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THE NEGOTIATION MODEL OF TENDER OFFER DEFENSES AND THE DELAWARE SUPREME COURT

Dale Arthur Oesterle†

During the ten-month period from May 1985 to March 1986, the Delaware Supreme Court decided four major cases concerning the propriety of tender offer defenses. Prior to these decisions, the court had routinely applied the business judgment rule to protect defensive tactics employed by target managers during tender offer contests.¹ In Unocal Corp. v. Mesa Petroleum Co.,² the first of the four cases, a crack developed in the shield. Although the court held for the target managers, it required that any defensive measure "be reasonable in relation to the threat posed" to qualify for protection under the business judgment rule.³ In the two decisions that followed, the court worried the crack but did not widen it.⁴ The court held that the defensive tactics employed in each case easily satisfied the Unocal modification, casting into doubt whether the modification had any practical effect. However, in the final published decision of the period, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,⁵ the crack became a fissure. The Revlon court ruled against target managers who had used a lock-up option to favor one bidder over another. Revlon unequivocally demonstrated that the traditional,


¹ See, e.g., Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984). The only significant issue in cases before May 1985 was who bears the initial burden of proof: Do defendant managers merit the protection of the business judgment rule only after demonstrating good faith and reasonable investigation, or do they automatically enjoy such protection unless the plaintiff proves a lack of good faith or of reasonable investigation? In Cheff v. Mathes, 41 Del. Ch. 494, 504-05, 199 A.2d 548, 554-55 (Del. 1964), a case involving selective stock repurchase by the corporation (greenmail), the court placed the burden upon the defendant managers, but left open whether the same burden would apply to other kinds of tender offer defenses. The court resolved this issue in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985), providing that defendant managers have the initial burden of proof whenever tender offer defenses are involved.


³ Id. at 955.


⁵ 506 A.2d 173 (Del. 1986). The Court decided Revlon from the bench before it released the written decision in Polk, issuing a written decision in Revlon after Polk.
A robust version of the business judgment rule would no longer protect target managers.

The extent to which the Delaware Supreme Court ultimately will redefine the traditional, robust business judgment rule in the tender offer context remains to be seen. This robust version of the rule asks whether corporate managers are disinterested and whether they have made sufficient investigation for an informed decision. If both answers are affirmative, the court will usually defer to the exercise of managerial discretion. In *Unocal*, the court merely purported to add a third, “reasonableness” requirement to the traditional requirements of disinterestedness and sufficient investigation.6 This third requirement, however, completely overwhelms the other two.7 In effect, this new test—that any defensive measures be reasonable in relation to the threat posed—becomes the sole and complete standard, and the court should recognize it as such.

However, the new test is formulated, the court must develop a sophisticated theory for determining when a given tender offer defense is in the target corporation’s best interests. Because the robust version of the business judgment rule is inapplicable, the court can no longer avoid assessing a particular defense’s merits by deferring to managers’ prerogatives. Instead, the court, not the managers, must determine whether a defensive mechanism is reasonable under the circumstances. This development has the officers of Delaware corporations understandably concerned over the prospect of unpredictable, ad hoc decisions in tender offer cases.8 Their con-

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6 For an application of the traditional, robust version of the business judgment rule, see Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
7 It is unclear whether the *Unocal* requirement that defensive tactics be “reasonable in relation to the threat posed,” 493 A.2d at 955, is really any different from the basic “fairness” or “best interest of the corporation” test routinely applied in all conflict of interest cases when the business judgment rule is inapplicable. In any event, if the defendants fail the threshold test, they will not meet any residual fairness standard. On the other hand, if they meet the threshold test, they will not lose under any residual application of a business judgment standard.
8 The Delaware Supreme Court’s reputation for orthodoxy and stability in matters of corporate law has contributed to the state’s popularity as a place of incorporation for the nation’s largest companies. See Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 670 (1974); Seligman, *A Brief History of Delaware’s General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249, 284-85 (1976). The court’s recent holdings in tender offer and “squeeze-out” merger cases have weakened this reputation. See, e.g., Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1104 (Del. 1985) (“[A]ppraisal is not necessarily a stockholder’s sole remedy.”); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 940 (Del. 1985) (holding that previous cases did not abolish Delaware Block valuation method); Weinberger v. UOP, Inc., 457 A.2d 701, 704 (Del. 1983) (“[W]e adopt a more liberal, less rigid and stylized, approach to the valuation process than has heretofore been permitted by our courts.”); Singer v. Magnavox Co., 380 A.2d 969, 977 (Del. 1977) (“[D]efendants cannot meet their fiduciary obligations to plaintiffs simply by relegating them to a statutory appraisal proceeding.”). These cases represent the Delaware court’s vacillating responses to criticism aimed at its decision in *Stauffer v. Standard*
cerns will persist until the court establishes a sophisticated, workable distinction between acceptable and unacceptable conduct by target managers. The first four cases under the Unocal standard comprise the embryonic stages of such a theory. These initial pronouncements are both hopeful and troublesome.

In this journal's November 1985 issue, I urged that target managers be viewed as the negotiating agents of target shareholders, and that the agents' performance be assessed accordingly. When written, the article was at odds with the Delaware court's existing holdings. The Revlon case appears partially to accept my view, with some significant restrictions. Moreover, since my earlier piece the Office of the Chief Economist of the Securities and Exchange Commission has gathered data that bears directly on the validity of a negotiation orientation to tender offers. This comment will first further elucidate the theory that target managers should be viewed primarily as negotiating agents for target shareholders, and then evaluate the current position of the Delaware Supreme Court.

Brands Inc., 41 Del. Ch. 7, 187 A.2d 78 (Del. 1962) in the form of a veiled slight by the United States Supreme Court in Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 n.16 (1977) (possible interpretation of rule 10b-5 "would impose a stricter standard of fiduciary duty than that required by the law of some States"), and by Judge Mansfield's blunt attack in Green v. Santa Fe Indus., Inc., 533 F.2d 1283, 1298 n.4 (2d Cir. 1976) (Mansfield, J., concurring) ("[P]rocedural the Delaware appraisal route is far inferior to a federal cause of action in terms of protection for the minority shareholders."). rev'd, 430 U.S. 462 (1977). These cases may affect future incorporation decisions. See, e.g., PRITTSTON COMPANY, PROXY STATEMENT 9-21 (Apr. 7, 1986) (proposal to eliminate dual incorporation in Delaware and Virginia in favor of incorporation in Virginia); Honabach, Domicile: New Virginia Law May Rival Delaware's, 1 Corp. Couns. Weekly (BNA) 8 (June 18, 1986).

The Delaware legislature is already nullifying some of the effects of the new court doctrine. 65 Del. Laws 289 (1986) (reducing directors' liability); see also Lewin, Delaware Law Allows Less Director Liability, N.Y. Times, June 19, 1986, at D1, col. 1 (Delaware law reduces directors' liability in partial solution to liability problem created by Delaware courts).

I

TARGET MANAGERS AS NEGOTIATING AGENTS FOR SHAREHOLDERS

A. The Evidence

Robert Comment and Gregg Jarrell circulated their study of two-tier tender offers in March 1986.11 Their study analyzes data collected for an earlier study by the Office of the Chief Economist of the SEC.12 The Comment and Jarrell study demonstrates the high frequency of negotiated tender offers; tender offers in which the bidder and the target board of directors agree on an acceptable price. Of the 225 sample tender offers successfully executed between January 1981 and December 1984, more than half were negotiated from the start, and four-fifths were ultimately negotiated.13 The study found that most any-or-all offers14 were ultimately negotiated; virtually all successful two-tier offers15 were ultimately negotiated; and only two-fifths of the pure partial offers16 were ultimately negotiated.17 Moreover, each year the proportion of negotiated tender offers increased substantially, reaching eighty-eight percent in 1984.18

The results suggest that the assent of target managers is often crucial to a tender offer's success, implying that target managers possess significant bargaining power in dealing with bidders. Management's method of acquiring this power usually consists of creating contract rights that are contingent on a change of control and that would prove onerous to any new controlling interest. The po-

12 OFFICE OF THE CHIEF ECONOMIST, SEC, THE ECONOMICS OF ANY-OR-ALL, PARTIAL, AND TWO-TIER TENDER OFFERS (1985) [hereinafter TENDER OFFERS STUDY]
13 R. Comment & G. Jarrell, supra note 10, at 28 (table 2).
14 In an any-or-all tender offer, the bidder offers to buy all tendered shares of the target, if a minimum number of shares are tendered.
15 A two-tier tender offer combines a partial tender offer with a subsequent cashout merger. In a partial tender offer, the bidder sets both a maximum and a minimum for the number of shares it is willing to purchase. If the number of shares tendered exceeds the maximum, the Williams Act requires that the tendered shares be prorated. 15 U.S.C. § 78n(d)(6) (1982). If the number of shares tendered does not meet the minimum, the bidder need not accept any shares. In a two-tier tender offer, the partial tender is usually a cash offer, referred to as the "front-end" payment, sufficient to obtain a controlling interest in the target firm. If the partial tender offer succeeds, the bidder uses its controlling position in the target to execute a "clean-up" merger with the target, exchanging its own securities (referred to as the "back-end" payment) for the outstanding shares of the target.
16 In a pure partial tender offer, the bidder does not announce any intention to effect a subsequent merger and does not execute a clean-up merger following the successful partial offer.
17 R. Comment & G. Jarrell, supra note 10, at 29 (table 3).
18 Id. at 28 (table 2). The percentage of tenders offers that were ultimately negotiated rose from 69% in 1981 to 76% in 1982 to 82% in 1983 to 88% in 1984. Id.
potential target may create such contract rights through a stock dividend program (poison pill plan),\textsuperscript{19} through an amendment to its articles of incorporation (shark repellent amendment),\textsuperscript{20} or both.\textsuperscript{21} The plans provide for cancellation, waiver, or redemption of these rights, but only by the existing board.\textsuperscript{22} Thus a bidder must negotiate with the target’s board, offering terms attractive enough to convince the existing board to cancel, waive, or redeem these contingent rights.\textsuperscript{23} Some commentators have harshly criticized these contingent contract rights for shifting the shareholders’ power to the board, thereby allowing the board to serve its own personal

\textsuperscript{19} The target distributes preferred stock, stock purchase rights, or note purchase rights to common shareholders. The preferred stock (termed “poison pill preferred”) carries a right of redemption contingent on a change of control and, in the event of a second-stage merger, a right of conversion to common stock of the bidder (known as “flip-over” rights) or the target (known as “flip-in” rights), depending on which entity survives the merger. “Trigger” provisions typically define “change of control” as either a tender offer for greater than 30% of the target’s common stock, or a private or open market acquisition of 20% or more of the target’s common stock. For an argument that the market acquisition trigger in such laws is overbroad, see \textit{infra} note 132. The stock purchase rights, also contingent on a change of control, grant holders one or more of the following: the right to acquire more stock in the target (flip-in rights), to redeem their shares (back-end rights) or, in the event of a second-stage merger, stock in the bidder (flip-over rights). The redemption and exercise prices so favor the target shareholder (two or three times the current market value of the securities underlying the rights) that the bidder cannot afford to trigger either. A note purchase right operates similarly to a stock purchase right, except that each shareholder receives as a dividend the right to exchange common stock for a short-term note, again contingent on a change of control. Potential targets often combine stock purchase rights and note purchase rights into one plan. Some plans create a special redemption right, exercisable only by the existing target board, to extinguish the plans at little or no expense either before or shortly after the triggering event. See generally Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The “Poison Pill” Preferred, 97 HARV. L. REV. 1964, 1967 (1984) (describing typical plans); Fleischer & Golden, \textit{Poison Pill}, Nat’l L.J., Feb. 24, 1986, at 17 (discussion of warrant dividend plans companies may issue in planning against takeovers).

\textsuperscript{20} The charter amendments come in a variety of forms, all dependent on a control change that is not favored by the existing board. Some impose supermajority voting requirements on second-stage mergers, others give remaining shareholders a right to redeem stock at favorable prices or a right to a favorable price in a second-stage merger.

\textsuperscript{21} Indeed, in the SEC study, of the 245 firms adopting poison pills about 65% had adopted fair price or other strict supermajority requirements to guard against bids structured to stampede shareholders. \textit{Poison Pill Effects}, \textit{supra} note 10, at 3 n.3.

\textsuperscript{22} For poison pills, the target board’s redemption rights in the case of a tender offer trigger expire upon either announcement of the offer or consummation of a successful tender. Redemption rights in the case of a private stock acquisition trigger usually expire 30 days after the triggering event.

\textsuperscript{23} Courts should invalidate plans which combine a “first trigger” (when a relatively small change in stock ownership vests the conversion or redemption rights) with the lack of a ready mechanism for cancelling the rights once vested. Such a plan does not serve as a negotiating device, but effectively blocks all offers. \textit{See Dynamics Corp. of Am. v. CTS Corp.}, 794 F.2d 250 (7th Cir.), \textit{prob. juris. noted}, 107 S. Ct. 258 (1986); Amalgamated Sugar Co. v. NL Indus., Inc., 644 F. Supp. 1229 (S.D.N.Y. 1986).
interests at the expense of its shareholders.24

Empirical evidence showing the effect of active negotiating efforts by target managers on the price of target shares is sparse. There are numerous instances of the successful use of poison pill plans to bargain for higher prices,25 but more general studies are equivocal. The lack of statistical evidence is understandable; such studies require concrete, accurate, and easily ascertainable indicators of negotiation behavior. Such indicators are not readily available, and approximations may mislead rather than inform.26 Gregg Jarrell's study on litigious targets suggests that target managers who do not defeat all control changes, but who resist for a time an outstanding offer in order to secure a higher bid obtain much higher

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26 Gathering data pertinent to the issue of whether target managers best serve shareholders by erecting defenses to front-end loaded offers is a difficult task because so much depends on the facts of each case. Rather than conducting a refined, fact-sensitive analysis, the Comment and Jarrell study bluntly compares negotiated and hostile tender offers. The comparisons, although incapable of providing solid answers, are intriguing nonetheless.

Analyzing aggregate premiums associated with two-tiered offers, the study demonstrates that total premiums paid in negotiated offers slightly exceeded total premiums paid in hostile offers. R. Comment & G. Jarrell, supra note 10, at 33 (table 7). If the bidder and target negotiated the initial offer, the ultimate average blended premium was 59.3% over market value; if the initial offer was hostile, target shareholders received an average blended premium of 51.1%. Id. If the subsequent executed tender offer was negotiated, the average blended premium was 55.5%; if the executed tender offer was hostile, target shareholders received an average blended premium of 51.2%. Id. This suggests that target boards negotiate better offers in response to two-tier tender offers than their shareholders would otherwise receive. Indeed, because it is safe to assume that target managers are not totally passive during unnegotiated offers (and that they may have positively affected the price), the data may understate this conclusion.

On the other hand, premiums paid in negotiated pure partial tender offers were significantly lower than those paid in hostile tender offers of the same type. The average premium paid in pure partial offers was 14.5% for negotiated initial offers, 42.2% for unnegotiated initial offers and 19.7% and 22.2%, respectively for executed negotiated and unnegotiated offers. Id. This suggests that target managers negotiated poorer deals in response to partial tender offers than the shareholders would have otherwise receive. Indeed, because the negotiated pure partial offers resulted in acquisition of a much larger percentage of total shares (45.9%) than in unnegotiated pure partial offers (30.1%), id. at 36 (table 10), one would expect the prices in the former to be higher than the latter.

Again, however, the lack of knowledge of the extent of the managers' roles in unnegotiated offers weakens this inference. Moreover, the sample lumps tender offers for minority control blocks together with offers for significant but noncontrolling interests, two very different phenomena.
tender offer premiums for their shareholders.27

On the other hand, the SEC Chief Economist's studies on poison pill plans and on shark repellent amendments suggest otherwise. The studies on poison pill plans found, on average, either a neutral or a slightly negative effect on stock prices when firms announced the creation of poison pill plans.28 Both studies exhibit methodological weaknesses common to most studies employing a cumulative abnormal return analysis. Interpretation of the results depends on the selection of an appropriate measurement period, and this is an inexact art.29 More important, such studies do not necessarily prove that poison pill plans are inherently bad, but perhaps only that the courts have been too permissive in monitoring their actual use, allowing target managers to defeat takeover attempts rather than to bargain with potential purchasers. Indeed, the second SEC study suggests that target managers too frequently use the plans to block any sale of their company.30

The study on 649 proposed shark repellent amendments similarly found, on average, either a neutral or a slightly negative effect on stock prices when firms adopted the charter amendments.31 Interestingly, the pure supermajority amendments had no effect; the supermajority amendments that allowed a board waiver had negative effects; and supermajority amendments with board waivers and

28 POISON PILL EFFECTS, supra note 10, at 29 & table 5 (1986) (decline in stock prices of 245 firms averaged .22% over two-day period surrounding announcement of plan's adoption); POISON PILLES ECONOMICS, supra note 10, at 11 & table 1 (decline in stock prices of 32 companies averaged nonstatistically significant .93%).

The latest SEC study found, however, that in cases subject to takeover speculation, stock prices declined on average 1.74% over the two-day period surrounding announcement of the plan's adoption. See POISON PILL EFFECTS, supra note 10, at 30 & table 9.

29 See R. Gilson, The Law and Finance of Corporate Acquisitions 235-38 (1986). Do the results suggest poison pill plans are too weak or too strong as defensive devices? For example, suppose that some of the firms in the study had signaled, long before the announcement of the poison pill plans, a general inclination to protect their shareholders from coercive offers. In sum, the announcement date of the poison pill plans may not be an appropriate date for measuring whether a defensive program helps or hurts target shareholders.

30 In 30 control contests, 46% of the targets remained independent, primarily because of the effectiveness of their poison pill plans. POISON PILL EFFECTS, supra note 10, at 41 & table 2. These companies experienced, on average, stock price decreases of 17%. Id. at 41 & table 3. Those companies that did use poison pill plans to stimulate auctions gained, on average, 14% in stock returns over those returns attributable to the initial bid. Id. at 41 & table 4. Moreover, the study found, id. at 41-42 & table 10, that target managers used the plans to block any-or-all offers more frequently than the more coercive two-tier tender offers. See infra note 46.
31 SHARK REPPELLENTS STUDY, supra note 10.
conditioned on a price (fair price amendments) had no effect.\textsuperscript{32} Again, because courts have deferred too broadly to board negotiating behavior, thus permitting both proper and improper behavior, the study may measure not the advantages of empowering negotiating agents but instead the quality of existing legal doctrine. Indeed, the neutral effect of the more circumscribed delegation of negotiating power to the board in the context of fair price amendments as compared with the negative effect of an open-ended delegation of waiver authority implies that some control of the board’s authority is needed. Because a full and sensible detailing of proper board behavior is beyond the capacity of those who draft amendments to corporate articles the optimal solution would seem to be an evolving common law that restrains board discretion.

B. The Theory

The question of how to evaluate the defensive tactics of target managers hinges upon whether target shareholders need to rely on bargaining agents to respond to tender offers. If target shareholders need no such representation, then target managers should not interfere. But if target shareholders can gain an advantage through the use of an agent, their needs define both when and how target managers should act on their behalf.

Two arguments support an active role for target managers. The first, applicable to all tender offers, says that target managers know more than shareholders about their company’s value and therefore can better assess pending offers. The second argument relates to front-end loaded tender offers (which could take the form of an any-or-all, two-tier, or pure partial tender offer), and holds that if the tender offer succeeds, shareholders who tender are better off than shareholders who do not; thus, the fear of being the only nontendering shareholder in a successful tender offer coerces shareholders to tender when they would rather not. I will consider each argument in turn.

The strongest statement of the first argument is that target managers know more than shareholders about their company’s value. Target managers, backed by retained financial experts, repeatedly claim that their company’s worth exceeds market price, and courts listen.\textsuperscript{33} (A variation of the same claim occurs when target

\textsuperscript{32} Id. at 5 & table 4. Usually, the price upon which amendment is conditioned is the tender offer price.

\textsuperscript{33} See A.B.A. Comm. on Corp. Laws, Guidelines for Directors: Planning for and Responding to Unsolicited Tender Offers, 41 Bus. Law. 209, 218 (1985) (in responding to tender offer, board should consider, among other things, liquidation and breakup values of corporation and its prospects as going concern over next several years). One of the worst examples is GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D.N.Y.)
managers assert that the market overvalues the securities offered by a bidder in an exchange offer. If these claims are based on public information, they fly in the face of the efficient market theory widely held by academics. This theory holds that a corporation's share price is the most accurate measure of the company's future prospects at that moment. The most widely-held version of this theory, the "semi-strong" thesis, is that share price reflects all public information on the company and its milieu, and that investors relying on public information alone will not consistently earn above normal rates of return. On the other hand, if the claim of manager superiority is in fact based on inside information, the best solution may not be managerial control or a tender offer defense, but disclosure to shareholders of managers' opinions on the company's worth. Fully informed shareholders can then decide for themselves whether to tender. Some commentators have urged that the law limit manager participation to such a role.

A weaker version of the argument has more validity. In the heat of a tender offer, some information is extremely difficult to communicate to shareholders in a timely fashion. Target managers tend to fear public disclosure, which can destroy the value of confidential information. One such type of information relates to the company's ongoing business: a mineral discovery on land for which the company was paid a premium over market price, would "after paying off its acquisition indebtedness through a substantial liquidation, result in a virtual gift to GAF of Carbide's valuable industrial gas and chemicals and plastics businesses, because GAF would acquire them at no cost." The court accepted this assertion without comment.

See A.B.A. Comm. on Corp. Laws, supra note 33, at 218 (target board should consider value of noncash consideration). A weaker form of this position may have some validity. Target managers may obtain information during a partial tender offer that identifies the bidder as a "looter" who will breach promises to remaining shareholders or otherwise mistreat them. Id. (target board should consider impact on remaining shareholders). The issues are whether disclosure of this information by the target board is a sufficient remedy and, if not, whether sufficient protection is created solely by shareholder suits.


Arguably, false classification of information affecting market price may explain claims allegedly based on inside information.

pany owns only exploration rights, or a new product likely to spawn imitations soon after it is announced. In addition, the tender offer itself often generates inside information relating to bargaining among tender offer participants, information which was obtained in confidence or which would adversely affect the target if disclosed. Sanitized disclosures that merely allude to the information’s existence may suffice in certain circumstances, but such stopgap disclosure measures are of limited use to shareholders and do not fully address the more basic criticism that divulging inside information often damages the interests of both the target and its shareholders.

Even in a weak form, however, this argument provides only limited justification for target management responses, and may too easily conceal target manager selfishness. Arguments based on confidential information are always easy to make, and, unless investigated on a case-by-case basis, serve only to insulate target managers from accountability. Such a case-by-case evaluation would be costly and a broader rule disfavoring the arguments based on confidential information may prove the more prudent choice.

The second argument, which states that front-end loaded tender offers are inherently coercive, has many proponents. Indeed, the debate in some quarters is not over whether coercion exists, but rather whether this aspect of tender offers is desirable. This coercion exemplifies the classic prisoner’s dilemma. In a

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40 This argument assumes that the stock’s market price would be higher if the public knew of confidential information. Of course, this assumption fails where significant insider trading on the basis of such information raises the stock price.

41 For example, target managers often solicit bargain-specific information from existing or prospective bidders on the condition that such disclosures remain confidential.


43 The debate between those who would preclude target managers from responding at all, as well as repeal most of the Williams Act’s protections, and those who believe that some defensive measures are justified is summarized in Oesterle, supra note 9. Those in the former camp favor tender offers to discipline managers and argue that target manager resistance dissipates potential gains of the successful bidder, thereby reducing the incentive to make an initial bid (or engage in the often costly search for potential targets). In response, I noted that disabling target managers from representing shareholders will simply drive shareholders to less efficient methods of consolidating bargaining power; bidders will have no greater incentive to bid, and target shareholders will incur higher transaction costs in fashioning collective response devices. Id. at 75-81.

44 In the classic prisoner’s dilemma, prisoners A and B are arrested for the same
front-end loaded tender offer, the initial offer's value is substantially greater than that which nontendering shareholders can expect to receive if the offer succeeds. Even a shareholder who is convinced that the initial premium is too low will tender for fear that other, similarly fearful shareholders will tender leaving her, if the takeover succeeds, with the inferior back-end position of a nontendering shareholder. The greater the difference between the front-end premium and the back-end position, the greater the potential cost to nontendering shareholders. Thus, a tender offer could succeed
even if over fifty percent of target shareholders believe the price too low.47

Perfect competition between bidders should, in theory, eliminate the coercive nature of front-end loaded tender offers. Once competing bidders reach the absolute lower limit on back-end value, they will compete on the front-end price, raising the total blended premium. In actual practice, however, back-end value is never certain. The residual price of the nontendered stock (or its substitute if a back-end merger follows the tender offer) is highly speculative48 because of market uncertainty and other factors, such as predictions about court decisions on appraisal rights. As a result, two different bidders rarely offer equivalent back-end positions to the same target shareholders (each offering, for example, a back-end exchange of an equivalent value of its own securities for target stock). Even if they did, shareholders would still face the task of evaluating whether

have caused this result. It is necessary to investigate each case to determine if target managers acted to neutralize the advantages of a partial offer over an any-or-all offer. But see AC Acquisitions Corp. v. Anderson, Clayton & Co., [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,942 (Del. Ch. Sept. 18, 1986) (partial self-tender has unfair advantage over two-tier, nonfront-end loaded tender, in which outside bidder promises to pay same price for shares acquired by tender or by second-stage merger).

47 Professor Bradley argues that in principle a partial tender offer can succeed with a negative blended price. In other words, a partial tender can induce an inefficient transfer of a company to a lower valued user. Bradley, supra note 42, at 354-56. See also Bradley & Rosenzweig, Defensive Stock Repurchases, 99 HARV. L. REV. 1377, 1412-17 (1986) (prisoner’s dilemma ensures success of bidding firm’s offer). Such cases will be rare, however. I have yet to see a description of an actual successful tender offer of this type.

Proposals to limit the use of certain defensive tactics often overlook the fact that even though the blended price exceeds the total pre-offer value of the target shares, shareholders are denied the chance to bargain for further price increases. See Oesterle, supra note 9, at 80-81 (describing black-market behavior created by this approach). For example, Professors Bradley and Rosenzweig propose limiting the use of defensive self-tender offers. These limits are designed to allow self-tender offers only to combat inefficient takeovers. This approach would not allow target managers to use defensive self-tender offers as a bargaining device whenever the bidder offers a blended price exceeding the pre-offer value of the target shares.

Other commentators merely question how target shareholders selling above pre-announcement market price can be injured. E.g., R. Gilson, supra note 29, at 763-64. Either shareholders systematically undervalue company worth or they should be happy with any increase over market price. Neither statement is accurate. Once a special bidder appears with the potential for creating gains from the merger of the two companies, the issue becomes how the two parties will divide the gains. Target shareholders should be allowed to maximize their slice of the gain, even if over pre-announcement market prices. Legal rules that attempt to block target shareholders’ ability to do so will inevitably create inefficient black-market behavior designed to extract true value. Moreover, rules that successfully block target shareholders from bargaining effectively will discourage potential targets from becoming more attractive takeover targets, from searching for bidders, and from spending resources to find optimal new combinations.

both offers are reasonable. Although bidder competition benefits shareholders, some residual effect of the prisoner's dilemma could conceivably lead target shareholders to tender to the lower bidder.49

The best solution for target shareholders is, of course, collusion. An organized refusal to tender to the lower offer breaks the dilemma. Target shareholders should collectively spend on collusion until the marginal losses from front-end loaded tender offers are equal to the marginal costs of further organization. The more efficient the method of this organization, the lower the losses from front-end loaded offers. Of the types of collusion available, simultaneous shareholder voting carries substantial administrative costs,50 and pure shark repellent provisions in corporate charters are too inflexible.51 The most workable method and the one seemingly most often chosen by corporations, is to delegate negotiation responsibility to management. Target managers are ideally situated to consolidate shareholder power, permitting the collusion which generates the largest possible total blended premium. Through the creation of, among other devices, revocable poison pill plans and

49 Consider, for example, the case in which the bidder willing to pay the highest blended premium misjudges court appraisal rights and therefore overestimates the minimum back-end merger price.

50 Bebchuk's thoughtful proposal would eliminate much of the administrative cost of a traditional shareholder vote. Bebchuk, supra note 42, at 1747-64. He suggests that the target corporation ask its shareholders to vote in the letter of transmittal which must accompany all tendered shares. A bidder failing to obtain a majority vote may not accept any tendered shares, even if the number of shares tendered conforms to the offer's terms. In other words, shareholders could vote to reject the offer even though they tender their shares. The proposal borrows from several state takeover statutes that codified similar voting requirements but fell, for the most part, to constitutional challenges. See, e.g., Illinois Business Take-Over Act, 1978 Ill. Laws 80-1421 (declared unconstitutional by Edgar v. Mite Corp., 457 U.S. 624 (1982) (repealed 1989)).

The proposal has merit, but I am not sanguine about its effects. A substantial number of shareholders will not make the effort to gather enough information to make the kind of sophisticated independent evaluation necessary to separate their voting decision from their tendering decision. Many will have an individual stake too small to justify research costs, and even those with larger stakes may prefer to sit back and hope to "free ride" on others' research. Of the few major players who will speak publicly on a tender offer's merits, target managers are likely to wield the greatest influence.

For this reason, the ultimate effect of Bebchuk's proposal may simply be a consolidation of power in the hands of target managers. The SEC study indicates that target manager recommendations have significant impact on shareholder decisions; negative recommendations seem to cause many shareholders not to tender, even when tendering is in their best interest and the tender offer is front-end loaded. TENDER OFFERS STUDY, supra note 12, at 22. Bebchuk's proposal would eliminate some pressure to not follow target manager recommendations.

51 Pure shark repellent provisions consist of amendments to corporate charters that impede any second-stage merger, making the target a less attractive takeover candidate. Some amendments require supermajority approval (sometimes up to 95%) for any second-stage merger, and are not easily waived or removed. See SHARK REPELLANT STUDY, supra note 10.
waivable supermajority vote provisions, target managers can effectively and efficiently maximize the ultimate tender price.

Target managers can therefore play a role in tender offers, primarily depending on whether and to what extent the offer is front-end loaded. The more heavily front-ended loaded the offer, the less likely shareholders are free to tender based on their independent valuations of the sufficiency of the offer price. Because partial tender offers are more likely than any-or-all tender offers to be heavily front-end loaded, management responses to the former should be less intrusive than to the latter. In any event, there exists a very real danger that target managers may use the occasion of a tender offer to further their own interests at shareholder expense. Selfish behavior by target management may arise in two contexts: it can block tender offers that should be encouraged and it can encourage tender offers that should be resisted.

Blocking behavior takes two forms: first, management may improperly erect a complete defense to block a tender offer; and second, management may misuse the negotiation power granted them through an otherwise sensible program. One obvious reason why target managers may seek to block a tender offer is the fear of losing their jobs and salaries. A more subtle incentive to obstruct derives from the desire to reduce unsystematic risk. While shareholders can nullify the unsystematic risks of investing in a potential target by diversifying their stock portfolios, the human capital investment of managers cannot be diversified. As a consequence, managers may choose to run a firm more conservatively than is in the shareholders' best interests. A program of resisting tender offers protects managers' ability to substantially reduce unsystematic risk. Indeed, the program itself may reduce such risk by taking the firm out of the

52 Comment and Jarrell found, for example, that average blended premiums ultimately received in negotiated any-or-all tender offers were 51.9% for negotiated initial offers and 56.4% for negotiated executed offers. The same figures for un negotiated any-or-all tender offers were 67.7% and 71.8% respectively. R. Comment & G. Jarrell, supra note 10, at 33 (table 7). One could infer from the data that intervention by target managers in any-or-all tender offers may have more costs than gains. Yet, active intervention by target managers during hostile takeover battles is often very rigorous, and the intensity of their negotiation positions may explain why the prices in un negotiated takeovers are higher. Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983).


54 See Beck & Zorn, Managerial Incentives in a Stock Market Economy, 37 J. Fin. 1151 (1982).
TENDER OFFER DEFENSES

takeover market. The refusal of managers to negotiate on behalf of shareholders, on the other hand, may also breach their obligations. The prospect of one-time personal gain (usually in the form of a bribe from the potential acquiror) may induce management to sell out at too low a price. Courts should therefore accept the task of evaluating whether target managers have acted as faithful negotiating agents whenever plans that empower target managers to act as negotiators are adopted or exercised.

Simple criteria should guide court analysis. Only the existence of significant confidential business information or a failed negotiation gambit aimed at securing a higher price justifies a target manager's total defeat of a tender offer. Similarly, only an effort to induce a higher bid or to neutralize the disadvantage of an any-or-all tender offer in competition with a front-end loaded tender offer justifies acts that give one bidder an advantage over another in an auction.

C. Problems of Implementation

Those troubled by the idea of corporate bargaining mechanisms are unduly concerned about three phenomena. First, the sheer mechanical complexity of many devices can cause some observers to focus on a single part of a device that in isolation seems unfair. In stockholder rights plans, for example, a tender offer that succeeds without management approval may entitle the shareholder to double the value of his shares. All of the plans have features that discriminate in some fashion against shares held by the bidder. At first blush, these may appear questionable—even fraudulent. Yet such an exchange ratio and discrimination against the

55 An investment by a firm in becoming a target is a gamble, but one that, in some circumstances, a firm ought to take.

56 This form of behavior is classically associated with the final stages of an extended "prisoner's dilemma" situation. See R. AXELROD, THE EVOLUTION OF COOPERATION 10-11, 42-43 (1984); supra note 44 and accompanying text. Professor Williamson has characterized such behavior as "opportunistic" breach of contract. O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 26-30 (1975); see also R. GILSON, supra note 29, at 579 (discussion of "final period" principle).

57 The most severe plans contain flip-in provisions that give all stockholders other than the acquiror the right to buy target stock at half-price if an acquiror buys more than a specified percentage of the target stock. See Fogg, supra note 25, at 26, cols. 1-2 (describing Sea-Land Corporation rights plan).

58 The discrimination takes two basic forms. First, the inchoate rights issued as dividends on the common stock cannot be transferred until they are vested by a triggering event. E.g., Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252, 1256 (S.D.N.Y. 1985). Accordingly, a bidder who acquires stock after the record closing date for the rights dividend cannot acquire the rights. Second, when the rights vest, by their terms they can only be exercised by shareholders other than the shareholder who triggers
bidder are not intended to net windfall gains for existing shareholders, but to insure that the triggering event—a tender offer without board approval—will never happen. The higher and more absolute the penalty for acquisitions without approval, the less likely that unapproved acquisitions will occur.

Target boards thus create contingent contract rights that are designed to serve as deterrents and nothing more. Such contingent rights, which are not actually intended to be triggered, pose difficult enforcement problems for courts. The existence of these problems represents the best attack on the plans themselves, and supports their elimination in favor of more direct agency delegations. If bidders can trigger the plans and then run to court to have the onerous effects of the contingent rights enjoined, then the plans become worthless. Yet courts have proven reluctant to enforce plans where the plans' stiff residual consequences have been enforced them—the bidder. E.g., Amalgamated Sugar Co. v. NL Indus., Inc., 644 F. Supp. 1229, 1233 (S.D.N.Y 1986).


The statutes at issue in these cases are intended to protect existing shareholders from a dilution of their equity position by unilateral board action taking place after the shareholder has invested. E.g., N.J. Stat. Ann. § 14A:9-1(2)(f) (West 1969). The board cannot unilaterally assign a dividend to all shareholders with last names beginning with A, for example. The discrimination in poison pills is not of this type, however, because all shareholders who purchased after the record closing date under the first form knew they were buying stock without conversion rights and all shareholders under the second form who triggered the rights knew they would be excluded from exercising such rights. Thus, these purchasers were not disadvantaged by a change in their positions after they had purchased their stock. Indeed, if one asks whether the plans discriminated among shareholders at the time of the rights dividend, the technical answer would be no; the bidder's acts created the discrimination. Asking whether the plan created the discrimination or whether the bidders knowingly triggered the discriminatory effects completely misses the point. The real issue is whether the poison pill plans provide a benefit to target shareholders.

Of course, if target boards could consolidate shareholder bargaining power through more direct methods, like share transfer restrictions, such complexities could be avoided. Unfortunately, the law is unclear, if not disabling, on the matter.

They are like the doomsday bomb in the movie, "Dr. Strangelove."

See infra text accompanying notes 181-82.

It is no surprise that the latest SEC study found that discriminatory poison pill plans, the most severe of such plans, were instrumental in defeating tender offers in 64% of the cases, as compared to defeats in only 31% of the cases involving straight flip-over poison pill plans. Poison Pill Effects, supra note 10, at 25-26 & table 2.
triggered. Courts have not squarely faced the issue: Do they enforce the severest plans once triggered to deter bidders from gambling that a plan once triggered will be enjoined, or do they act as a safety valve for triggered plans that disable a firm and encourage bidders to gamble on court relief? Such uncertainty creates a drafting nightmare. The more severe the contingent rights, the more likely a judge will act to nullify them once triggered. But the less severe the contingent rights, the less likely a bidder will find them a hinderance to unapproved takeovers. So drafters of poison pill plans must now find the perfect balance: a plan that deters bidders and that courts will enforce once triggered. An error in either direction has monstrous consequences.

Most bidders are not currently willing to take the huge gamble of triggering a plan and then seeking court relief. Rather, they run to court on the eve of triggering the plan, asking the court to enjoin the plan or force the target board to redeem, cancel, or waive the contingent rights. Courts face yet another difficult issue: The bidder claims it will go no higher and the target is holding out for more; should the court force the target to accept the bidder's last price? If courts too often require targets to accept the bidder's last price, then bidders will be encouraged to hold out with lower offers and use courts as a bargaining weapon. But if courts too often refuse to require targets to accept the bidder's last price, either some beneficial acquisitions will fail and subsequent suits against target managers will inevitably follow or bidders will try the gamble, trigger the plan, and try to convince a court to grant relief.

What is the optimal enforcement posture of the courts on these questions? If poison pill plans are allowed at all (and I favor more direct delegations of negotiation authority), courts should take a rather harsh approach in order to limit the judicial role in the actual bargaining, assuming that the plan itself is not a complete block and therefore infirm but rather is a means of concentrating bargaining authority in the target managers. If triggered plans are enforced, then target boards will not have to accept bidders' "final" offer, and relief will come in the form of after-the-fact damage awards against target managers. If target managers acted selfishly or if they took a

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64 For example, Sir James Goldsmith was able to structure a second-stage merger transaction that avoided the flip-over effect of the Crown Zellerbach Corporation rights plan. See Fogg, supra note 25, at 25, col. 3, 26, col. 1.
foolish gamble, then they should be personally liable.\textsuperscript{66}

Second, devices created without shareholder approval give rise to the argument that control of the corporation has shifted from shareholders to managers without shareholder approval, thereby permitting managers unilaterally to change the basic contract. Some commentators urge that courts only declare poison pill plans valid if installed by a shareholder vote.\textsuperscript{67} Past practice suggests, however, that such approval acts merely as a rubber stamp of management proposals, and penalizes only those managers who, having waited too long to put a plan in place, vainly attempt to secure shareholder ratification after a bidder has already made a tender offer. In the end, the debate reduces to whether corporate codes should presume that shareholders normally favor or oppose giving their managers the power to create poison pill plans. If knowledgeable shareholders generally favor such plans, then the law should require a charter amendment to divest managers of the power to create them; if the plans are generally dis favored, then the codes should require a charter amendment to vest managers with the power to create them. In any event, the most effective check on plans that are ultimately against shareholder interest will come from the resulting depressed stock prices. The fact that over 190 companies have poison pills in place\textsuperscript{68} suggests that the plans have value beyond mere entrenchment of target managers.

Third, some observers may feel that courts may not be equipped to discern selfish behavior by target managers. Skillful lawyers can usually disguise acts motivated by the self-interest of target managers. Yet the decision whether to resist is often patently suspicious; one can easily evaluate both the tender offer price and the target board's reactions to it. Moreover, the offer's effect on target managers' personal positions ought to help to determine whether the managers' acts were intended to be in the best interests of shareholders.\textsuperscript{69} Courts to date hesitate to make even the simplest

\textsuperscript{66} The one exception is for acts of target managers in responding to an offer that are clearly motivated by self-interest. Here, a grant of preliminary injunctive relief in cases brought before the rights have been triggered could avoid compounding the losses created by such behavior.

\textsuperscript{67} See, e.g., Note, supra note 19, at 1964 n.2; 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); Vise, "Bill of Rights" Seeks to Boost Power of Shareholders, Wash. Post, Apr. 13, 1986, at F1, col. 1. The SEC has requested comments on the subject. See infra note 68.

\textsuperscript{68} See SEC Exchange Act Release No. 23,486, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,018, at 88,203 (July 31, 1986). The Commission is requesting comment on possible regulation of "poison pill" plans, id. at 88,199, implying that it is leaning toward imposing a shareholder approval requirement.

\textsuperscript{69} Some commentators argue that motives are impossible to distinguish and sort and therefore should be irrelevant to the inquiry. E.g., Macey & McChesney, A Theoreti-
investigations of target managers' positions; they refuse to consider as relevant, for example, evidence that the target managers will be ousted if the offer succeeds. This hesitation, which defies common sense, is not evident in standard breach of loyalty cases outside the context of tender offers. In fact, one study of ninety-five cash tender offers found that the greater the positive impact of a tender offer on target managers' personal wealth, the lesser the likelihood of target management resistance.

Some very recent cases illustrate that courts are capable of discerning selfish behavior. Self-interested behavior is most often obvious in multiple-bidder situations. For example, in *Edelman v. Fruehauf Corp.*,\(^7\) the target board accepted incumbent management's leveraged buy-out proposal without giving the competing outside bidder a chance to raise its offer. The board then summarily rejected the outsider's subsequent increased bid.\(^7\) To close out the outsider completely, the board restricted its ability to negotiate with any other bidder by entering into a no-shop agreement with the investment bank that was to finance the buy out.\(^7\) The board also amended its stock option plan, incentive plan, and pension plan to render all company-issued options immediately exercisable, all incentive payments immediately due, and the $70 to $100 million of overfunding in the pension plan, which had been available for corporate uses, irrevocably committed to the fund if anyone, without board approval, obtained a forty-percent interest in the corporation.\(^7\) The Sixth Circuit had no difficulty in holding that the board's actions were not taken in a good faith effort to negotiate the best

\(^{68}\) See, e.g., *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 708-04 (2d Cir. 1980) (record "unusually sparse, if not nonexistent" for proposition that retention of control motivated directors' actions); *GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1022 (S.D.N.Y. 1985) (no inference of self-interest merely where directors' acts to defeat tender allow them to remain on board).


\(^{70}\) *Id.* at 882 (6th Cir. 1986).

\(^{71}\) *Id.* at 885.

\(^{72}\) *Id.*

\(^{73}\) *Id.*
deal for the shareholders. They acted as interested parties and did not treat the [target] managers and the [outside bidder] in an even handed way but rather gave their colleagues on the Board, the inside managers, the inside track and accepted their proposal without fostering a real bidding process.\(^{76}\)

Even in less obvious cases, the necessary inquiry need not delve into the personal finances of target managers. The very nature of the defensive plan adopted may be sufficient for courts to conclude that the target board has breached its duty of loyalty. In *Dynamics Corp. of America v. CTS Corp.*\(^{77}\) for example, the target CTS adopted a "flip-in" rights plan that combined a relatively quick trigger with effective irreversibility. If an outsider acquired fifteen percent or more of the corporation's common stock, the rights vested, became irredeemable, and entitled all shareholders other than the acquiror to purchase CTS securities at twenty-five percent of market value. The Seventh Circuit noted, "[I]t is apparent that the insiders on the board... decided from the start to block the tender offer, before its ramifications for shareholder welfare were considered . . . ."\(^{78}\)

CTS restructured the plan in an effort to gain court approval,\(^{79}\) increasing the triggering threshold to twenty-eight percent, changing the flip-in consideration to $50 of short-term notes, and providing a tolling period of 120 days if the acquiror announced an any-or-all tender offer for more than $50 in cash per share. The rights could be extinguished if the offer were completed during the tolling period, or if redeemed by the board at five cents per share.\(^{80}\) The district court, evaluating the revised plan, refused to grant the acquiror's motion for a preliminary injunction and held that the revised plan was not intended as "a mere 'ploy' to get reelected."\(^{81}\) On appeal, the Seventh Circuit remanded the case for a determination of whether the restructured plan also prevented all takeovers.\(^{82}\) The court questioned whether the $50 tender offer price necessary for cancelling the plan was too high in light of an existing market price of $29 and the bidder's willingness to pay $43.\(^{83}\)

Finally, cases exist where the plan itself might pass muster when promulgated but the target's management misuses the negotiating

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\(^{76}\) Id.

\(^{77}\) 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986).

\(^{78}\) 794 F.2d. at 257.

\(^{79}\) The district court had previously enjoined the target's original plan. *Dynamics Corp.*, 637 F. Supp. 406 (N.D. Ill. 1986).

\(^{80}\) *Dynamics Corp.*, 635 F. Supp. 1174, 1176 (N.D. Ill. 1986).

\(^{81}\) Id. at 1181. The district court, in light of the Seventh Circuit's subsequent written decision, 794 F.2d 250 (7th Cir.), *prob. juris. noted*, 107 S. Ct. 258 (1986), examined and adhered to this conclusion. 638 F. Supp. 802 (N.D. Ill. 1986).


\(^{83}\) Id. at 94,867-69.
power given it by the plan. In *Amalgamated Sugar Co. v. NL Industries, Inc.*, the board established a more typical and less sensitive triggering event: a market acquisition of twenty percent or an announcement by the acquiror of a tender offer for thirty percent or more of the outstanding common shares. Atypically, however, the rights were not redeemable once triggered by private acquisitions. Before the trigger had been pulled, a group of outside purchasers requested that the target board redeem the rights in exchange for an offered price. The board refused, arguing that the prospective price offered underestimated the inherent value of the business. The purchaser group then acquired over twenty percent of the target's stock. The rights vested and flip-over and flip-in provisions kicked in to block any attempt at a second-stage merger; the corporation was effectively locked out of any corporate combinations for ten years. The district court, focusing on the finality of the plan once the rights had vested, granted a preliminary injunction to prevent its execution, suggesting that a plan must provide more lenient opportunities for reversibility and, most significantly, that a board must negotiate fully and carefully with a potential acquiror before the last, irreversible triggering event.

An investigation into the personal stake of management may be unavoidable, however, in cases where target officials "accept" an offer, deciding not to negotiate for a higher price. Such an investigation might be necessary in order to distinguish decisions motivated by poor judgment from those prompted by personal greed. In any event, given the vitality of the duty of loyalty/duty of care dichotomy in other contexts, courts' historical reluctance to consider the impact of managerial acts during a tender offer on the personal fortunes of target managers is curious indeed.

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85 The rights have a 10-year life. For a complete description of the plan, see *id.* at 1232-33.
86 *Id.* at 1236.
87 *Id.* at 1240.
88 See *Smith v. Good Music Station, Inc.*, 36 Del. Ch. 262, 129 A.2d 242 (Del. Ch. 1957). *But see Pupecki v. James Madison Corp.*, 376 Mass. 212, 382 N.E.2d 1030 (1978) (summary judgment for defendants inappropriate where plaintiff alleged corporation sold most of its assets for inadequate consideration, with additional consideration diverted to majority shareholder for separate employment and noncompetition agreements). This reluctance, in the form of a presumption against selfish actions, is more understandable in the context of statutory mergers and asset acquisitions, where a shareholder vote and full disclosure of all factors material to such a vote (such as generous employment contracts between target managers and the surviving corporation) are required. See 13B B. Fox & E. Fox, *Business Organizations: Corporate Acquisitions and Mergers* § 24.02 (1986) (survey of state statutory requirements). In negotiated tender offers, however, target shareholders may not be aware of any side deals between the bidder and target managers when deciding whether to tender their shares.
II
COMPARING A NEGOTIATION THEORY WITH THE DOCTRINE OF THE DELAWARE SUPREME COURT

A sophisticated theory of tender offer defenses must answer three related questions. First, whose interests should target managers represent? Second, when, if ever, should target managers completely block a tender offer? Third, when, if ever, should target managers favor one bidder over another? (The answer to the first question affects the answers to the second and third, and the third is essentially a subissue of the second.) As noted above, a negotiation theory responds that target managers should represent shareholders, that they should rarely completely block a tender offer, and that they should rarely favor one bidder over another. The Delaware Supreme Court, however, has given other answers on the first two questions and, somewhat incongruously, appears to agree with the answer to the third.

A. Whose Interests Should Target Managers Represent?

The first question breaks down into two subparts: first, should management decision making balance the demands of all of the corporation's constituencies, or should it favor shareholders?; and second, when should corporate managers discriminate among shareholders? Much scholarly debate has focused on the first issue. Commentators have asked whether managers should ever further the interests of creditors, customers, suppliers, or the local community at the expense of shareholder gain. In spite of the abundant scholarship, corporate law on this issue remains largely unchanged.

1. Equity Holders Versus All Other Interested Participants

The traditional and still dominant view is that managers represent the shareholders. Creditors, customers, suppliers, and employees create and protect their interests through contracts with the corporation. Specific legislation, such as employee safety require-

89 A succession of disclosures of substantial corporate misconduct during the early 1970s prompted this debate. See Oesterle, Limits on a Corporation's Protection of Its Directors and Officers from Personal Liability, 1983 Wis. L. Rev. 513, 514-16 & 514 n.4 (listing disclosures of illegal political contributions, commercial bribery, huge financial frauds, large scale environmental abuses, and unsafe consumer products).

90 In many cases, business decisions that account for the interests of one or more of a corporation's other constituencies maximize the interests of the shareholders as well. Respecting obligations to creditors, for example, can establish a good credit reputation, which is normally in the best interests of equity holders. The hard cases, such as tender offer situations, arise when circumstances indicate that shareholders' interests conflict with those of the other constituencies.
ments and consumer protection laws, also enhances their bargaining power. Legal standards of corporate conduct imposed by courts and legislatures protect constituencies who are not connected to the corporation, but may be affected by its operations (those who breathe air affected by corporate emissions, for example). Within these constraints, managers are charged with pursuing shareholder interests.\footnote{The only modification of this principle allows managers to make limited donations of corporate resources for humanitarian, educational, or philanthropic purposes, without the need to demonstrate a direct benefit to the corporation. Theodora Holding Corp. v. Henderson, 257 A.2d 398, 405 (Del. Ch. 1969) (overall social benefits of gift outweigh small loss to immediate stockholder interests). See generally Garrett, \textit{Corporate Donations}, 22 Bus. Law. 297 (1967) (tracing evolution of legitimacy of corporate donations).}

But are tender offers a special case? Some respond that they are, and the \textit{Unocal} court seemingly endorsed their position.\footnote{In \textit{Unocal}, the Delaware Supreme Court, citing Lipton \& Brownstein, \textit{Takeover Responses and Directors' Responsibilities: An Update}, 40 Bus. Law. 1403 (1985), stated that target managers could consider "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)." 493 A.2d at 955. Some corporate charters and state statutes expressly sanction board consideration of employee, supplier, customer, and local community interests. A.B.A. Comm. on Corp. Laws, \textit{supra} note 33, at 218.}

Although the position has never been well developed, it provides self-interested target managers with an endless supply of excuses for blocking offers that are actually in their shareholders' best interests.

The position's most powerful form is that tender offers provide shareholders with an unusual opportunity to disadvantage other corporate constituencies because the shareholders are exiting the corporation en masse. Ordinarily, developing and maintaining positive relationships with the corporation's many constituencies serves the shareholders' interests. During a tender offer, however, tendering shareholders may seek to maximize their exit payout at the expense of these other constituencies.\footnote{There is evidence, for example, that bondholders suffer when bidders and targets incur new debt to finance or fend off takeovers. Farrell, \textit{Takeovers and Buyouts Clobber Blue-Chip Bondholders}, Bus. Wk., Nov. 11, 1985, at 113 (27% of Moody's 134 downgrades of corporate bonds in 1985 resulted from takeover activity); Prokesch, \textit{Merger Wave: How Stock and Bonds Fare}, N.Y. Times, Jan. 7, 1986, at 1, col. 1 ("[B]ondholders on both sides [of a takeover] are often big losers.".). Stockholders normally have no incentive to increase bondholders' risks; to do so would affect prices of future corporate bond issues. Exiting stockholders, on the other hand, care little about future bond issuances and therefore would probably be indifferent to an increase in bondholders' risks. Leveraged takeovers, for example, are usually financed by bank loans secured by target company assets, and by junk bonds payable by the target. The claim dilution created by the additional debt can severely reduce the old bonds' value. Prokesch, \textit{supra}, at D4, col. 2.} Shareholders will leap at a premium price and transfer control to a bidder even if they realize...
that the new owner will default on corporate obligations to non-shareholders.\textsuperscript{94} Accordingly, it is argued, target managers should be charged with protecting other constituencies' interests in tender offers, even at the risk of occasionally frustrating a majority of shareholders who wish to tender.\textsuperscript{95}

The above argument may accurately describe the motivations of exiting shareholders, but it ultimately breaks down. First, it incorrectly assumes that this exit motivation is unique to tender offers. Such exit strategy can also occur in a negotiated sale of control (consummated, for example, through a statutory merger), yet no one has seriously argued that managers of the acquired corporation should press creditors' interests over those of shareholders in the sale. Second, there is no reason to think that the new owners would be any more likely to abuse the corporation's nonshareholder constituencies than the exiting owners.\textsuperscript{96} Third, it is unrealistic to assume that even well-intentioned managers can choose properly whom to represent, and how vigorously to represent them. Predicting abuse by a bidder is problematic, and fashioning an appropriate response within the psychological turmoil of a hostile tender offer is even more so. Finally, the exercise of discretion by target managers contemporaneous with a tender offer may not be the best method of protecting these potentially disadvantaged constituencies. Non-shareholders typically have pre-established legal recourse once threatened injury becomes a reality; creditors, for example, can sue on the underlying debt contract.\textsuperscript{97} The creditors' ultimate protection is the lending price. Routine abuse at the hands of shareholders in the context of tender offers will tend to raise interest rates that corporations have to pay in order to sell their bonds and notes.\textsuperscript{98} Consequently, corporations will have an incentive to signal to bondholders, with adequate guarantees, that they will not disadvantage creditors in tender offers.

\textsuperscript{94} This argument, if valid, still does not support target manager intervention on behalf of nonshareholder constituencies unless a threat exists that the bidder will breach existing contractual or legal obligations. Even if a bidder threatens to close down the local factory and move the facilities to Korea, the economic impact on the community would not provide target managers with a justification for defending the offer at shareholder expense.


\textsuperscript{96} Indeed, the new owners, to preserve the company's value, may have an incentive to monitor the selling owners' exit behavior.

\textsuperscript{97} One commentator argues, however, that indenture covenants currently do not provide sufficient protection to bondholders. Directors, therefore, should have a duty to protect bondholders as well as shareholders. McDaniel, Bondholders and Corporate Governance, 41 Bus. Law. 413 (1986).

\textsuperscript{98} See Prokesch, supra note 93, at D4, col. 2.
TENDER OFFER DEFENSES

The pigeons came home to roost in Revlon. In defense to a hostile tender offer, the Revlon board executed a self-tender offer, exchanging senior subordinated notes and preferred stock for common stock. The newly issued notes contained covenants limiting Revlon's ability to incur additional debt, sell assets, or pay dividends. This exchange offer served to concentrate stock ownership in friendly hands and the note covenants made the company very unattractive to potential purchasers. The existing board, however, could waive the note covenants in order to sell the company. An auction developed between two bidders and the Revlon board announced that it would waive the covenants, causing a dramatic drop in the value of the notes. The directors ended the auction by favoring one bidder with a lock-up option on one of Revlon's choice assets. In the ensuing suit by the spurned bidder, the Revlon board, citing Unocal, justified its actions by pointing out that the favored bidder promised to protect the injured noteholders.

Three factors make the case particularly intriguing. First, the board that cited concern for noteholders to justify its choice of suitors had itself depressed the value of existing bonds when it created the new class of subordinated notes. If the board acted reasonably in protecting new noteholders, then did it not act unreasonably in failing to protect the old bondholders? Second, the complaining new noteholders were originally shareholders that had responded to a board request and recommendation to exchange stock for notes, and were burned by the board as a result. Thus, the complaining noteholders had become noteholders precisely because they obediently complied with the board's recommendation at a time when the board was subject to a direct fiduciary obligation to them. Third, the Revlon facts provide a paradigmatic opportunity for exit strategy, a one-time raid on both the new noteholders (old shareholders) and old bondholders that would have no adverse effect on the company's financial reputation because new management would control the company. Thus, the case's facts provided the court with the strongest possible case for requiring that the board protect old and new noteholders from exit behavior that would reward remaining shareholders.

100 Eighty-seven percent of the shareholders accepted the offer. Id. at 177.
101 Id.
102 Angry noteholders, who immediately lost close to 13% of the value of their notes, deluged the directors with irate phone calls. Id. at 178.
103 Id.
104 Id. at 182.
105 The favored bidder agreed to support the par value of the outstanding notes by an exchange of new notes that would presumably trade at par value once the offer was consummated. Id. at 178-79.
The Delaware Supreme Court instead did an about-face. Rather than respect the Revlon board's efforts to balance noteholder and shareholder interests, the court held that the board erred even to consider the noteholders; the board's role was to get its shareholders the best price. The court modified its Unocal position by adding the caveat that a board may consider various nonshareholder constituencies "provided there are rationally related benefits accruing to the stockholders."106 Because the board adhered to the specific terms of the note covenant, it did not breach any duty of good faith to the noteholders.107 The court had, in essence, returned to the traditional rule: The shareholders' interests are primary, and the board may consider other constituencies' interests only when they comport with those of the shareholders.

2. Discrimination Among Shareholders: The Bidder Versus All Other Shareholders or Arbs Versus Long-Term Shareholders

Having decided which interests target managers may consider in responding to a tender offer, one must now decide whether target managers may discriminate among their own shareholders. Often, the bidder, prior to mounting a tender offer, buys a toehold or beach head in the target through the market. Once a bidder surfaces, speculators trade heavily in the suspected target's stock, hoping to turn a quick profit if an acquisition is consummated. May target managers devise defenses involving stock rights that discriminate against the stock held by either bidders or speculators?

In Unocal, the Delaware Supreme Court held that a corporation's repurchase offer in competition with a hostile tender offer could exclude the bidder's shares.108 The court also implied that the board could subordinate the interests of speculators to those of

106 Id. at 182-83. This caveat admits of two interpretations. The first is that target managers must pay primary attention to maximizing share price in an auction; only in single bidder situations may managers consider nonshareholder interests. More broadly interpreted, this language suggests that the Unocal standard was too broad, and that target managers are responsible in all cases for maximizing share price; nonshareholder interests merit consideration only when their satisfaction would have a positive effect on share price.

107 Id. The case's true irony is that any suit by noteholders will probably allege that the Revlon board violated its duties to the tendering shareholders by misrepresenting the notes' value in its exchange offer. If the plaintiffs succeed, the corporation will have to pay (either directly or, through indemnification of its directors, indirectly), and the company's value to the new owners will drop. It makes sense therefore for the new owners to negotiate a sale that, in essence, settles the lawsuit. Consequently, the lawsuit's settlement value is a factor when considering two outstanding bids. The court's language on the illegitimacy of the board and favored bidder's deal on the noteholders' claims therefore seems somewhat overstated.

108 Unocal, 493 A.2d at 958-59.
"longer-term" shareholders.\textsuperscript{109} The court's approval of the exclusionary exchange offer (known as "reverse greenmail") provoked substantial criticism, and the SEC promulgated a rule that effectively overrules this case. This new rule, which became effective July 17, 1986, requires that all tender offers be open to all holders of a particular class of securities, and requires that the consideration paid to any security holder equal the highest consideration paid to any other security holder during the tender offer.\textsuperscript{110} The court's comment on the position of speculators, on the other hand, has received little attention.

Most criticism of exclusionary exchange offers derives from the belief that all shareholders in a single class merit equal treatment, regardless of whether the particular discrimination in issue ultimately serves the target shareholders' interests.\textsuperscript{111} The new SEC rule seems to vindicate this view, but perhaps too unequivocally. The rule may also signal an attack on discriminatory poison pill plans\textsuperscript{112} and selective stock repurchases (greenmail). Yet, both rights plans and the threat of an exclusionary self-tender can often serve shareholder interests. Both consolidate shareholder bargaining power in the target board when necessary to respond effectively to a tender offer. Greenmail can also serve a legitimate function by allowing target managers to buy off unwanted suitors and stimulate higher subsequent offers.\textsuperscript{113}

This is not to say that the \textit{Unocal} court's arguments in favor of discrimination are completely correct. The court's comment that target managers can favor long-term shareholders over "speculative" shareholders\textsuperscript{114} is aimed at the "arbs," and has no merit. The arbs, or arbitrageurs, buy shares in potential takeover targets solely to profit from the takeover premium—they buy to sell. Target managers view them with considerable disdain because such purchases

\textsuperscript{109} Id. at 955-56.
\textsuperscript{111} The principle of shareholder equality creates as many questions as it answers. Some acts that are ostensibly equal, such as the decision to pay a dividend, may affect shareholders in different tax brackets unequally. High bracket taxpayers could be outvoted by low bracket taxpayers in the decision to declare a dividend. Would equalizing net after-tax gains (by paying dividends that vary with the tax rates of the recipients) be a more equal treatment of shareholders? Moreover, other acts with unequal effects, such as selective offerings of newly issued stock, do not violate the rule. The legality of these acts is not established by the concept of equality, but by the concepts that define the legitimate exercise of controlling power in the corporate form. \textit{See generally} Westen, \textit{The Empty Idea of Equality}, 95 HARV. L. REV. 537 (1982).
\textsuperscript{112} For a discussion of discriminatory poison pill plans, see \textit{supra} note 58.
\textsuperscript{113} \textit{See} Macey & McChesney, \textit{supra} note 69, at 26 ("ability to pay greenmail thus increases the probability of a takeover attempt occurring").
\textsuperscript{114} \textit{Unocal}, 493 A.2d at 955-56.
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contribute to the upward pressure on the stock price, increasing the pressure on managers to agree to sell the company. Managers blocking an offer risk a precipitous decline in stock price as the arbs cash out, and this decline fuels shareholder litigation. The managers must then explain in court why their acts were appropriate in spite of the foreseeable and severe stock decline. Managers, therefore, often deem arbs second-class stockholders with no real long-term interest in the company, and argue that arb losses are relatively unimportant. The Delaware Supreme Court, in dicta, seemed to favor the argument.

The court’s dicta flies in the face of efficient market theory, which ignores any distinction between long-term and short-term interests. The trading activity of the arbs, and of any other shareholders, accurately values the shares consistent with all relevant public information. Indeed, such activity should theoretically aid target managers when they decide how best to respond to a tender offer. If, for example, the market price of a target’s shares jumps to a level exceeding the likely blended premium of a pending partial tender offer, then it is likely that the bidder has made too low an offer, or that another higher bidder waits in the wings.

B. When Should Target Managers Block a Bid?

The question of when target managers should block a bid may arise in two different contexts, and hence may be rephrased as two separate questions: First, when should target managers block a bidder so that the target survives with no major control changes? Second, when should target managers block one bidder so that another can succeed? Of course, the conclusions of the previous discussion about whom managers represent have significant bearing on these two questions. If, as the Delaware Supreme Court noted in Unocal, target managers may protect the interests of employees, localities, or “long-term investors,” then target managers have unlimited justifications for blocking bids. If, on the other hand, target managers may protect only shareholders, then management power is much more limited.

1. The Target Remains Independent

The negotiation model posits that target managers may unilaterally block a tender offer only if they possess confidential information, the value of which would disappear if revealed to shareholders, or if target managers made a reasonable but unsuccessful attempt to

115 Id.
116 Id.
squeezed out a higher bid. Delaware Supreme Court opinions are light years away from the model. Even if one assumes the primary importance of shareholder interests, the court gives the target board significant discretion in blocking a bid.

In Unocal, for example, the board listened to the advice of two investment houses and determined after a nine-and-one-half-hour meeting that a bid at a substantial premium over the market price was "grossly inadequate."117 The advisers presented the board with two arguments: First, the company's liquidation value exceeded both the market value of its stock and the value of the bid, and, second, similar recent acquisitions in the oil and gas industry had generated higher target prices.118 The first claim is at best simply inaccurate, ignoring that the current market value of a company's stock partly reflects its liquidation value. At worst, it indicates that the existing managers are breaching their fiduciary duty to their shareholders by not liquidating the undervalued company. The second claim, if true, is indirect evidence that other bidders may pay more, but without more specific information that other bidders will appear in the near future, such evidence is insufficient to justify completely blocking an existing offer. Target managers can usually find such accommodating advice, and they are quite willing to pay for it.119

The following Delaware Supreme Court case involving a successful defense to a threatened tender offer is Polk v. Good.120 In Polk, Texaco's directors thwarted a threatened tender offer by the Bass brothers by repurchasing the Bass's holdings at a slight pre-

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117 Id. at 950. Five days after the tender offer commenced, the Unocal board convened to consider the bidder's price of $54 per share. Peter Sachs (on behalf of Goldman Sachs & Co.) advised the board that the minimum cash value realizable upon an orderly liquidation of all of the company's assets would exceed $60 per share. Unocal stock traded for $49.75 the day before the offer began. Id.

118 Id.

119 See, e.g., Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250 (7th Cir.) (target board's reliance on financial adviser's advice disallowed where adviser would lose $75,000 bonus if it advised board that offer was fair, and offeror displaced existing board as a result), prob. juris. noted, 107 S. Ct. 258 (1986). As if open-ended reliance on friendly investment advisers was not enough, the Unocal court also dropped a gratuitous footnote approving a seriously flawed study by another firm. 493 A.2d at 956 n.11; see Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979). Lipton's study found that the stock of target companies that successfully defeat tender offers usually sells at prices higher than the tender offer price. This study stands alone in its conclusions; all serious study by academics is to the contrary. See, e.g., Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers, 11 J. Fin. Econ. 183, 189-98 (1983) (if target management defeats tender offer and no subsequent offer arises within two years, stock price, after temporary up-surge in price around announcement of tender offer, returns to pre-offer level within two years).

120 507 A.2d 531 (Del. 1986).
mium over the market price. Texaco paid half in cash, and the other half in voting preferred stock, which the Bass brothers agreed to vote in proportions matching the votes cast by all other Texaco common shareholders. The ensuing derivative suit was settled for attorney fees (which were substantial) and legal expenses, largely because any further prosecution would have been futile. The court affirmed the chancellor's approval of the settlement terms and found that the Texaco board was likely to survive any challenge under Unocal's modified business judgment rule. The court noted that ten of the thirteen directors to approve the repurchase were independent, outside directors, and that the Bass brothers posed an "immediate disruptive effect" and a "potential long-term threat" to Texaco and its shareholders.

The "immediate effect" to which the court alluded was the threat to Texaco's ongoing attempt to buy Getty Oil. Rumors in the financial press tied the Bass brothers to Pennzoil, Texaco's main rival in the Getty Oil acquisition, and hinted that the Bass brothers, if they acquired a controlling position in Texaco, would act to divest Getty. The court found that the Texaco board believed itself "vulnerable in warding off a hostile shareholder group whose actions might be contrary to the best interests of a majority of the company's stockholders." The court never explained what it saw as a "potential long-term threat."

It is hard to imagine weaker reasons for paying greenmail. First, the court was content to let the Texaco board justify its position by reference to unsubstantiated "rumors." Second, the Bass brothers' willingness to pay a premium for Texaco shares in order to divest Getty Oil from Texaco may have indicated that the Getty Oil acquisition was against the best interests of Texaco shareholders, not the reverse. Finally, the payment of greenmail is best justified either by the existence of valuable inside information or by an attempt to stall one bidder in an effort to attract other higher bidders. Texaco offered neither justification.

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121 Id. at 534.
122 Id. at 535.
123 When the suit was initially brought, the Bass brothers had agreed to vote their preferred stock according to the directions of the Texaco board. Once this agreement had been modified into the one noted in the text, the plaintiffs' lawyer concluded that additional relief was unlikely. The settlement payment for attorney fees was a whopping $700,000. Id.
124 Id. at 537.
125 Id.
127 Polk, 507 A.2d at 533-34.
128 The argument that the pending Getty Oil acquisition created significant inside information was apparently not made.
Polk was a disappointment because it followed on the heels of a more promising case, Moran v. Household International, Inc. In Moran, the court considered the merits of a stock purchase rights plan adopted by the Household board to prepare for future tender offers. Either the announcement of a tender offer for thirty percent of the company's shares or the acquisition (either through private or open market purchases) of a twenty-percent block of stock triggered the rights. Household could redeem the rights for fifty cents a share if vested by a tender offer, but not if vested by open market purchases.

A negotiation model characterizes the tender offer portion of the rights plan as a mechanism that empowers target managers to bargain on behalf of shareholders during tender offers, particularly partial tender offers. Thus the tender offer portion of such a plan is not necessarily illegitimate, and evaluation of the conduct of target managers must be postponed until an actual tender offer. The

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129 500 A.2d 1346 (Del. 1985).
130 Id. at 1348.
131 Id. at 1349.
132 Oesterle, supra note 9, at 67-68. The portion of the plan relating to private and open market purchases, however, is more difficult to justify. The language in Moran implies that the target board cannot withdraw or otherwise redeem the rights to facilitate an open market purchase of 20% or more of the stock even if the board determines that such acquisitions are in the company's best interests. 500 A.2d at 1349, 1354. In essence, the provision forces even friendly suitors to employ statutory merger or asset sale forms of acquisition. Whether poison pills should affect privately negotiated acquisitions is a complex and troublesome question. On the one hand, because normal open market purchases do not carry the same potential for shareholder coercion as partial tender offers, see supra notes 42-47 and accompanying text, such a provision may concentrate unnecessary power in the board.

In most cases the bidder does not inform market participants that they had better sell or suffer the back-end price. Indeed, an acquiror is motivated to keep the subject of an acquisition quiet as long as possible. On the other hand, an adroit bidder could choose to disclose its intent to buy control, structuring the offer to pay a premium to a limited number of shareholders on a first-come, first-serve basis. See Wellman v. Dickenson, 475 F. Supp. 783 (S.D.N.Y. 1979) (private offers to several potential purchasers with one-hour deadline and threats of "fleeting" premium), aff'd, 682 F.2d 355 (2d Cir. 1982), cert. denied, 460 U.S. 1069 (1983). The threat mirrors the threat implicit in a traditional tender offer, those who do not sell are threatened with a lower back-end price. To the extent that these kinds of privately negotiated or open market purchases are not classified as tender offers, a matter much in dispute, a poison pill plan legitimately could provide a vehicle for target shareholder collusion in response. Because most market acquisition "triggers" are broadly drafted to include all market purchases, even those without any coercive incentives to sell, the triggers are overbroad. See Andé, Unconventional Offers Under the Williams Act: The Case for Judicial Restraint, 11 J. CORP. L. 499 (1986). The Williams Act protects those responding to a tender offer that has mandated disclosure and rules for equal treatment (particularly the pro rata rule on oversubscriptions). These protections do not exist for those selling in privately negotiated or open market transactions. Arguably a poison pill plan triggered by private acquisitions may empower target managers to provide target shareholders some protection in private or open market acquisitions that approximates that provided by the Williams Act.

133 Dynamics Corp. of Am. v. CTS Corp., 637 F. Supp. 406 (N.D. Ill.) (interpreting
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Moran court seemed to agree with this view:

While we conclude for present purposes that the Household Directors are protected by the business judgment rule, that does not end the matter. The ultimate response to an actual takeover bid must be judged by the Directors’ actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders.134

In Polk, however, the court had an opportunity to evaluate target managers’ response to a specific tender offer threat, and under the Unocal standard, found no impropriety. Polk effectively closed the door left open by Moran, and simply returned to Unocal’s basic message: In single bidder cases, target managers have significant leeway.135

The Revlon case, the last case of the period (other aspects of Delaware law), aff’d, 794 F.2d 250 (7th Cir.), prob. juris. noted, 107 S. Ct. 258 (1986), is an example of a court evaluating the use of a poison pill plan. See supra text accompanying notes 77-83.

134 Moran, 500 A.2d at 1357 (citations omitted).

135 A recent and similarly troublesome case is Turner Broadcasting Sys. v. CBS, 627 F. Supp. 901 (N.D. Ga. 1985). In Turner, CBS made an exchange offer of notes for common stock as part of its defense to a tender offer by Turner. The notes contained restrictive covenants that prohibited CBS from incurring any additional debt or from selling any major assets without the approval of a majority of its “independent” directors, a carefully defined group of nonemployee directors with the core on its current board. Id. at 904. The note covenants would seriously jeopardize Turner’s junk-bond financing unless they were waived. Although there was no opprobrium in creating the covenants, the board’s subsequent refusal to honor Turner’s request and waive the covenants deserved closer scrutiny. The board’s refusal to waive the covenants did not constitute a gamble that could have induced Turner or another bidder to pay more, but was an absolute defense to the Turner offer. The board relied on the opinion of an investment house (the same adviser that had earlier proposed CBS’s recapitalization scheme to “mak[e] it less attractive as a takeover prospect,” id. at 905) that the Turner/CBS merger would create a failing enterprise: The new entity, said the advisers, would carry too much debt for its income flow; the new notes that existing CBS shareholders would receive in exchange for their stock would trade at well below face value; and numerous affiliates would disassociate themselves from the new enterprise. Id. at 904.

Turner’s tender offer was not partial, but was an any-or-all offer carrying a minimum requirement. Thus the coercive aspect of a true partial tender offer was largely absent. Moreover, the CBS board could have easily disseminated to its shareholders the information on the potential unattractiveness of the new notes. The opinion therefore offers no reason why the CBS shareholders could not have decided the offer’s merits for themselves. The court, however, relied heavily on the traditional business judgment rule, and denied Turner’s request for a preliminary injunction. Id. at 908-10.

The only significant case to hold against target managers in their total defense against a single bidder is Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255 (2d Cir. 1984) (interpreting New York law). The target board created an Employee Stock Option Plan and Trust and funded it with target stock at no cost to employees, making it more difficult for a hostile bidder to obtain control. The court held that the target managers breached their fiduciary duty by establishing the plan “solely as a tool of management self-perpetuation.” Id. at 266.

which will be discussed in detail below\textsuperscript{137}), illustrates a target board's legitimate decision to delay an existing tender offer. During the offer, the board learned from an investment house that the bidder could turn a profit of from fifteen to twenty-five dollars per share if it acquired the target at the existing price and broke it up.\textsuperscript{138} In other words, there was substantial give in the bidder's price. The target created a note purchase rights plan and executed a defensive share repurchase program (exchanging stock for notes and preferred stock) to stall the sale. These tactics drove the bidder's price up by over ten dollars per share before a competing bidder entered the contest and drove the price up even further.\textsuperscript{139} In the end neither tactic stood in the way of the ultimate acquisition.

The Delaware Supreme Court may soon have an opportunity to consider another case involving a complete defense. In \textit{AC Acquisitions Corp. v. Anderson, Clayton \& Co.},\textsuperscript{140} decided in the Court of Chancery, the target used a front-end loaded self-tender offer to block a nonfront-end loaded two-tier tender offer. The outside bidder offered $56 per share for fifty-one percent of the outstanding shares, promising to pay the same price in a close-out merger.\textsuperscript{141} The target managers countered with an offer to buy sixty-five percent of the outstanding shares for $60 per share.\textsuperscript{142} The parties disagreed over the back-end value of the remaining stock after a successful self-tender offer; estimates ranged from $22 to $52.\textsuperscript{143}

The court enjoined the self-tender offer, which it labeled "coercive," after reasoning that it gave shareholders no choice but to reject the outside bid.\textsuperscript{144} The target board, under the pretext of providing shareholders with a choice, had erected a complete block to the outside bidder. The court noted correctly that the front-end loaded self-tender offer provided no choice at all, and struck it down. Could the target board have saved the plan by arguing that it improved the position of target shareholders? The board claimed that the self-tender offer gave shareholders a substantial cash distribution at capital gains rates and permitted a continuing equity participation in the growth of a better leveraged company. These benefits, the board argued, made the plan equivalent in value to the

\textsuperscript{137} See infra notes 155-71 and accompanying text.  
\textsuperscript{138} Revlon, 506 A.2d at 177.  
\textsuperscript{139} Id. at 177-78. After Revlon's note purchase rights plan and defensive share repurchase program failed to discourage Pantry Pride (the first bidder), Revlon management solicited a friendly bid from Forstmann Little & Co. After Forstmann entered the auction, the high bid rose by another four dollars. Id. at 178.  
\textsuperscript{141} Id. at 94,597-98.  
\textsuperscript{142} Id. at 94,599.  
\textsuperscript{143} Id. at 94,601.  
\textsuperscript{144} Id. at 94,601-02.
outside offer.\textsuperscript{145} The board's claims are dubious; modern finance theory suggests that recapitalization rarely creates value.\textsuperscript{146} The court was also suspicious; it noted that the board had considered a similar program of recapitalization earlier in the year, valuing the program at between $43 and $47 per share.\textsuperscript{147}

On the other hand, the target board could have argued, as it did not, that the self-tender offer represented a negotiating tactic intended to coax a higher bid from the outsider. Indeed, the board, after rejecting the $56 offer, agreed to provide the bidder with non-public information,\textsuperscript{148} and representatives of both parties met in further unsuccessful efforts to discuss a purchase price.\textsuperscript{149} If the board intended the block as a negotiating ploy, then the court should have required that the board justify the ploy as reasonable under the circumstances. Because the outside bid was not front-end loaded, however, there was no demonstrated disadvantage in allowing shareholders to decide for themselves whether to tender. Recognizing this, the court suggested that the board should have delayed the self-tender offer until the shareholders had a chance to accept the outside bid.\textsuperscript{150} The board could have disseminated any information pertaining to the appropriateness of the price. Absent a demonstration that shareholders could not decide autonomously to accept the offer, the injunction was proper.

2. The Target Favors One Bidder over Another

When more than one bidder is involved, the negotiation model suggests that the target may temporarily block one bidder to encourage others\textsuperscript{151} or may neutralize the advantage that a partial tender offer has over an any-or-all offer.\textsuperscript{152} The target, however, rarely should completely paralyze one of the participants, because this could short circuit the escalation of competing bids.\textsuperscript{153} One could also argue that target managers should intervene when they

\textsuperscript{145} Id. at 94,595, 94,601.

\textsuperscript{146} E.g., W. Klein & J. Coffee, Business Organization and Finance 272-95 (2d ed. 1986).

\textsuperscript{147} AC Acquisitions, [Current] Fed. Sec. L. Rep. at 94,596.

\textsuperscript{148} Id. at 94,598.

\textsuperscript{149} Id. at 94,599.

\textsuperscript{150} Id. at 94,602.

\textsuperscript{151} Earlier I concluded that defenses are "legitimate only if, first, they disadvantage all existing bidders to give target managers time to find other bidders, and second, they are reversible so that once an auction is established, the bidding is unaffected by the tactic." Oesterle, supra note 9, at 93.

\textsuperscript{152} Indeed, the coercive effect of partial or two-tiered tender offers is the most compelling justification for the role of target manager as negotiator. See id. at 56-63; supra notes 42-49 and accompanying text.

\textsuperscript{153} When the target permanently disables one of the bidders, there is a risk that management has acted in its own self-interest. See Oesterle, supra note 9, at 92.
are convinced that one bidder's promises have exceeded its financial resources. A simple disclosure by the target to its shareholders of the financial inadequacies of one of the participants should usually provide the necessary protection. The only likely case in which a target board should terminate bidding arises when the target board is convinced that normal bidding is over and that only a lock-up option, for example, can elicit any higher bid. Surprisingly, in *Revlon* the Delaware Supreme Court seems to have accepted the negotiation model on this point, for it rejected Revlon management's attempts to intervene in the bidding process.

In *Revlon* the court demonstrated that the modified business judgment rule first announced in *Unocal* had teeth. Revlon found itself the subject of a bidding war between Pantry Pride and Forstmann. Pantry Pride boldly announced that it would top any Forstmann offer. Forstmann approached the Revlon board with an offer exceeding Pantry Pride's. But Forstmann's offer included a contingency; Forstmann demanded both a lock-up option on some of Revlon's prime assets and a no-shop clause. Under the option, if Forstmann acquired over forty percent of Revlon's shares, Forstmann had the right to purchase over $700 million of Revlon assets for $525 million. The no-shop clause effectively prohibited the Revlon board from negotiating with anyone other than Forstmann, because Pantry Pride could not afford to pay a premium price only to suffer a bargain sale. The Revlon board granted both of Forstmann's requests and thus ended the contest.

The court enjoined the lock-up option and the no-shop clause, finding that they were "measures which end[ed] an active auction and foreclose[d] further bidding . . . to the shareholders' detriment." Thus the case, in spirit, adopts the negotiation model for auction contests. Ironically, *Revlon* may be the rare case in which a lock-up is a rational gamble for the target managers. Pantry Pride was publicly committed to beat by a hair any additional Forst-

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154 Thus, target managers who block one bidder on the grounds that the bidder is financially unstable should be required to show that public disclosure of this opinion was not a sufficient cure.

155 The Delaware Supreme Court's reversal was influenced heavily by the Second Circuit opinion in *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264 (2d Cir. 1986) (interpreting New York law). In *Hanson*, the Second Circuit granted a preliminary injunction against a lock-up option on substantial target company assets, holding that the plaintiffs showed a likelihood of proving that the target board had breached its duty of care both by underpricing the option and by using it to foreclose additional bidding. *Id.* at 275, 282-83.

156 For a more detailed recounting of the facts, see *Revlon*, 506 A.2d at 176-79.

157 *Id.* at 183.

158 In fairness to the court, however, the numerous less meritorious arguments urged by the defendant's lawyers may have obscured the true nature of the bargaining gamble.
mann offer, and Forstmann looked to have one last, slightly sweeter offer to make. Why make the offer if Pantry Pride will beat it? If Forstmann never makes its last offer, then Pantry Pride need not increase its pending offer to win the contest. One could thus argue that a potentially higher price is lost unless the Revlon board intervenes and encourages Forstmann to make its final offer.

This argument has two problems. First, the Revlon board must be convinced both that Forstmann has just one more bid and that Forstmann will not make it without encouragement. If Forstmann can run an effective bluff, the Revlon shareholders lose. Target managers might well make more incorrect than correct decisions in such situations. Second, why should Forstmann need encouragement to make its final offer? Even if Revlon provides no guarantees, Forstmann, already outbid, loses nothing by being outbid at its final position; there is also the chance that Pantry Pride is bluffing and that it could not top Forstmann’s last bid. Thus, Forstmann has nothing to lose, and might have something to gain, by making its last bid, even without encouragement from Revlon.

The Delaware court noted that lock-up options and no-shop clauses may be more justified when used to encourage a bidder to enter an auction than when used to terminate an auction. The court has a point. The risk that a potential bidder will choose not to enter the bidding absent encouragement is greater than the risk that an existing bidder will not increase its offer, because the potential entrant may not have incurred the substantial preparatory costs required to make a sound financial decision; an existing bidder, however, has already incurred these costs. A lock-up option could persuade the potential bidder to incur these preparatory costs. Nevertheless the use of lock-ups to encourage entry (and final) bids is problematic. Once a bidder is successfully wooed with lock-up options, the bidding ends. The target must be convinced not only that the favored potential entrant will not enter the bidding without encouragement, but that no other bidder will appear as well. Perhaps potential bidders may too often falsely play the reluctant bidder to gain a clear advantage through a lock-up. In addition, a potential bidder incurs expense by acquiring the information necessary to solicit a lock-up option. No target will grant the lock-up without assurance on price, and the potential entrant must incur significant costs just to calculate that price. Finally, targets have better means to en-

159 Such options might entice other bidders to enter a control contest, creating an auction for the company and maximizing shareholder profit. Because of current economic conditions in the takeover market, a “white knight” like Forstmann might only enter the bidding if it receives some form of compensation to cover the risks and costs involved.
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courage potential entrants. For example, a target could agree to guarantee a potential entrant a minimum profit even if it loses the bidding war. Such a guarantee could take the form of a "leg-up" agreement, in which the target agrees to sell the potential entrant a block of stock at or slightly below market price, conditioned on the entrant making a set tender offer. If the entrant loses the subsequent bidding contest, it cashes in its target stock at a profit, thereby offsetting preparatory costs.

The Revlon court also addressed the legality of Revlon's note purchase rights plan. Revlon adopted a variant of the common share purchase rights plan, substituting contingent rights to buy notes for contingent rights to buy stock. The board could redeem the rights prior to vesting for a nominal amount. Both bidders recognized that, for their offers to succeed, Revlon would have to redeem these rights. Thus, the board could have blocked either offer by agreeing to redeem the rights for only one of the bidders. The board claimed instead that it would redeem the rights for any bidder that made an offer of over $56 per share. Thus, the board, while using the threat of not redeeming the rights to escalate the bidding, did not favor one bidder over another.

The court held that the plan itself was reasonably created and that the board used the plan in the best interests of the Revlon shareholders.

Although approaching the negotiation model, the Revlon case falls short in two ways. The first is a serious limitation in theory; the second is a political weakness that the Delaware legislature has exploited. The major theoretical shortcoming of the Revlon case derives from its suggestion that Unocal survives largely intact. The Revlon court carefully limited its analysis to auctions and other situations in which target managers recognize the inevitability of the company's sale. In single bidder cases, target managers can apparently still summon a variety of arguments to justify a decision to "maintain the corporate enterprise," including the claim that the "intrinsic value" of a company's stock exceeds a forty-percent pre-

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160 This matched Forstmann's bid at the time. Later, the board apparently upped the lower limit to $57.25 per share. Id. at 181.
161 The court noted that "[f]ar from being a 'show-stopper,' as the plaintiffs had contended in Moran, the [rights] measure spurred the bidding to new heights, a proper result of its implementation. See Moran, 500 A.2d at 1354, 1356-67." Revlon, 506 A.2d at 181.
162 Id.
163 Id. at 180-81.
164 The court stated, "The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the Unocal standards." Id. at 182.
165 Id.
mium over its market price. The court also may have retained *Unocal*'s broader list of justifications because of its disdain for “bust-up” takeovers.

*Revlon*'s second shortcoming is more political than doctrinal. The Delaware Supreme Court, following the lead of the Second Circuit, appears to hold that the *Revlon* board violated the duty of care, not the duty of loyalty, to shareholders when it agreed to the lock-up option and the no-shop clause. Yet the holding is incongruous; the court tightened its duty of care standard precisely because of the threat of duty of loyalty violations. The state legislature responded by passing a bill allowing Delaware corporations to eliminate the financial liability of their directors for duty of care cases. The new bill will apparently reach allegations of the *Revlon* type. Had *Revlon* rested on duty of loyalty grounds, the new

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166 See *supra* notes 33-39 and accompanying text.
167 The court noted that once the sale of the company is certain, the directors' role changes from that of chivalric “defenders of the corporate bastion” to that of “auctioneers.” *Revlon*, 506 A.2d at 182.
168 If a company is worth more sold in pieces than it is as a whole, then the board ought to break it up; tender offerors therefore provide a service when they break up a company that its prior managers stubbornly refused to liquidate. But the court apparently views “bust-up” takeovers as somehow sleazy, akin to automobile stripping by car thieves. The big difference between automobile stripping and “bust-up” takeovers, of course, is that tender offerors do not steal their subjects. They are gambling that the break-up process, with its transactions costs, will exceed the price they paid for the stock.
169 The opinion’s language, although ambiguous, seems to apply the duty of care standard: “No such defensive measure can be sustained when it represents a breach of the directors’ fundamental duty of care. In that context the board’s action is not entitled to the deference accorded it by the business judgment rule.” *Revlon*, 506 A.2d at 185 (citation omitted).
170 See *Bennett v. Propp*, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (Del. 1962) (“[T]he purchase of shares with corporate funds . . . when a threat to control is involved [is inherently dangerous]. The directors are of necessity confronted with a conflict of interest . . . . Hence, . . . the burden should be on the directors to justify such a purchase as one primarily in the corporate interest.”).

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders . . . .

The bill may lead to a similar statute that allows corporations to limit such liability for themselves as well. Some of the literature supports this approach. See Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983). Scott suggests that the duty of care lawsuit is of “minor importance” because “successful actions are exceedingly rare, and substantial recovery is still rarer.” *Id.* at 936 & n.36 (citing *Principles of Corporate Governance and Structure: Restatement and Recommendations* § 7.06(e)(i) (Tent. Draft No. 1, 1982)).
bill would not have applied. Passing a provision that would limit or 
eliminate corporate liability for duty of loyalty cases would prove 
politically very difficult, even in Delaware. It is difficult to under-
stand the court’s reluctance to ground its holdings on straight duty 
of loyalty investigations, and the Delaware legislature has exploited 
this reticence.

III
MATCHING DOCTRINE WITH THEORY: SHOULD POISON 
PILLS AND SHARK REPELLENT AMENDMENTS BE 
ILLEGAL?

The most important implication of the negotiation model is 
that courts should limit the scope of allowable defenses. Target 
boards can only justify a total seige defense by showing the exist-
ence of valuable confidential information, and can only justify a 
stalling defense by demonstrating that they reasonably believed that 
higher-paying bidders would soon appear.

I have already urged courts to impose stiffer burdens of proof 
upon target managers who employ defenses that are only infre-
quently justifiable. In time, experience will add to our under-
standing of which defenses fall into this category. At present, I favor 
including in this category any defenses erected by the target board 
that pose substantially permanent blocks to any bidder. Such de-
fenses include those that the board itself cannot easily remove later. 
If defenses conclusively block a sole bidder, or hinder one of two 
bidders in order to effect a sale to the other, then courts should limit 
the arguments advanced to justify board action and require that 
boards prove the need for such defenses by clear and convincing 
evidence. Thus, most poison pills and most shark repellent 
amendments that are absolute, giving no leeway for boards to re-
move them if a serious offer to buy the company arises, should fail.

Defenses intended to delay tender offers in order to coax a bet-
ter price from a bidder or to stimulate an auction should fare better. 
The erection of such defenses is not itself a problem, but target 
managers can misuse the defenses to secure or gain personal advan-
tages. Courts must therefore critically evaluate target boards’ use 
of powers from defensive plans.

One of the strongest residual criticisms against the use of any 
defensive tactics by target managers focuses on the complexities and 
external costs of the mechanisms required. Defensive tactics with

172 See Oesterle, supra note 9, at 83-95.
173 My earlier piece provided a more complete explication of this idea. Id. at 86-94.
174 See supra note 71 and accompanying text.
175 See Bebchuk, supra note 42.
significant external costs, such as filing lawsuits in as many different courts and on as many legal theories as possible,\textsuperscript{176} are cause for alarm. Defenses so complicated that their details cannot be understood by many shareholders are similarly troublesome. A particularly important factor that can get lost in the maze of legal documents is the ease with which target boards can remove any defense erected.\textsuperscript{177}

The overriding feature of most poison pill plans and many shark repellent amendments\textsuperscript{178} is that they create onerous contingencies that the target itself does not want triggered. This feature causes the difficult enforcement problems noted earlier,\textsuperscript{179} and these enforcement problems—not the discriminatory nature of the defenses or the lack of shareholder consent—provide the most powerful criticism against their use. Triggered plans with flip-overs, for example, present the court with the dilemma of either enforcing the plan and leaving a locked-up\textsuperscript{180} target or not enforcing the plan and encouraging other bidders to ignore similar plans. Suits on the eve of a triggering event force a court to evaluate whether the bargaining is over or just beginning in assessing the reasonableness of the target's continued resistance.

Discriminatory flip-in provisions alleviate one problem but create another. A discriminatory flip-in provision, once triggered, gives rightholders other than the triggering acquiror the right to buy stock in the target at an outrageously low price. Once the flip-in is triggered, the only injury is to the acquiror, because the other shareholders enjoy the gains of diluting the value of his stock in the target. No bidder would purposely trigger such a plan, hoping for court nullification. Yet the gain to the target from a triggered flip-in provision may be too tempting. Some target managers may be induced to forego bargaining for a good price in favor of holding out and trying to convince a court that a bidder has in fact triggered the flip-in. Moreover, flip-in plans do not relieve the court of evaluating

\textsuperscript{176} See Jarrell, supra note 27, at 174 ("The targets that defeat the takeover attempt by vigorous litigation lose the entire takeover premium.").

\textsuperscript{177} The initial defensive exchange offer by Unocal, which answered one front-end loaded partial tender offer by establishing a back-end loaded partial exchange offer, is a classic example of such convolution. \emph{Unocal}, 493 A.2d at 950-51. In essence, the Unocal board answered one prisoner's dilemma by creating another. Unocal offered an amount in excess of the tender offer price to all shareholders who had not tendered if the Mesa tender offer succeeded. The board thus encouraged Unocal shareholders not to tender to Mesa so as to get the higher back-end price, but if enough chose not to tender to Mesa, the Mesa offer failed and the shareholders lost both the front-end premium and the back-end premium. The Unocal board later removed the contingency. \emph{Id.} at 951.

\textsuperscript{178} Some fair price amendments are an exception.

\textsuperscript{179} See supra notes 60-66 and accompanying text.

\textsuperscript{180} When the flip-over rights vest, the target cannot merge with any other entity.
the quality of outstanding offers in suits prior to the triggering event.

In sum, the use of contingencies that are designed not to be triggered encourages strategic behavior by parties playing on judicial sensibilities. Whether judges can chart a sensible course in this maze is uncertain. A good deal of complexity and confusion could be avoided if shareholders were entitled unequivocally to do directly what they now must do indirectly. Shareholders should be able to vest in the hands of an identified agent the exclusive right to tender stock in the event of a tender offer for a specified percentage of the stock. The right not to tender even if the agent recommends it could remain with the shareholders; shareholders are bound only by the agent's decision that they should not tender. The agent would then have the power to negotiate for the best price. To eliminate the conflict of interest that now often obscures the judgment of target managers, the agent's compensation could be tied to the difference between the market price of the stock before a tender offer is publicly announced and the blended tender offer price if the company is sold or the stock price of the target if the company remains independent. Indeed, courts could and should evaluate the performance of the negotiating agent in this kind of system under the traditional robust version of the business judgment rule.

A step in this direction is the device, newly approved by the New York Stock Exchange and awaiting SEC approval, of creating two classes of voting stock. By placing the dominant class of voting stock in the hands of a selected group of insiders, a corporation can, in essence, empower a subgroup to act as negotiating agents for the remainder when confronted by an offer to purchase the company. The system has definite advantages over the poison pill plans and the shark repellent amendments in that there is no erection of onerous contingencies based on control changes, but it has its own disadvantages. The creation of two classes of voting stock not only affects takeover situations but normal firm operations as well. Those with concentrated voting power will also wield that power in normal elections of directors and votes of shareholder resolutions. The optimal system would empower bargaining agents for takeover contests and not create a spillover effect that rebalances voting power in nontakeover situations.

181 See Oesterle, supra note 9, at 67.