THE PRESSURE TO TENDER: AN ANALYSIS AND A PROPOSED REMEDY

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I. Introduction

In the face of a takeover bid, shareholders' tender decisions are subject to substantial distortions. A target's shareholder might well tender his shares even if he views the offered acquisition price as lower than the value of the independent target. The shareholder might tender out of fear that, if he does not tender, the bidder might still gain control, in which case the shareholder would be left with low-value minority shares in the acquired target. Consequently, a bidder may succeed in gaining control over a target even if the value-maximizing course of action for the target's shareholders would be to reject the bid.

This distortion of bid outcomes has already received much attention and has been extensively discussed by many commentators.[1]

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1. Discussions of the problem by practicing lawyers include: Balotti & Finkelstein, *"Coercive" Structures in Tender Offers*, 15 Rev. Sec. Reg. 820 (1982); Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 Sec. Reg. L.J. 291 (1984); Greene & Junewicz, *Reappraisal of Current Regulations of Mergers and Acquisitions*, 132 U. Pa. L. Rev. 647, 676-93 (1984); Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101, 113-14 (1979).

Discussions of the issue by legal academics start with Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 Harv. L. Rev. 297, 336-40 (1974). Such discussions also include Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 Harv. L. Rev. 1028, 1039-41 (1982) [hereinafter Bebchuk, *Competing Bids*]; Bebchuk, *The Case for Facilitating Competing Bids: A Reply and Extension*, 35 Stan. L. Rev. 23, 45-46, 48-49 (1982) [hereinafter Bebchuk, *Reply and Extension*]; Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 Am. B. Found. Research J. 341; Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Colum. L. Rev. 1145, 1183-95 (1984); Easterbrook & Fischel, *Corporate Control*

The SEC Advisory Committee on Tender Offers and the SEC have examined it in their recent examination of takeover law.[2] Courts have considered this distortion, as targets have increasingly used it to justify various defensive tactics, from discriminatory self-tender offers to poison pills.[3] Many corporations have in recent years adopted charter provisions aimed at addressing this problem.[4] Some states have adopted antitakeover statutes which appear to be at least partly motivated by a similar goal.[5] Although the distortion of bid outcomes has received much attention, the understanding of it has remained deficient. As this paper will show, many common views concerning both the nature of this problem and the best ways for dealing with it are significantly incomplete or flawed. This paper therefore seeks to contribute to the understanding of this problem and how it might be best addressed.[6]

Transactions, 91 YALE L. J. 698, 710-11 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 859-62 (1981); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 307-09 (1983).

Finally, the issue has been also discussed by economists. *See* Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. Bus. 345, 352-56 (1980); DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329 (1983); Grossman & Hart, *Takeover Bids, the Free Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 44-47 (1980); Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?*, 28 J.L. & ECON. 151, 154-58 (1985); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 31-32 (1983).

2. *See* SEC Advisory Committee on Tender Offers, Report of Recommendations 24-26 (1982) [hereinafter Advisory Committee Report]; Securities Exchange Act Release No. 21079 [1984 decisions] Fed. Sec. L. Rep. (CCH) ¶ 83,637 (June 21, 1984) [hereinafter SEC Release].

3. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (discriminatory self-tender offer); Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985) (poison pill). Targets' claims that the distortion of bid outcomes justifies defensive tactics have been endorsed by various commentators. *See infra* note 69.

4. *See, e.g.*, Carney, *supra* note 1, at 373-74.

5. *See, e.g.*, Block, Barton & Roth, *State Takeover Statutes: The "Second Generation,"* 13 SEC. REG. L.J. 332 (1986).

6. This paper restates, and presents in a more concise and accessible form, the gist of an analysis that I developed in two previous papers. An earlier, highly detailed analysis of the subject was presented in Bebchuk, *Toward an Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985) [hereinafter Bebchuk, *Undistorted Choice and Equal Treatment*]; and a mathematical, game-theoretic analysis, formally deriving many of this paper's points, was presented in Bebchuk, *A Model of the Outcome of Takeover Bids*, Discussion Paper No. 11, Program in Law and Economics, Harvard Law School (Nov. 1985) [hereinafter Bebchuk, *Model of Bids*].

Section II puts forward the objective of "undistorted choice": a target should be acquired if and only if a majority of its shareholders view the offered acquisition price as higher than the independent target's value. It is suggested that ensuring undistorted choice is desirable from the perspectives of both target shareholders and society. This objective should thus guide public officials in the design of takeover law, and should guide practitioners in the design of corporate charters.

Section III provides an account of how current takeover rules and the dynamics of takeover bids lead to "distorted" outcomes, i.e., outcomes deviating from the undistorted choice standard. The analysis shows that the nature and scope of this problem are often misunderstood. In particular, contrary to the perception of commentators, courts, and regulators, the problem is not limited to partial bids and two-tier bids.

Section IV proposes an arrangement (indeed, two versions of it) that is capable of ensuring undistorted outcomes. Under one version of the arrangement, tendering shareholders would be able to indicate whether or not they "approve" a takeover, and the bidder would only be allowed to purchase a controlling interest if it attracts the required number of "approving" tenders. Under the other version, which is similar to an arrangement contained in some recent state statutes, a bidder would be allowed to proceed only if its bid gains approval in a prior, separate vote among the target's shareholders. The proposed arrangement could in principle be adopted either through appropriate legal rules or through appropriate charter provisions; and both methods of implementation will be considered.

Finally, Section V examines five alternative remedies which have been suggested in the literature or adopted by various corporations. Using the preceding sections' analysis of the distorted choice problem, Section V analyzes the effectiveness and costs of each of these arrangements. As will be shown, some of these arrangements are much better than others, but even the best are somewhat inferior to the arrangement put forward in Section IV.

Before proceeding, it should be noted that this paper is concerned only with acquisitions of targets that prior to the acquisition were not controlled by a single shareholder (or a group of shareholders acting in concert). Acquisitions of targets that were previously controlled by a single shareholder pose a special set of problems and require a separate analysis.

II. THE UNDISTORTED CHOICE OBJECTIVE

According to the undistorted choice objective, a company should be acquired if and only if a majority of its shareholders view the offered acquisition price as higher than the independent target's value. By "majority of the target's shareholders," I mean shareholders holding a majority of the target's shares. The term "the independent target's value" refers to the value that the target will have if it remains, at least for the time being, independent. This value of the independent target obviously includes the value of the prospect of receiving higher acquisition offers in the future.

The undistorted choice objective provides a standard for evaluating the outcome of any acquisition attempt—whether by a takeover bid, by a merger proposal, or by open-market and privately negotiated purchases. This paper's analysis, however, will be limited to takeover bids.[7]

As explained below, ensuring undistorted choice not only benefits target shareholders but also produces substantial social gains. Consequently, I suggest, this objective should guide public officials in the design of takeover law.[8] The social desirability of ensuring undistorted choice is based on efficiency considerations. Efficiency requires that corporate assets be put to their most productive uses. While the acquisition of some companies would produce efficiency gains from an improvement in management or "synergy," the assets of other companies are best left under the existing, independent mode of operation. Thus, choosing the mechanism that will determine whether a given company will be acquired presents an important question of social policy.

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7. For a discussion of the legal rules that should (in light of the proposed objective) govern acquisitions through open market and privately negotiated transactions, see Bebchuk, *Undistorted Choice and Equal Treatment, supra* note 6, at 1788-92.

8. Ensuring undistorted choice should not be the only objective guiding public officials in the design of takeover law. Other objectives are discussed in Bebchuk, *Undistorted Choice and Equal Treatment, supra* note 6, at 1706-08, 1780-87, 1792-94. First, on grounds of efficiency, it is desirable not only to ensure undistorted choice by targets but also (i) to ensure undistorted choice by acquirers, and (ii) to address the distortions resulting from the existence of private gains (such as gains from tax savings and increased market power) that do not represent net social gains. Second, on grounds of fairness considerations, it is desirable to ensure that the acquisition price in a target's acquisition be distributed *pro rata* among the target's shareholders. Ensuring undistorted choice by target shareholders is perfectly consistent with, if not conducive to, pursuing these other objectives. *Id.*

Consider for a moment the outcome of an offer to purchase a sole owner's assets. The law generally conditions the sale of a sole owner's assets upon his consent. Consequently, such a sale will take place if and only if the owner views the offered acquisition price as higher than the value to himself of retaining his assets (including the value of the prospect of receiving higher acquisition offers in the future).

The mechanism of enabling sole owners to accept or reject offers appears to serve efficiency. This mechanism prevents an acquisition whenever the potential buyer is unwilling to pay as much as the value to the owner of retaining his assets. In such cases, efficiency is indeed most likely to be served by having the owner retain his assets. To be sure, this mechanism for allocating sole owners' assets is not perfect. For example, sole owners might make mistakes in estimating the value to themselves of retaining their assets. Yet, this mechanism appears to be the best available—the one that would bring us closest to efficiently allocating sole owners' assets.

According to the undistorted choice objective, the mechanism governing corporate acquisitions should parallel the mechanism used in the sole owner context. A target should be acquired if and only if its shareholders view selling their company as the value-maximizing course of action. When the shareholders judge the offered acquisition price to be lower than the independent target's value, then the bid should fail. In such a case, efficiency would likely be served by having the target remain independent. Of course, like the corresponding mechanism in the sole owner context, the proposed undistorted choice mechanism is not perfect. But, again, the undistorted choice mechanism appears to be the one that would bring us closest to efficient allocation of targets' assets.[9]

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9. The two main reasons why the undistorted choice mechanism is not perfect are discussed in Bebchuk, *Undistorted Choice and Equal Treatment*, *supra* note 6, at 1770-74. First, a target's shareholders might make mistakes in their assessment of how the offered acquisition price compares with the independent target's value. Second, a bidder that values a target's assets by more than the independent target's value might still offer an acquisition price below the independent target's value; consequently, although such a failing bidder might raise its bid, it might also elect not to do so because of strategic considerations or transaction costs. After examining these problems, one can conclude that they are similar in severity to the corresponding problems present in the sole owner context, and that the undistorted choice mechanism appears to be the best we can employ.

While a sole owner obviously has only one view as to whether accepting an offer would be value-maximizing, a target's shareholders might well differ in their judgments of how the offered acquisition price compares with the independent target's value. It is thus necessary to specify some fraction of a given target's shareholders who must view accepting an offer as value-maximizing if the offer is to be accepted. The undistorted choice objective suggests that this decisive fraction should be a majority of the shareholders. The reasoning behind this choice of the decisive fraction is that the majority is more likely to be right than the minority in its assessment of the shareholders' value-maximizing course of action.[10]

Later in this paper, I shall address two possible objections which are likely be raised against the claim that ensuring undistorted choice is socially desirable. First, acquisition offers are usually made at a premium over the pre-bid market price of the target's shares, and it might be argued that a target's shareholders can never rationally view the rejection of a premium offer as value-maximizing. As Section III will explain, however, there are good reasons to believe that rejecting a bid would be value-maximizing in a significant number of instances. Second, it might be argued that, while ensuring undistorted choice would produce an efficient outcome of bids, it might also entail some significant efficiency costs (e.g., by discouraging the search for takeover targets). As Section IV will explain, however, ensuring undistorted choice through the arrangement proposed in Section IV would be unlikely to involve any significant efficiency costs.

Finally, it is important to point out that ensuring undistorted choice is desirable not only from the perspective of efficiency but

10. This reasoning presumably underlies those corporate law doctrines which follow the majority judgment in matters requiring shareholder vote. (For example, most state corporation statutes use the majority of shareholders as the decisive fraction in a merger vote.) It is important to note, however, that the proposed definition of the decisive fraction is in no way crucial to this paper's thesis—and that one who would define the decisive fraction differently should find the paper's analysis wholly relevant. This is because the paper's analysis will focus on ensuring that shareholders' tender decisions reflect their judgment as to whether the offered acquisition price exceeds the independent target's value; and the desirability of ensuring such undistorted tender decisions does not depend on how the decisive fraction is defined. Thus, for example, the arrangement proposed in Section IV could be easily amended to one ensuring that a company will be acquired if and only if a supermajority (rather than a simple majority) views the acquisition as value-maximizing.

also from the perspective of target shareholders. Ensuring undistorted choice would enable target shareholders to follow that course of action which would be most likely to be value-maximizing. Therefore, the following analysis of the ways to ensure undistorted choice should be of interest not only to public officials concerned with designing optimal takeover rules but also to private parties concerned with designing optimal corporate charters.

III. THE DISTORTED CHOICE PROBLEM

Under current takeover rules, and in the absence of special charter provisions, the outcome of bids might be "distorted"—that is, might deviate from the one required by the undistorted choice objective. This problem of distorted choice is rooted in the general presence of a gap between the bid price and the value that minority shares are expected to have in the event of a takeover. I shall first examine this gap, and shall then proceed to analyze the resulting distortions and to discuss their practical significance.

A. *The Post-Takeover Value of Minority Shares*

As the analysis below shows, the post-takeover value of minority shares is generally lower than the bid price. This analysis is supported by the empirical evidence that, after a successful bid is closed, the market price of minority shares is significantly lower than the bid price.[11]

A successful bidder is usually able to effect a takeout merger between itself and the target—a merger that "freezes out" minority shareholders, requiring them to exchange their shares for either cash or securities of the bidder. Takeovers might be thus divided between those that are expected to be followed by a takeout within a short period and those that are not expected to be followed by such a takeout. Below I explain why the post-takeover value of minority shares is usually lower than the bid price in *both* kinds of bids.

1. Takeovers Accompanied by an Immediate Takeout

Under current takeout law, successful bidders may pay minority shareholders in an immediate takeout a consideration with a value lower than the bid price. Acquirers are constrained only by the

11. *See* Bradley, *supra* note 1, at 352-56.

appraisal rights of the minority shareholders.[12] Appraisal statutes are not designed to give a target's shareholders any share of the gains from the target's acquisition; such statutes generally exclude from the required compensation any element of value arising from the accomplishment of a merger.[13] Furthermore, in assessing the target's pre-acquisition value, the appraisal process draws substantially on past earnings and stock market prices.[14]

Consequently, although appraisal rights usually ensure that minority shareholders are paid no less than the target's pre-bid price, they usually do not require a takeout consideration as high as the price of a premium takeover bid. Indeed, in recent immediate takeouts, minority shareholders often received securities with a value substantially lower than the bid price.[15] Challenges to such pricing structures have been rejected by the courts.[16]

2. Takeovers Unaccompanied by an Immediate Takeout

Many successful bidders do not effect an immediate takeout but rather maintain the target for the time being as a partly-owned subsidiary. An acquirer that does not effect an immediate takeout might still be able to take advantage of minority shareholders. First, the acquirer might operate the target's business in such a fashion as to divert to itself part of the target's profits.[17] For example, the acquirer might engage in self-dealing (transacting with the target on terms favorable to itself),[18] or it might allocate to itself business

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12. Indeed, some legislatures have even permitted the elimination of appraisal rights when there is an active market in the target's stock. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(h)(1) (1983); MODEL BUSINESS CORP. ACT § 81 (1977).

13. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(h); MODEL BUSINESS CORP. ACT § 81 (1971).

14. Courts have usually given weight to the target's stock market prices, its current and past earnings, and the sale value of its assets. *See, e.g.*, Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439 (1981). In the recent case of Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), however, the Delaware Supreme Court showed a willingness to use a more flexible approach to valuation.

15. *See, e.g.*, Radol v. Thomas, 556 F. Supp. 586 (S.D. Ohio 1983).

16. For example, in the immediate takeout that followed the takeover of Marathon Oil by U.S. Steel, minority shareholders received a per share consideration dozens of dollars below the bid price. *See* Wall St. J., Feb. 3, 1982, at 2, col. 3.

17. *See* Brudney, *Efficient Markets and Fair Shares in Parent Subsidiary Mergers*, 4 J. CORP. L. 63, 69-70 (1978).

18. *See, e.g.*, Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

opportunities belonging to the target.[19] Although such practices might be unlawful, engaging in them might be possible because it is often difficult to detect and challenge them.

The second way in which an acquirer that does not effect an immediate takeout might be able to take advantage of minority shareholders is by effecting a takeout later on. Indeed, when an acquirer decides against an immediate takeout, it presumably keeps in mind the possibility of a distant takeout. Postponing the takeout might benefit the acquirer by enabling it to influence the size of the takeout consideration to which minority shareholders are entitled. As the Delaware Supreme Court recently noted, the timing of a takeout might be controlled by the acquirer "to favor the majority only, based upon the status of the market and the elements of an appraisal."[20] For example, because earnings and market price are common elements of the appraisal formula, the acquirer might time the takeout to occur when earnings are abnormally low or when the market price is substantially below the value suggested by the acquirer's inside information. Moreover, the acquirer might also manage the target so as to further lower the elements of appraisal. For example, the acquirer might depress the target's earnings in the period prior to the takeout; or it might depress the target's market price in that period by using its control over both the target's dividend policy and its release of information.[21]

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19. *See, e.g.*, Swanson v. American Consumer Indus., 415 F.2d 1326 (7th Cir. 1969); Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427 (Del. 1968).

20. Roland Int'l Corp. v. Najjar, 407 A.2d 1032, 1037 (Del. 1979).

21. Indeed, the prospect of a takeout might by itself depress the market price of minority shares. Even supposing that the informational efficiency of capital markets is perfect, the threat of an impending takeout might lead the market to price minority shares at a considerable discount. Suppose, for example, that the per share value of the acquired target's future earnings is $100. Suppose also that investors believe that the acquirer is committed to a strategy of paying no dividend until it will be able to effect a takeout at $50 per share. In this case, the value that investors will rationally attach to minority shares is $50 per share, and this valuation will be immediately reflected in the market price. Of course, different expectations concerning the acquirer's strategy will lead to different discounts (or even to no discount at all). Finally, it is important to note that postponing a takeout might be also profitable for the acquirer because the acquirer might obtain inside information that will improve its ability to predict whether a takeout will prove profitable. If the inside information suggests that the target's prospects are good, the acquirer will effect a takeout before the information becomes reflected in the market price. If the inside information is unfavorable, the acquirer will let minority shareholders retain their shares. In this way the acquirer will expose minority shareholders to the downward side of the target's uncertain prospects, while denying them the potential benefits of the upward side.

Because of the expectations that the acquirer will divert earnings or effect a distant takeout, the post-takeover value of minority shares in takeovers unaccompanied by immediate takeouts is generally lower than the bid price. Indeed, as is indicated by the empirical evidence, the post-takeover value of minority shares in such instances is usually even lower than the consideration that would be required in an immediate takeout.[22] This is because an acquirer usually will not decide against an immediate takeout unless it expects that, by diverting earnings or by effecting a distant takeout, it will be able to leave minority shareholders with even less than it would have to pay them in an immediate takeout.

To understand the acquirer's reasoning, suppose that an immediate takeout would require the acquirer to pay $8 per share; and suppose that $X is the per share value that investors would attach to minority shares if they expected no takeout to occur for at least, say, five years following the takeover. If $X were higher than $8, then the acquirer would likely profit from an immediate takeout—even if the acquirer does not wish to remain the owner of all of the target's shares. For the acquirer could effect an immediate takeout at $8 per share and then resell the acquired minority shares to public investors, committing itself not to effect another takeout within five years. Given this commitment, the acquirer would be able to sell the shares for $X per share and would hence make a profit of $(X-8) per share (less the relatively small transaction costs involved). Thus, because an immediate takeout would likely be profitable if $X exceeded $8, it follows that the acquirer would decide against an immediate takeout only if $X were lower than the $8 per share consideration required in an immediate takeout.

In sum, the expected post-takeover value of minority shares is lower than the bid price not only when the acquirer is expected to effect an immediate takeout but also when the acquirer is not expected to do so. It follows that this will be the case as well when there is uncertainty as to which course of action the bidder will follow upon gaining control.

B. *The Acquisition Price in a Takeover*

The concept of the "acquisition price" in a takeover is important in defining the undistorted choice objective and in examining de-

22. *See* STUDY BY THE OFFICE OF THE CHIEF ECONOMIST, SEC, THE ECONOMICS OF ANY-OR-ALL, PARTIAL, AND TWO-TIER TENDER OFFERS (APR. 1985).

viations from this objective. It is therefore necessary to clarify this concept.

In a takeover, the successful bidder usually does not acquire through its bid all of the target's shares. There are two reasons for the common presence of unacquired shares. First, many bids are "partial"—that is, the bidder does not commit to purchase more than a specified fraction of the target's shares. When a partial bid is oversubscribed, the bidder may, and usually does, refuse to purchase more shares than the number sought. Second, although a successful bidder by definition attracts enough tenders to gain control, it usually does not (nor is it expected to) attract tenders from all of the target's shareholders. As the evidence indicates, there is a significant incidence of non-tendering in successful bids of all kinds—both partial bids and bids for all shares.[23]

Nonetheless, a takeover is in an important sense equivalent to purchasing the target as a whole. To understand this equivalency, consider a bidder that gains control of a 100-share target by purchasing 70 shares for a bid price of $10 a share; and suppose that the post-takeover value of the remaining 30 minority shares is $8 per share. At first blush, it might seem that this takeover does not involve the purchase of the target as a whole, but involves only the purchase of 70 shares. This view, however, ignores the consequences of acquiring a controlling interest.

Unlike the acquisition of a non-controlling block, the acquisition of a controlling block clearly changes the position of non-selling shareholders. A share in the acquired target will have a different value (whether higher or lower) than a share in the independent target. In a sense, these two shares are different assets, representing different streams of future earnings. The takeover terminates the asset known as "a share in the independent target" and replaces it with "a minority share in the acquired target."

Therefore, we should not view the takeover in our example as involving only 70 shares. Rather, we should view the bidder as having purchased all 100 shares of the independent target, with each of 70 shares purchased for the bid price of $10, and with each of 30 shares exchanged for a minority share worth $8. The bidder should thus be regarded as having acquired the target for a total acquisition price of (70 x $10) + (30 x $8) = $940, or a per share acquisition price of $9.40.

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23. *Id.*

This characterization of the takeover is definitely accurate from the perspective of the target's shareholders. As a result of the takeover, the shareholders, as a group, have lost all of their 100 shares in the independent target. Instead, they find themselves with $700 in cash and with 30 minority shares worth $240. This characterization of the takeover is also accurate from the bidder's perspective. The value of the minority shares—30 shares worth $8 each, or $240—represents the part of the target's future earnings that the minority shareholders can expect to capture. The bidder, in turn, can expect to capture all of the acquired target's future earnings less $240. Hence, from the bidder's perspective, the takeover is equivalent to a transaction in which it would purchase all of the target's shares for $940 and then sell to public investors 30 minority shares worth $240.

C. *The Distortion of Outcomes*

I now turn to explain how the outcome of bids might be distorted. For an illustrative example, let us consider a case in which a bidder is offering $10 a share and in which the expected post-takeover value of minority shares is $8 a share; and let us denote the independent target's per share value by $V.

1. The Distortion

The main reason for distorted outcomes is that shareholders' tender decisions might be distorted.[24] In analyzing these decisions, I shall assume that they are all made at the "moment of truth"—the time just prior to the bid's closing. Although shareholders often tender at earlier stages, early tenders can commonly be withdrawn

24. A second reason which is worth noting is that a bidder might gain effective control even if it does not attract tenders from a majority of the target's shareholders. In the absence of special anti-takeover charter provisions, it is often possible to gain effective control merely by purchasing a substantial plurality of the target's shares.

To see how the possibility of effective control without majority ownership might by itself lead to distorted outcomes, assume for the moment that shareholders will tender their shares if and only if they estimate $V, the independent target's per share value, to be lower than the offered per share acquisition price. Next suppose that 40% of the shareholders view the offered per share acquisition price as higher than $V, while 60% hold the contrary view. According to the undistorted choice objective, the bid should fail. But tendering by the 40% who view the offered per share acquisition price as higher than $V might be sufficient to give the bidder control over the target. *See* Bebchuk, *Undistorted Choice and Equal Treatment*, *supra* note 6, at 1718-19 (discussion of the effective control problem and how the problem might produce deviations from the undistorted choice objective).

until the moment of truth and hence become final and irrevocable only at that moment. Consequently, at the moment of truth, shareholders who made early tenders make a decision (at least implicitly) whether to withdraw their shares—a decision that is equivalent to a tender decision.[25]

In deciding whether to tender, any given shareholder will realize that his decision is unlikely to determine the bid's outcome. Therefore, the shareholder will take into account the two possible outcomes of the bid—the bidder's gaining control and the bidder's failure to do so—and he will examine for each of them whether he will be better off tendering or holding out.

Consider first the case in which the bidder succeeds in gaining control. In this case, tendering by the shareholder will lead to his having his shares (or at least some of them) acquired for $10 a share, while holding out will lead to his ending up with minority shares worth $8 a share. Therefore, supposing that the bid is going to succeed, the shareholder will prefer to tender no matter how high his estimate of $V. Thus, as long as the bid has some chance of success, the prospect of a takeover will pressure the shareholder to tender his shares. As will be later emphasized, this pressure exists in all bids (i.e., whether or not the bid is partial and whether or not the bid is a two-tier one).

Consider now the case in which the bid fails and the target remains independent. Assuming that the bidder has retained an option not to purchase shares if the bid fails, the bidder might either return tendered shares or elect to purchase them. If the bidder returns tendered shares, the shareholder's tender decision will of course make no difference. If the failing bidder elects to purchase tendered shares, however, the shareholder's decision will matter: tendering will lead to his having his shares acquired for the bid price of $10 a share, while holding out will lead to his retaining shares in the independent target. Thus, assuming that the bid is going to fail, the shareholder will prefer to tender if and only if he views $V as lower than $10. Thus, whereas the shareholder will always wish to have his shares acquired in the event of a takeover, he may or may not wish to

25. Furthermore, because shareholders can always postpone tendering until the moment of truth, a shareholder will not tender early unless he expects that at the moment of truth he will probably still prefer to tender. Therefore, for our purpose—that of understanding how a bid's outcome is determined—the critical question is what determines shareholders' explicit or implicit tender decisions at the moment of truth.

have his shares acquired in the event that the target remains independent.

What, then, will the shareholder elect to do? Consider first the case in which the shareholder considers $V to be lower than the $10 bid price. In this case, the shareholder will surely tender. Whether the bid is going to succeed or fail, the shareholder will prefer selling his shares at the bid price to retaining them.[26]

Consider now the case in which the shareholder views $V as exceeding the $10 bid price. The shareholder will wish, as always, to have his shares acquired in the event of a takeover. But he will also wish to retain his shares in the event that the target remains independent. Consequently, he might or might not tender. The greater the probability that he attributes to the bid's success, and the greater the gap between the bid price and the expected post-takeover value of minority shares ($2 in our example), then the greater the likelihood that the shareholder will tender even though he views $V as higher than $10.

It might be asked why a rational shareholder would attribute any positive probability to the possibility of a takeover when he views $V as higher than the $10 bid price. There are two reasons why a rational shareholder might do so. First, the shareholder might be uncertain as to what other shareholders' estimates of $V are and as to what other shareholders' estimates of the likelihood of a takeover are. Second, even assuming that all the shareholders view $V as higher than the $10 bid price and that they are all aware of this fact, a rational shareholder might still attach a significant likelihood to the possibility of a takeover. Because shareholders cannot coordinate their actions, they must make tender decisions without assurance as to how others will act. In such a situation, it might be perfectly rational for some, many, or indeed most shareholders to attach a significant likelihood to the possibility of a takeover. For such initial expectations might be self-fulfilling—they could lead to

26. That shareholders will tender if they view $V as lower than the $10 bid price implies by itself that their tender decisions might be distorted. According to the undistorted choice objective, shareholders should tender only if they view $V as lower than the expected per share acquisition price. As explained earlier, the expected per share acquisition price is generally significantly lower than the bid price in both partial bids and bids for all shares.

To use an example, suppose that the $10 bid is for 50% of the target's shares. In this case, $V, the expected acquisition price is $9 per share. Thus, according to the undistorted price objective, shareholders should tender only if they view $V as lower than $9. But, as the analysis has shown, the shareholders will surely tender as long as they view $V as lower than $10.

tenders of a sufficient number for the bidder to gain control; and since such initial expectations might be self-fulfilling, it might be rational to adopt them in the first place.[27]

This analysis may be summarized as follows. If the shareholders view $V as lower than the expected per share acquisition price—that is, if a takeover is desirable—then the bid will indeed succeed. If the shareholders view $V as higher than the expected per share acquisition price—that is, if a takeover is undesirable—then the target might still be acquired. If the shareholders' estimates of $V lie between the expected per share acquisition price and the bid price, the target will surely be acquired. Even if the shareholders view $V as not only higher than the expected per share acquisition price but also higher than the bid price, the target might still be acquired if enough shareholders attach a sufficiently significant likelihood to the possibility of a takeover.

To be sure, my claim is not that the described distortions are irresistible. Bids are not all bound to succeed, and bids indeed fail every now and then. A bid is likely to fail, however, only if (i) the shareholders' estimates of $V exceed not only the expected per share acquisition price but also the bid price, and (ii) there is a widespread confidence among shareholders that the bid will fail. A bidder, then, can offer a per-share acquisition price significantly below the shareholders' estimates of $V and still enjoy a high likelihood of success. Thus, the distortions are not irresistible, but they are substantial.

2. The Generality of the Distortion

It is widely believed that, to the extent that any distortions of shareholder choice exist, they result from, and hence are limited to, partial bids and two-tier bids. In particular, this view appears to be held by the SEC and the SEC Advisory Committee on Tender Offers,[28] by many commentators,[29] and by litigants and courts.[30]

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27. To be sure, it is also possible that all or most shareholders would adopt initial expectations that the bid will fail, and such initial expectations might also be self-fulfilling. Thus, shareholders' initial expectations can go either way; and because these initial expectations are likely to be self-fulfilling, the bid's outcome can also go either way.

28. In examining the possible existence of a pressure to tender, the SEC Advisory Committee and subsequently the SEC have limited their examination to partial and two-tier bids. *See* Advisory Committee Report, *supra* note 2, at 24-26; SEC Release, *supra* note 2, at 86, 914-15.

29. *See, e.g.*, Balotti & Finkelstein, *supra* note 1; Finkelstein, *supra* note 1; Greene & Junewicz, *supra* note 1.

30. *See* Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y.

That many people have come to hold such a view is quite understandable. As previously discussed, the pressure to tender results from the fact that, should a takeover occur, the value of minority shares will be lower than the bid price. Consequently, the presence of this pressure is much more apparent in two-tier bids and partial bids. In a two-tier bid, the expected low value of minority shares is very conspicuous; and in a partial bid it is clear that in the event of a takeover some shareholders must end up with minority shares. As the preceding analysis demonstrates, however, the problem of distorted choice is in no way limited to, or even especially acute in, partial bids and two-tier bids. For nothing in that analysis has depended on the bid's being a partial bid or a two-tier bid. To verify this point, consider first a bid for all shares. What is special about such a bid is that a shareholder tendering to it is assured of having all of his shares acquired in the event of a takeover. This assurance, however, in no way protects shareholders from the pressure to tender. The pressure to tender is rooted in the consequences that the shareholder might suffer if he does not tender. Clearly, the assurance that the shareholder will not end up with any minority shares if he *does* tender in no way alleviates his fear that he will end up with low-value minority shares if he *does not* tender. As long as the expected value of minority shares is lower than the bid price, this fear introduces a pressure to tender. This low expected value of minority shares, which arises from the powers that a successful bidder would have upon gaining control, does not depend on whether the successful bidder's offer was partial or for all shares.

To illustrate that the distorted choice problem is not limited to two-tier bids, consider a bid that is not expected to be followed by an immediate takeout. Again, the pressure to tender will exist, because the expected value of minority shares is lower than the bid price. To be sure, if the bid succeeds, it is expected that minority shareholders will be able to retain their shares. Yet, the value of minority shares in such a case would still be lower than the bid price, because of the possibilities of earnings diversion and distant takeout. Indeed, as explained earlier, in takeovers unaccompanied by immediate takeouts minority shares usually have a value even lower than the consideration which the acquirer would have to pay in an immediate takeout.

1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

In sum, the problem of distorted choice exists in bids of all kinds—that is, whether the bid is partial or for all shares, and whether or not the bid is expected to be followed by an immediate takeout. The problem, then, is more general than is commonly believed.

3. Market Trading and the Distortion of Outcomes

It might be argued that the analysis thus far is flawed because no attention has been paid to the existence of an active market trading throughout the period in which the bid is open. The market price of the target's shares, so the argument goes, will reflect shareholders' estimates of $V, the independent target's per share value. If most shareholders consider $V to be higher than the per share value that tendering shareholders can expect to receive in a takeover, then the market price of the target's shares will also exceed this per share value. Consequently, it is argued, no shareholder will tender, since tendering will clearly be inferior to selling into the market.

This market trading objection, however, is invalid. The paper's analysis has focused on the time just prior to the bid's expiration—the "moment of truth." No matter how many times the target's shares have changed hands since the bid's announcement, at the moment of truth they are all necessarily owned by someone. At this point in time, the shares' ultimate owners face only two alternatives—tendering their shares or maintaining them beyond the bid's expiration. Thus, the preceding analysis of shareholder choice is perfectly applicable to the decisions that the shares' ultimate owners must make at the moment of truth: they might tender even if they view $V as higher than the per share value they expect to receive in a takeover.

Because a bid's outcome is determined by the shareholders' decisions at the moment of truth, showing that these decisions are distorted is sufficient to refute the market trading objection. Still, it is worth pointing out that, in contrast to what this objection mistakenly assumes, the market price of the target's shares during the bid period might not fully reflect investors' estimates of $V.

During the bid period, the market price might be affected by the anticipated distortions of shareholders' decisions at the moment of truth. Investors who buy the target's shares during this period are aware that they (or, if they resell the shares, those who will buy the shares from them) will be ultimately subject to the pressure to tender. The price that they will be willing to pay will inevitably reflect this awareness. Indeed, in calculating the price that they are

willing to pay, investors usually assume that the bid will likely succeed unless it is superseded by a higher bid or impeded by obstructive defensive tactics. Thus, once a bid is made, the target's market price might fail to fully reflect subsequent revisions in investors' estimates of $V. In particular, the market price might be capped by the bid price even if investors' most recent estimates of $V exceed the bid price.

D. *The Practical Significance of the Problem*

Thus far the analysis has shown that a bid might succeed even if the target's shareholders view rejection of the bid as their value-maximizing course of action. It might be argued, however, that this problem is a purely hypothetical one because shareholders never hold such a view. Acquisition offers usually include a premium over the pre-bid market price of the target's shares. This pre-bid price presumably reflects investors' pre-bid estimates of the independent target's value. Therefore, so the argument goes, shareholders can never rationally view the rejection of a premium bid as value-maximizing.

This argument, however, ignores the ever-changing nature of investors' estimates and the fact that shareholders' tender decisions are usually made several weeks after their company became a takeover target. Investors' estimates of a given company's value usually vary from month to month. Estimates are continuously revised as new information about the company and the overall economic picture is revealed. In the case of takeover targets, the flow of new information and the resulting revision of estimates are likely to be especially substantial.

A target's shareholders are likely to receive a great deal of new information between the last pre-bid trading time and the time of their tender decisions. For example, investors might well draw inferences concerning the target's value from the very making of the bid and from the bid's terms. Investors might also revise their estimates, especially in a hostile bid, in reaction to disclosures by the target's management concerning future plans, proposed structural changes, and previously undisclosed facts. Finally, a bid attracts the investment community's attention, and intensified investigations by market participants are likely to reveal a wealth of new information concerning the target.

Because most of this new information is likely to be "good news," investors are likely to hold at the time of their tender decisions

an estimate of the independent target's value that exceeds the pre-bid market price. Consequently, they might judge the independent target's value to be higher than the acquisition price offered by a premium bid. It should be emphasized that, in such a case, investors' estimates at the time of their tender decisions are likely to be superior to the estimate implicit in the target's pre-bid market price. While some shareholders' information might be limited, all shareholders are presumably aware of the pre-bid price. Assuming minimal rationality on their part, they will adopt a revised estimate only if, on the basis of new developments and new information, they have a good reason to do so. Therefore, although shareholders' decisions to revise their pre-bid estimates might sometimes prove mistaken, such decisions would presumably be more often right than wrong.

That rejection of a premium bid might sometimes be value-maximizing is also indicated by the empirical evidence. A study by Professors Bradley, Desai, and Kim identified several dozen instances in which shareholders rejected a premium bid.[31] In these instances, rejecting the bid indeed proved to be value-maximizing: once the bid was rejected, the market price of the target's stock was significantly higher than the offered per share acquisition price.[32]

Among the various reasons that might lead shareholders to rationally view rejecting a premium bid as value-maximizing, several are likely to be important and deserve specific mention. First, the target's shareholders might expect that another bidder, who can put the target's assets to a more valuable use than can the present bidder, will come forward later with a higher offer. Indeed, in the cases of bid rejection studied by Bradley, Desai, and Kim, many of the targets that remained independent were later acquired through a higher bid.[33] The Williams Act provides a delay period that often enables competing bidders to come forward before shareholders have to make irrevocable decisions concerning the initial bid.[34] But the prescribed delay might in many instances fall short of the time necessary for a competing bid to materialize.[35]

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31. *See* Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183, 188 (1983).

32. *Id.* at 204-05.

33. *Id.* at 194.

34. *See* 15 U.S.C. § 78n(d)(5) (1982).

35. Of course, the prescribed delay period could be extended. But, since the resolution of bids should not be delayed unnecessarily, adopting a long mandatory delay period would be undesirable. Ensuring undistorted choice would provide target

Second, the shareholders might expect that rejection of the present bid would lead the present bidder to make a higher offer. Indeed, at present a bidder might offer less than the competitive price—that is, the price that other potential buyers would be willing to pay. The threat of competing bids might be insufficient to secure a competitive price because the competition in the market for corporate acquisitions is far from perfect. In particular, if other potential buyers view the present bidder as the one that places the highest value on the target, they will not enter a costly bidding contest—one which they are bound to lose—even if the present bid is below the competitive price.[36]

Third, the shareholders might believe that the bidder's motive for making the bid was the possession of private information that the target's shares were undervalued by the market; and the shareholders might conclude that the target's accurate value exceeds the offered acquisition price. While undervaluation might not be the dominant motive for takeovers, it might well be motive in a nontrivial number of cases. The recent wave of takeovers of oil companies, for example, was widely regarded as motivated by the undervaluation of these companies' stock.[37]

Finally, the shareholders might raise their estimates of the independent target's value above the offered acquisition price as a result of plans and proposals that the incumbent management puts forward subsequent to the bid. Management, for example, might put forward a plan for a financial or economic restructuring of the target.[38] Such a plan might lead investors to raise significantly their estimates of the independent target's value.

How often are targets acquired even though the target's shareholders view remaining independent as value-maximizing? Although one cannot be certain, there are grounds to believe that there is a substantial number of such instances. Because of the described distortions, a target is likely to remain independent only if the independent target's per share value exceeds the offered per share acquisition price by a considerable margin; the instances of bid

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shareholders with the necessary flexibility: the mandatory delay period would remain quite limited; but when further delay would seem beneficial, the shareholders would be able to choose freely to remain independent for the time being.

36. *See* Bebchuk, *Competing Bids*, *supra* note 1, at 1036 n.45.

37. *See* Lowenstein, *supra* note 1, at 277.

38. *See, e.g.*, Hicks, *Zellerbach Rejects Goldsmith's Offer*, N.Y. Times, Apr. 12, 1985, at D5 (Zellerbach's management proposed major restructuring of the company in response to a tender offer by Sir James Goldsmith).

rejection identified by Bradley, Desai, and Kim probably belong to that category. Because bidders wish to pay as little as possible, they presumably attempt to set the acquisition price at or just above the minimal level that, given the existing distortions, would be sufficient for the bid's success. The current instances of bid rejection are thus those in which the bidder undershoots even that minimal level. Thus, there are likely to be many takeovers in which the bidder offers less than the independent target's per share value—but not by a sufficiently large margin for shareholders to overcome the existing distortions and reject the bid.

IV. A PROPOSED REMEDY

This Section puts forward an arrangement (indeed, two versions of it) that would effectively ensure undistorted outcomes. The main idea behind the proposed arrangement is to enable shareholders to express their preferences concerning the bid's success separately from their desire to have their shares acquired in the event of a takeover. As will be explained below, the arrangement could in principle be adopted either through appropriate legal rules or through appropriate charter provisions; the latter route, however, will be seen to face some difficulties.

The arrangement should apply to all bids aimed at purchasing a controlling interest. It would thus have to include a specification of the level of ownership that would be assumed to provide a buyer with a "controlling interest." This crucial threshold level should be determined so as to ensure that shareholders holding less than the threshold block would be generally unable to exercise any substantial measure of control. For the sake of consistency, the following discussion assumes that this threshold level would be specified at 20% ownership.

A. *The Proposed Arrangement*

1. The Scheme of Approving and Disapproving Tenders

One version of the proposed arrangement would enable tendering shareholders to tender either "approvingly" or "disapprovingly"—that is, to indicate whether or not they "approve" a takeover. Specifically, tendering shareholders would be able to indicate their approval or disapproval by marking an appropriate box on the tender offer form which accompanies all tendered shares.

As will be explained below, under the proposed scheme shareholders would by and large tender their shares, either approvingly or disapprovingly. The bid's success would be determined, however, not by the number of tendered shares, but rather by whether or not the bid attracts the required number of approving tenders. Specifically, the bid's success would depend on whether the bidder attracts approving tenders from a majority of the target's shareholders.

If the bidder succeeds in attracting the required majority of approving tenders, then the bidder would be allowed to purchase as many shares as it wishes, and a takeover would take place. To ensure that shareholders' choices between tendering approvingly and disapprovingly would indeed reflect their preferences concerning the bid's success, a successful bidder would be prohibited from penalizing disapproving tenders. That is, in purchasing shares, the successful bidder would have to treat equally all tendering shareholders, whether they tendered approvingly or disapprovingly. In a bid for all shares, the bidder would have to purchase all tendered shares. In a partial bid, the bidder would have to use the same proration ratio for all tendering shareholders.

If the bidder fails to attract the required majority of approving tenders, then the bidder would be prohibited from acquiring a controlling interest, and the target would remain independent. The failing bidder, however, might still be able to use its bid to purchase a non-controlling block. A bidder that wants the option of purchasing a non-controlling block if its bid fails would have to include in its tender offer form a second question (in addition to the question whether the tenderer approves a takeover). Tendering shareholders would be asked to indicate, by marking an appropriate box, whether or not they permit the bidder to purchase their shares in the event that the bid fails. Subsequently, if the bid indeed fails, the bidder would be allowed to purchase shares of those tendering shareholders who granted it permission to purchase their shares in such a case.[39]

39. The proposed arrangement for determining a bid's fate is similar to one that the British City Code applies to partial bids. *See* City Code on Takeovers and Mergers, Rule 27 (City Working Party 1976). The Code prohibits the purchase of any shares through a partial bid unless the bid has been approved by the target's shareholders. Approval is signified by an entry in a separate box on the tender form, where a tendering shareholder can indicate whether or not he approves the partial bid. The limitation of the approval requirement to partial bids is apparently a result of the drafters' belief that partial bids pose different and more serious problems than do bids for all shares (a belief which is, as we have seen, mistaken).

2. Effectiveness in Attaining Undistorted Choice

Under the proposed scheme of approving and disapproving tenders, the vast majority of a target's shareholders would tender their shares, either approvingly or disapprovingly. Any particular shareholder who has an opportunity to tender (and has no compelling tax reasons for avoiding a sale of his shares) could only profit by tendering. No matter how high the shareholder's estimate of the independent target's value, holding out would be definitely inferior to tendering disapprovingly (with an indication of unwillingness to sell shares in the event that the bid fails). These two courses of action would produce different results for the shareholder only if a takeover occurs, and in that case holding out will bring clearly inferior results.

Given that shareholders would by and large tender, the important issue becomes how a tendering shareholder would decide between tendering approvingly and disapprovingly. Under the proposed scheme, the shareholder's decision will affect his position only if his decision proves pivotal and determines the bid's outcome. Therefore, the shareholder's decision will be determined by his judgment of whether, assuming his decision is going to be pivotal, he would prefer the bid to succeed or to fail.

If the shareholder's decision is going to be pivotal and he makes an approving tender, then a takeover will occur; and because the vast majority of shareholders are expected to tender, the shareholder will expect that the resulting takeover will leave him with roughly his *pro rata* share of the acquisition price. On the other hand, if the shareholder's decision is going to be pivotal and he makes a disapproving tender, then he will end up with shares in the independent target.

Thus, assuming that the shareholder's choice is going to be pivotal, he would prefer the bid to succeed—and would hence tender approvingly—if and only if he views the expected acquisition price as higher than the independent target's value. It follows that the proposed scheme would bring us fairly close to ensuring undistorted outcomes.[40]

In bids for all shares, the Code established a different arrangement, which distorts outcomes against bidders. For a detailed discussion of the British arrangements and a comparison of these arrangements with the arrangement proposed in this paper, see Bebchuk, *Undistorted Choice and Equal Treatment*, *supra* note 6, at 1795-801.

40. Although the proposed arrangement, as thus far outlined, would bring us close to attaining undistorted choice, it might not do a "perfect" job. As explained

3. The Separate Vote Version

Under the proposed scheme of approving and disapproving tenders, shareholders would be able to express their preferences concerning the bid's success in conjunction with the tendering of shares. An alternative version of the proposed arrangement would enable shareholders to express these preferences in a separate vote. Under this alternative version, a vote would be conducted among the target's shareholders (and the vote's outcome would become known) prior to the bid's closing. The bidder would be allowed to purchase a controlling interest only if its bid obtains a prior majority

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below, the two main reasons for this possible imperfection are the possible presence of non-tendering shareholders and of shares held by the bidder. These two problems could be largely addressed by two refinements of the required number of approving tenders. Therefore, although the precise specification of the required number of approving tenders is not central to my thesis, these two refinements are worth describing.

[i] *Non-tendering Shareholders.* Although under the arrangement most shareholders would tender their shares (either approvingly or disapprovingly), some shareholders would still hold out either because of lack of an opportunity to tender or because of some special tax circumstances. Note that these non-tendering shareholders would not be characterized by especially high estimates of the independent target's value: under the arrangement, a high estimate of the independent target's value would by itself lead not to holding out but rather to making a disapproving tender. Thus, there is no reason to assume that the distribution of estimates among the non-tendering shareholders would be significantly different from the distribution of estimates among the tendering shareholders. It follows that requiring bidders to attract approving tenders from a majority of the target's shareholders (i.e., from more than a majority of the tendering shareholders) would be likely to introduce a slight bias against the bidder (vis-a-vis the benchmark established by the undistorted choice objective). Instead, we should require the bidder to attract approving tenders only from a majority of the tendering shareholders.

[ii] *Shares Controlled by the Bidder.* In the preceding analysis of shareholder choice, I have assumed that every shareholder is "disinterested"—in the sense that his preference concerning the bid's success is determined by the effect that a takeover would have on the value of his shareholdings (and thus by his judgment of how the expected acquisition price compares with the independent target's value). In fact, however, some shareholders' preferences concerning a takeover might be shaped by considerations other than the takeover's expected effect on the value of their shareholdings.

In particular, the bidder might own, directly or through subsidiaries, some initial stake in the target. The bidder would presumably prefer the bid to succeed whether or not it views acceptance of the bid as the shareholders' value-maximizing course of action. Counting the approving tenders made by the bidder and its affiliates would clearly distort the outcome, because they would make such approving tenders regardless of whether they view the offered acquisition price as higher than the independent target's value. Therefore, the bidder should be required to attract approving tenders not from a majority of the tendering shareholders, but rather from a majority of the disinterested tendering shareholders.

approval in this vote. This separate-vote scheme is similar to the arrangement contained in the "control share acquisition" statutes that were recently adopted by some states and upheld by the Supreme Court in *CTS Corp. v. Dynamics Corp. of America*.[41]

The similarity in operation between the two versions of the proposed arrangement should be clear. A voting shareholder's choice between voting in favor of or against a takeover would be determined in a similar way to a tendering shareholder's choice between tendering approvingly and disapprovingly. The voting shareholder's choice will affect his financial position only in the event that his choice will determine the bid's fate. If the shareholder's vote is going to be pivotal, then his voting in favor of a takeover would lead to a takeover and to his ending up with his *pro rata* share of the acquisition price; his voting against a takeover, on the other hand, would lead to the bid's failure and to his retaining his shares in the independent target. Consequently, assuming that the shareholder's vote is going to be pivotal, he will prefer a takeover—and hence will vote in favor of it—if and only if he views the offered acquisition price as higher than the independent target's value.

The scheme of approving and disapproving tenders, however, is in my view somewhat preferable to the separate vote scheme. Under the former scheme, expressing approval or disapproval of a takeover would be done in conjunction with the tendering of shares, and shareholders would thus have to act only once. In contrast, the separate vote scheme might require shareholders to act twice—once to cast a vote, and possibly again to tender their shares. This two-stage process would involve higher transaction costs as well as unnecessary delays in consummating acquisitions.

4. Adoption of the Arrangement

a. *Adoption Through Charter Provisions*

In principle, companies could adopt the proposed arrangement through appropriate charter provisions. The policies of the stock

41. 107 S. Ct. 1637 (1987). Control share acquisition statutes typically require acquirers to obtain a vote of approval from the target's shareholders prior to making a "control share acquisition" (usually defined as any acquisition of at least 20% of the target's stock). *See, e.g.*, OHIO REV. CODE ANN. § 1701.831 (Baldwin 1985). It is important to emphasize that not all the elements commonly found in such statutes are desirable according to the undistorted choice objective. While having

exchanges and elements of state corporate law, however, make it difficult for most companies to do so.

The proposed arrangement would restrict the transferability of shares in that it would prohibit bidders from purchasing a controlling interest if they fail to attract the required number of approving tenders. The New York Stock Exchange and the American Stock Exchange, however, generally prohibit listed companies from including in their charters restrictions on share transfer (unless the restrictions are required by some external regulatory body).[42] This policy of course makes it difficult for all companies listed on these two exchanges to adopt the proposed arrangement.

Additionally, a company's adoption of the proposed arrangement might be impeded by state law constraints.[43] In particular, significant difficulties might arise from the constraint that state law commonly imposes on the retroactivity of limitations on transfer. Under many state corporation statutes, a charter amendment limiting the transfer of shares is effective only with respect to shares whose holders voted in favor of the amendment.[44] As explained below, this rule makes it difficult for existing companies to adopt a charter amendment imposing the proposed arrangement.

Because of this rule, some shareholders would vote against a charter amendment adopting the proposed arrangement even if they wish that the amendment be approved. Since a shareholder will realize that his vote is unlikely to determine whether or not the

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a vote that would express shareholders' preferences concerning a takeover is in principle desirable, the statutes often impose substantial delays and procedural obstacles in bidders' way to such a vote. These impediments are not required by (and indeed are inconsistent with) the goal of ensuring undistorted shareholder choice—and they appear to be designed primarily to protect incumbents from hostile tender offers.

42. As confirmed in telephone conversations between the author and officials of the two exchanges, this prohibition has been the general and consistent policy of the exchanges. The exchanges have made exceptions—for example, in the case of some savings and loan associations—only when the restrictions on transfer were required by some external regulatory body because of the particular nature of the company's business.

43. The ability of companies to adopt the proposed arrangement under existing state corporate law was the subject on which Marshall Small focused in his comments on this paper at the Columbia conference on takeovers and contests for corporate control. His comments are scheduled to appear as Chapter 29 of the forthcoming conference volume, *Knights, Raiders, and Targets: The Impact of the Hostile Takeover* (J. Coffee, L. Lowenstein, & S. Rose-Ackerman eds., Oxford University Press).

44. *See, e.g.*, DEL. CODE ANN. tit. 8, § 202(b) (1983); CAL. CORP. CODE § 204(b) (West Supp. 1987); REVISED MODEL BUS. CORP. ACT § 6.27 (1984).

amendment will be approved, he will consider the possibility that the amendment is going to be approved regardless of how he votes. In such a case, the shareholder will be able to enjoy the amendment's benefits (e.g., higher potential acquisition prices offered) even if he votes against the amendment. In the event that the amendment passes, voting against it would make the shareholder's own shares exempt from the amendment's reach, which would make these shares more valuable. Thus, because shareholders' votes might be distorted in this way, the provision might fail to pass even if most shareholders would like it to be adopted.

Because the exchanges' policies and the state law doctrines are directed against limitations on share transfer, companies wishing to adopt the proposed arrangement could try to escape the reach of these policies and doctrines by cleverly formulating the arrangement to hide the limitation on transfer that it involves. In particular, a company might adopt a provision which imposes substantial obligations (say, in favor of minority shareholders) on any bidder that gains control without attracting a majority of approving tenders. Obviously, if the obligations imposed are substantial enough, the provision would be practically equivalent to one that prohibits a bidder from gaining control without attracting a majority of approving tenders.

b. *Adoption Through Legal Rules*

Of course, the proposed arrangement could also be adopted by law. Indeed, due to the difficulties involved in adoption through charter provisions, provision by law might be the only way to enable many companies to benefit from the arrangement. To be sure, provision by law does not imply that the arrangement will be mandatory. Companies might be allowed to opt out of it—that is, to adopt charter provisions exempting bids for their shares from the prescribed arrangement.

It is worth noting that, even if there were no impediments whatsoever to charter adoption, there would still be some advantages to providing the proposed arrangement by law. Provision by law (while allowing companies to opt out) has several advantages over adoption through numerous private initiatives: it would enable the design of a uniform, efficient mechanism for ensuring compliance by bidders with the arrangement's requirements; it would save transaction and information costs; and it would reduce uncertainty (thus facilitating business planning).

B. *Would the Proposed Arrangement Involve Any Significant Costs?*

I now wish to point out that ensuring undistorted choice through the proposed arrangement would be unlikely to involve any significant "costs"—from the perspective of either efficiency or target shareholders. Below I therefore consider the three main ways in which ensuring undistorted choice might be initially thought to harm the interests of efficiency and/or target shareholders.

1. The Search for Potential Targets

Professors Easterbrook and Fischel have emphasized that for the corporate acquisition market to operate efficiently, it is necessary to provide prospective buyers with an incentive to search for potential targets.[45] They argued that the need to encourage such search makes it desirable to maximize searchers' returns and hence to minimize the premium that is necessary to acquire a discovered target.[46] On this view, ensuring undistorted choice through the proposed arrangement would be undesirable because it would increase takeover premiums.

The need to encourage search, however, does not warrant opposing the proposed arrangement. As I explained in previous work, curtailing takeover premiums is not at all necessary to induce an adequate level of search: competitive acquisition prices are consistent with providing searchers with rewards that are substantial relative to search costs.[47] For example, prior to making a bid for an identified target, a searcher can and often does make secret purchases of the target's stock.[48] Whether or not the searcher ultimately acquires the target, the searcher will usually make a substantial profit on its secret pre-bid purchases.[49]

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45. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1199-201 (1981); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982).

46. *See id.*

47. *See* Bebchuk, *Competing Bids*, *supra* note 1, at 1035; Bebchuk, *Reply and Extension*, *supra* note 1, at 30-39.

48. The searcher may purchase 5% of the target's stock without being required by the Williams Act to disclose the purchases. 15 U.S.C. § 78n(d)(1) (1982).

49. If the searcher acquires the target, then its pre-bid purchases will enable it to save the bid premium on the stock it already owns. If another buyer acquires the target, the searcher will earn on its stock the acquisition premium paid by that buyer. Finally, if the target's shareholders reject all available bids, then the searcher will still make a substantial gain, because in such a case the market price of the

Moreover, even assuming that an increase in the rewards for search is desirable, such an increase could be accomplished by raising the statutory limit on the amount of the target's shares that a searcher can secretly purchase without being required to disclose its purchases.[50] As long as the searcher is required to stay below the effective control threshold, an increase in the disclosure threshold would be consistent with ensuring undistorted choice through the proposed arrangement. Thus, since the existing disclosure threshold of five percent[51] is far below any reasonable specification of the effective control threshold, the existing substantial rewards for search could be greatly enhanced without sacrificing undistorted choice.

Finally, sacrificing undistorted choice to magnify further searchers' rewards might lead to a socially excessive level of search. Search is beneficial to society only to the extent that searchers look for targets whose acquisition would produce efficiency gains. When shareholder choice is distorted and targets might consequently be acquired for less than the independent target's value, bidders would often go after targets whose acquisition would profit the bidder but would not produce efficiency gains (and perhaps even produce efficiency

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independent target's shares will probably be substantially higher than the pre-bid price for which the searcher bought its shares. The gain that a searcher can make on its pre-bid purchases often approaches two to three percent of the target's value. *See* Bebchuk, *Competing Bids, supra* note 1, at 1035-36.

In addition to making a profit on pre-bid purchases, searchers can also gain in other ways. In particular, even in a regime of undistorted choice, a searcher that acquires an identified target would often not have to pay as much as its valuation of the target. Of course, the searcher would have to pay at least the competitive price—that is, the price that other potential buyers would be willing to pay. The searcher, however, might place a higher value on the target's assets than do other potential buyers: buyers often vary substantially in the amount of efficiency gains that they can produce by acquiring the target. In such a case, the searcher would usually capture a substantial fraction of those gains from the acquisition that other buyers would be unable to produce. Indeed, the searcher would likely capture the lion's share of these gains: the searcher would have a substantial advantage in the "bargaining" over the division of these gains between itself and the target's shareholders—because in the takeover context, unlike a standard buyer-seller situation, only the bidder can make offers.

Finally, it is worth noting that search costs do not appear to be all that large. Because prospective buyers often lack appropriate in-house resources, the search is frequently done by investment bankers. In such cases, the search costs are a fraction of the investment bankers' total fees. These total fees, in turn, are often less than one percent of the target's value. *See id.* at 1036-37.

50. *See* 15 U.S.C. § 78n(d)(1).

51. *Id.*

losses). Therefore, since searchers would not limit themselves to looking for potential efficiency gains, they would make socially excessive investments in search.

In sum, the need to reward search does not justify foregoing the substantial benefits that ensuring undistorted choice would produce. Even assuming that existing incentives are inadequate, which is by no means clear, the remedy that should be advocated is that of raising the ceiling on secret pre-bid purchases. Indeed, sacrificing undistorted choice to increase search further would not only forego the substantial benefits that undistorted choice would produce, but might also have an undesirable effect on the search activity itself.

2. Beneficial Acquisitions of Discovered Targets

Having considered the effect of the proposed arrangement on the search for targets, let us now examine whether the arrangement might prevent some desirable acquisitions of identified targets. Professors Easterbrook and Fischel have suggested that the existing pressure to tender might be necessary for bids to succeed.[52] If such pressure did not exist, they warned, shareholders would have a strong incentive not to tender even if they prefer that the bid succeed.[53] Thus, Easterbrook and Fischel argued, the existence of a pressure to tender is in the interest of both society and target shareholders.[54]

The analysis of this paper, however, indicates that the above concern is unwarranted. As we have seen, it is quite possible to eliminate the pressure to tender without creating any undue incentive to hold out. Under the proposed arrangement, the only acquisition attempts that would be prevented from succeeding are those that indeed should fail—those in which a majority of the target's shareholders view the independent target's value as higher than the offered acquisition price.

3. Partial Acquisitions

Since many believe that partial acquisitions serve valuable economic functions,[55] it is important to point out that the proposed arrangement would in no way either penalize or discourage such

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52. *See* Easterbrook & Fischel, *supra* note 1, at 705, 710-11. *See also* Grossman & Hart, *supra* note 1, at 44-45 (discussing the extent to which the value of minority shares must be "diluted" for takeovers to be possible).

53. *See* Easterbrook & Fischel, *supra* note 1, at 710-11.

54. *Id.*

55. *See, e.g.*, Advisory Committee Report, *supra* note 2, at 24-25.

acquisitions. Under the proposed arrangement, a bidder would be free to set any limit it wishes on the number of shares that it would acquire. The bidder would be only required to attract the specified number of approving tenders (or approving votes), and to enable all the tendering shareholders to have the same fraction of their shares acquired for the bid price. Consequently, the arrangement would not prevent any beneficial partial acquisition. A bidder's attempt to purchase a partial interest would fail only if a majority of the target's shareholders view the bidder's purchase of such a block as value-decreasing. In such a case the bid's failure would indeed be desirable.

Conversely, under the proposed arrangement, bidders would make partial bids whenever a partial acquisition is more efficient than a complete acquisition. When a partial acquisition would be more efficient, the bidder would be able to offer a higher per share acquisition price in a partial bid than it would be able to offer in a bid for all shares. Therefore, since under the proposed arrangement the bidder's chances of success would be enhanced by an increase in the offered acquisition price, the bidder would elect to make a partial bid.

V. ALTERNATIVE REMEDIES

Having put forward a remedy to the distorted choice problem, I now wish to examine alternative remedies. Again, these remedies might be adopted (at least in principle) either through appropriate charter provisions or through appropriate legal rules. For each of the alternative remedies to be considered, I shall examine both its effectiveness in attaining undistorted choice and its costs. As the analysis will show, these remedies vary greatly in their effectiveness and costs: some of them are much better than others. None of these remedies, however, can perform as well as the arrangement proposed in the preceding section.

A. *Prohibiting Partial Bids*

As already noted, many hold the view that any existing distortions of shareholder choice must be rooted in the use of partial bids.[56] This view has naturally led to proposals that such bids be prohibited or at least discouraged.[57]

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56. *See, e.g.*, *supra* notes 28-30 and accompanying text.

57. The SEC Advisory Committee considered a ban on partial bids, but decided against recommending such a ban because it believed that partial bids serve

As the analysis of this paper has shown, however, the distorted choice problem is not limited to—nor even especially acute in—partial bids; the popular view to that effect rests on a misconception of the problem. The problem of distorted choice is largely rooted in the presence of a gap between the bid price and the expected post-takeover value of minority shares, a gap that is generally present in bids of all kinds. Consequently, the problem is substantially present not only in partial bids but also in bids for all shares. It follows that prohibiting or discouraging partial bids would do very little to ensure undistorted choice.

B. *Requiring that the Consideration in Immediate Takeouts be Equal to the Bid Price*

As previously noted, the gap between the bid price and the expected post-takeover value of minority shares is most conspicuous in two-tier bids, and such bids have therefore attracted considerable attention. Professors Brudney and Chirelstein have made a well-known proposal that courts require the consideration in an immediate takeout to equal the bid price.[58] In recent years, many companies have adopted a similar requirement by incorporating "fair price" provisions in their charters,[59] and a significant number of states have added such a requirement to their state corporation statutes.[60]

The SEC's Advisory Committee and the SEC's Chief Economist have recently suggested, however, that prohibiting immediate takeouts below the bid price would be counter-productive. They observed that the post-takeover value of minority shares is lower in takeovers not accompanied by an immediate takeout than in takeovers followed by an immediate takeout below the bid price. Hence, they reasoned,

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valuable economic functions. Instead, the Committee recommended discouraging such bids by requiring that they remain open longer than bids for all shares. *See* Advisory Committee Report, *supra* note 2, at 24-26. One member of the Committee, however, expressed disappointment that the Committee did not recommend "anything meaningful" to regulate partial bids. *See id.* at 144-45 (statement of Jeffrey Bartell). Similarly, Greene & Junewicz, *supra* note 1, at 691-93, criticized the regulatory disincentive proposed by the Committee as too weak.

58. *See* Brudney & Chirelstein, *supra* note 1, at 336-40; Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1361-65 (1978).

59. *See* Carney, *supra* note 1, at 341.

60. *See, e.g.*, CONN. GEN. STAT. § 33-366 (1984); MD. CORPS. & ASS'NS CODE ANN. § 3-602 (1982). For a discussion of these state law provisions, see Block, Barton & Roth, *supra* note 5, at 332.

allowing such takeouts benefits minority shareholders and reduces the gap between the value of their shares and the bid price.[61]

Below I explain that contrary to the views of the Advisory Committee and the Chief Economist, requiring the consideration in immediate takeouts to equal the bid price would narrow the gap between the post-takeover value of minority shares and the bid price. I shall then go on to show, however, that such a requirement would not generally eliminate this gap (a showing which by itself indicates that the requirement would not ensure undistorted choice).

1. The Requirement Would Narrow the Gap

The problem with the analysis of the Advisory Committee and the SEC Chief Economist is that they drew an incorrect inference from a valid empirical observation. To see the flaw in their analysis, consider the choice that a successful bidder faces. The bidder can take advantage of minority shareholders by effecting an immediate takeout below the bid price. Refraining from effecting such an immediate takeout, however, might enable the bidder to take advantage of minority shareholders by diverting earnings or effecting a distant takeout. The bidder will presumably follow the strategy that will enable it to take maximum advantage of minority shareholders.

Thus, those instances in which the acquirer decides against an immediate takeout are exactly the instances in which the acquirer expects that, by diverting earnings or effecting a distant takeout, it will be able to leave minority shareholders with even less than it would have to pay them in an immediate takeout. This explains the empirical evidence on which the Advisory Committee and the Chief Economist relied, i.e., the evidence that minority shareholders fare worse in takeovers unaccompanied by an immediate takeout than in takeovers accompanied by an immediate takeout below the bid price. By the same logic, however, those instances in which the acquirer effects an immediate takeout below the bid price are exactly the instances in which the acquirer views such a takeout as the best means of taking advantage of minority shareholders.

It follows that, in instances where immediate takeouts currently occur, requiring that the consideration in such takeouts be equal to the bid price would enhance the post-takeover value of minority

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61. *See* Advisory Committee Report, *supra* note 2, at 24-25; SEC Release, *supra* note 2, at 86,679.

shares. This requirement would have no effect on the post-takeover value of minority shares in those instances where the acquirer currently does not effect an immediate takeout. Hence, the requirement would operate to narrow the average gap between the bid price and the post-takeover value of minority shares.

2. The Requirement Would Not Eliminate the Gap

Although the requirement would often narrow the gap between the bid price and the post-takeover value of minority shares, it would fall short of eliminating it, because acquirers would still be able to take advantage of minority shareholders in other ways than effecting an immediate takeout. Even at present, when acquirers can effect an immediate takeout below the bid price, there are many instances where they elect not to effect an immediate takeout. As previously explained, the post-takeover value of minority shares in these instances is generally lower than the bid price because of the possibility that the acquirer will divert earnings or effect a distant takeout.[62] In all these instances, the requirement would of course leave intact the existing substantial gap between the bid price and the post-takeover value of minority shares.

Moreover, the requirement would greatly increase the proportion of instances in which an immediate takeout does not occur. Instead of effecting an immediate takeout and paying a consideration equal to the bid price, most bidders would presumably refrain from effecting an immediate takeout and rely instead on the possibilities of diverting earnings and effecting a distant takeout. Thus, the instances in which an immediate takeout does not occur would be likely to constitute the great majority of cases, and the effect of the requirement would thus be much more limited than might be initially thought.

In sum, the requirement would not generally eliminate the gap between the bid price and the post-takeover value of minority shares. It follows that the requirement would not ensure undistorted choice.

C. *Ensuring that Minority Shares Have Value Equal to the Bid Price*

While prohibiting immediate takeouts below the bid price would not ensure equality between the bid price and the post-takeover value of minority shares, such equality could be secured by adopting some supplemental or alternative measures. Such an equality could be

62. *See supra* note 22 and accompanying text.

ensured, for example, by requiring a successful bidder to provide minority shareholders in the aftermath of a takeover with the option of redeeming their shares at the bid price.[63]

Among the five alternative remedies examined in this section, it appears that the approach under consideration would do the best job. As explained below, however, this approach would still perform imperfectly and, in particular, would not perform as well as the arrangement proposed in Section IV. It should be first noted that ensuring the sought equality would all but preclude partial acquisitions. Providing an option to redeem minority shares at the bid price would have such an effect since most minority shareholders would be likely to use their redemption rights. Similarly, it appears that any alternative measure that would secure equality between the post-takeover value of minority shares and the bid price would also practically preclude partial acquisitions.[64] This prevention of partial acquisitions would be undesirable, because a partial acquisition might sometimes be the most efficient form of a given transaction.

The main problem with the approach under consideration, however, is not that it would preclude partial acquisitions, but that it would not ensure undistorted outcomes. Under an arrangement ensuring equality between the value of minority shares and the bid price, the outcome of bids would be systematically distorted against bidders, i.e., in a direction opposite to the existing distortions.

Consider the tender decision of a shareholder whose estimate

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63. Recently, several states adopted a statute requiring successful bidders to give minority shareholders a redemption option. *See, e.g.*, 15 PA. CONS. STAT. §§ 1408, 1409.1, 1910 (Supp. 1986). For a discussion of these statutes, see Block, Barton & Roth, *supra* note 5. Under these statutes, however, minority shareholders who redeem their shares are entitled not to the bid price but rather to the "fair value" of their holdings as of the date prior to the takeover.

64. Consider, for example, measures aimed at limiting the extent to which an acquirer that does not effect an immediate takeout can, by diverting earnings or by effecting a distant takeout, take advantage of minority shareholders. Because of the nature of the activities regulated, such measures cannot ensure that, whenever an immediate takeout does not occur, the value of minority shares will be exactly equal to the bid price. Consequently, if the measures are stern enough to ensure that the post-takeover value of minority shares never falls below the bid price, then they will in most circumstances drive that post-takeover value above the bid price. Such a result would force bidders always to commit themselves to effecting an immediate takeout upon gaining control; for if an immediate takeout is not expected, and if minority shares are expected in this case to have a post-takeover value exceeding the bid price, then shareholders might hold out even if they view the bid price as higher than the independent target's per share value.

of the independent target's value is lower than the bid price. According to the undistorted choice objective, the shareholder should of course tender his shares. Under the considered arrangement, however, the shareholder might hold out his shares. The shareholder will realize that, if a takeover occurs, the arrangement will ensure that tendering and holding out will have the same results for him. Therefore, the shareholder will only ask himself what will be his best course of action assuming that the bid is going to fail. Assuming that the bid is going to fail implies, the shareholder will reason, that most shareholders are likely to have estimates of the independent target's value that are higher than his own estimate and perhaps even higher than the bid price. Therefore, to determine his best course of action under the assumption that the bid is going to fail, the shareholder will revise his own estimate upwards. His estimate *conditional* on the bid's failure might thus exceed the bid price, and consequently he might hold out his shares.

In other words, by limiting shareholders' considerations to the scenario in which the bid fails, the arrangement under consideration would lead shareholders to focus on the contingency that others' estimates exceed their own and to ignore the contingency that the opposite is true. As a result, all shareholders would clearly bias their estimates upwards to make their tender decisions. This revision upwards would distort the outcome of bids against bidders.[65]

Finally, it is worth explaining why the above problem would not impair the effectiveness of the proposed arrangement put forward in Section IV. Under this arrangement, a shareholder that decides between tendering approvingly and disapprovingly would focus on the scenario in which his decision will be pivotal. Thus, he would focus not on the scenario in which most other shareholders have

65. There is another way to demonstrate that the arrangement under consideration would not ensure undistorted outcomes—by first assuming that it would, and then showing that this assumption creates a contradiction. Assuming that the arrangement would ensure undistorted outcomes implies that shareholders would hold out only if they view the independent target's per share value as higher than the bid price. Hence, the target would remain independent only if most shareholders view the independent target's per share value as higher than the bid price. This proposition in turn implies that, if the bid fails and the target remains independent, the market price of the independent target's shares will be likely to exceed the bid price. This latter proposition, however, means that a shareholder might well find it in his interest to hold out even if his own estimate of the independent target's per share value is lower than the bid price. This possibility contradicts the initial assumption that shareholders' tender decisions would be undistorted.

estimates exceeding his own, but rather on the scenario in which others' estimates are split above and below his. In focusing on such a case, the shareholder would have little reason to bias his own judgment significantly in either direction.[66]

D. *Giving Veto Power to the Target's Management*

At present, applicable legal rules and company charters generally leave a target's management free to use some defensive tactics, such as litigation or creation of antitrust obstacles, which prevent the bid (at least temporarily) from reaching the shareholders. Furthermore, in recent years some companies have adopted charter provisions that have the effect of strengthening the incumbents' ability to impede a bidder's quest for control;[67] and some companies have issued "poison pills" that also have such an impeding effect.[68]

Giving the target's management some degree of veto power over an acquisition might be viewed as a remedy for the distorted choice problem.[69] If shareholders' tender decisions might lead to a distorted outcome, then it might sometimes be desirable to take the decision

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66. Having seen that eliminating the gap between the bid price and the post-takeover value of minority shares would distort outcomes against bidders, it might still be suggested that undistorted outcomes could be attained by curtailing this gap to some "low" optimal level. Unfortunately, there is no "optimal" level for the post-takeover value of minority shares (or for the gap between this post-takeover value and the bid price) that could be specified and would ensure that the outcome of future bids would not be distorted either in favor of or against the bidder. To be sure, for any particular situation, there might exist a level of the expected post-takeover value of minority shares that would ensure an undistorted outcome. This level, however, depends on such features of the situation as the height of the effective control threshold and the extent to which the distribution of shareholders' estimates is widespread. Consequently, this level is not only hard to identify for a particular situation, but, more importantly, might vary from situation to situation. Therefore, no arrangement that guarantees a certain post-takeover value for minority shares could be designed to ensure an undistorted outcome in future situations—whose particular features are unknown at the time of adopting the arrangement.

67. *See* Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982).

68. *See* Note, *Internal Transfers of Control under Poison Pill Preferred Issuances to Shareholders: Toward a Shareholder Approval Rule*, 60 ST. JOHN'S L. REV. 94 (1985).

69. Several commentators have argued that the possible distortions of shareholder choice justify defensive tactics. *See* Greene & Junewicz, *supra* note 1, at 676-93; Lipton, *supra* note 1, at 113-14; Lowenstein, *supra* note 1, at 307-09. Lipton would allow such tactics subject only to the liberal test of the business judgment rule. Lowenstein would allow such tactics subject to a shareholder vote of approval. Greene and Junewicz would allow such tactics only in partial bids, the bids to which they believed the distorted choice problem is limited.

away from them. Management would use its power to impede or block bids, it might be hoped, in those instances where the independent target's value exceeds the expected acquisition price.

Giving management some or complete veto power, however, is a very costly and inadequate remedy for the problem of distorted choice. Most importantly, managers are not perfectly loyal agents of the shareholders and they might well abuse their veto power. To start with, management might refrain from using their power against an inadequate offer by management's favored acquisition partner—a potential buyer that promises management some attractive job prospects or side payments. Even worse, management might decide to obstruct a bid whose acceptance would be value-maximizing. Management might choose to do so in order to retain its independence, to extract side payments from the obstructed bidder, or to facilitate an acquisition by a rival bidder offering a lower acquisition price to shareholders but a better deal for the managers.

Thus, giving management the power to impede bids is a very poor remedy to the problem of distorted choice. Not only does it not ensure undistorted outcomes, but it also might distort outcomes that would otherwise conform to the undistorted choice objective.

E. *Increasing the Control Threshold*

Increasing the threshold of effective control obviously makes it more difficult for bids to succeed. In recent years, many companies have therefore adopted charter provisions that raise the control threshold ("supermajority provisions").[70]

Increasing the control threshold, however, cannot ensure undistorted outcomes. There is no "optimal" level of the control threshold that could be identified and specified in advance and would subsequently ensure that the outcome of any future bid for the company would not be distorted either in favor of or against the bidder. Thus, supermajority arrangements might fail to prevent an undesirable acquisition and might prevent a desirable acquisition.

Several other commentators have used the distortion of bid outcomes as a basis for an argument supporting a particular kind of defensive tactic. *See, e.g.*, Bradley & Rosenzwieg, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986) (defending self-tenders); Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 Yale L.J. 13 (1985) (defending greenmail); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984) (defending poison pills).

70. *See* Carney, *supra* note 1; Gilson, *supra* note 67.

To illustrate, consider a supermajority arrangement that increases the control threshold to 70%. To see that the amendment might fail to prevent an undesirable acquisition, consider an offer that is viewed as inadequate by a majority of the shareholders. The fact that a majority of the shareholders view the offered acquisition price as inadequate in no way rules out the possibility that, say, 80% (or, indeed, even 100%) of the shareholders will tender (some out of concern that the bid will succeed).

To see that a supermajority arrangement might prevent a desirable acquisition, consider an offer that is viewed as adequate by shareholders holding between 50% and 70% of the target's shares. Because of the arrangement, the tenders of this group of shareholders alone would be insufficient to ensure the bid's success. Although the pressure to tender might produce a sufficient number of additional tenders, this need not be the case.

Finally, it is important to note the effect that a super-majority provision might have when the target's management has a significant stake in the target. In such a case, the increase in the level of the control threshold might give management a veto power. As was already explained, however, giving management such veto power in no way ensures undistorted outcomes, because management might well abuse its veto power and use it in a self-serving way.

VI. CONCLUSION

Shareholder choice in corporate takeovers might be distorted. This paper has provided a framework for evaluating this problem, has described the nature and operation of the existing distortions, has examined the effectiveness of various proposed remedies, and has put forward a proposed arrangement that would likely address the problem without any significant costs. It is hoped that this analysis of the problem and the possible remedies will prove useful to practitioners in designing charters and strategies, and to courts and regulators in designing takeover rules.