, the most important of which is whether there are multiple bidders. *See* Leebron, *supra* note 70, at 184. *See generally* Michael Bradley et al., *Synergistic Gains From Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3 (1983).

[73]*See* ADAM M. BRANDENBURGER & BARRY J. NALEBUFF, CO-OPETITION 41-43 (1996). This distinction between partial bids and 100% bids is best illustrated through the following card game. Imagine a game with 26 black cards and 26 white cards. Each pair of one black card and one white card receives a $100 payoff, but a black card or a white card on its own receives nothing. Acquirer controls all the black cards and individuals A through Z each control one red card. Acquirer must bargain with each red card holder individually, and the red card holders cannot bargain together as a group. Game theory predicts that acquirer will buy all 26 cards at a price of $50 each. This is because each red card holder has $100 of value-added, and the negotiation process should yield an equal split of the value created. *See id.*

In the second version of the game, Acquirer has 25 black cards rather than 26 but all of the other rules are the same. Now, the value added of each individual red card holder is zero. Game theory predicts that each red card holder will end up with very little of the value created. In the tender offer context, if cards represent shares, the first game models a 100% tender offer situation and the second game models the partial bid situation. *See id.*

For the acquirer, a two-tier offer enabled her to successfully execute a takeover without having to produce as much cash as would be involved in a 100% offer. For the shareholder, a two-tier offer created a social dilemma:[74] if the shareholder did not tender into the front-end offer, she would potentially be left with the back-end, less attractive consideration if the acquirer successfully gained control in the front-end. Therefore, a risk-averse shareholder might be inclined to tender even though she believed that the value being offered in the front-end is too low. In negotiation terms, two-tier tender offers presented a collective action problem to minority shareholders. Unsure about how the other shareholders would respond to an offer, a shareholder would inevitably tender into the front-end of an offer to avoid the risk of being squeezed-out at the back end.[75]

Note that a shareholder must tender all her shares into the front-end in order to ensure getting the blended price, because a partial tender will drag down the weighted average of the shareholder's return toward the back-end price. To take a stylized example, imagine a two-tier tender offer with a front-end offer for 50% of the shares at $100 and a back-end squeeze-out for the remaining 50% at $80. As described above, the two-tier nature of the bid pressures shareholders to tender into the front-end.

---

[74]The two-tier offer has been incorrectly characterized by some scholars as an "N-person prisoner's dilemma." *See, e.g.*, Stephen Mahle, *Proxy Contests, Agency Costs, and Third Generation State Antitakeover Statutes*, 15 J. CORP. L. 721, 728 n.60 (1990) ("Of course, this presents the prisoner's dilemma."); Dale Arthur Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 126 (1986) ("This coercion exemplifies the classic prisoner's dilemma."). Formally, four features characterize an N-person prisoner's dilemma:

> (1) [e]ach of the N-persons has two choices, . . . [cooperate or defect]; (2) [t]he payoffs for both choices increase monotonically with the proportion of people who [cooperate]; (3) [t]he [defect] choice always yields a higher outcome than the cooperat[e] choice; and (4) [t]he [payoff] if everyone makes a cooperative choice is greater than the . . . [payoff] if everyone makes a . . . [defect] choice.

Samuel S. Komorita, *A Model of the N-Person Dilemma-Type Game*, 12 J. EXPER. SOC. PSYCHOL. 357, 358 (1976). In the tender offer context, if we define "sell" as the defect strategy and "hold" as the cooperate strategy, a tender offer meets condition (1) but does not necessarily meet conditions (2), (3), or (4). Instead, social psychologists have classified this problem under the heading of "social dilemma," *see* ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 190 (1988), and game theorists have classified it as a "Dangerous Coordination Game." ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 27 (2d ed. 1994).

[75]*See* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113 (1979) ("[T]he special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion — they will tender, therefore, it is misleading to speak of a free shareholder choice at all.").

If all shareholders tender, the acquirer takes half of each shareholder's tender at $100, as required by the Williams Act,[76] and then squeezes out the remaining 50% of shares at $80. In this scenario, if an individual shareholder owns 100 shares and tenders fifty in the front-end, she will receive $100 per share for only twenty-five shares under the proration requirement; the remaining seventy-five shares will be squeezed out at $80. Her result would be a blended price of $85. Only by making a full tender into the front-end would she be able to achieve a blended price of $90.

Some commentators argue that tender offers are not coercive because the blended price usually represents a premium over the market price of the stock.[77] Indeed, empirical research strongly supports the conclusion that acquirers offer a premium over the current market price in a tender offer situation.[78] There are still two reasons why we should prefer to eliminate the coercive nature of tender offers. First, assuming that shareholders' valuations for the stock follow a normal distribution, the tender offer will always be unfair to some fraction of shareholders. For these shareholders, the coercive nature of the offer forces them to tender even though they attach a higher value to the shares than the offer price. Therefore, for these shareholders the offer is both coercive and unfair.

Second, and more generally, even if a shareholder concedes that the offer price represents fair value for the shares, the offer can still be unfairly coercive.[79] The reason is the well-known social psychological phenomenon in which framing effects and endowments influence decision-making.[80] Here, the value for owning and the value for buying might diverge for an individual investor. That is, a shareholder who would not have bought the stock at $100 because the price was too high might nevertheless be unwilling to sell for $100. Therefore, coercing the shareholder to sell for $100 is unfair even though the price itself

---

[76]*See generally infra* notes 91-94 (explaining the specifics of the Williams Act).

[77]*See, e.g.*, C. Steven Bradford, *Stampeding Shareholders and Other Myths: Target Shareholders and Hostile Tender Offers*, 15 J. CORP. LAW 417, 426-27 (1990).

[78]*See* Steven Lipin, *Takeover Premiums Lose Some Luster*, WALL ST. J., Dec. 31, 1996, at A1 (citing a study by J.P. Morgan which showed a median takeover premium of 27.9% in 1996, compared to 56% in 1990). *See also* ECONOMIC REPORT OF THE PRESIDENT 197 (1985) ("The evidence is overwhelming that successful takeovers substantially increase the wealth of stockholders in target companies . . . . [R]ecent studies find average gains in the range of 16 to 34 percent of the value of the targets' shares.").

[79]*Cf.* Lipton Interview, *supra* note 1, at 5 ("It may be coercive, but it's not unfair.").

[80]*See* Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 457 (1981).

represents fair value.[81] Eliminating the coercion would allow the individual shareholder to concentrate on the fairness of the offer.

The coercive nature of the tender offer game is magnified by the fact that a tender offer is primarily a simultaneous rather than a sequential game.[82] Although a tender offer game does have some sequential characteristics, because the success or failure of the offer might become clearer as the deadline for tendering approaches, two factors suggest that tender decisions are made at the "moment of truth," i.e., just before the offer closes. First, shareholders who tender early can withdraw their shares up to the moment of truth.[83] Therefore, shareholders who tender early implicitly decide at the moment of truth not to revoke their tender, which is equivalent to a tender decision at the moment of truth.[84] Second, option theory states that a rational actor will not exercise an option early unless there is a prospect of a dividend.[85] Without dividends, ostensibly American options (options that can be exercised at any time) become *de facto* European options (options that can only be exercised at the expiration date). Because there is no dividend analog in the context of a tender offer, there is no reason to exercise early, and a rational actor who wishes to maximize option value will only tender at the moment of truth.[86] For these two reasons, the tender offer game is best characterized as simultaneous rather than sequential.[87] Shareholders, therefore, cannot gain a sense of the majority's actions before making

---

[81]This distinction between fairness and coercion also shows why the presence of multiple bidders does not cure the coercive nature of two-tier tender offers. Multiple bidders may make the offer more fair to target shareholders, but they do not make the offer less coercive. Moreover, with the proliferation of poison pills, there is a significant first-mover advantage in the market for corporate control. For example, in the CSX tender offer for Conrail, discussed *infra* Part III, CSX was able to effectively shut Norfolk Southern out by negotiating a friendly deal with Conrail quickly and in secret. *See* Don Phillips, *Reshaping the Railroad Industry: A Conrail Deal Could Give CSX Control of East*, NEWSDAY, Jan. 2, 1997, *available in* 1997 WL 2677553. *See also* Kramer Interview, *supra* note 3, at 19 ("CSX did a good job. They have to get . . . points by moving over us and getting to Conrail first.").

[82]*See infra* note 87.

[83]*See* Securities Exchange Act, 17 C.F.R. § 240.14d-7 (1997).

[84]*See* Lucian Arye Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911, 922-23 (1987).

[85]*See* BREALEY & MYERS, *supra* note 63, at 606-07.

[86]*See* Bebchuk, *supra* note 84.

[87]In fact, most commentators have characterized tender offers as a simultaneous game. *See, e.g.*, *id.* at 922-23; Leebron, *supra* note 70, at 188-89. *But see* Terence L. Blackburn, *The Regulation of Market Sweeps in Connection with Tender Offers*, 58 GEO. WASH. L. REV. 619, 632 (1990) (contrasting "normal" tender offer situations, in which the "target's shareholders have an opportunity to evaluate the likelihood of success of the tender offer on virtually a daily basis" with market sweeps which deny shareholders this opportunity).

their own tender decision. The resulting uncertainty leads risk-averse shareholders to tender.

In 1968, the federal government attempted to mitigate the coercive nature of tender offers with the Williams Act. Passed by Congress in 1968 as an amendment to the Securities Exchange Act of 1934,[88] the Act imposes rules on acquirers that are intended to regulate the tender offer process. Congress had two distinct purposes in passing the Williams Act: first, to ensure informed decision-making by target shareholders;[89] and second, to achieve neutrality between the acquirer and target shareholders.[90] For example, section 13(d) of the Act requires that anyone who purchases 5% or more of the outstanding common stock of a company must file a disclosure statement with the SEC.[91] Section 14(d) requires that all shares tendered during a tender offer must be purchased at the same price.[92] If the offer is oversubscribed, the acquirer must purchase shares on a pro rata basis.[93] If the offer price increases during the tender offer, all shares tendered previously must receive the higher price.[94] Section 14(e) of the Act requires that all tender offers stay open for at least twenty business days.[95]

The Williams Act effectively eliminated particular coercive practices such as Saturday Night Specials and first-come, first-serve tender offers. In passing the Williams Act, however, Congress did not define what a "tender offer" was.[96] To determine whether a purchase

---

[88]15 U.S.C. § 78a, 48 Stat. 881 (1995).

[89]*See* 113 CONG. REC. 24,664 (1967) (statement of Sen. Williams that the Williams Act "is designed solely to require full and fair disclosure for the benefit of investors").

[90]*See* 113 CONG. REC. 854 (1967) (statement of Sen. Williams that the objective of the Williams Act is to "balance the scales" between acquirers and shareholders).

[91]*See* Securities Exchange Act of 1934, § 13(d), 15 U.S.C. § 78m(d)(1)(A)-(E) (1995). The statement must disclose the purchaser's identity, background, purpose of purchase, size of position, and source of funds. *See id.*

[92]*See id.* § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1995).

[93]*See* Securities Exchange Act, 17 C.F.R. § 240.14d-8 (1997).

[94]*See* Securities Exchange Act of 1934, § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1995). *See also* Ralph C. Ferrara et al., *Tender Offers: Toughing It Out, in* INTERNATIONAL SECURITIES MARKET 1990, at 344-45 (Ralph C. Ferrara ed., 1990).

[95]*See* Securities Exchange Act of 1934, 17 C.F.R. § 240.14e-1 (1995).

[96]*See, e.g.*, David A. Greenblatt, *Post-Tender Offer Purchases: Rebalancing the Scales*, 65 TEX. L. REV. 185, 187 (1986) (discussing the original concept of a tender offer). The legislative history suggests that the drafters of the Williams Act intended the term to apply primarily to conventional tender offers. *See id.* For example, committee reports describe a tender offer as "a bid by an individual or group to buy shares of a company — usually at a price above the current market price. . . . The person making the offer obligates himself to purchase all or a specified portion of the tendered shares if certain specified conditions are met." *Id.* (quoting H.R. REP. NO. 90-1711, at 2 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2811,

plan is a "tender offer" for purposes of the Williams Act, the SEC and courts have generally adopted the eight-part Wellman test as first proposed in *Wellman v. Dickinson*.[97] Courts have generally held that the back-end of a two-tier tender offer is not part of the tender offer and therefore does not receive protection under the Williams Act.[98] Therefore, the Williams Act was inapplicable in precisely the situations where it was needed the most.

In the wake of the Williams Act, state legislatures enacted a series of antitakeover statutes that were intended to regulate the back-end of two-tier bids.[99] The current versions of these antitakeover statutes can be classified into four categories.[100] First, control share acquisition statutes allow management to delay a hostile tender offer until the offer has been approved by a majority of shareholders.[101] Second, fair price provisions

---

2811).

[97]475 F. Supp. 783 (S.D.N.Y. 1979). The eight characteristics of a tender offer are:

> (1) active and widespread solicitation of public shareholders for the shares . . .; (2) solicitation . . . for a substantial percentage of the . . . stock; (3) offer to purchase [is] made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed . . . maximum number to be purchased; (6) offer open only a limited period of time; (7) offeree subjected to pressure to sell his stock; . . . [and (8)] whether the public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target company's securities.

Id. at 823-24. Courts have not, however, required that all eight characteristics be present to find that a purchase plan is a tender offer. Instead, courts typically weigh the factors according to their importance on the particular facts of the case. *See, e.g.*, Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 56-57 (2d Cir. 1985) (recognizing that the absence or presence of some of the eight factors will only be determinative according to the facts of any given case); SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945, 950 (9th Cir. 1985) (stating that "[n]ot all factors need be present to find a tender offer; rather, they provide some guidance as to the traditional indicia of a tender offer"); *Wellman*, 475 F. Supp. at 824 (emphasizing the importance of the circumstances involved in the particular case and the degree to which whose facts are influenced by one or more of the eight factors). *But see* Brascan Ltd. v. Edper Equities Ltd., 477 F. Supp. 773, 791 (S.D.N.Y. 1979) (declining to apply the eight-factor test and stating that "I believe it is not desirable because the application of so vague a test would introduce a crippling uncertainty in . . . [these already complex situations]").

[98]*See* Richard A. Booth, *The Problem with Federal Tender Offer Law*, 77 CAL. L. REV. 707, 724-28 (1989). *See also* Robert Owen Ball, III, *Second Step Transactions in Two-Tiered Takeovers: The Case for State Regulation*, 19 GA. L. REV. 343, 351 (1985) ("Since the second step merger transaction proceeds virtually free of federal regulation, bidders are able to employ whatever measures they wish to insure the success of their offer.").

[99]*See* Booth, *supra* note 98, at 761.

[100]*See* David F. Crabtree, *The Constitutionality of State Takeover Legislation Revisited: The Effect of* CTS Corp. v. Dynamics Corp. of America, 1988 UTAH L. REV. 675, 680-82.

[101]*See, e.g.*, 15 PA. CONS. STAT. ANN. §§ 2561-2568 (West 1995). Twenty-six states

require acquirers to provide equal consideration to shareholders in the back-end of a two-step tender offer.[102] These statutes effectively expand the coverage of the Williams Act to the back-end of two-step offers. Third, redemption rights provisions provide all shareholders with the right to demand the tender offer price for all shares held, effectively converting partial offers into any-and-all (100%) offers.[103] Fourth, delayed control restrictions prohibit business combinations between the target and the acquirer for some minimum period, usually three to five years, unless the acquisition is approved by the target's board.[104]

The impetus for these state antitakeover statutes was the perception that bargaining power had shifted too far toward acquirers, and that the Williams Act did not go far enough in recalibrating the balance. While these statutes certainly moved in the right direction, none of them achieved the efficient takeover objective as defined at the beginning of this Part.[105] Each type of statute, and the reasons for its inefficiency, is discussed in turn below.

The first type of state antitakeover statute, a control share acquisition statute, has received considerable support among academics.[106] Control share acquisition statutes, however, have two deficiencies that

---

currently have control share acquisition statutes. *See* LIPTON & STEINBERGER, *supra* note 4, § 5.03[1][b], at 5-28 to 5-31. Notably, neither Delaware nor New York has a control share acquisition statute. *See id.* § 5.03[1][b], at 5-28 n.7.

[102]*See, e.g.*, ARIZ. REV. STAT. ANN. § 10-1222(3) (Supp. 1987). Twenty-five states have fair price provisions. *See* John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1439 n.65 (1991).

[103]*See, e.g.*, UTAH CODE ANN. § 16-10-75.5 (1995). Two states have redemption rights statutes. *See* Matheson & Olson, *supra* note 102, at 1440 n.70.

[104]*See, e.g.*, DEL. CODE ANN. tit. 8, § 203(a)(3) (1991); N.Y. BUS. CORP. LAW § 912(c) (McKinney 1986). Thirty-five states have delayed control restrictions. *See* LIPTON & STEINBERGER, *supra* note 4, § 5.03[1][a], at 5-26.

[105]*See supra* text accompanying note 20.

[106]Professor Bebchuk's "revealed preferences" proposal represents one manifestation of a control share acquisition statute. *See* Bebchuk, *supra* note 84, at 931; Bebchuk, *supra* note 21, at 1752-54; Lucian Arye Bebchuk, *A Model of the Outcome of Takeover Bids, Discussion Paper No. 11, Program in Law and Economics, in* Harvard Law School (1985). Under this scheme, shareholders would first vote on whether they "approve" of the tender offer in the sense that they believe it adequately reflects the value of the shares. An acquirer would be able to purchase a controlling interest only if a majority approved of her offer. Second, shareholders would be allowed to indicate whether, in the event of a takeover, they would then tender their shares. This two-part vote would allow shareholders to express their preferences more precisely, because it allows them to receive their pro rata share of the tender offer premium in the event of a takeover even if they vote against it. *See* Bebchuk, *supra* note 84, at 931-33.

make them unlikely to achieve an efficient outcome in the corporate control market. First, there is the problem of rational apathy:

> A substantial number of shareholders will not make the effort to gather enough information to make the kind of sophisticated independent evaluation necessary to separate their voting decision from their tendering decision. Many will have an individual stake too small to justify research costs, and even those with larger stakes may prefer to sit back and hope to "free ride" on others' research. Of the few major players who will speak publicly on a tender offer's merits, target managers are likely to wield the greatest influence. For this reason, the ultimate effect of . . . [control share acquisition statutes] may simply be a consolidation of power in the hands of target managers.[107]

The second problem with most control share acquisition statutes is that they dilute the true preferences of disinterested shareholders by allowing the acquirer to vote her shares. For example, assuming 80% shareholder turnout overall, an acquirer who has gained 20% of the target's shares only needs one out of four disinterested shareholders to vote in favor of a waiver in order to gain a controlling share. On one hand, not allowing acquirers to vote their previously acquired shares might overly deter efficient takeovers because it would reduce the incentive to acquire a stake.[108] On the other hand, allowing an acquirer to vote her shares might lead to an approving vote even in the situation where a majority of disinterested shareholders do not approve of the tender offer.[109] Either way, control share acquisition statutes fail in their

---

[107]Oesterle, *supra* note 74, at 129 n.50.

[108]*See* Kramer Interview, *supra* note 3, at 15-16 ("[T]hose shares ought to be votable; otherwise, you're going to discourage people from buying stakes at all.").

[109]For a dramatic illustration of this problem, see discussion *infra* Part III regarding Conrail's tender offer for CSX. CSX deliberately acquired a 19.9% stake in Conrail before calling the shareholder vote so that it could vote its shares in favor of waiving the Pennsylvania control share acquisition statute. *See* Lipton Interview, *supra* note 1, at 1 ("[I]t could have been possible to go for the vote first and then to do a 40% tender offer, but obviously with the prospect of competition from Norfolk Southern there was a desire to get the 20% stake as soon as possible to protect the deal."). As a result, CSX only needed 7% of disinterested shareholders to vote with it in order to get a waiver of the control share acquisition statute. *See infra* text accompanying notes 202-04. The fact that CSX was not able to get even this much support for its bid shows the degree of antipathy toward the CSX tender offer. *See* Kramer Interview, *supra* note 3, at 18.

[I]t was a vote for Norfolk Southern against CSX, it was a vote for Norfolk

objective of gauging the fairness assessment of a disinterested shareholder majority.

Admittedly, neither of these objections on its own is insurmountable. In some situations, shareholders might not be apathetic, and states might prohibit acquirers from participating in a control vote while still preserving sufficient incentives for acquirers to accumulate a stake in a target company. Nevertheless, when considered together, these two arguments cast considerable doubt on the ability of control share acquisition statutes to achieve an efficient outcome in tender offer situations.

The next two types of state statutes can be considered together because the arguments against them are the same. Fair price provisions and redemption rights provisions effectively mandate equal treatment of all shareholders by the acquirer.[110] This proposal would clearly mitigate the coercive nature of tender offers. The rule, however, might discourage efficient tender offers. Under the equal treatment rule, capital-constrained acquirers will not make tender offers if they cannot afford to purchase all the shares.[111] And even if capital markets function perfectly and an acquirer with an attractive target can get unlimited financing, risk-aversion might make an acquirer reluctant to expose herself to the entire risk of the target company.[112] Therefore, equal treatment provisions in

---

> Southern against Conrail, it was an anti-Conrail vote, it was a vote saying to CSX that if you want this company, you better pay more since somebody else is willing to pay more. . . . [I]t was all those things. But it takes all those things to get all the shareholders to agree.

[110]Professors Brudney, Chirelstein, and Andrews are prominent proponents of this view that acquirers should be required to treat all shareholders equally. *See* William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505, 515-22 (1965). "[W]henever a controlling stockholder sells his shares, every other holder of shares (of the same class) is entitled to have an equal opportunity to sell his shares, or a pro[ ]rata part of them, on substantially the same terms." *Id.* at 515. *See also* Brudney, *supra* note 12, at 1072, 1074 ("[A]ll shares of a particular class . . . are to be treated as homogeneous claims on enterprise wealth . . . [and] each shareholder should receive equal amounts or participate equally per share with each other investor."); Brudney & Chirelstein, *supra* note 19, at 313 (contemplating current and proposed fairness standards).

[111]*See* Bebchuk, *supra* note 18; John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 366-67 (1996).

[112]*See* George B. Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420, 426 (1965) ("It might be sensible to decline to buy more than the bare amount necessary for control on the principles of diversification of risk and of opportunity. This might render the equal treatment rule ineffectual as a means of automatically distinguishing 'good' and 'bad' purchasers.").

state statutes go too far in protecting shareholders from coercive tender offers.

Statutory appraisal rights are similar to equal treatment statutes to the extent that they mandate that the acquirer provide "fair value" to minority shareholders.[113] While equal treatment provisions go too far, however, appraisal rights do not go far enough because they can only be used by shareholders after the acquirer has achieved control. Moreover, most commentators consider appraisal rights to be a weak remedy for shareholders.[114] Although appraisal rights are being strengthened in some states,[115] they currently do not provide an adequate remedy for coercive tender offers.

The fourth and final form of state statute is a delayed control restriction. These statutes are deficient for two reasons. First, delayed control restrictions stand some risk of being invalidated as violations of the Dormant Commerce Clause of the federal Constitution.[116] The Supreme Court has defined the permissible boundaries for state regulation of takeovers in two cases from the 1980s. In *Edgar v. MITE Corp.*,[117] the Supreme Court struck down the Illinois Business Take-Over Act as a violation of the Commerce Clause.[118] The Court disapproved of a provision in the Illinois Act allowing the Illinois Secretary of State to call a hearing to determine the "substantive fairness" of a tender offer and to reject any tender offers deemed "inequitable" to shareholders.[119] The

---

[113]*See, e.g.*, DEL. CODE ANN. tit. 8, § 262(h) (1991); N.Y. BUS. CORP. LAW § 623(h) (McKinney 1986); MODEL BUS. CORP. ACT ANN. § 13.01(3) (Supp. 1996).

[114]*See* Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 85 (1969) (arguing that appraisal rights are generally a "remedy of desperation"); Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 232-33 (1962) ("[I]t is hard to see that the average shareholder . . . can hope to gain anything from the [appraisal] statutes.").

[115]*See* Recent Case, *Corporate Law — Appraisal Rights — Delaware Supreme Court Holds that a Minority Shareholder is Entitled to Value Added During the Interim Period of Two-Step Takeover* — Cede & Co. v. Technicolor, Inc., *684 A.2d 289 (Del. 1996)*, 110 HARV. L. REV. 1940 (1997) (stating that the Delaware Supreme Court recognized a minority shareholder's right to receive gains from a two-step takeover in a statutory appraisal proceeding).

[116]*See* U.S. CONST. art. I, § 8, cl. 3. Under the Dormant Commerce Clause, the statute is constitutional if it "regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental . . . unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

[117]457 U.S. 624 (1982).

[118]*See id.* at 630.

[119]*See id.* at 643-44.

majority held that this power placed an impermissible burden on interstate commerce because it enabled states to prevent takeover bids.[120]

In *CTS Corp. v. Dynamics Corp. of America*,[121] on the other hand, the Supreme Court upheld an Indiana takeover statute governing the acquisition of in-state corporations.[122] The Indiana statute sterilized the voting rights of acquired shares until a majority of disinterested shareholders voted to restore voting rights in the acquired stock. This provision in effect required disinterested shareholders to approve of a takeover before it could become effective.[123] The Court held that Indiana had a legitimate state interest in regulating the affairs of corporations incorporated under its own laws, and this interest justified the moderate restrictions that it had imposed on acquisitions.[124]

Although the Court has been silent on the precise distinction between these two cases, most commentators have distinguished *MITE* from *CTS* on the grounds that the statute in *MITE* applied to all corporations, regardless of the state of incorporation, while the statute in *CTS* only applied to corporations incorporated within the state.[125] Delayed control restrictions cannot meet this jurisdictional requirement because they affect not only the target company, presumably incorporated within the state, but also the acquiring company, which might not be incorporated within the state. Limiting their application to in-state acquirers would render these statutes ineffective.[126] Therefore, they cannot be adequately tailored to meet the jurisdictional requirements implicitly set out in *MITE*. As in *MITE*, they stand some chance of being invalidated because they "upset the careful balance struck by Congress" in passing the Williams Act.[127]

Even if delayed control restrictions are eventually upheld by the Supreme Court, a second argument against them is that they overly deter tender offers. The reason is that an efficient tender offer, in which the

---

[120]*See id.* at 627, 643-44.

[121]481 U.S. 69 (1987).

[122]*See id.* at 86-87.

[123]*See id.* at 73-74.

[124]*See id.* at 93.

[125]*See, e.g.*, Crabtree, *supra* note 100, at 686; ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 55-56 (1993).

[126]Again, the illustration in *infra* Part III provides a good example. Conrail was incorporated in Pennsylvania while CSX and NS are both Virginia corporations. A delayed control restriction statute with a narrow jurisdictional reach would be completely ineffective in protecting Conrail from CSX or NS.

[127]*Edgar*, 457 U.S. at 634. *See also* Ball, *supra* note 98, at 375 ("The Supreme Court's decision in MITE cast a shadow over all state takeover legislation.") (footnote omitted).

acquirer will create significant synergies, might become a negative NPV project for the acquirer if she has to wait three to five years before being able to achieve those synergies. Therefore, delayed control restrictions are inefficient because they make efficient tender offers unattractive to the acquirer.

In sum, state legislatures began to cut back on the power that squeeze-out statutes had granted to acquirers. Although state legislatures were clearly triangulating toward an efficient takeover mechanism, none of the adopted devices had proven successful in achieving the correct balance between shareholders and acquirers.

C. *The Era of Management Power (1990-Present)*

Triangulation was upset in the mid-1980s when the poison pill injected a new player between acquirers and shareholders, namely, management. Most commentators attribute the invention of the poison pill to eminent corporate lawyer Martin Lipton in 1983.[128] To implement the pill, a board of directors distributes warrants to all common shareholders to purchase the company's common stock in the event of an acquisition (the "flip-in" provision) or to purchase the acquiring company's stock in the event of a squeeze-out (the "flip-over" provision) at a significant discount.[129] The dilution resulting from triggering either device makes a tender offer a prohibitively expensive method of acquisition.[130] Instead, potential acquirers are forced to negotiate a merger with the target's board.[131]

Early forms of the poison pill were questioned by financial and legal commentators as a potential breach of the board's fiduciary duty to its shareholders.[132] In 1985, however, in the seminal case of *Moran v. Household International, Inc.*,[133] the Delaware Supreme Court held that Household's flip-over poison pill was an appropriate exercise of

---

[128]Lipton conceived of the idea in December 1982 as a defensive tactic for El Paso Railroad against Burlington & Northern Railroad's hostile bid. *See* MOIRA JOHNSTON, TAKEOVER 36-37 (1986). El Paso and Burlington & Northern eventually reached a settlement in which Burlington & Northern gained control. *See id.*

[129]*See* Wachtell, Lipton, Rosen & Katz, Preferred Share Purchase Rights Plan, Memorandum to the Board of Directors, I-1 (Mar. 1997) (on file with *The Delaware Journal of Corporate Law*) [hereinafter Wachtell Board Memorandum].

[130]*See* Booth, *supra* note 98, at 728-29.

[131]*See* Oesterle, *supra* note 74, at 120-21.

[132]*See* Interview with Martin Lipton, Wachtell, Lipton, Rosen & Katz, in New York, N.Y. (June 5, 1997).

[133]500 A.2d 1346 (Del. 1985).

Household's business judgment.[134] This decision opened the floodgates to poison pills. By 1997 more than 1700 companies had installed preferred share purchase rights plans as amendments to their bylaws.[135] Some commentators have praised poison pills, arguing that defensive mechanisms allow managers to protect shareholders from the inherently coercive nature of tender offers and provide "a way for the target to fight fire with fire."[136] The poison pill, however, moves the negotiating balance too far toward management because it effectively requires management approval for any takeover. Delaware courts have adopted an "enhanced business judgment rule" to assess the actions of managers acting ostensibly in the interest of shareholders.[137] Although this rule requires that defensive tactics are "reasonable in relation to the threat posed,"[138] the Delaware Supreme Court has generally given broad deference to management under this rule.[139] In particular, Delaware courts have upheld a board of directors' right to "Just Say No," that is, to reject a hostile tender offer without having to provide an explanation.[140] Although the validity of the "Just Say No defense" is a constant source of litigation in the Delaware courts, most practitioners agree that it remains viable today.[141]

---

[134]*See id.* at 1357.

[135]*See* Wachtell Board Memorandum, *supra* note 129, at 1.

[136]Booth, *supra* note 98, at 729.

[137]*See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (1985).

[138]*Id.* at 955.

[139]*See, e.g.*, Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984) (finding that board's actions were not a breach of their fiduciary duties and thus did not excuse demand). *But see* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986) (holding that target management may not use a lock-up option to "end an active auction and foreclose further bidding").

[140]*See, e.g.*, Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 43 n.13 (Del. 1994) ("[W]here a potential sale of control by a corporation is not the consequence of a board's action, this Court has recognized the prerogative of a board of directors to resist a third party's unsolicited acquisition proposal or offer."); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990). *See also* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 859 n.4 (1993) (describing the deterrence effect Delaware's deference has had on hostile takeover activity). For obvious reasons, the "Just Say No" defense has also been called the "Nancy Reagan defense."

[141]*See* Kramer Interview, *supra* note 3, at 5-6 ("[D]o you think there is any chance in the world that Conrail wouldn't have sat behind their barriers and the poison pill and just said 'no no no no no'?"); Interview with an Investment Banker Central to the Conrail Acquisition, *supra* note 2, at 3 ("If you're running an auction between two proposals, the board can decide whether it likes pineapple upside down cake versus apple cake. It's discretionary."). *See also* Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Takeover Response*

In defense of the "Just Say No defense," some commentators argue that management is well-positioned to decide on behalf of its shareholders how to respond to a hostile acquisition. Management can be an effective negotiating agent for shareholders because it knows the company better than anyone else and therefore can accurately assess offers.[142] Indeed, the poison pill effectively addresses the collective action problem that made shareholders so weak relative to acquirers in the previous era. In addition, "[c]onscientious managers of a target company may be able to negotiate with the initial offeror and other potential bidders to extract gains for the shareholders that shareholders would not realize if they responded individually."[143]

The problem is that agency issues and entrenchment problems might prevent efficient tender offers from being completed. To take the simplest example, management clearly has an incentive to reject an offer that would provide high value to shareholders but would lose management their jobs.[144] Part III of this article presents a very clear example of these agency issues. At the very least, placing decision-making power in the hands of people who do not control the assets is a prescription for high agency costs.[145] This outcome stands in contrast to the previous era when decisions were at least made by the parties owning the assets, namely, the shareholders.

Early empirical assessments of the poison pill were mixed. Some studies found a small but significant decline in shareholder value when a company announced a poison pill,[146] while other studies found no such

---

Checklist, at 1 (May 1, 1996) (on file with *The Delaware Journal of Corporate Law*) (describing the "erroneous, but widely held" view that corporate boards of directors cannot "just-say-no" to a takeover attempt with a poison pill defense).

[142]*See* Oesterle, *supra* note 74, at 124.

[143]Dale A. Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53, 58 (1985). *See also* Memorandum from Wachtell, Lipton, Rosen & Katz, Preferred Share Purchase Rights Plan I-5 (undated) ("Many institutional investors have come to recognize that a rights plan can be an effective negotiating tool for a responsible board of directors.").

[144]*See* Booth, *supra* note 98, at 730 (arguing that management "remains free to make self-serving decisions motivated primarily by a desire to remain in office").

[145]*See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). The median CEO owns 0.25% of her company's stock. *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 260-61 (1990).

[146]*See* OFFICE OF THE CHIEF ECONOMIST, SEC, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS 29 (1986) (showing a 0.22% decline in the stock price of 245 firms over a two-day event window surrounding the announcement of a poison pill plan).

decline.[147] These results are intuitively correct because poison pills in their early years served socially efficient and socially inefficient purposes, depending on the circumstances of the transaction. On one hand, poison pills effectively deterred "two-tier, front-end-loaded, junk-bond-financed, boot-strap, bust-up takeover[s]" that were indeed desirable to deter.[148] On the other hand, pills also deterred strategic, value-creating acquisitions. In the 1980s, when the pill was devised, takeovers were often financially rather than strategically motivated; therefore, the pill was often beneficial. In the 1990s, on the other hand, bidders are invariably strategic.[149] Poison pills have missed this distinction because they were designed in response to the specific threat of front-end-loaded offers,[150] but have been used in a far broader context since then.[151]

Not only has the nature of the deals changed since the poison pill was first invented, but the people being "protected" by the pill have changed as well. In the 1980s, coincident with the appearance of the pill, the diffuse shareholder base that characterized the previous era began to give way to institutional investors. Institutional investors owned 38% of

---

[147]*See* Scott C. Linn & John J. McConnell, *An Empirical Investigation of the Impact of 'Antitakeover' Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361, 397 (1983) (finding no decline).

[148]Martin Lipton, Memorandum from Wachtell, Lipton, Rosen & Katz, *The Poison Pill — Some Current Observations* (Mar. 10, 1997) (on file with *The Delaware Journal of Corporate Law*).

[149]*See* Steven Lipin, *Corporations' Dreams Converge in one Idea: It's Time to Do a Deal*, WALL ST. J., Feb. 26, 1997, at A1 ("[T]he mergers of today are overwhelmingly being done for strategic business reasons. Thus, this merger boom differs from that of the 1980s, when some buyers were financial types simply angling for undervalued assets they could resell, and also from the conglomerate era that began in the early 1960s."); Lipton Interview, *supra* note 1, at 6 ("We were [against hostile bids] in the 80s, when they were . . . bust-up transactions. But now in an era of strategic acquisitions, I'd say we're on the bidder's side as much as we're on the target's side . . . .").

[150]*See* Lipton Interview, *supra* note 1, at 10 ("The reason why the pill was developed was to counter front-end-loaded deals. Until the pill, you couldn't deal with it."). In partial defense of the poison pill, Professor Bebchuk has suggested that it might have played a role in changing the nature of the deals that were made, i.e., since hostile deals are often financial, the elimination of hostile deals made the remaining deals primarily strategic. *See* Conversation with Lucian Bebchuk in Cambridge, Massachusetts (Sept. 18, 1997).

[151]*See* Interview with an Investment Banker Central to the Conrail Acquisition, *supra* note 2, at 9.

> The pill is evolving over time from something different from what it was . . . . I think the conventional view is that eventually we'll pull back on it. It is a substitute for having some legislative procedure, but, yes, the complexity and layering of tender offer takeover regulation should have been federally preempted in some logical scheme.

Id.

total market capitalization in the United States in 1981, 45% by 1986, and 53% by 1990.[152] The emergence of institutional investors has reduced the coercion problem that the pill was intended to respond to, because institutions can wield significant bargaining power against acquirers and coordination problems are reduced.[153] Even the small shareholders who continue to own shares directly can free ride on the protection against coercive tender offers afforded by institutional investors. Therefore, the pill is protecting shareholders who can mainly fend for themselves.

In short, changes in the nature of the transactions and changes in the shareholder base have made poison pills detrimental to the market for corporate control. Consistent with this conclusion, more recent studies of poison pills show that adoption of a pill tends to have a negative impact on shareholder wealth.[154] In effect, the poison pill is too powerful because it makes a company impermeable to attack by a hostile bidder.[155] From a negotiation perspective, the poison pill upsets the careful calibration which state legislatures and Congress were triangulating toward during the previous era, resulting in an inefficient market for corporate control.

Gradually, shareholders are beginning to recognize the detrimental effects of poison pills on the value of their stock. According to a report by the Investor Responsibility Research Center, a nonprofit organization in Washington, D.C., fifty-two nonbinding measures to curb or repeal poison pills won a majority of the votes cast between 1988 and 1996; half of these companies subsequently abandoned their pills.[156] Nevertheless, shareholder activism is a slow and tedious way to affect change for two reasons. First, the board is generally free to reject a shareholder request for rescission under the protection of the business

---

[152]*See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 126 n.4 (1994) (citing CAROLYN KAY BRANCATO & PATRICIA A. GAUGHAN, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE table 10 (Colum. L. Sch. Institutional Investor Project, Sept. 12, 1991)). The authors define "institution" to include pension funds, mutual funds, insurance companies, bank-managed trusts, and foundation and endowment funds. The definition excludes shares owned by investment banks, bank holding companies, and nonbank, nonpension trusts.

[153]*See* Roe, *supra* note 17, at 324-28.

[154]*See, e.g.*, BRUNER, *supra* note 6; John S. Strong & John R. Meyer, *An Analysis of Shareholder Rights Plans*, 11 MANAGERIAL & DECISION ECON., May 1990, at 73, 73-74.

[155]*See* Kramer Interview, *supra* note 3, at 5 ("[T]here's actually an impenetrable wall right there that Marty Lipton has originated, which is the pill.").

[156]*See* Joann S. Lublin, *'Poison Pills' Are Giving Shareholders a Big Headache, Union Proposals Assert*, WALL ST. J., May 23, 1997, at C1.

judgment rule.[157] In fact, Martin Lipton contends that votes to repeal poison pills reflect irrational shareholder activism;[158] he advises boards of directors to disregard shareholder votes that demand redemption of the pill.[159]

Second, many shareholders may be afraid of the unknown. Shareholders might be reluctant to vote out poison pills because they fear a return to the earlier era of collective action problems and acquirer coercion. As a result of these two factors, only 1.5% of the pills that have been installed in corporate bylaws have subsequently been rescinded, despite the dramatic changes in the corporate control landscape since the 1980s.

Part III illustrates the current state of the bargaining relationship and the consequences of this inefficiency on the market for corporate control. Part IV identifies a new type of takeover defense mechanism that would provide a reasonable replacement for the poison pill.

III. AN ILLUSTRATION: *CSX V. NORFOLK SOUTHERN*

The recent bidding war between CSX and Norfolk Southern (NS) for Conrail presents a very high profile, very high stakes illustration of the current state of the bargaining relationship among acquirers, shareholders, and management. Since 1976, when Conrail was formed, both CSX and NS had been eyeing Conrail as an attractive inroad to the northeast. In particular, Conrail's 11,000 miles of routes in the northeast gave it a "virtual lock" on rail freight into the New York City metropolitan area, the country's largest buyer of consumer goods.[160]

Despite overtures from both railroads, Conrail had fought vigorously to avoid being taken over as part of the 1980s consolidation wave in the railroad industry.[161] It therefore came as a shock when, on

---

[157]*See* Spiegel v. Buntrock, 571 A.2d 767, 772-73 (Del. 1990); Auer v. Dressel, 118 N.E.2d 590 (N.Y. 1954).

[158]*See* Lipton Memorandum, *supra* note 148 ("Shortly after the pill became popular with major companies, activist institutional shareholders . . . sponsored precatory resolutions attacking the pill. Today many institutions blindly vote for such resolutions . . . .").

[159]*See id.*

> Whether a company should have a pill is a board of directors issue, not a shareholder issue. . . . Accordingly, if the board of directors determines that having a pill is in the best interest of the company and its shareholders, the company should not redeem its pill even if more than 50% of the shares vote for an anti-pill resolution.

Id.

[160]*See* Machalaba & Mathews, *supra* note 9, at A1.

[161]*See* Joseph Weber & Christina Del Valle, *What Might Derail the CSX-Conrail*

October 15, 1996, CSX announced a friendly acquisition of Conrail for cash and stock valued at $8.1 billion.[162] The combination would create the nation's largest railroad network, with 29,600 miles of track stretching from Miami to Chicago to Boston.[163]

A. *The Bids*

The CSX offer involved two tiers: first, a tender offer for 40% of Conrail stock at $92.50 per share; and second, an exchange of 1.85619 CSX shares for each of the remaining sixty percent of Conrail shares.[164] The ratio for the back-end was calculated on October 9, when CSX shares were trading at $49.875, with the objective of providing equal consideration in the front-end and the back-end of the offer.[165] Indeed, if CSX shares had remained at this price, the back-end would have been worth almost exactly $92.50, and shareholders would have had a relatively free choice between the front-end cash and the back-end stock. Arbitrageurs, who typically make short-term investments, would take the cash, and longer-term investors who wanted to preserve their stakes in the combined railroads would take the stock.[166] The result would be beneficial for target shareholders, who would have an uncoerced choice, and the new company, since only loyal shareholders would self-select into the joint entity.

Between October 9, when the ratio was set, and October 15, when the deal was announced, however, CSX shares dropped more than $3.00 to $46.75.[167] Because the back-end ratio remained unchanged, the back-end was now worth $86.78, compared to $92.50 cash for the front-end.

Merger, BUS. WK., Oct. 28, 1996, at 50. The railroad industry went from 40 major companies in 1980 to five large systems in 1996. *See* Daniel Machalaba & Anna Wilde Mathews, *Conrail's Mixed Results Raise Question of Why Two Suitors Are Fighting over It*, WALL ST. J., Oct. 25, 1996, at B2.

[162]*See* Steven Lipin & Daniel Machalaba, *CSX Agrees to Acquire Conrail for $8.1 Billion in Cash and Stock*, WALL ST. J., Oct. 16, 1996, at A3.

[163]*See* Justin Martin, *The Great Train Game*, FORTUNE, Nov. 11, 1996, at 151.

[164]*See* Suzanne Wooton, *Norfolk Southern Ups Bid for Conrail; $110 a Share Tops CSX's Latest Offer*, BALT. SUN, Nov. 9, 1996, at 11C.

[165]*See* Lipton Interview, *supra* note 1, at 1.

[166]In addition, tax considerations might induce shareholders to take the stock, since the stock swap would have been tax-free and shareholders could have deferred recognition of the capital gains on the CSX stock. See MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS 515-16 (1996). In contrast, taking cash would have required recognizing capital gains equal to the difference between the consideration received (here, $92.50) and the shareholder's tax basis in the stock. *See* I.R.C. § 61(a)(3) (1994).

[167]*See* Bloomberg database search (Mar. 3, 1997).

Shareholders now faced a dilemma: if they did not tender into the front-end of the transaction, they risked getting squeezed-out in the less attractive back-end. Instead, by tendering, they could assure themselves of getting at least the blended price.[168]

Within a week of the CSX bid, NS made a hostile, $100-a-share, all-cash bid for 100% of the stock.[169] Widely regarded as the best-managed railroad in the United States,[170] NS had accumulated a $13 billion warchest on its balance sheet[171] that analysts predicted it would be willing to use in order to acquire Conrail.[172] On November 6th, CSX responded to the NS threat by increasing the front-end of its bid to $110, but leaving the back-end ratio unchanged. Following this announcement, the CSX stock price dropped another $2.50 to $43.125, making the back-end worth $80.[173] Therefore, the new CSX offer improved the blended price to $92 but actually increased the coercive nature of the bid by increasing the downside of not tendering into the front-end.[174] This phenomenon is typical in part-cash, part-stock tender offers: as the front-end cash increases, the market will take some of that value out of the

---

[168]*See* Lipton Interview, *supra* note 1, at 5 ("A front-end-loaded transaction is always coercive, by its nature, because if you don't tender into the front end, you're not going to get the same consideration as the other shareholders . . . .").

[169]*See* Steven Lipin et al., *Norfolk Southern Bids $9.1 Billion for Conrail*, WALL ST. J., Oct. 24, 1996, at A3. NS felt that it had to make a 100% offer rather than a two-tier offer because it was a hostile bidder. *See* Kramer Interview, *supra* note 3, at 6 ("[W]e had to use the classic hostile takeover approach. We go in with consideration that you can't challenge, we go as high as economically feasible, and we say we're here forever with this price.").

[170]*See* Lipin et al., *supra* note 169, at A3; *cf.* Daniel Machalaba & Anna Wilde Mathews, *How Norfolk's Chief Pulled Off Conrail Coup*, WALL ST. J., Mar. 5, 1997, at B1 (citing one analyst who described NS as "the Darth Vader of the railroad industry," as well as "overpowering").

[171]*See* Machalaba & Mathews, *supra* note 170, at B1. Moreover, NS's exceptionally strong credit rating gave it access to an enormous line of credit. *See id.*; Kramer Interview, *supra* note 3, at 6 ("[W]e signaled the banks what we needed, and they offered us $25 billion or so. . . . [CSX CEO John Snow] could have raised it but it would have destroyed his balance sheet.").

[172]*See* Roger Lowenstein, *Conrail Battle Seems Like Old Times*, WALL ST. J., Nov. 21, 1996, at C1; *see also* Steven Lipin & Anna Wilde Mathews, *Norfolk Likely to Seek CSX-Conrail Concessions*, WALL ST. J., Oct. 17, 1996, at A10 (quoting one commentator who said, "You don't want to be odd man out in the East, and today, Norfolk Southern is odd man out").

[173]*See* Bloomberg database search (Mar. 3, 1997).

[174]*See* Kramer Interview, *supra* note 3, at 8 ("Every time you raise the front end, your stock goes down on the back end. That's the problem: you can keep raising the front end, but your back end keeps going down, and it just becomes more coercive.").

back-end by devaluing the stock.[175] NS fired back two days later with a $110-a-share, all-cash, 100% bid.[176]

B. *The Negotiations*

In effect, there were two negotiations going on simultaneously. First, there was the negotiation among top management of CSX, NS, and Conrail. While in the previous era acquirers could basically ignore the target's management, Conrail's poison pill effectively bought management a seat at the table — in fact, the only seat. Conrail management could support either bid, protected in its decision by a Pennsylvania antitakeover law that allowed management to consider not just shareholders' interests but also those of other constituencies.[177] In making its choice, Conrail management preferred the CSX bid because CSX offered a more attractive deal to Conrail management on the so-called "social issues."[178] For example, CSX proposed a "merger of equals" with Conrail, while NS's bid was more clearly an acquisition.[179] In CSX's bid, Conrail CEO David LeVan would become chief operating officer of the new railroad, and CEO of the combined entity two years later.[180] CSX also guaranteed key roles to top Conrail officials, and promised to move its headquarters from Richmond to Philadelphia, where Conrail is based.[181] NS, in contrast, offered no such guarantees.[182]

---

[175]The magnitude of this impact depends on two factors: the size of the target relative to the acquirer and the scope of the front-end. Here, Conrail was approximately 35% as large as CSX, and the front-end offer was for 40% of the stock. Therefore, assuming efficient markets, each dollar increase in the front-end should lead to a 14¢ drop (35% x 40%) in the price of the CSX stock.

[176]*See* Steven Lipin & Daniel Machalaba, *Norfolk Lifts Conrail Offer to $10 Billion*, WALL ST. J., Nov. 8, 1996, at A3.

[177]*See* 15 PA. CONS. STAT. ANN. § 1715(a) (1995). The Pennsylvania constituency statute is particularly expansive because "directors are not required to consider the interests of [any] one group . . . [such as shareholders] as dominant with respect to the interests of other corporate constituencies." LIPTON & STEINBERGER, *supra* note 4, § 5.03[1], at 5-33 to 5-34.

[178]*See* Lipin et al., *supra* note 169, at A3.

[179]*See* Charles Slack, *Battle for Conrail Far from Over CSX Bid to Buy Rival Rattled Norfolk Southern, Surprised Industry*, RICHMOND TIMES-DISPATCH, Dec. 27, 1996, at B6.

[180]*See* Joseph Weber, *CSX-Conrail: How Shareholders Would Get Railroaded*, BUS. WK., Nov. 25, 1996, at 44. LeVan's pay would increase from $539,000 in 1995 to at least $2.3 million as CEO. *See id.*

[181]*See* Slack, *supra* note 179, at B6.

[182]*See* Lipin et al., *supra* note 169, at A3. As a hostile bidder, NS could not reasonably match CSX on the social issues. *See* Kramer Interview, *supra* note 3, at 7 ("[W]e couldn't match the social issues. We couldn't say, we'll make you CEO too in the context of it all . . . .").

Not surprisingly, Conrail management awarded CSX the inside track over NS, declaring the CSX bid to be friendly and the NS bid to be hostile.[183] CSX management was able to impose this decision on its shareholders in three ways. First, and most importantly, Conrail had a poison pill, which it amended to exempt the CSX offer but left in place with respect to the NS offer.[184] The pill eliminated the possibility that NS could make an end-run around the Conrail/CSX deal by appealing to shareholders directly with its higher cash offer.[185] Second, the merger agreement provided for Conrail to pay CSX a $300 million termination fee (also known as a "break-up" fee) in the event that their deal fell through.[186] This fee represented 2.9% of the transaction price, an unprecedented amount for a deal of this size.[187] Finally, the merger agreement provided a "no-shop" clause which prevented Conrail's board of directors from soliciting or participating in any other bids until April 15, 1997.[188] These three lock-up provisions sent a clear message to Conrail shareholders that they would make a deal with CSX or with no one at all. Some investors were unhappy with these apparent agency issues.[189] In effect, Conrail's management froze-out the hostile bidder and froze-in its shareholders to a less attractive friendly acquirer.[190]

The second negotiation was among the Conrail shareholders in responding to the CSX offer. The two-tier structure of the CSX bid

---

[183]*See* Phillips, *supra* note 81, at 19.

[184]*See* Kramer Interview, *supra* note 3, at 8 ("The pill is malleable. You just lift the curtain for anybody you want and you keep the steel curtain in place for anybody you don't like.").

[185]*See id.* at 5-6 ("[D]o you think there is any chance in the world that Conrail wouldn't have sat behind their barriers and the poison pill and just said 'no no no no no'?").

[186]*See* Merger Agreement § 5.9(b).

[187]Among deals since 1990 worth more than $10 billion, the Conrail/CSX termination fee was the highest as a percentage of deal value. *See* Search of Securities Data Corporation database (Apr. 20, 1998). The next highest were Bell Atlantic/NYNEX and Worldcom/MFS Communications, both of which had termination fees at 2.6% of deal value. *See id.*

[188]*See* Merger Agreement § 4.2.

[189]A managing director at one investment firm, whose clients held 50,000 Conrail shares, said, "For shareholders to take the word of Conrail's board that in the long term this is in the best interest of everyone, that's really stretching it." Steven Lipin & Anna Wilde Mathews, *CSX Proposal Riles Conrail Shareholders*, PITT. POST-GAZETTE, Nov. 12, 1996, at C12. Another investor went further: "I've never seen a board let something like this happen. . . . It's more and more obscene." Steven Lipin et al., *Key Conrail Vote May be Easy for CSX*, WALL ST. J., Dec. 16, 1996, at A2.

[190]*See* Interview with an Investment Banker Central to the Conrail Acquisition, *supra* note 2, at 10 ("The conclusion is that the front-end-loaded friendly deal is a vehicle for boards to support a friendly bidder and ward off the hostile. . . . In other words, the world is biased toward the friendlies. . . . It's a hostile world for the hostile bidder.").

forced shareholders into a social dilemma.[191] If everyone sold to CSX, then under the Williams Act, all shareholders would receive the CSX blended price of $92. At the other extreme, if everyone held, then the Conrail board would be forced to open the door to NS. In this scenario, everyone would get the NS price of $110, because its offer was an any-and-all offer. Therefore, holding was the optimal collective strategy. In theory it should not have been difficult to achieve the optimal strategy since virtually all disinterested shareholders favored the NS offer to the CSX offer.[192] Uncertainty about the actions of the majority, however, led to a problem: if an individual shareholder held while the majority sold, the individual would be left with the unattractive back-end of $80 after CSX gained control and completed its squeeze-out.

How did shareholders respond to this game? As social psychology[193] and game theory would predict,[194] they overwhelmingly sold. By the time the tender offer expired, roughly 85% of Conrail's outstanding shares had been tendered.[195] Because Pennsylvania takeover

---

[191]*See* note 74 and accompanying text.

[192]One analyst, whose company controlled 800,000 Conrail shares, said, "On the face of it, the Norfolk Southern bid is clearly superior to the CSX offer in terms of the pure financial aspects." *See* Steven Lipin & Anna Wilde Mathews, *CSX's Move to Derail Norfolk's Offer Has Conrail Investors Feeling Railroaded*, WALL ST. J., Nov. 11, 1996, at C1. *See also* Ed Peterson, *A Conrail Deal to Keep Competition on the Rails*, PITT. POST-GAZETTE, Dec. 30, 1996, at A14 ("Stockholders certainly would want N/S's [Norfolk Southern's] higher cash offer . . . .").

[193]From the social psychological perspective, experimental evidence suggests that cooperation is less likely as the size of the group increases. In the tender offer context, often with hundreds or thousands of shareholders who are widely dispersed and have no formal means of communication, social psychology would predict that cooperation is unlikely. *See generally* MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION 22-36, 53-66 (1968) (discussing small groups, group size, and group behavior). *But cf.* Booth, *supra* note 98, at 763 (arguing that large shareholders "may even be in touch with each other and thus capable of concerted action").

[194]Game theorists focus on the risk aversion inherent in a Dangerous Coordination Game. *See supra* note 74. A Dangerous Coordination Game has a bigger downside from not coordinating for one player (here, the individual shareholder) than the other, making non-coordination "dangerous" for that player. *See* RASMUSEN, *supra* note 74, at 27. Game theorists predict that the combination of risk aversion and uncertainty as to the actions of the majority will lead shareholders to tender. *See id.* That is, within some reasonable range of offers, a risk-averse shareholder will choose the certainty of a tender offer premium to the possibility of being frozen out in the back-end at an unattractive price, or, even worse, being left with an illiquid minority position because the market for the shares dries up after the successful tender offer. *See* Lipton, *supra* note 75, at 113 ("[T]he special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion — they will tender, therefore, it is misleading to speak of a free shareholder choice at all.").

[195]*See* Ritchenya A. Shepherd, *Conrail Shareholders Move CSX Closer to Merger*,

laws prohibited CSX from acquiring more than 19.9% in this first tender offer,[196] CSX paid $110 in cash for 23% of the shares tendered and distributed CSX stock for the rest.[197] CSX management announced that the shareholder response indicated strong interest in the proposed merger.[198] Most analysts, however, argued that shareholders had been coerced into tendering.[199]

C. *The Stalemate*

In January 1997, CSX asked Conrail shareholders to vote to waive the Pennsylvania law that prevented CSX from buying more than 19.9% of Conrail's outstanding shares.[200] The positive response to the tender offer in November might have suggested that Conrail shareholders generally supported a merger with CSX. Instead, on January 17, 1997, Conrail shareholders rejected "overwhelmingly" a waiver of the Pennsylvania law, and, by extension, rejected a merger with CSX.[201] The outcome was all the more surprising because, by this time, CSX owned 19.9% of Conrail and Conrail employee trusts controlled another 13%.[202] Both of these groups intended to vote to waive the Pennsylvania law.[203] In order to win, CSX needed the approval of a majority of those voting, not a majority of the shares outstanding.[204] Therefore, assuming approximately 80% turnout for the vote, CSX only needed another 7%

CHARLESTON GAZETTE, Nov. 22, 1996, at 3C.

[196]*See* 15 PA. CONS. STAT. ANN. §§ 2555, 2564, 2662 (West 1995).

[197]*See* Shepherd, *supra* note 195, at 3C.

[198]*See id.*; Lipton Interview, *supra* note 1, at 9 (arguing that shareholders tendered because "[i]t was $110 a share").

[199]One analyst said, "'I would have expected more . . . [shareholders to tender]. They . . . [shareholders have] been caught in the classic prisoner's dilemma.'" Shepherd, *supra* note 195, at 3C (quoting William H. Clark Jr.). Note, however, that the game that shareholders faced was not actually a prisoner's dilemma. *See supra* note 74.

[200]*See* 15 PA. CONS. STAT. ANN. § 2551 (West 1995) (current through Act 1997-50). This section empowers a corporation to opt out of the statute upon a majority vote of noninterested shareholders. Any amendment to the articles exempting the corporation from the statute would not take effect for 18 months after the vote.

[201]*See* Jack Burke, *Prospects for Negotiated Peace*, J. COM., INC. TRAFFIC WORLD, Jan. 27, 1997, at 8.

[202]*See* Steven Lipin et al., *Key Conrail Vote May Be Easy for CSX*, WALL ST. J., Dec. 16, 1996, at A2.

[203]*See* Shepherd, *supra* note 195, at 3C. Employee support may have been induced by CSX's superiority on the so-called "social issues." *See supra* text accompanying notes 178-82.

[204]*See* Steven Lipin, *Conrail Sets Vote on a Key Step Toward Its Acquisition by CSX*, WALL ST. J., Nov. 26, 1996, at B4.

of shareholders to vote with it.[205] Instead, NS estimated that 95% of the nonaligned shares went its way.[206]

On its surface, the November tender offer should not have presented a threat to Conrail shareholders because CSX wanted 40% of Conrail and the Pennsylvania antitakeover statute prevented CSX from acquiring more than 19.9%;[207] therefore the back-end of the two-tier CSX bid would never materialize. There was, however, some danger of a squeeze-out through a bootstrapping strategy. First, CSX would acquire 19.9% in the tender offer. Then, CSX would vote that 19.9% in favor of waiving the Pennsylvania statute. If another 7% of Conrail shareholders voted with CSX, CSX would have been able to gain control and complete the back-end squeeze-out.

In fact, after the successful tender offer in November,[208] some commentators predicted that this bootstrapping strategy would succeed.[209] Therefore, in view of the possibility that CSX would gain control, risk averse shareholders tendered in November even though there was a better offer on the table from NS.[210] By contrast, in January, shareholders could express their true preferences because there was no downside to a "no" vote.[211] Shareholders who thought that the CSX offer was preferable voted "yes" and shareholders who thought it was not preferable voted "no." This expression of true preferences demonstrated convincingly that

---

[205]*See* Lipin et al., *supra* note 202, at A2.

[206]*See* Kramer Interview, *supra* note 3, at 17-18 ("When you take out CSX's votes, we got 19 out of every 20 shares voted. . . . [T]here's never been a mandate like that, an anti-management mandate, in American corporate history.").

[207]*See supra* note 200.

[208]Between the November tender offer and the January vote, CSX had sweetened its offer by adding convertible preferred stock, bringing its total blended package to $102-per-share. Within hours, however, NS had responded by increasing its bid to $115-a-share, thereby maintaining the differential between the two bids at approximately $13. *See* Steven Lipin & Anna Wilde Mathews, *Norfolk Sweetens Hostile Bid for Conrail Hours After CSX Raises Friendly Offer*, WALL ST. J., Dec. 20, 1996, at A3. Therefore, this last round of bidding led to a pure wealth transfer from the bidders to shareholders. *See* Interview with an Investment Banker Central to the Conrail Acquisition, *supra* note 2, at 7 ("The only thing that didn't go as expected here is that this settlement could have gone $5 cheaper. Norfolk got nervous and they unilaterally raised it $5, which is just burning money.").

[209]*See, e.g.*, Lipin et al., *supra* note 202, at A2; Anna Wilde Mathews, *CSX-Conrail Proviso Wins U.S. Backing*, WALL ST. J., Jan. 10, 1997, at A3.

[210]Some Conrail shareholders were able to resist the pressure to tender. The California Public Employees Retirement System (CALPERS) refused to tender to CSX in November in order to send "a clear message to CSX and Conrail." Lipin et al., *supra* note 202, at A2.

[211]Professor Bebchuk's "revealed preferences" solution to the coercion problem is based precisely on this point. *See* Bebchuk, *supra* note 21, at 1752-54.

shareholders wanted NS to come to the table.[212] The CSX tender offer in November, however, was successful because it was coercive. Even Martin Lipton, whose law firm Wachtell, Lipton, Rosen & Katz advised CSX on its bid, has conceded that two-tier offers are inherently coercive.[213] It is precisely the coercive nature of two-tier offers that make them so attractive for acquirers.[214]

D. *The Settlement*

In short, the poison pill forced shareholders to negotiate with one bidder rather than two, and the coercive nature of CSX's two-tier bid forced shareholders to tender. This bargaining regime is problematic because assets do not go to their most efficient use. Pennsylvania's control share acquisition statute effectively prevented CSX from achieving complete victory, but under a more efficient legal regime, CSX should not have been in the game at all because NS placed a better deal on the table.

After reaching the January stalemate, CSX and NS negotiated a settlement in April 1997 giving 42% of Conrail's assets to CSX and 58% to NS.[215] Conrail shareholders should be pleased with this negotiated agreement because they received $115 per share.[216] The settlement is inefficient, however, because CSX ended up with a significant piece of Conrail even though NS ostensibly values Conrail more.[217]

---

[212]*See* Steven Lipin & Anna Wilde Mathews, *Conrail's Failure to Win Holder Vote May Lead to CSX-Norfolk Stalemate*, WALL ST. J., Jan. 20, 1997, at A3. A NS advisor said, "If Mr. LeVan [Conrail CEO] wants to call this a failure to communicate with shareholders, he is mistaken. . . . This was a failure to coerce shareholders, who have said, 'I'm mad as hell, and I'm not going to take it anymore.'" *Id.*

[213]*See* Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 19 (1987) ("The difference in the prices of the tiers unfairly pressures the target shareholder. A shareholder who would prefer that the target remain independent will usually tender anyway . . . .").

[214]*See* Charles M. Nathan, *The Meaning of Marathon: Novel Legal Question Explored*, NAT'L L.J., Mar. 29, 1982, at 31 ("[T]he two-tiered pricing structure can, and is intended to, create an atmosphere of stampede among the target company's shareholders.").

[215]*See* Charles V. Bagli, *Rival Railroads Agree on Conrail's Assets*, N.Y. TIMES, Apr. 9, 1997, at D3.

[216]*See id.*

[217]"Inefficient" here is used purely in the context of the market for corporate control. In economic terms, dividing up Conrail between CSX and NS is probably more efficient because it avoids a monopoly over rail routes in the northeast. *See* Anna Wilde Mathews, *Shippers, Ports and Congress Oppose Conrail Sale to an Unexpected Extent*, WALL ST. J., Nov. 27, 1996, at A3.

Quantifying this inefficiency based on the prices offered in the initial round of bidding results in a deadweight loss calculation of more than $1 billion.[218] Unfortunately, more precise estimates will have to wait until early 1999 when CSX and NS will take over the day-to-day operations of Conrail.[219] Until then, we can only speculate about which railroad will deploy the Conrail assets most efficiently. One rough benchmark is the expected benefits that each railroad intends to achieve from the breakup: NS expects $564 million of benefits while CSX expects $410 million.[220] Although these estimates are often dismissed as mere posturing between rivals, they are consistent with the overall expectation among analysts that NS will deploy the Conrail assets more efficiently.

In theory, if NS truly values Conrail more than CSX, it can make an offer to CSX for its piece of Conrail.[221] Under this reasoning, the phenomenon of coercive tender offers merely affects the distribution of the surplus rather than the final ownership of the assets; efficiency is

---

[218]The deadweight loss is the difference between the value that CSX attached to the average share ($92) and the value that NS attached to the average share ($110), multiplied by the number of shares that CSX got in the end (42% of 87.5 million shares) = $1.0 billion. This calculation assumes that the two bidders revealed their true preferences as to asset values in the first round of bidding, and that the subsequent bidding war did not reflect actual value attached to the shares.

[219]NS and CSX may not exercise operational control over Conrail until the takeover is approved by the federal Surface Transportation Board a process that is not expected to be completed until mid-1998. *See Norfolk Rail Accused of Jumping Gun*, VIRGINIAN-PILOT, July 11, 1997, at D2. Under the Board's schedule, oral arguments in the case will take place on April 9, 1998, with a final decision slated for June 8, 1998 and a final consummation of the transaction likely on July 8, 1998. *See* Jack Burke, *Application Filed, All 14,810 Pages; NX, CSX See a Billion Dollars in Annual Benefits from the Conrail Takeover*, J. COM., INC. TRAFFIC WORLD, June 30, 1997, at 11.

[220]*See Estimation of Benefits from Conrail Breakup Raised by Railroads*, WALL ST. J., July 3, 1997, at C16. Although the average benefit per dollar of asset value is approximately the same between the two railroads, NS has a higher marginal benefit per dollar of asset value because NS has more assets. If NS and CSX had the same marginal benefit curve, then NS would have a lower average benefit than CSX because NS has more assets, assuming diminishing marginal returns to assets. Because NS and CSX have the same average benefit per dollar of asset value, NS must have a higher marginal benefit curve than CSX. This conclusion is consistent with the hypothesis that NS will deploy the assets more efficiently than CSX. *See generally* ALFRED MARSHALL, PRINCIPLES OF ECONOMICS 78-85 (8th ed. 1920) (describing the concept of marginal utility).

[221]Antitrust concerns, however, probably prevent CSX or NS from owning a clear majority stake in Conrail. *Cf.* Interview with an Investment Banker Central to the Conrail Acquisition, *supra* note 2, at 3-4 ("Conrail is a very simple deal. It has nothing to do with the public marketplace. At all. It is all about the government in Washington. That's all it is. The government wanted the railroad split, so the railroad's going to get split.").

unaffected by coercive tender offers.[222] In reality, however, tender offers are far from costless and ownership of corporate assets is generally "sticky."[223] Therefore, even on efficiency grounds we should prefer a rule that distributes corporate assets to their most valued use in the first transaction itself. This objective can be achieved by recalibrating the negotiation among acquirers, shareholders, and management. Part IV proposes such a regime.

IV. A PROPOSED ALTERNATIVE

Part III illustrated the problem of relying on poison pills and concluded that they put too much discretion in the hands of management which may ultimately lead to inefficient transactions in the corporate control market. Shareholders, however, are reluctant to vote down poison pills for fear of leaving their company "naked" to the aggressive acquisition tactics of the previous takeover era. The emergence of institutional investors has somewhat reduced the coercion problem in tender offers because larger shareholders can wield significant bargaining power against acquirers. Yet, coordination problems among even large shareholders suggest the potential for coercion in the absence of a pill.[224] Some companies have replaced their pills with other types of innovative defenses; however, these alternatives suffer from flaws that make their general usefulness extremely limited.[225] As a result they have failed to

---

[222]*See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960).

[223]One study estimated that the transaction costs may amount to at least 13% of the post-offer market price of the target's shares. *See* Robert Smiley, *Tender Offers, Transaction Costs and the Theory of the Firm*, 58 REV. ECON. & STAT. 22 (1976); *accord* Oliver E. Williamson, CORPORATE CONTROL AND BUSINESS BEHAVIOR: AN INQUIRY INTO THE EFFECTS OF ORGANIZATION FORM ON ENTERPRISE BEHAVIOR 100 (1970) (estimating 10-25%). NS, for example, had $75 million in acquisition-related expenses through December, 1996 on its Conrail bid. *See Talks by Conrail, CSX, Norfolk Appear Stalled*, WALL ST. J., Feb. 11, 1997, at B2.

[224]In 1990, institutions owned 53% of the equity in U.S. public companies. *See supra* text accompanying note 152.

[225]For example, the "suicide" or "people" plan was announced by Borden Company in 1989. In it, the 25 top managers of the company agreed to resign en masse if shareholders did not receive "fair value" in a takeover and if any one of the 25 managers were fired or demoted. Although the plan has never been triggered, enforcement seems problematic and defection, therefore, very likely. Another, less radical, takeover defense mechanism that is gaining popularity is the so-called "chewable" poison pill. *See* Jonathan R. Macey, *A Poison Pill that Shareholders Can Swallow*, WALL ST. J., May 4, 1998, at A22. The chewable pill automatically expires when there is an all-cash offer for 100% of the company's stock at a price at least 25% above the market price. *See id.* The problem with the chewable pill is that it is underinclusive: some efficient changes of control will be deterred because managers still

gain market share among takeover defense mechanisms. What is needed is Goldilocks' third porridge — something that constructs appropriate barriers to coercion but does not discourage efficient tender offers. This Part proposes an "equal treatment agreement" as the remedy that is "just right."

A. *The Proposal*

At a conceptual level, an efficient legal rule would put decision-making power in the hands of the people who own the assets, namely, the shareholders, while eliminating the coordination problem among them. Drawing from negotiation theory, coordination problems can often be cured if the participants can make binding, enforceable commitments among themselves. Consider an analogy to the prisoner's dilemma:[226] if the two prisoners could talk to each other before being interrogated individually, and they could establish a credible, binding commitment between themselves, they would cooperate and achieve the optimal outcome. In the context of tender offers, shareholders can achieve this goal through a binding, enforceable bylaws provision that forces them to "cooperate" in the context of a tender offer. By presenting a unified front to acquirers, shareholders will gain bargaining power in the tender offer context. As a by-product, the market for corporate control will become more efficient.

The basic proposal can be stated simply: shareholders should replace their poison pills with a binding and enforceable agreement, *ex ante*, to share any premium they receive in the context of a tender offer. More specifically, shareholders should agree that anyone who sells during a tender offer, including shareholders who sell in the back-end of a two-tier bid, will receive equal consideration for their shares (an "equal treatment agreement"). This approach breaks the dilemma inherent in the tender offer process by taking advantage of the fact that shareholders can

---

retain complete discretion when the offer price is less than 25% above market price. Therefore, the chewable pill also does not meet the efficiency criterion posited at the beginning of *supra* Part II.

[226]In the prisoner's dilemma, two prisoners are being interrogated separately and are unable to communicate with each other. If both prisoners confess, each is sentenced to eight years in prison; if both deny their involvement, each is sentenced to one year. If just one confesses, he is released but the other prisoner is sentenced to ten years. Game theory demonstrates that the dominant-strategy equilibrium is for both prisoners to confess, which is worse for both prisoners than if both prisoners denied their involvement. *See* RASMUSEN, *supra* note 74, at 17. Note, however, that a two-tier tender offer is not strictly a prisoner's dilemma. *See supra* note 74.

communicate among themselves through their corporate bylaws.[227] In the case of a two-tier offer, shareholders will not rush to tender in the attractive front-end because, under their agreement, they will have to give some of it back to compensate shareholders who tender in the back-end. Instead, shareholders will focus on the blended price because a shareholder cannot do any better than the blended price if she tenders. Shareholders will tender only if the blended price is greater than the value that they attach to their shares. More importantly, and in contrast to the current regime, shareholders will refuse to tender when the blended price is less than the inherent value of the shares. Coercion is eliminated because shareholders effectively insure each other against the back-end threat. Finally, by focusing on the blended price rather than the front or back-end, shareholders will create an efficient tender offer mechanism.

Note, however, that an equal treatment agreement does not create excessive obstacles for the acquirer as do state antitakeover laws. For example, as discussed in Part II, state statutes mandating equal treatment *of* shareholders by the acquirer might deter some efficient tender offers in the situation where the acquirer does not want to make (or cannot make) an any-and-all offer.[228] In contrast, equal treatment *among* shareholders allows acquirers to still make partial bids, thereby preserving efficient tender offers. In fact, equal treatment among shareholders imposes no additional restrictions on the acquirer. Instead, it only changes how shareholders view the acquirer's offer.

In particular, acquirers would still be free to make part-cash, part-stock offers. As discussed in the context of the CSX bid for Conrail, acquirers may have legitimate, value-creating reasons for making these types of dual-consideration bids.[229] Under an equal treatment provision, shareholders would avoid the coercion inherent in one side of the bid as soon as the stock price moves. In fact, acquirers might indirectly benefit from this effect because it would eliminate shareholder resentment against the two-tier bid, potentially making shareholders more likely to tender.[230] The only other way for an acquirer to avoid coercion in a part-stock, part-cash bid is to fix the value of the stock (e.g., $92.50 worth of CSX

---

[227]*See* Gow v. Consolidated Coppermines Corp., 165 A. 136, 140 (Del. Ch. 1933) ("[T]he by-laws are generally regarded as the proper place for the self-imposed rules and regulations deemed expedient for . . . [the corporation's] convenient functioning to be laid down.").

[228]*See supra* text accompanying notes 111-12.

[229]*See supra* text accompanying notes 165-66.

[230]As an example of this phenomenon, the CALPERS claimed that it refused to tender in the CSX November tender offer because it resented the bid's coercive nature. *See* Lipin et al., *supra* note 202, at A2.

stock) instead of fixing the conversion ratio of target stock to acquirer stock. This approach, however, creates significant uncertainty on how much stock the acquirer needs to issue, and might create unacceptable dilution.[231] Therefore, an equal treatment provision preserves the acquirer's flexibility in structuring the deal while eliminating its coercive aspect.

Even though such an outcome is efficient for the market as a whole, why would shareholders make such an agreement? Astute investors might want to preserve the premium they get by playing "smart" and tendering quickly in a tender offer situation. Certainly *ex post*, shareholders who tender quickly are hurt by such an agreement because they are forced to share their premium with shareholders who tender later. *Ex ante*, however, all shareholders benefit, because an equal treatment agreement sends a signal to potential acquirers that shareholders will, effectively, bargain as a group when faced with a tender offer decision. Therefore, an acquirer cannot exploit the coercive nature of a two-tier bid. Both parties have relatively equal bargaining power, and acquirers will have to offer a fair price in order to achieve control.

One potential objection is that equal treatment agreements go too far. By eliminating the threat for not tendering, equal treatment agreements effectively eliminate the incentive to tender, and therefore encourage shareholders to adopt a wait-and-see strategy when faced with a tender offer.[232] The response to this argument can be found in the time value of money. Arbitrageurs, who often play a critical role in tender offers,[233] will tender immediately if the tender offer is attractive because of their extremely high cost of capital.[234] With an equal treatment agreement, however, arbitrageurs will not tender simply because the front-end is attractive, because they can never expect to get more than the blended price for their shares. Investors who wait-and-see will

---

[231] *See* Kramer Interview, *supra* note 3, at 24.

> The way to avoid . . . [coercion], of course, is to not fix an exchange ratio on your stock portion, but to say "I'll give you $92.50 cash and $92.50 worth of stock." The trouble is, you don't know how much stock is going to end up being issued.

Id.

[232] *See* Interview with André Perold, Harvard Business School, in Boston, Mass. (Oct. 14, 1997).

[233] *See* EDWARD ROSS ARANOW & HERBERT A. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 173-74 (1973).

[234] *See* Lipton Interview, *supra* note 1, at 10 ("Generally as a rule of thumb, an arbitrageur is looking for a return of 1.5% a month."); Interview with an Investment Banker Central to the Conrail Acquisition, *supra* note 2, at 3 ("[I]f you're an arbitrageur, and you're looking at things at 2% a month, it's a very different perspective than Mr. Average Investor.").

subsequently tender if it becomes clear that the acquirer is going to gain control of the company. Therefore, ultimately they will get their pro rata share of the front-end premium. The delay in getting the premium is not a significant factor for these investors because they do not have such a high cost of capital. In short, the time-value of money will provide the "kick" for arbitrageurs to tender if the blended price is attractive, and other investors will follow if the acquirer gains control. It is acceptable, and perhaps even desirable, to position arbitrageurs as the "lead steers" in the tender offer context because they are often sophisticated investors who can assess value more accurately than individual investors.[235]

Consider what would have happened if Conrail shareholders had an equal treatment agreement rather than the combination of a poison pill and a control share acquisition statute. At the critical juncture, Conrail shareholders had to decide between CSX's blended offer of $92 and NS's $110 all-cash bid.[236] Under an equal treatment agreement, a shareholder who tendered into the CSX front-end in order to get the premium would have to give some of it back to shareholders who tendered in the back-end. As a result, a shareholder would no longer need to tender into the CSX front-end in order to share in the premium. Therefore, the rational shareholder would look only at the blended price of $92, because that is the price that she would be assured to get in the end. Because this price is lower than the guaranteed $110 from NS, Conrail shareholders would have collectively resisted the coercive nature of the two-tier bid from CSX. The collective action problem would be eliminated, and assets would go to their most efficient use in NS's hands. In short, the equal treatment agreement would have reached the efficient outcome more effectively than the combination of a poison pill and a control share acquisition statute.

B. *Implementation*

The most direct method for implementing an equal treatment agreement provision would be through a provision in the company's bylaws. The provision would state that all shareholders who tender in a tender offer *or* who subsequently tender to an acquirer in a second-stage squeeze-out shall receive equal consideration for their shares. Noncash

---

[235]*See* William S. Feinstein, *Securities Fraud, Pleading Securities Fraud with Particularity — Federal Rule of Civil Procedure 9(b) in the Rule 10b-5 Context:* Kowal v. MCI Communications Corporation, 63 GEO. WASH. L. REV. 851, 860 n.60 (1995) (contrasting the information requirements of "reasonable investors" with those of arbitrageurs).

[236]*See supra* text accompanying notes 161-67.

consideration should be valued at the moment when such consideration becomes freely tradable. For example, in the case of stock offered in a back-end squeeze-out, value would be assessed for most publicly traded companies at the moment the acquirer swaps the target's shares for the acquirer's shares. It is conceivable that a shareholder who tenders quickly might try to avoid an equal treatment requirement by executing a short-against-the-box transaction rather than the standard tender.[237] Mirroring the Treasury Department's handling of this issue, the equal treatment agreement should specify that any transaction that substantially eliminates the risk of loss and the opportunity for profit with respect to the stock is equivalent to a disposal and therefore would be subject to equal treatment.[238]

Who would write such an agreement into the bylaws? As explained above, shareholders should favor such a bylaws provision because it reclaims decision-making power and simultaneously discourages coercive tender offers. Most states, however, do not allow shareholders to initiate voluntary bylaws amendments.[239] Most importantly, Delaware's corporate law is ambiguous on this issue.[240] Among those states that do allow shareholders to initiate voluntary bylaws amendments, shareholders may lack the incentive to pursue the bylaws amendment route on their own[241] or they may encounter

---

[237]Shorting against the box involves shorting stock that one owns, thereby creating the economic equivalent of disposal without recognizing capital gains. *See* Michael S. Powlen & Raj Tanden, *Corporate Tax Shelters or Plus Ca Change, Plus C'est La Meme Chose*, 398 PLI/TAX 187, 230 (June 1997).

[238]The Treasury Department has proposed regulations that would treat the substantial elimination of risk and the opportunity for profit as a recognition event. *See id.*

[239]*See* Park McGinty, *Replacing Hostile Takeovers*, 144 U. PA. L. REV. 983, 997 (1995).

[240]*Compare* DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter. . . .") *with* DEL. CODE ANN. tit. 8, § 109(b) (1991) ("The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation . . . ."). *See generally* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 607-08 (1997) (describing the tension between these two sections, but acknowledging that "[t]he search for a sensible accommodation of these two broad provisions must also recognize that judicial decisions have exhibited some hostility to shareholder attempts to encroach upon the board's authority").

[241]*See* William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1903-25 (1995) (describing the incentive problems that impair shareholders' effective participation in corporate governance).

coordination problems in writing the amendment.[242] Nevertheless, either management or the state legislature should be willing to write an equal treatment agreement into the company's bylaws on behalf of shareholders.

First, management or the board could provide an equal treatment agreement as a way of signaling concern for shareholders' interests. At first glance, it might seem that managers should prefer a poison pill to an equal treatment agreement because the poison pill provides absolute protection against hostile takeovers while an equal treatment provision does not provide such protection.[243] There are, however, two reasons why managers should nevertheless favor an equal treatment provision over a poison pill. First, while managers' self-interest clearly favors the pill, managers' fiduciary duty to shareholders requires a balance between defending against coercive tender offers and allowing shareholders to accept value-creating deals.[244] This article has argued that an equal treatment agreement strikes the appropriate balance between these two concerns by effectively transferring the decision-making power from management to shareholders. Second, and perhaps more importantly, there is a big difference between poison pills and equal treatment agreements in their impact on stock price: the former decreases the stock price when announced,[245] while the latter, in theory, should increase the stock price. The reason to expect a positive impact on the stock price from an equal treatment agreement is that the agreement ensures that shareholders investing in the company will not be subjected to a coercive tender offer. In effect, it protects one aspect of the investor's downside, and for that reason investors should be willing to pay more for the stock.

State legislatures could preempt management's choice on this issue by imposing an equal treatment agreement through state statute. Because a state legislature does not face the same agency issues as management, it might be a better avenue for achieving equal treatment. Moreover, because the statute would only apply to corporations incorporated within the state, it would fall well within the jurisdictional constraints imposed

---

[242]*See* Manuel A. Utset, *Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition*, 44 EMORY L.J. 71, 86-88 (1995).

[243]*See* Kramer Interview, *supra* note 3, at 4 (arguing that the poison pill standing alone is "an absolute, complete barrier to takeovers"); Lipton Interview, *supra* note 1, at 11 ("The best protection a target company can have is a pill, a state constituency statute, and, in any state where there is a doubt, a pill validation statute.").

[244]*Cf.* Interview with an Investment Banker Central to the Conrail Acquisition, *supra* note 2, at 9-10 ("[T]he board should worry about the blended value . . . . [T]he real problem here is a board prerogative.").

[245]*See supra* note 154 and accompanying text.

by *MITE*.[246] A state statute, however, is less optimal than a company-by-company approach because, in the context of equal treatment agreements, one size does not fit all. In particular, companies may have good reasons to vary the terms of their equal treatment agreements in response to the sophistication and concentration of the shareholder base. For example, companies that are held predominantly by institutional investors may need less protection than companies that are held predominantly by individuals. Further, even with individual investors, a company with a single shareholder clearly does not need an equal treatment provision because there is no collective action problem. Companies should tailor their agreements to the particular needs of their shareholder base. State legislatures might be able to partially achieve this objective with different types of agreements for different types of companies, but clearly any legislative effort would be less effective than the company-by-company approach described above. Nevertheless, state legislative efforts to implement equal treatment agreements would be a reasonable second-best solution.

C. *Potential Obstacles*

There are two potential obstacles to the implementation of equal treatment agreements. First, there might be some difficulty in determining the appropriate time frame for equal treatment. For example, does a squeeze-out two years after the initial tender offer trigger the agreement? Shareholders might write an explicit time horizon in their bylaws, but the problem with a bright-line rule is that an acquirer then knows exactly when to stage the squeeze-out in order to avoid the equal treatment provision. To take a simple example, if the bylaws amendment stipulates that all shareholders who tender within one year of a tender offer shall receive equal treatment, an acquirer could announce her intention to squeeze-out minority shareholders thirteen months after the initial tender offer, thereby avoiding the agreement and reinstating the coercive nature of the two-tier offer. Instead, equal treatment agreements should combine a minimum time frame for equal treatment (e.g., six months) with standards for assessing what subsequent events would also qualify for equal treatment. These standards should balance, on one hand, the interest of shareholders to settle their accounts (because an open equal treatment agreement always has the possibility of mandatory payments among shareholders), with, on the other hand, the interest of

---

[246] *See* Edgar v. MITE Corp., 457 U.S. 624 (1982). *See supra* text accompanying notes 125-27.

shareholders to create an equal treatment agreement that effectively protects them against coercive tender offers.

The second potential problem involves the interplay between equal treatment agreements and the rules of some major stock exchanges. Both the New York Stock Exchange and the American Stock Exchange prohibit listed companies from including restrictions on share transfer in their charters, unless the restrictions are required by some external regulatory body.[247] The question then becomes whether an equal treatment agreement would be considered a restriction on share transfer. Facially, an equal treatment agreement does not seem like a "restriction" on transfer because shareholders are still perfectly free to sell their shares in any tender offer. There might, however, be an implicit restriction if, because of the equal treatment agreement, a shareholder would be forced to share some of the gain from selling with her fellow-shareholders. A broad reading of "restriction" might encompass the situation in which a shareholder who would have sold for the pure front-end offer does not sell because she will only get the blended price. Without a test case, there is some uncertainty on how equal treatment agreements would fare against the rules of these two exchanges.

Ultimately, because equal treatment agreements contribute to efficiency in the tender offer market, stock exchanges should be willing to change their rules to explicitly accommodate such provisions. After all, companies are customers of the exchanges and exchanges should be responsive to their needs.[248] In the long run, if the benefits of equal treatment agreements are significant, companies will migrate from exchanges that do not allow such provisions to exchanges that do allow such provisions. The subsequent "race to the top" will spur the proliferation of equal treatment agreements across companies that are listed on the major exchanges.[249]

---

[247] *See* Bebchuk, *supra* note 84, at 936.

[248] *See* Booth, *supra* note 98, at 757 ("The . . . [NYSE] is, after all, a business as well as a self-regulatory organization, and competition among exchanges for listings is fierce."). *Cf.* Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1025 (1990) (arguing that the "emergence of close substitutes for . . . services offered by the NYSE" suggests it is constrained from "exercising market power").

[249] *Cf.* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6(2) J. LEGAL STUD. 251, 256 (1977) (arguing that competition among states to attract corporations will result in a "race to the top"). *But cf.* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (arguing that the market for incorporation is a "race to the bottom").

Some practitioners have been skeptical about the feasibility of an equal treatment agreement, but have provided no clear answers on why such agreements would not work. It is interesting to note that practitioners were equally skeptical of poison pills when they were first introduced.[250] Notably, John Whitehead, co-senior partner of Goldman Sachs at the time that Martin Lipton first proposed the poison pill, had serious doubts that they would be upheld in court.[251] In the absence of any clear legal or logistical barriers to the implementation of equal treatment agreements, perhaps the only way to truly determine whether they would work is to bring a test case in the Delaware courts. The equivalent of a *Household International* decision would open the door for companies to replace their poison pills with equal treatment agreements.

One specific concern can be met at the outset. Some practitioners with whom I have discussed my proposal argue that it would be difficult to track shareholders and the amounts they received for their shares.[252] It is true that an equal treatment agreement might require the cooperation of the company's stock exchange in monitoring individual trades. However, because the exchanges might need to modify their rules to allow equal treatment agreements anyway, once they make such modifications they should be willing to go the further step of managing company records that implement equal treatment agreements. It is important to note that such record-keeping would involve no new data collection because the SEC tracks all equity sales anyway for purposes of Rule 10b-5.[253] Moreover, as electronic markets begin to replace the traditional exchanges for some companies, the information necessary to implement an equal treatment agreement will be available to the company on-line.[254]

---

[250]*See* Lipton Interview, *supra* note 132 (describing his collection of articles from the early 1980s that explain why the poison pill would not work).

[251]*See* Letter from Martin Lipton to Guhan Subramanian (Feb. 20, 1998) (on file with *The Delaware Journal of Corporate Law*). As a director of Household, Mr. Whitehead voted against the adoption of the pill by Household. *See id.*

[252]*See, e.g.*, Kramer Interview, *supra* note 3, at 16 ("I guess my question is, how would you police it? In other words, you have what?, thousands to tens of thousands of people.").

[253]*See* 17 C.F.R. § 240.10b-5 (1997). Rule 10b-5 prohibits, *inter alia*, "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." *Id.*

[254]In 1996, the SEC issued a no-action letter granting Real Goods Trading Corporation permission to sell private and public offerings to accredited investors via the Internet. *See* Real Goods Trading Corp., SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226, at 77,131 (June 24, 1996); Recent Agency Action, 110 HARV. L. REV. 959, 959 (1997). Since then Internet securities trading has proliferated. *See* Eric J. Savitz, *Turned On, Tuned Out*, BARRON'S, Sept. 1, 1997, at 15, 16.

V. CONCLUSION

Corporate boards of directors are facing a fork in the road as the poison pills that they put into place a decade ago are now coming up for renewal. This article has proposed that the market for corporate control has changed dramatically from the environment that spurred the creation and proliferation of the poison pill in the 1980s. Currently, the pill destroys shareholder value by taking decision-making power away from the people who own the assets. An equal treatment agreement would restore this power to shareholders while simultaneously solving the collective action problem that plagued the corporate takeover process in the previous era. A far-sighted board of directors can create significant value for shareholders by replacing the poison pill with an equal treatment agreement. As a by-product, the market for corporate control will become more efficient. In view of the record-breaking deal volume over the past three years, equal treatment agreements could create significant value for the economy overall.