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TOWARD AN AUCTION MARKET FOR CORPORATE CONTROL AND THE DEMISE OF THE BUSINESS JUDGMENT RULE*

MARK J. LOEWENSTEIN**

I. INTRODUCTION

Nineteen eighty-nine marks the twenty-first year since the passage of the Williams Act, a federal statute designed to provide some regulation of tender offers.¹ While the Act has increased the amount of disclosure made in connection with tender offers and provided some regulation of the manner in which offers proceed, it said little about the legality of the responses of target management to unsolicited, or hostile, tender offers.² Rather, resolution of these problems was left largely to state law.

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1. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976). The Williams Act is the popular name of Pub. L. No. 90-439, 82 Stat. 454 (1968), originally entitled: Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids. The Act was passed in response to a growing number of tender offers and Congressional concern that the offers were lacking in disclosure or were otherwise unfair to target shareholders. See S. REP. NO. 550, 90th Cong., 2d Sess. 2-3, reprinted in 1968 U.S. CODE CONG. & ADMIN. NEWS 2811, 2812. The Act added a new section 13(d) to the Securities Exchange Act of 1934, requiring certain disclosures by persons who acquire more than 10% (later amended to 5%) of any registered equity security; a new section 14(d) requiring that certain disclosures be made in connection with a tender offer; a new section 13(e) relating to issuer tender offers; a new section 14(f) to require certain disclosures of specified changes in the board of directors of an acquired company; and a new section 14(e), a broad antifraud rule applicable to all tender offers.

2. A regulation adopted by the Securities and Exchange Commission under § 14(e), the antifraud provision, requires the target company to disclose to its shareholders whether it recommends acceptance or rejection of the tender offer, is remaining neutral with respect to the offer, or is unable to take a position on the offer, in each case with its reasons. 17 C.F.R. § 240.14e-2 (1988).

Litigation has been brought under § 14(e) alleging that defensive maneuvers, such as lock-up options, were manipulative and, therefore, violated the section. See, e.g., Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981), cert. denied, 455 U.S. 982 (1982). The U.S. Supreme Court rejected such arguments in Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985), holding that

This dichotomy, in which federal law regulates the offer and state law the substantive response by the target, has been responsible for the development of an odd jurisprudence in the state courts. Early cases gave a great deal of discretion to target management to defeat hostile tender offers, in contrast to federal law, which at least permitted tender offers. Applying the well-accepted "business judgment rule," the state courts generally held that target management could undertake a broad range of measures to ward off an unwanted suitor, so long as the target board of directors was not acting "solely or primarily" to perpetuate its control of the corporation.³ Actions so motivated meant that the board was acting in its own interest, not the shareholders', and, therefore, the business judgment rule would not apply. Directors of target companies seemed to have little trouble demonstrating that they were motivated, at least in part, by concerns other than retaining their positions.⁴ Thus, they were able to prevail in actions brought by hostile bidders seeking to enjoin the board's defensive actions⁵ and in suits by shareholders seeking damages for the lost opportunity to tender into attractive offers.⁶

The period of deference to target directors generated much thoughtful criticism from academia⁷ and eventually gave way to an era of judicial

"manipulation" requires a showing of misrepresentation or nondisclosure. See generally Loewenstein, *Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons*, 71 GEO. L.J. 1311 (1983) (arguing that Rule 10b-5 precedents should not set the bounds of a cause of action under Section 14(e)).

3. *E.g.*, *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980); *Northwest Indus. v. B.F. Goodrich Co.*, 301 F. Supp. 706 (N.D. Ill. 1969).

4. See Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901, 926 (1979) ("Regardless of the tactic employed, management can easily manufacture a 'legitimate' corporate purpose for its action, even when it employed the tactic solely to perpetuate its own status."). This position has been quoted in M. STEINBERG, *CORPORATE INTERNAL AFFAIRS* 238 (1983). But see *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984) (board unable to legitimate placement of stock in ESOP to defeat tender offer); *Royal Indus. v. Monogram Indus., Inc.*, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863 (C.D. Cal. 1976) (defensive acquisition preliminarily enjoined).

5. *E.g.*, *Treadway Cos.*, 638 F.2d at 357.

6. *E.g.*, *Panter*, 646 F.2d at 271.

7. A few writers, drawing on traditional tools of economic analysis, argued that target management should remain passive when faced with a tender offer, thereby minimizing the "cost" of takeover bids and maximizing shareholder wealth. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter *Proper Role*]; Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982). The thesis of these authors is that the rules governing target responses to tender offers should operate to maximize shareholder welfare. This occurs if target management takes a passive role when a tender offer is made because even if it could take action to increase the price paid to its shareholders, the shareholders as a whole would not benefit. It is important, the authors argue, not to discourage

skepticism and restrictions on that discretion. The genesis of this latter

hostile tender offers because "the number of offers affects the efficiency with which corporations are managed," and that benefits all shareholders. *Proper Role, supra*, at 1164. In this regard, the authors were building on the influential work of Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965), who argued that a potential change of control polices corporate managers. This view has received some judicial recognition. See *Edgar v. Mite Corp.*, 457 U.S. 624, 643 (1982) ("The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced [when a state official can block a tender offer]."); *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987) ("[Through tender offers] the market for corporate control will be kept fluid and corporate assets will be transferred, with a minimum of friction, to those who value them the most, as measured by the prices they offer.").

A second position is that after one bid has been made, target management should act in a way that encourages an auction for its shares. This approach, too, finds justification in economic analysis. See *Bebchuk, The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); *Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); *Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) [hereinafter *Structural Approach*]; *Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

Coffee argues persuasively that the Easterbrook & Fischel approach overstates the efficacy of the hostile tender offer as a means of corporate accountability and understates the other mechanisms that exist, such as the monitoring function of independent boards of directors and shareholder litigation, for encouraging efficient management. Coffee also analyzes the diseconomies that result from a high level of takeover activity, concluding that economic efficiency is best served by a policy that encourages a competitive auction market for corporate control.

It is not the purpose of this Article to revisit the economic analysis so ably undertaken by the scholars cited in this and the preceding footnotes. It is now well accepted that the tender offer plays an important role in the market for corporate control and that allowing management unfettered discretion to defeat hostile tender offers is both unwise as a matter of economic policy and increasingly unacceptable as a matter of state corporate law. *City Capital Assocs. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 799 (1988) ("To acknowledge that directors may employ . . . 'poison pills' to deprive shareholders of the ability effectively to choose to accept a noncoercive offer, after the board has had a reasonable opportunity to explore or create alternatives, or attempt to negotiate on the shareholders' behalf, would, it seems to me, be so inconsistent with widely shared notions of appropriate corporate governance as to threaten to diminish the legitimacy and authority of our corporation law."). At the same time, the original thesis of *Proper Role*, that management should remain passive in the face of a hostile tender offer, has gained no acceptance in the courts and appears very doubtful as a matter of economic policy.

A third school of thought would give target management considerable leeway in deciding how to respond to a hostile tender offer, based on various corporate law doctrines. The most prominent proponent of this position is Martin Lipton, who has argued the case for management autonomy in several articles. See *Lipton, Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); *Lipton, Takeover Bids in the Target's Boardroom; An Update After One Year*, 36 BUS. LAW. 1017 (1981); *Lipton, Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook & Fischel*, 55 N.Y.U. L. REV. 1231 (1980). See also *Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983); *Scherer, Takeovers: Present and Future Dangers*, BROOKINGS REV. (Winter-Spring 1986). Much of Lipton's argument proceeds from the premise that tender offers do not play a role in policing inefficient management and that target management is in a better position than shareholders to decide when and for how much the target should be sold. He also argues that the takeover phenomenon causes corporate management to focus on short term profitability and that the stock market does not efficiently or accurately reflect

era was the Delaware Supreme Court's 1985 decision in *Unocal Corp. v. Mesa Petroleum Co.*⁸ As a result of *Unocal*, the Delaware courts have moved toward, although not embraced, an "auction model" for corporate control: once a bona fide offer is made for a corporation, its directors should react in a way that maximizes the return to shareholders, generally through an auction for the corporation's shares. At the same time, the Delaware courts have clung, at least nominally, to the business judgment rule, as modified by *Unocal*, as the proper way to analyze defensive maneuvers. Because of the influence of Delaware law in this area, it is fair to say that the *Unocal* approach represents the trend for many states.⁹

As a result of *Unocal* and its progeny, it is federal law, not state law, that inhibits the auction model. This is true primarily because under the Williams Act, a tender offer need remain open only for 20 business days to comply with federal law, often too short a period of time for the target corporation to generate additional offers for its shares or otherwise formulate an alternative for its shareholders. Consequently, the Delaware courts have had to countenance defensive maneuvers that have the potential of discouraging all offers to assure the generation of the highest offer.¹⁰ This, in turn, mistreats the first bidder, who must litigate the target's defensive maneuvers against an uncertain case law.

This Article examines the transformation in the law of tender offers and the continuing utility of the business judgment rule as a doctrine to measure the appropriateness of defensive maneuvers. In brief, I conclude that the business judgment rule has been battered by the storm of tender offer litigation because it is ill-suited for the issues to which it has been applied. The rule focuses too heavily on the relationship between directors and their shareholders and too lightly on the relationship between the bidder and the target's shareholders. The bidder serves an important role in the market for corporate control and in providing shareholders

the economic prospects of the traded companies. The problem with Lipton's work, as Coffee has noted, is that it proceeds from largely impressionistic evidence and fails to articulate a coherent theory "that explains why greater reliance on the market for corporate control could be problematic." Coffee, *supra*, at 1154. See also *Structural Approach, supra*, at 848-65, for a careful analysis and effective refutation of the arguments in Lipton's articles, and the Separate Statement of Frank H. Easterbrook and Gregg A. Jarrell in Advisory Committee on Tender Offers, SEC, Report of Recommendations, 70-120 (1983), reprinted in Fed. Sec. L. Rep. No. 1028 (CCH extra ed. July 15, 1983) [hereinafter *Advisory Committee Report*] for a cogent statement of the economic justification for limiting the discretion of target management.

8. 493 A.2d 946 (Del. 1985).

9. See, e.g., *Dynamics Corp. of America v. CTS Corp.*, 635 F. Supp. 1174 (N.D. Ill. 1986) [hereinafter *Dynamics III*].

10. See *infra* notes 98-104 and accompanying text.

with opportunities to realize a profit on their investment.¹¹ The considerable expense involved in making a tender offer, together with the importance of maintaining an incentive to potential bidders, requires that the law recognize the interest of a tender offeror, as an offeror, and not just as another shareholder of the target.¹²

Such an approach would prohibit any action of target management undertaken after a bid is made, or in anticipation of a bid, that materially disadvantages the original bidder vis-à-vis other bidders, or has the effect of precluding the bidder from proceeding with its offer. The bidder would thus create a protectable economic expectancy as a result of a good faith offer for the securities of a target corporation. As a necessary corollary to this approach, the fiduciary duties of directors to their shareholders would be altered; no longer would directors be required, or indeed allowed, to "defend" against tender offers that they deemed to be "inadequate" or "injurious" to the corporation by implementing defenses that effectively preclude the shareholders from accepting the offer. To the contrary, their fiduciary duties would obligate them to allow shareholders to tender their shares to a bidder or, if the directors believe that a higher bid can be obtained, to help facilitate such a bid. Finally, I recommend that the Williams Act be amended to increase the minimum period that a tender offer must remain open to 60 calendar days.¹³ The effect of this change in federal law would be to enhance the auction process and remove many of the justifications for defensive maneuvers. It would also bring federal law into harmony with the evolving state law, as each would encourage an auction market for corporate control.

11. See *Proper Role*, *supra* note 7, at 1173; *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987) [hereinafter *Dynamics II*]. See generally *supra* note 7 (cases supporting positions which maximize shareholder profit).

12. If a bidder claims unlawful interference by the target company's board with its offer, it would not, under the standard proposed here, have to resort to derivative litigation against the board. This would relieve the bidder of having to make a demand on the board and the other limitations of derivative litigation. See *Gearhart Indus. v. Smith Int'l*, 741 F.2d 707 (5th Cir. 1984) (noting that a tender offeror complaining of defensive maneuvers by the target company's board could not maintain a direct cause of action).

13. Several recent legislative proposals call for an increase in the minimum period that a tender offer must remain open. See Tender Offer Reform Act of 1987, S. 227, 100th Cong., 1st Sess., 133 CONG. REC. S465 (daily ed. Jan. 6, 1987) (which would extend the minimum offering period for tender offers for any and all of a company's outstanding shares to 30 calendar days, and for partial offers to 40 calendar days); S. 678, 100th Cong., 1st Sess., 133 CONG. REC. S2820 (daily ed. Mar. 6, 1987) (which would extend the minimum offering period for tender offers to 60 calendar days); and S. 1323, 100th Cong., 1st Sess., 133 CONG. REC. S1323 (daily ed. June 4, 1987) (which would extend the offering period to 35 business days).

Part II examines, briefly, the early cases challenging defensive maneuvers and the establishment of the business judgment rule doctrine that has dominated the analysis of such cases. Part III looks at the shift in the case law that has taken place since 1985, when the Supreme Court of Delaware decided *Unocal Corp. v. Mesa Petroleum Co.*¹⁴ This section concludes that the Delaware cases, particularly in the Chancery court, are moving toward the auction model. Finally, Part IV suggests that the courts continue in the direction that started with *Unocal* by abandoning the business judgment rule entirely in cases challenging the propriety of director misconduct in response to a hostile tender offer. An amendment to the Williams Act extending the minimum time period during which an offer must remain open would allow the courts to complete the transition started by *Unocal*.

II. THE ESTABLISHMENT OF THE BUSINESS JUDGMENT RULE

The traditional business judgment rule is based on two principles. First, most state corporation statutes expressly entrust to the directors the management of the business and affairs of the corporation.¹⁵ Second, courts are, for various reasons, reluctant (or so they say) to second-guess the business decisions of corporate directors.¹⁶ The directors' statutory authority and the judiciary's professed timidity combine to allow corporate directors a degree of independence in which to exercise their business judgment.

This independence gives rise to the following rule: Directors' business judgments are immune from judicial review if the directors had no conflict of interest with respect to the decision in question, acted in good faith and on an informed basis, and rationally believed that their action was in the best interest of the corporation.¹⁷ Delaware courts have created a presumption that directors behave in this fashion. The burden is,

14. 493 A.2d 946 (Del. 1985).

15. See, e.g., REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, [its] board of directors, . . . subject to any limitation set forth in the articles of incorporation.").

16. E.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("Absent an abuse of discretion, [the directors' business] judgment will be respected by the courts.").

17. *Id.* See also *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *Gimbel v. Signal Cos.*, 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974). The New York formulation of the business judgment rule is set forth in *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) and is discussed in the context of a takeover in *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984). See generally *Duty of*

therefore, on one challenging a corporate action to prove that the directors, in approving the action, fell short of the presumed standard.¹⁸

If the directors lose the protection of the rule because they acted on a matter in which they had an interest or otherwise acted without good faith,¹⁹ they must bear the burden of proving that their action was "fair and reasonable to the corporation."²⁰ If the directors were uninformed when they acted, which, according to the leading Delaware case of *Smith v. Van Gorkom*,²¹ means that they were at least grossly negligent in deciding how much information they had and needed, they will bear personally the adverse consequences of the decisions so made.²² The directors have similar exposure if they did not rationally believe that the action taken was in the best interests of the corporation. All of this

Care and the Business Judgment Rule in ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 4, Apr. 12, 1985) (the ALI's reformulation of the business judgment rule); R. CLARK, CORPORATE LAW 123-40 (1986) (a good overview of the business judgment rule); Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979) (defining and explaining the rule).

In various statements of the rule, it is unclear whether if good faith and due care are present, the decision of the directors might nonetheless be set aside. In *RJR Nabisco, Inc. Shareholders Litigation*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,710 n.13 (Del. Ch. 1989), the court indicated that when the disinterested board acts in good faith and with due care, further judicial review is unwarranted.

18. Typical is this statement from *Aronson*, 473 A.2d at 812: "[The business judgment rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption."

19. If the complaint alleges that the directors had a conflict of interest with respect to the challenged action, the presumptions favoring the directors arise only after they have initially established that the decision was made in good faith after reasonable investigation. *Solash v. Telex*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch. 1988).

20. *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980). The Delaware Supreme Court has characterized this as the "entire fairness" test. *Mills Acquisition Co. v. Macmillan, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,401, at 92,595 (Del. 1989) ("In such a context, the challenged transaction must withstand rigorous judicial scrutiny under the exacting standards of entire fairness.").

21. 488 A.2d 858 (Del. 1985). See also *RJR Nabisco, Inc. Shareholders Litigation*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,713 (Del. Ch. 1989) ("In connection [with the plaintiff's charge that the directors did not act with due care], their burden of course will be to establish at a final hearing that . . . the directors were grossly negligent."); *In re Amsted Industries, Inc. Litigation*, Civ. Ac. No. 8224 (Del. Ch. 1988) (LEXIS, State cases library, Delaware file) (held, record did not establish that defendant board was grossly negligent in its reliance on special committee).

22. While Delaware law on director liability is probably representative of state law generally, some variations exist from state to state. In Texas, for instance, directors would appear to have greater immunity from liability. In the course of discussing the director's duty of care, the court in *Gearhart Indus. v. Smith Int'l*, 741 F.2d 707, 721 (5th Cir. 1984) observed, "Texas courts to this

learning, and quite a bit more, has summarily been called the "business judgment rule."

With these principles as a guide, the courts have considered challenges to the actions taken by target management in response to a hostile tender offer or a threatened change in control. *Panter v. Marshall Field & Co.*,²³ a typical case, arose out of a 1977 exchange offer for Field common stock by Carter Hawley Hale (CHH). CHH initially offered one share of its stock, valued at \$36.00, for each share of Field's stock, a premium of 64% over the pre-offer market price of Field stock. This offer was later increased; CHH offered \$42.00, in cash and CHH stock, for each Field share tendered. Field responded with litigation and an aggressive acquisition program that made it less attractive to CHH. These tactics were effective; CHH withdrew its offer and Field's shares dropped to a trading price of \$19.00 in the market.

Disappointed by the lost opportunity to tender their shares, several Field shareholders filed a class action in federal court seeking money damages from Field and its directors. The complaint alleged violations of the Williams Act and Rule 10b-5, breach of fiduciary duty, and interference with prospective advantage. The district court granted defendants' motion for a directed verdict at the close of plaintiffs' case,²⁴ and the U.S. Court of Appeals for the Seventh Circuit affirmed.²⁵ The federal claims were dismissed either because the necessary proof was lacking or because the statute in question did not provide a remedy for the loss alleged. The business judgment rule provided the necessary defense to the claim of breach of fiduciary duty.

Of particular interest was the appellate court's attitude toward the interest of CHH. The plaintiff-shareholders argued that the directors were motivated by a desire to fend off all offers, regardless of merit. The court said that actions so motivated would not breach the directors' fiduciary duty, unless the motive was the directors' "sole or primary"

day will not impose liability upon a noninterested corporate director unless the challenged action is ultra vires or is tainted by fraud."

The reaction of the corporate bar to the Delaware decision in *Van Gorkom* was strong and resulted in an amendment to the Delaware corporate law. See DEL. CODE ANN. tit. viii, § 102(b)(6) (1986). This provision allows a Delaware corporation to include within its articles of incorporation a provision eliminating or limiting the personal liability of a director for breach of the duty of due care, provided the director acted in good faith and did not engage in intentional misconduct or a knowing violation of law. Other states have followed the Delaware lead. See, e.g., COLO. REV. STAT. § 7-3-101 (Supp. 1988).

23. 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

24. *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168 (N.D. Ill. 1980).

25. *Panter*, 646 F.2d at 271.

motive.²⁶ In other words, the directors could take defensive action against a tender offer, presumably even a favorable offer, for the purpose of defeating it, so long as some other motivation could be shown. In this case, the board's response to the CHH offer included "defensive acquisitions," which were also "motivated" by a desire to expand Field's business into new markets. Thus, the actions were protected by the business judgment rule. More importantly, the decision reflected a low regard for protecting the interests of the bidder; the target board has a relatively low burden of proof to legitimate its actions.

Disappointed bidders fared no better in the courts. In *Northwest Industries v. B. F. Goodrich Co.*,²⁷ the tender offeror, Northwest Industries, sought to enjoin a deal by the target, Goodrich, that would have made the tender offer uneconomical. The objectionable deal was with Gulf Oil and provided for an exchange of Gulf's interest in a Gulf-Goodrich joint venture for a large block of Goodrich stock. Gulf and Goodrich had discussed a termination of their joint venture for some time, but only came to terms when Northwest's tender offer surfaced. The effect of the Gulf-Goodrich transaction was to increase the number of Goodrich shares outstanding and place them in the hands of a shareholder friendly to Goodrich and disinclined to tender them to Northwest. The injunction was denied because Northwest failed to show that the directors were improperly motivated.

In both cases, the motivation of the directors is of little concern to the bidder. What the bidder is objecting to is the nature of the action undertaken by the target and the effect of that action on its interests. But the analysis of the courts is limited to the propriety of the board action vis-à-vis its own shareholders. So long as the board acts consistently with its fiduciary duties, its actions will not be closely scrutinized by the courts. Conversely, and this is the irony of the approach in *Panter* and *Northwest Industries*, if the board breaches its fiduciary duty to its shareholders, then a third party, the tender offeror, can complain of the board's action. Even though the tender offeror in such situations is not complaining of the breach of fiduciary duty, that breach gives rise to the

26. See *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981) (articulating this test).

27. 301 F. Supp. 706 (N.D. Ill. 1969).

cause of action.²⁸ This is well illustrated in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,²⁹ a Second Circuit decision.

In *Hanson*, the bidder (Hanson) sought to preliminarily enjoin the exercise of a lock-up option granted by the target (SCM Corp.) to a rival bidder, a group consisting of the management of SCM and Merrill Lynch, Pierce, Fenner & Smith Incorporated (Merrill group). The option allowed the Merrill group to acquire SCM's "crown jewel"—its pigments and consumer foods businesses—at a favorable price if another party acquired more than one-third of SCM's outstanding shares. Hanson acquired more than a third of SCM's shares in a "street sweep" following a terminated tender offer and then sued to enjoin the exercise of the option.³⁰

The *Hanson* trial court denied the relief, holding that the board's actions were protected by the business judgment rule. The Second Circuit reversed in a split decision. While the appellate court did not disturb the lower court's findings that the directors acted in good faith and without fraud or self-dealing, it did not agree that the directors acted with due care. After reviewing the evidentiary findings, the appellate court concluded that the directors granted the lock-up option too hastily and with too little information. Because the board breached its fiduciary duty of due care, the burden shifted to the defendant directors to demonstrate that the transaction in question was fair to the corporation. Hanson was able to persuade the appellate court that there were serious questions regarding the defendants' ability to meet this burden. Furthermore, Hanson argued that the failure to grant preliminary relief would irreparably injure it and the SCM shareholders. Therefore, the appellate court remanded the case to the trial court and ordered it to issue a preliminary injunction.

28. In most cases the bidder owns some shares in the target company and, in theory, has standing as a shareholder to allege a breach of fiduciary duty by the board in a derivative action. Some courts have suggested that a bidder cannot, however, maintain a direct action as a shareholder. *Enterra Corp. v. SGS Assocs.*, 600 F. Supp. 678, 689 (E.D. Pa. 1985). *But see Williams v. Geier*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,283 (Del. Ch. 1987) (shareholder could maintain a direct action to challenge a corporate restructuring that allegedly interfered with his voting rights). Under the approach suggested in this article, disappointed bidders would have standing *qua* a third party to complain of director action that was harmful to it. *See Loewenstein, Tender Offer Litigation and State Law*, 63 N.C.L. REV. 493 (1985) [hereinafter *State Law*].

29. 781 F.2d 264 (2d Cir. 1986).

30. A street sweep is the acquisition of securities during or immediately following a tender offer, generally from arbitrageurs who have acquired substantial holdings of the security. *See Acquisitions of Substantial Amounts of Securities During and Following a Tender Offer*, Exchange Act Release No. 34-24976, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,160 (Oct. 1, 1987), a rule proposed by the SEC that would regulate such transactions.

It is odd that Hanson's relief turned on a finding that the board acted without due care. Hanson was harmed because the grant of the lock-up option had the effect of potentially depriving it of the assets that it sought, leaving, in the court's words, a "denuded company."³¹ However, that would be true whether or not the board exercised due care in granting the option. From Hanson's perspective, it was almost fortuitous that the board acted hastily. This tension between the gravamen of Hanson's complaint, the unfairness of the grant of a lock-up option to a rival bidder, and the litigated claim that the board breached its fiduciary duty of due care is apparent in the three published opinions in *Hanson*.

First, the opinion of the court, authored by Judge Pierce, has a revealing discussion of appropriate relief. Arguably, money damages would provide an adequate remedy for the shareholders if a portion of the company's business were sold for inadequate consideration. That was the relief granted in the Delaware case of *Smith v. Van Gorkom*,³² which Judge Pierce cited earlier in the opinion. However, Judge Pierce dismisses this possibility in a single sentence borrowed from an earlier Delaware case, *Gimbel v. Signal Co.*,³³ suggesting that a damage claim against the directors is not a meaningful alternative. But damages might have been a reasonable alternative in this case,³⁴ because the directors probably had considerable insurance and, more importantly, the deep pocket of Merrill Lynch was available. Merrill Lynch and the other parties affiliated with the Merrill group might have been considered aiders and abettors to the breach of fiduciary duty and, if so, could have been held accountable for their role.³⁵ Because these issues were not explored

31. *Hanson*, 781 F.2d at 282.

32. 488 A.2d 858 (Del. 1985).

33. 316 A.2d 599, 603 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974).

34. *Cf. Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829, 845 (D. Minn. 1986), *aff'd in part and vacated in part*, 811 F.2d 414 (8th Cir. 1987) (The lower court denied the bidder's request for a preliminary injunction of certain defensive maneuvers reasoning, in part, that because the bidder intended to liquidate the target, its loss would be a monetary one and at trial it could recover "the difference between the lost liquidation potential and the cost of its bid.")

35. *See Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987) ("[O]ne who knowingly joins with a fiduciary, including corporate officials, in a breach of fiduciary obligation is liable to the beneficiaries of the trust relationship."). *See also Fry v. Trump*, 681 F. Supp. 252 (D. N.J. 1988) ("greenmailer" may be liable as aider and abettor of breach of fiduciary duty by directors authorizing the repurchase of his shares); *Heckmann v. Ahmanson*, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985) (joint liability for directors who breached fiduciary duty); *Deutsch v. Cogan*, Civ. Ac. No. 8808 (Del. Ch. 1989) (LEXIS, State cases library, Delaware file) (acquiror may be liable for aiding and abetting breach of fiduciary duty by the target's directors). Merrill's liability would depend on a showing that it knew that the SCM board acted without adequate care, it was an active participant in the process, and it benefitted from it.

by the court, it is difficult to say whether money damages were an alternative.

This relief would not, however, address Hanson's real concern: the inability to acquire SCM on a fair basis. Judge Pierce implicitly recognized this when he said that "market forces can best be permitted to determine the outcome of this contest if the lock-up option is preliminarily enjoined"³⁶ because this is the sort of relief usually sought by a bidder, not a shareholder complaining of a breach of fiduciary duty.

The majority opinion also fails to characterize the directors' conduct—leaving it unclear whether the option was set aside because the directors were negligent in granting it. The court is clear that the directors' conduct did not amount to gross negligence. However, if the directors were merely negligent, then the case is a significant precedent because directors are generally not accountable in a derivative action for their mere negligence if the conditions of the business judgment rule are met.³⁷ While there was evidence that the exercise price for the optioned businesses was in some respects too low, the directors argued that they relied on the expert opinion of a respected investment banker that the price was "fair." Moreover, the option was intended to create an incentive for the optionee to make a bid. Therefore, it was appropriate, as the court conceded, that the price represent a bargain. Given these considerations, the court should be reluctant to second-guess the directors, which is why the district court found in favor of the defendants, why the concurring opinion emphasized that this was an "extremely close case,"³⁸ and why Judge Kearsse dissented from the result.

The explanation for the result is that the court needed to find a basis for setting aside the option, and it did so even though it meant deciding that the district court's denial of a preliminary injunction was an abuse of judicial discretion and that the lower court's findings of fact were clearly

36. *Hanson*, 781 F.2d at 283.

37. R. CLARK, *supra* note 17, at 126, notes that cases in which directors are held liable for negligence are rare, leading him to doubt that courts "are serious when they say directors may be held liable for negligence." See also *Gearhart Indus. v. Smith Int'l*, 741 F.2d 707, 721 (5th Cir. 1984) (The court noted that under Texas law a director will not be liable for a breach of the duty of care unless the action is "ultra vires or is tainted with fraud."); *Dynamics Corp. of America v. CTS Corp.*, 637 F. Supp. 406, 417 (N.D. Ill.), *aff'd*, 794 F.2d 250 (7th Cir. 1986) [hereinafter *Dynamics I*] ("the standard for determining whether a board exercises informed business judgment is governed by a standard of 'gross negligence'" [citing *Moran v. Household Int'l*, 500 A.2d 1346, 1356 (Del. 1985)]); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968) (the author reviewed cases over a period of several decades and found only four in which directors were held liable); See also *supra* note 21.

38. *Hanson*, 781 F.2d at 285 (Oakes, J., concurring).

erroneous. The court could have avoided those hard decisions by holding that the disappointed bidder may maintain an action in its own right as a bidder³⁹ and that the business judgment rule provides no defense under these circumstances because the board cannot unfairly interfere with the offer.⁴⁰ The court chose to reach that result by indirect means.

Hanson and other cases provide examples of the clumsiness of a business judgment rule analysis when the bidder presents a sympathetic case.⁴¹ *Hanson's* case was sympathetic because it was bidding for the

39. In the typical case, the bidder must maintain a derivative action as a shareholder of the target. See *Gearhart Indus.*, 741 F.2d at 707. The U.S. Supreme Court has suggested that a bidder might maintain a tort action for interference, *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977), but there has been little reported litigation involving that tort in the context of tender offers. See generally *State Law*, *supra* note 28 (discussing traditional elements and recent treatment of tortious interference with economic advantage).

40. Some courts have suggested that the business judgment rule is not relevant when director action is challenged in the context of a tender offer. A particularly forceful statement of this notion can be found, in dictum, in *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1260 n.6 (S.D.N.Y. 1985):

The right of a shareholder to sell his stock is a private transaction between a willing seller and a willing purchaser and in no way implicates the business judgment rule. Therefore, a board of director's assertion of a unilateral right, under the business judgment rule, to act as a surrogate for the shareholder's independent right of alienation of his stock is troublesome. However, because of our holding we need not reach this issue.

To a similar effect is dictum by the court in *Conoco, Inc. v. Seagram Co.*, 517 F. Supp. 1299, 1303 (S.D.N.Y. 1981):

What is sometimes lost sight of in these tender offer controversies is that the shareholders, not the directors, have the right of franchise with respect to the shares owned by them, . . . The Directors are free to continue by proper legal means to express to the shareholders their objection and hostility to the . . . proposal, but they are not free to deny them their right to pass upon this offer or any other offer for the purchase of their shares.

This sentiment is further quoted in Steinberg, *Tender Offer Regulation: The Need for Reform*, 23 WAKE FOREST L. REV. 1, 10 (1988).

41. See also *Plaza Sec. Co. v. Fruehauf Corp.*, 643 F. Supp. 1535 (E.D. Mich.), *aff'd sub nom. Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986); *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 767 (Del. Ch. 1988) (The Board's decision to leave stock rights in effect was not reasonable, but restructuring was a reasonable response that did not breach their duties.); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988) (Directors' failure to prove their restructuring in response to a threat was reasonable entitled shareholders to preliminary relief barring restructuring.). In *Plaza Sec.*, which is typical of these cases, the bidder, Edelman, made an all cash offer for the target, Fruehauf. *Plaza Sec.*, 643 F. Supp. at 1537. The response included a management leveraged buy-out, structured as a two-tier, front-end loaded tender offer. The leveraged buy-out was favored by a special committee of the target board composed of outside directors. Management's offer was coercive, and the bidder sought to enjoin it. *Id.* at 1538, 1541. The court granted the injunction, finding that the board violated its fiduciary duties of care and loyalty. *Id.* at 1543, 1545-46. But these findings were questionable, as the special committee arguably insulated the board from charges that it had a conflict of interest. As to the claim that he committee failed to exercise due care, it is noteworthy that the appellate court decision drew a dissent, which argued that under the circumstances, the special committee did what it could. *Id.* at 887 (Guy, J., dissenting) ("The constraints of time alone, coupled with the lack of familiarity of the outside directors with the day-to-day operations of Fruehauf, place practical limits on their function and responsibility.").

company in good faith and its expectations were conclusively frustrated by the target board. This sympathy was enhanced because the beneficiary of the board's action was a group, including target management, that was proposing a leveraged buy-out of the company. Because instances of the target board defeating a hostile bid were not infrequent, the Delaware Supreme Court took a cautious step to limit the protections afforded by the business judgment rule in two celebrated cases, *Unocal Corp. v. Mesa Petroleum Co.*⁴² and *Revlon Inc. v. MacAndrew & Forbes Holdings, Inc.*,⁴³ which are discussed in the next section.

III. LIMITATIONS ON THE BUSINESS JUDGMENT RULE

Unocal and *Revlon* require the target board to treat the unwanted bidder with a measure of fairness, though the decisions use other terms. In *Unocal*, which was decided in 1985, the Delaware Supreme Court held that director action in response to tender offers would be protected by the business judgment rule only if the directors "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership" and the defensive action taken was "reasonable in relation to the threat posed."⁴⁴ *Revlon*, decided the following year, added a corollary: once the company is on the "auction block" (that is, events have made the sale of the target company inevitable), the board's role becomes akin to that of an auctioneer, and any action that they take should be consistent with maximizing the price to the shareholders.

Taken together, these cases recognize that at least some duty is owed to the bidder. The *Unocal* decision held that the directors can react only when a threat is present and then only with reasonable action,⁴⁵ and *Revlon* limited the ability of the directors, at least in an

42. 493 A.2d 946 (Del. 1985).

43. 506 A.2d 173 (Del. 1986).

44. *Unocal*, 493 A.2d at 955.

45. Two "threats" were identified in *Unocal*. The first was a two-tier offer by Mesa Petroleum in which the front-end consisted of \$54 cash per share for 64 million shares (which would increase Mesa's ownership to 51% of Unocal) and the back-end consisted of a merger in which the remaining shareholders would receive "junk bonds" with a value of \$54 per share. *Id.* at 949-50. The second threat was speculative—that Mesa would seek to "greenmail" Unocal into repurchasing its shares. *Id.* at 956. Unocal's response to this threat was to offer to exchange senior debt securities with a par value of \$72 per share for the stock held by shareholders other than Mesa upon completion of the first tier of Mesa's tender offer. The effect of Unocal's tactic, which was upheld by the Delaware Supreme Court, was to cause Mesa to withdraw its offer, lest it end up as the sole shareholder in a company with an enormous senior debt burden. *Id.* at 946.

auction situation, to favor one bidder over another.⁴⁶ The impact of these principles depends on the courts assessment of both "threat" and "reasonable action." Most courts can be characterized as deferential to target management's assessment of whether a threat exists.⁴⁷ Bidders have fared somewhat better, however, when arguing that the response was unreasonable in relation to the threat.⁴⁸ These concepts are treated separately below.

A. THE PRESENCE OF A THREAT

Unocal made it virtually inevitable that the courts would find a threat present with the making of a tender offer, inasmuch as the burden of demonstrating that a "threat" exists is satisfied, according to the opinion, if the directors acted in good faith and made a reasonable investigation.⁴⁹ In other words, if these procedural requirements are satisfied, it is not even necessary to examine the merits of the ultimate decision. Furthermore, lest the burden on the board be too great, the *Unocal* court provided a means to lessen it: "such proof [that a threat existed] is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors"⁵⁰

Most identified "threats" fall into two broad groups: (1) tactics by the offeror that arguably threaten the voluntary choice of the target shareholders and (2) offers that are arguably inadequate from an economic perspective, but are not coercive.⁵¹ In other cases, the target board has argued that the bidder's post-acquisition plan to liquidate the target, doubts about the bidder's ability to finance its offer, or fears that the bidder or some third party may engage in a "street sweep" of the

46. The target board may favor one bidder over another if it is in the shareholders' interest to do so. *J.P. Stevens & Co. Shareholders Litigation*, 542 A.2d 770 (Del. Ch. 1988) (topping fee of up to \$.40 per share and expense reimbursement provision of up to \$1.00 per share were not a violation of a target board's duties if the shareholders would benefit).

47. See *infra* note 87, discussing several recent Delaware cases in which the *Unocal* test was applied. In each case the Delaware courts found that a threat was present.

48. See *infra* notes 85-110 and accompanying text.

49. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

50. *Id.* New York courts would seem not to apply a different standard for outside directors. *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 266 n.12 (2d Cir. 1984) ("We are not persuaded that a different test applies to 'independent' as opposed to 'inside' directors under the business judgment rule.") (applying New York law).

51. *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787, 790 (Del. Ch. 1988).

target's stock⁵² are "threatening" under *Unocal* and, therefore, justify a strong response.⁵³

There is, of course, no threat to the company in these circumstances. These situations are quite unlike a threatened labor disturbance or consumer boycott or a possible unfavorable legislative enactment, where the board feels compelled to take some measures to avoid an adverse impact on corporate earnings or assets. In such situations, there should be no doubt that the board may take some action. The legality of a board's "defensive" action, assuming it exercised due care in adopting it and did not act in a way that benefitted the directors personally, would be measured by the same external standards that apply to any corporate action, e.g., provisions of criminal law, tort law, statutory law, etc.

To the extent the identified threat endangers the shareholders, its nature is in most instances similarly amorphous. One exception, however, is the so-called "two-tier, front-end" loaded partial offer.⁵⁴ Using this tactic, the bidder offers a high cash price for a portion of the shares (generally a majority) and discloses an intent to purchase the balance of the stock at a lower price in a "squeeze-out" merger. This is a threat to the shareholders because they feel pressure to tender into an offer that might lack economic merit. The pressure arises because the shareholders understand that if they fail to tender into the "front-end," they will be left with the lower, "back-end" price for all their shares.

Fortunately, the truly coercive two-tier offer is all but extinct, probably because so many tender offers are challenged with competitive bids that avoid the tactic. Even hostile offers often end with a negotiated

52. A "street sweep" is the rapid accumulation of target securities in the open market during and/or shortly after a tender offer for those securities. The securities are generally purchased from arbitrageurs. See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1337 n.3 (Del. Sup. Ct. 1987); Acquisitions of Substantial Amounts of Securities and Related Activities Undertaken During and Following a Tender Offer for Those Securities, Exchange Act Release No. 34-24976 (1987).

53. The *Unocal* court gave some examples of takeover bids that might qualify as threatening: "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange." *Unocal*, 493 A.2d at 955. (The Delaware court clarified its reference to other 'constituencies' in *Revlon*, when it said that a target board may take into account such constituencies "provided there are rationally related benefits accruing to the stockholders." *Revlon*, 506 A.2d at 182. Further, such concerns are inappropriate once an auction has commenced. *Id.*) But the Court did not explain in what respect these matters are threatening.

54. For a description of the two-tier bid and its economic effect on target shareholders and potential competitive bidders, see Lederman, *Tender Offer Bidding Strategy*, 17 REV. SEC. REG. 917 (1983).

transaction.⁵⁵ Moreover, the shareholders are not totally defenseless. Some states have enacted "fair price" provisions in their statutes.⁵⁶ In states without such legislation, if the "squeeze-out" price is unfair, state corporate law may provide an appraisal remedy for dissatisfied shareholders.⁵⁷ Additionally, protection is afforded under the fiduciary duty rules applicable to the majority shareholders under those circumstances.⁵⁸

Despite these factors, however, the coercive, two-tier bid remains a problem, and it illuminates a frequently noted deficiency in the Williams Act.⁵⁹ Ideally, either the tactic should be banned or the minimum offering period should be expanded to allow competitive bids to emerge. By providing a mechanism for the acquisition of a corporation by a tender offer but setting forth a time limit that is theoretically too brief for competitive offers to emerge, the Williams Act burdens target shareholders and provides its directors with a rationale for a myriad of defensive maneuvers.

The inadequate time limit in the Williams Act, combined with the courts' disdain for the coercive two-tier offer, has another consequence. When a partial offer is made that does not expressly include a second-tier merger, target boards frequently assert that the bidder may impose a squeeze-out merger at a later date at an unfair price.⁶⁰ Thus, the argument continues, "preclusive" defensive action—action that as a practical matter withdraws from the shareholders the option to accept the offer—

55. *City Capital Assocs.*, 551 A.2d at 790. Indeed, the current high prices offered in recent tender offers have resulted in most deals being completed in negotiated transactions. See A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING 36 (1983) (Supp. 1987) [hereinafter DEFENSES]; *Promoter of Poison Pill Prescribes Stronger Remedy*, Wall St. J., Dec. 1, 1988, at C1, col. 4.

56. See, e.g., CONN. GEN. STAT. ANN. § 33-374a to -374c (West Supp. 1988) (requiring approval of 80% of outstanding or 75% of disinterested stock); FLA. STAT. § 706.108 (West Supp. 1988) (requiring approval by 75% of disinterested shares); GA. CODE ANN. §§ 14-2-232 to -234 (Supp. 1987) (requiring unanimous board approval and majority approval by disinterested shareholders); WIS. STAT. ANN. § 180.725 (West Supp. 1988) (requiring approval by 80% of the outstanding voting stock and 75% of the disinterested shareholders).

57. REVISED MODEL BUSINESS CORP. ACT § 13.30 (1984); DEL. CODE ANN. tit. VIII, § 262 (1986).

58. See *Weinberger v. UOP Inc.*, 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

59. See Advisory Committee Report, *supra* note 7, at 77. See also Lowenstein, *supra* note 7 (focus on the Bendix-Martin-Marietta case); Lynch & Steinberg, *supra* note 4 (posing solutions for unclear management standards); Steinberg, *supra* note 40 (SEC should have primary jurisdiction).

60. E.g., *Dynamics III*, 635 F. Supp. 1174 (N.D. Ill.), *aff'd*, 794 F.2d 250 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987); *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585 (Del. Ch.), *aff'd*, 535 A.2d 1334 (Del. 1987).

is justified. The problem with allowing target boards this freedom of action is that it provides a rationale for defeating all partial offers.⁶¹ However, the Williams Act specifically contemplates partial offers,⁶² and the law ought not to permit target boards to frustrate this policy. In sum, the two-tier threat would best be handled by an outright ban or, as is argued here, by an extension of the mandatory offering period and other policies that encourage an auction market, rather than by allowing target management to defeat all two-tier and partial offers.

The claim that the offered price is inadequate and defensive maneuvers are therefore justified makes the case for target management less persuasive.⁶³ First, this claim is too easy for the target board to make and, for that reason, ought not to justify preclusive action. The bidder, after all, is invariably offering a substantial premium over the market price, while target management, on the other hand, is often pointing to the "hoped-for" effects of its plans and economic trends. If target management proves wrong, shareholders lose a valuable opportunity.⁶⁴

Second, the threat to shareholders—that they will not realize as much on their share holdings as they might if they did not tender and held their stock for some indeterminate period of time—is not a threat that, in other circumstances, the directors are obliged to counter. The Delaware court has created a new duty for the directors that it may well reexamine. Under current law, for instance, the board has no duty to monitor the market for the company's stock and take action to detect and thwart the manipulation of its share prices.⁶⁵

61. Were a truly coercive, two-tier front-end loaded tender offer to be made, the target board would not be defenseless. The possibilities of other bidders, a management-led leveraged buy-out, direct negotiation with the bidder, or a noncoercive self-tender are all available tactics that respect the interests of the bidder.

62. Section 14(d)(6) of the Exchange Act sets forth a rule requiring pro rata acceptance of oversubscribed partial offers. 15 U.S.C. § 78(n)(d)(6) (1988).

63. Delaware law seems to be evolving toward this conclusion. In *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 289 (Del. Ch. 1989), the court observed the following: "It is difficult to understand how, as a general matter, an inadequate all cash, all shares tendered offer with a back end commitment at the same price in cash, can be considered a continuing threat under *Unocal*." Nevertheless, the Vice Chancellor went on to hold that under the peculiar facts of this case, the target board could interpose a reasonable defense based on an allegedly inadequate offer. See *infra* note 82 and accompanying text.

64. See Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J. LAW & ECON. 151 (1985) (study concluding shareholders of targets that defeat tender offers through litigation are unequivocally worse off); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 29-40 (1983).

65. Assume, for instance, that there was a perception in the marketplace that the company's stock was overpriced and that, as a result, a number of investors were short-selling the company's stock. If the board believes that the short-sellers are driving the price too low, a duty to protect

Third, the threat of the inadequate bid, like other threats that have been identified by the courts, can be addressed by measures that respect the rights of the bidder to continue its bid. Directors should be free to seek other bidders. Recent history has shown that the ready availability of capital for leveraged buy-outs (not to mention the availability of capital for conventional acquisitions) makes target management a potential purchaser, no matter how large the purchase price.⁶⁶ Moreover, if a previous bid is truly inadequate, market forces operate to produce a competitive bid, and these market forces would be enhanced if the minimum bid period were lengthened.

When the identified "threat" is that the hostile bidder will, if successful, "bust up" or liquidate the target, it does appear, at least at first blush, that there is a threat to the company. On closer analysis, however, it is clear that no danger is present and that preclusive defensive action is unjustified. Assuming adequacy of price, it should make little difference to the shareholders whether the bidder, the purchasers in liquidation, or some combination of the two ultimately will be managing the assets of the corporation.⁶⁷

As a preliminary matter, it is important to note that the corporation is, in essence, a business or a group of businesses. If these businesses are profitable, or more generally if someone values these businesses as going

shareholders might suggest that they have to take some action to counteract the shorts. Of course, this scenario can be distinguished from the two-tier tender offer because the shareholders are not being "coerced" to sell. But seeing the price being driven down does put pressure on shareholders to sell, particularly when they have reason to believe that the raid will be successful. At the present time directors need not respond to the short raid, but if the Delaware decisions are construed as creating a duty to protect share prices, they may be required to do so. *Champion Parts, Inc. v. Oppenheimer & Co.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,524 (7th Cir. 1989) (a target company does not have a protectable interest in the market for its shares).

It is easy to lose sight of the fact that the statutory responsibility of directors is to manage the "business and affairs" of the corporation. *See supra* note 15. In that respect, the dealings that shareholders have with third parties in the purchase and sale of their shares is beyond the responsibility of the board of directors. *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1260 n.6 (S.D.N.Y. 1985). *See also* *Grand Metropolitan PLC v. Pillsbury*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,104, at 91,195 n.10 (Del. Ch. 1989).

66. It was reported that a management led team of RJR Nabisco Inc. bid in excess of \$25 billion for the company. *How Underdog KKR Won RJR Nabisco Without the Highest Bid*, Wall St. J., Dec. 2, 1988, at A1, col. 6.

67. It may make a difference to the creditors of the corporation, such as bondholders, who will continue to hold corporate debt after the takeover. The creditors can structure their debt instruments to protect themselves against corporate reorganizations that might adversely affect their positions. Regardless, directors do not owe a fiduciary duty to the creditors. *Prudential-Bache Securities, Inc. v. Franz Mfg. Co.*, 531 A.2d 953 (Del. 1987); *Katz v. Oak Indus.*, 508 A.2d 873 (Del. Ch. 1986); 3 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 849 (Supp. 1988).

concerns, then they will continue as such. Whether the businesses will be owned by one group of shareholders or by several groups of shareholders is of little consequence to the current owners or, with certain exceptions, to society.⁶⁸ Whether a combination or separation of businesses can bring about greater economic efficiency is best determined by the market, and to the extent that efficiency is enhanced, society will benefit. If the most efficient operation of a company's business is through the existing corporate structure, then the ever-present possibility of a management buy-out provides that alternative.

When target management justifies its response to a takeover offer on the basis of the bidder's post-acquisition plans, one must be skeptical. In effect, the response is that the existing management can more effectively manage the assets of the company than their as yet unnamed replacements. Not only is this response potentially inaccurate, it is also irrelevant if the shareholders are being cashed out. In that case the future management of the assets is of concern only to the present managers, who have an obvious conflict-of-interest on that question, and to creditors who have failed to place protective provisions in their debt instruments.⁶⁹

If the shareholders have no real concern, should the board? Put another way, is there some value in continuing the corporation as a unified entity and, if so, is the beneficiary of that value one to whom the board owes some duty?⁷⁰ I believe that whatever value can be attributed to continuing a corporation as a unified entity is insufficient to justify

68. The ownership of a corporation may be of concern when the business involves national security or raises potential antitrust problems. In these and other instances, the provisions of positive law can be applied to achieve the desired results. Ownership is therefore not a concern of corporate management. It is curious that courts have permitted target management to litigate antitrust issues, as though the target had a different interest than the purchaser. See *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981). The recent U.S. Supreme Court decision in *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104 (1986), cast doubt on whether a target corporation ought to have standing under the antitrust laws to challenge its own takeover. In *Cargill*, the Court held that a private plaintiff seeking to maintain an action to enjoin a merger under section 16 of the Clayton Act must demonstrate an "antitrust injury"; probable loss from increased competition that might result from the challenged merger was not such an injury. *Id.* at 113-19. Arguably, a target does not suffer an antitrust injury and would thus lack standing to challenge its own acquisition.

69. See *supra* note 67 and accompanying text.

70. The recent popularity of management-led leveraged buy-outs makes this question a particularly interesting one. If the board has a duty to other constituencies, the leveraged buy-out may be in jeopardy. The current state of the law is stacked against the nonmanagement bidder. If the offer is favorable to shareholders, the target board pleads the case of the nonshareholder constituencies to justify defeating the bid. If management is the bidder, then the maximization of shareholder values is the predominant value.

empowering the board of directors to defeat a tender offer. To the extent that the kinds of corporate restructurings that might follow a takeover are perceived as "evils," legislative solutions are preferable. Moreover, it is not only successful tender offerors who restructure companies. Restructurings are an integral part of the corporate culture and often emerge as defenses to hostile tender offers. It seems irrational to permit a corporation to restructure itself at any time, with the attendant dislocations, while allowing directors to take action that would preclude a potential purchaser of its stock from undertaking that same course of action. If there is an evil to corporate restructurings, then all restructurings ought to be regulated, not just those which might follow a tender offer.

An allied justification for prohibiting post tender offer restructuring is that the bidder, through the "bust-up," will make a quick and substantial profit. There are three responses to this. First, the bidder is assuming substantial risks in the transaction, and profitability cannot be a foregone conclusion.⁷¹ Second, even if the prognosis proves correct, it is unclear that the shareholders are harmed. The spread, or premium, between the pre-acquisition price of the company's assets (as measured by the stock market) and the liquidation price of those assets (as measured by the amounts paid by the ultimate purchasers of those assets) will be shared by the bidder and the target shareholders. At the same time, the company's assets will have moved to managers who place a greater value on them than the stock market did and possibly a greater value than target management did.⁷² The only "losers" are those who

71. Reports of troubled leveraged buy-outs are increasingly common. For instance, when Beatrice Co. was acquired by Kohlberg Kravis Roberts & Co. for \$8.2 billion in a 1986 leveraged buy-out, KKR estimated that it could realize a profit of \$3.8 billion after Beatrice was liquidated. Because KKR and its partners, which included top management of Beatrice, invested \$417 million in the acquisition, the estimated return was more than nine times their investment. More than two years after the deal, however, key units of Beatrice remained unsold, and it was reported that the "rosiest" estimate of investor profit at that time was about \$382 million. *Beatrice, Once Hailed as the Deal of the Century, Proves Disappointing*, Wall St. J., Nov. 21, 1988, at A1, col. 6. For another example, see *Campeau Retail Chains are Heavily in Debt, Facing Rising Troubles*, Wall St. J., Dec. 14, 1988, at A1, col. 6.

72. This is a hypothesis of the efficient capital market theory and is the basis for the argument that economic efficiency is enhanced when takeovers proceed unimpeded. See *Dynamics II*, 794 F.2d 250, 253 (7th Cir. 1986); *Proper Role*, *supra* note 7, at 1165-68. A study recently completed by the SEC concluded that companies that make unwise acquisitions are themselves more likely to become targets of takeovers than companies that make wise acquisitions (as measured, in each case, by changes in the market price of the acquiror's stock following announcement of the acquisition). When these companies were later taken over themselves, part of the shareholders' gain in those transactions "reflects recovery of target equity value that had been lost because of the targets' 'poor' acquisition strategies. This evidence is consistent with the argument that hostile 'bust up' takeovers promote economic efficiency by reallocating the assets of target firms to higher uses, or by preventing

lost the franchise of managing the assets, a franchise that the law presumably does not protect. Third, the liquidation strategy is one that is available to incumbent management—if the target has experienced a low return on the fair market value of its assets, it is free to liquidate some or all of those assets and distribute the proceeds to its shareholders. In other words, to the extent a profit can be realized, target management can realize it for its shareholders and ought not complain when someone else does. Indeed, many companies have followed this course in recent years.⁷³

Yet another justification posed by target management for defeating a hostile tender offer, and one given credence by the courts, is that the bidder is unable to finance its offer.⁷⁴ It is unclear why this should necessarily justify defeating the bid. If the offer cannot be financed, it will self-destruct. With some exceptions, an offer without adequate financing cannot “pose a threat” to the target company any more than a pistol without bullets is a threat to fire. Where, however, the nature of the offer is such that the shareholders or the target would suffer significant harm were the offer to fail for inadequate financing, some response by target management is certainly justified. Interestingly, in one case where inadequate financing was alleged by target management, the bidder successfully obtained its financing before the offer had expired, but the court still declined to enjoin the target’s defensive maneuvers.⁷⁵

A final justification condoned by the courts for fending off a hostile tender offer is that the offer, if successful, would result in a change of control of the target company.⁷⁶ Here, again, target management is making the judgment as to who can best manage the company, a judgment it

target firms from making future unprofitable acquisitions.” SEC Study Says Bad Bidders Make Good Targets, Fed. Sec. L. Rep. (CCH) No. 1315, at 4-5 (Dec. 7, 1988).

73. See, e.g., *G.M. Sub Corp. v. Liggett Group, Inc.*, Civ. Ac. No. 6155 (Del. Ch. Apr. 25, 1980) (LEXIS, State cases library, Delaware file).

74. *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio), *aff’d*, 815 F.2d 76 (6th Cir. 1987); *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585 (Del. Ch.), *aff’d*, 535 A.2d 1334 (Del. 1987). As a matter of federal law, the bidder is not required to have its financing in place before commencing a tender offer. *Nomad Acquisition Corp. v. Damon Corp.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040 (Del. Ch. 1988); *IU Int’l Corp. v. NX Acquisition Corp.*, 840 F.2d 220, 222 (4th Cir.), 840 F.2d 229 (1988); *Newmont Mining Corp. v. Pickens*, 831 F.2d 1448 (9th Cir. 1987).

75. *Buckhorn, Inc.*, 656 F. Supp. at 225.

76. A good example of this is set forth in *Ivanhoe*, which arose out of a tender offer for Newmont by Ivanhoe. *Ivanhoe*, 535 A.2d at 1334. The Newmont board adopted certain defensive maneuvers that precluded Ivanhoe’s success and had the subsidiary effect of precluding a takeover by Newmont’s largest shareholder, Gold Fields. *Id.* at 1336. In a shareholder suit, joined by Ivanhoe, challenging the maneuvers, the court examined the appropriateness of the defenses with regard to both Ivanhoe and Gold Fields. Ivanhoe posed a “threat,” the court held, because its offer was

can hardly make dispassionately. While there is precedent for allowing corporate management to use corporate funds in a proxy contest, where control might be at stake,⁷⁷ such precedent does not justify use of the corporate machinery to preclude the shareholders from accepting a tender offer. At best, the board should be able to present its case to the shareholders, as in a proxy contest; they have no right to coerce votes.

A board should not be able to exercise greater powers for another reason. Corporations can be structured to give the board greater power in takeover situations and to protect against some of the perceived evils in takeover tactics. Since the Delaware Supreme Court decision in *Moran v. Household International, Inc.*⁷⁸ it is clear that, in the absence of a bid, a corporation can adopt a "poison pill" that has the effect of requiring potential bidders to negotiate with the board.⁷⁹ While the Household International poison pill was adopted by the board without submission to the shareholders, the board obviously can submit such a plan to the shareholders, thereby increasing the chances of judicial deference.

inadequate and its financing was uncertain. *Id.* at 1342. As to Gold Fields, the Chancellor said this: "Finally, the threat which Gold Fields posed was real. The Gold Fields board had in fact paused to weigh its options. Throughout these maneuvers it had considered in earnest the possibility of either independently purchasing control of Newmont or selling its interest to Ivanhoe." *Id.* In other words, the possibility that Gold Fields might act in a way that resulted in a change of control of Newmont justified defensive action by Newmont.

A different approach, with similar results, is evident in *AC Acquisitions v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986). In this case, the Chancellor examined the propriety of a coercive self-tender adopted in response to an all cash noncoercive offer, at an apparently attractive price. The threshold issue—whether there was a threat—was nonetheless resolved in favor of the target. The Chancellor reasoned that the requirement that the target demonstrate the presence of a threat is satisfied by showing that the defensive action had "a corporate purpose, not one personal to the directors." *Id.* at 112. The self-tender had such a purpose, the Chancellor ruled, because it offered the target shareholders the opportunity to receive a large, tax-advantaged cash distribution together with a continued participation in a new highly-leveraged entity. *Id.* This view of the "threat" test in effect guts it.

77. *Campbell v. Loew's, Inc.*, 134 A.2d 852 (Del. Ch. 1957); *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 309 N.Y. 168, 128 N.E.2d 291 (1955). See generally E. ARANOW & H. EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL* (1968).

78. 500 A.2d 1346 (Del. 1985).

79. After adopting a poison pill, the propriety of the board's decision of whether to redeem it when an offer is made is subject to the same standards as a board decision to resist an offer. In *Moran*, the Court said the following: "When the Household Board of Directors is faced with a tender offer and a request to redeem the [poison pill], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard they were held to in originally approving the [poison pill]." *Id.* at 1354.

In any event, these pre-offer devices are not the same as a poison pill adopted in the face of a hostile offer.⁸⁰ Such a maneuver changes the rules of the game midstream, disappointing the expectations of the bidder as well as the shareholders. Moreover, the shareholders can react to a poison pill or similar tactic that shifts the decisionmaking authority from the shareholders to the board by voting against incumbent management or by proposing a resolution or charter amendment that would undo its effects. However, neither of these options is available in the heat of a takeover contest.

Corporate boards can also propose "fair price" amendments to avoid the adverse effects of two-tier offers. Such devices, which can take various forms, have the effect of assuring shareholders who do not tender or whose shares are not purchased because of proration, that they will receive a "fair" price, usually not less than the tender offer price, if there is a second stage merger.⁸¹

Finally, corporate boards can recommend reincorporation in states with favorable anti-takeover legislation. While the regulatory schemes vary from state to state, the effect of such legislation is often to enhance the board's role in the takeover process and create some deterrence to hostile tender offers.⁸² The Indiana "control share" provisions,⁸³ for

80. See H. Pitt, Remarks at a Meeting of the ALI/ABA Conference on Insider Trading and Fiduciary Duty Under the Securities Laws, reported in 21 Sec. Reg. & L. Rep. (BNA) No. 19, at 696 (May 5, 1989). Mr. Harvey Pitt, a prominent tender offer lawyer with Fried, Frank, Harris, Shriver & Jacobson, observed that it is more difficult to justify a poison pill proposed in response to a hostile offer than one adopted as a planning measure. *Id.*

81. See DEFENSES, *supra* note 55, at 36-38; Smith, *Fair Price and Redemption Rights: New Dimensions in Defense Charter Provisions*, 4 DEL. J. CORP. L. 1 (1978).

82. State interest in regulating tender offers dates back to the 1970s, when the "first generation" of state tender offer statutes were enacted. The Illinois statute, which was typical of several first generation statutes, was declared unconstitutional in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). Seeking to avoid the infirmities of the Illinois statute, the states began adopting a "second generation" of statutes shortly after the Court's decision in *MITE*. Over half of the states now have statutes regulating tender offers, with many adopted following the Court's decision in *CTS*. See Veasey, Finkelstein, & Shaughnessy, *The Delaware Takeover Law: Some Issues, Strategies and Comparisons*, 43 BUS. LAW. 865, 868 (1988). Many are control share statutes like the Indiana statute upheld by the Court in *CTS*. See, e.g., ARIZ. REV. STAT. ANN. § 10-1211 (West Supp. 1988); HAW. REV. STAT. §§ 416-171 to -172 (Supp. 1987); LA. REV. STAT. §§ 12:135 to :140.2 (West Supp. 1988); MINN. STAT. ANN. § 302A.671 (West 1989); N.C. GEN. STAT. §§ 55-90 to 55-98.1 (Supp. 1988); OHIO REV. CODE ANN. § 1701.831 (Anderson 1985); WIS. STAT. ANN. § 180.25(9)(a) (West 1988).

A second type of state statute requires that takeovers be approved by a supermajority of the target shareholders or meet certain "fair price" criteria. See, e.g., CONN. GEN. STAT. ANN. §§ 33-374a to -374c (West 1989); FLA. STAT. § 706.108 (West Supp. 1987); GA. CODE ANN. §§ 14-2-232

instance, which were recently upheld by the U.S. Supreme Court,⁸⁴ limit the voting rights of a person who acquires a certain percentage of an Indiana corporation to which the provisions apply; full voting rights are available only upon approval of the disinterested shareholders. The law does contain an exemption for mergers or share exchanges to which the corporation is a party. Thus, when the Indiana provisions apply, a potential purchaser runs the risk of acquiring shares it cannot vote, a risk it can avoid by entering into an agreement with the corporation. Other state laws have the similar effect of increasing the power of the board or otherwise slowing down the acquisition.⁸⁵

In sum, the identification of a threat, a critical element in the *Unocal* test, is largely in the hands of the target board of directors, and the *Unocal* case provides too little guidance as to how the exercise of that discretion is to be judged.⁸⁶ Of equal importance are the unconvincing rationales for maintaining that discretion, which does not adequately protect the interests of the bidder. The possibility of adopting ex-ante structural changes to the corporation also exists as a means of eliminating many identified threats.

to -234 (Supp. 1987); ILL. ANN. STAT. ch. 32, para. 7.85 (Smith-Hurd 1988); WASH. REV. CODE ANN. § 23A.08.425 (Supp. 1989).

Another type of state statute requires anyone who acquires a certain percentage of a corporation's stock to give written notice to the remaining shareholders, who then may require that person to purchase their shares for "fair value." See, e.g., ME. REV. STAT. ANN. tit. 13-A, § 910 (West Supp. 1988); PA. STAT. ANN. tit. 15, § 1910 (Purdon Supp. 1988).

A final type of statute prohibits "business combinations" between one who acquires a certain portion of a corporation's stock (generally around 20%) and that corporation for a specified period after the acquisition (generally three or five years). See, e.g., 66 DEL. LAWS 204, § 203 (effective Feb. 2, 1988), codified at DEL. CODE ANN. tit. 8 § 203 (Supp. 1988); N.Y. BUS. CORP. LAW § 912 (McKinney 1986); N.J. STAT. ANN. § 14A:10A (West 1988); IND. CODE ANN. § 23-1-43 (Burns Supp. 1988).

Obviously, these various approaches are not mutually exclusive, and several states have adopted combinations of them.

83. IND. CODE ANN. §§ 23-1-42-1 to 23-1-43 (Burns Supp. 1988).

84. CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

85. See *supra* note 82 and accompanying text.

86. As Chancellor Allen noted in *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787, 796 (1988), "Delaware courts have employed the *Unocal* precedent cautiously." In addition to *City Capital*, only three cases have found defensive actions unreasonable in relation to the threats posed. *Grand Metropolitan PLC v. Pillsbury*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,104 (Del. Ch. 1988); *AC Acquisition Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986); *Robert M. Bass Group, Inc. v. Evans*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,924 (Del. Ch. 1988).

B. THE REASONABLENESS OF THE RESPONSE

The post-*Unocal* cases in Delaware do not yield a clear picture of how the reasonableness of the response will be determined. It is clear from these cases, however, that the flexible *Unocal* test requires significant judicial involvement whenever a defensive maneuver is used to counter a hostile offer. The Chancery courts of Delaware have applied the two-part test of *Unocal* in at least thirteen cases through mid-1989, and the Delaware Supreme Court has issued a full opinion in one of those cases. In every instance where a defensive maneuver was challenged and the presence of a threat was an issue, the Chancery courts found the presence of a "threat." This meant that the second test—judging the reasonableness of the defensive maneuver—had to be examined by the court. In brief, these cases suggest, in a very general way, that a defensive maneuver is "reasonable" in relation to a threat if it promotes an auction for the target and "unreasonable" if it does not lead to an auction or gives such an appearance.⁸⁷ Not all Chancery cases can be so

87. Cases that tend to support the proposition that the Chancery courts are moving toward an auction market for corporate control include: *MAI Basic Four, Inc. v. Prime Computer, Inc.*, Civ. Ac. No. 10428 (Del. Ch. 1988) (LEXIS, State cases library, Delaware file) (Plaintiff MAI's motion for preliminary injunction requiring removal of anti-takeover maneuvers, including poison pill, was denied. The court noted that such relief "at this early stage" would be inappropriate, but implied that should the "stalemate" continue indefinitely, the target's stockholders "will be denied the opportunity to make their own investment judgment."); *Grand Metropolitan PLC v. Pillsbury*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,104 (Del. Ch. 1988) (The court enjoined a proposed spin-off of a key target asset and ordered a redemption of the target's poison pill, reasoning that the only threat posed was an allegedly inadequate offer and the response was unreasonable in relation to the threat posed. The offer had been pending for several weeks, no competitive bids had emerged, and the offer was heavily subscribed. Finally, the plan of the target to enhance shareholder value was not obviously superior.); *City Capital Assoc.*, 551 A.2d at 787 (The court ordered redemption of a poison pill, but allowed restructuring to proceed so that the shareholders could have a choice between City Capital's tender offer and Interco's restructuring. The poison pill was found to be an unreasonable response to the threat, the possibility that the Interco shareholders might accept the City Capital offer, which the Interco board alleged was inadequate.); *Mills Acquisition Co. v. Macmillan, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch.), *rev'd on other grounds*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,072 (Del. 1988) (poison pill enjoined to allow shareholders to consider alternative offer); *Doskocil Cos. v. Griggy*, Civ. Ac. No. 10,095 (Del. Ch. 1988) (LEXIS, State cases library, Delaware file) (motion to require redemption of poison pill denied, as its presence may enhance the auction process); *Nomad Acquisition Corp.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040 (Del. Ch. 1988) (refused to order a redemption of a poison pill when the market price exceeded the tender offer price); *Robert M. Bass Group, Inc. v. Evans*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,924 (Del. Ch. 1988) (proposed restructuring was found to be unreasonable in relation to the alleged threat, an inadequate price, and was therefore enjoined); *Tate & Lyle PLC v. Staley Continental, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,764 (Del. Ch. 1988) (a "serious offer" had not yet been made because the market price exceeded the tender offer price and the poison pill serves to promote an auction for the target); *Facet Enterprises, Inc. v. The Prospect Group, Inc.*, Civ. Ac. No. 9746 (Del. Ch. 1988) (LEXIS, State cases library, Delaware file) (The court refused to enjoin a

characterized,⁸⁸ and this may not represent the view of the Delaware Supreme Court.

poison pill because the bidding for the target was proceeding and an order of redemption was premature.); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986) (coercive self-tender by target was held not reasonable in relation to the threat posed).

Cases that do not appear to support the proposition include: *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. 1989), *aff'd sub. nom.* *Literary Partners, Inc. v. Time, Inc.*, Civ. Ac. Nos. 10866, 10670 & 10935 (Del. 1989) (LEXIS, State cases library, Delaware file) (Plaintiff Paramount made a cash tender offer for Time following Time's announcement of a merger with Warner Communications. When Time and Warner restructured their deal to a cash tender offer by Time for Warner, Paramount sought an injunction. Held, Time's restructured offer for Warner was a reasonable response to Paramount's hostile tender offer.); *Shamrock Holdings, Inc. v. Polaroid Corp.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,340 (1989 Del. Ch.) [hereinafter *Polaroid II*] (Plaintiff bidder challenged target's plan to repurchase a large number of its outstanding shares, financed in part through the placement of a block of preferred stock in "friendly" hands. The court held that these measures were a reasonable response to the threat posed by the bidder, namely, an inadequate price.); *The Henley Group, Inc. v. Santa Fe Southern Pacific Corp.*, Civ. Ac. No. 9569 (Del. Ch. 1988) (LEXIS, State cases library, Delaware file) (The court refused to enjoin the issuance of debentures, which were part of a restructuring and contained provisions that made a takeover more difficult. The threat was that Henley "might commence a hostile tender offer" and that offer "might not be at a fair price and might jeopardize the restructuring." *Id.* at 46. The restrictive debentures were reasonable in relation to this threat since they were limited in duration and did not necessarily preclude a hostile tender offer.); *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585 (Del. Ch.), *aff'd*, 535 A.2d 1334 (Del. 1987) (preclusive defensive maneuver in response to a hostile two-tier, front-end loaded offer that the target board found inadequate was held justified).

88. Arguably, *Paramount*, *Polaroid II*, *Henley*, and *Ivanhoe*, discussed *supra* note 87, are cases in which the Chancery court condoned a defensive maneuver that had the effect of ending a bidder's interest in the target without creating an auction. However, each presents a distinguishing characteristic. In *Paramount* the Chancellor's opinion placed great emphasis on the fact that the Time-Warner deal, whether structured as a share exchange (the deal reached before Paramount's tender offer for Time) or a purchase by Time (the transaction following Paramount's offer), was part of Time's well-developed business strategy and was not simply reactive to Paramount's offer. The Chancellor's opinion thus distinguishes between structural defenses, such as corporate restructuring in *Robert M. Bass Group*, and a plan that was part of a business plan. In *Polaroid II*, it was not clear that the defensive maneuvers precluded a successful takeover, in *Henley* no bid was actually made for the target and the restrictive provisions in the debentures only limited highly leveraged takeovers, and *Ivanhoe*, discussed in the text, the nature of the offer—a coercive, two-tier offer—set it apart from the rest of the cases.

Two other recent Delaware cases, not applying *Unocal*, are worth noting. In *Shamrock Holdings, Inc. v. Polaroid Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,176, at 91,610 (Del. Ch. Jan. 6, 1989) [hereinafter *Polaroid I*], Vice Chancellor Berger refused to enjoin an ESOP established by the target, Polaroid, following Shamrock's acquisition of 5% of Polaroid's stock. The decision was on the merits, and thus the procedural obstacles that sometime preclude preliminary injunctive relief were not present. *Id.* Moreover, the Vice Chancellor held that the ESOP, despite its anti-takeover effects, was "fair." *Id.* at 91,623. The fairness issue was reached because the Polaroid Board had not undertaken a *Unocal* analysis to determine if Shamrock posed a threat to it or its shareholders. The Polaroid defendants argued that *Unocal* did not apply because Shamrock had not made a tender offer or indicated that it would. *Id.* at 91,619. The Vice Chancellor found that it was unnecessary to decide if *Unocal* applied because even if the defendants could not avail themselves of the business judgment rule, the ESOP would pass muster under a fairness analysis. *Id.* at 91,619-20. The opinion reflects a measure of deference to the Polaroid Board that

In *Ivanhoe Partners v. Newmont Mining Corp.*,⁸⁹ a major post-*Unocal* case in which the Delaware Supreme Court issued a full opinion, the court held that defensive action that precludes even an auction is "reasonable" if it is in response to a potential two-tier, front-end loaded offer. Although the *Ivanhoe* case is instructive and is discussed below, the Chancery opinions are more numerous and may give a better indication of the trend in the Delaware courts.

In *AC Acquisitions Corp. v. Anderson, Clayton & Co.*,⁹⁰ the first post-*Unocal* case decided by the Chancery court, Chancellor Allen issued a preliminary injunction against a self-tender proposed by the target, Anderson, Clayton, because its terms were coercive. The self-tender for 65% of the outstanding stock at \$60 per share ran simultaneously with AC's offer for 100% of the stock at \$56 per share. The AC offer was conditioned on the abandonment of the self-tender and the receipt of at least 51% of the outstanding Anderson, Clayton stock. The closing date for the Anderson, Clayton self-tender, however, was before the closing date of the AC tender offer. Consequently, Anderson, Clayton shareholders felt compelled to accept the self-tender in order to avoid the risk of losing the benefit of that offer and then seeing the AC offer fail because its conditions were not satisfied.

Chancellor Allen opined that the Anderson, Clayton self-tender was not reasonable in relation to the threat posed and, therefore, did "not qualify for the protection of the business judgment rule."⁹¹ This may have been because the board never clearly articulated the threat it faced. He also found that the effect of the maneuver, "albeit a possibly unintended one,"⁹² was to entrench the Anderson, Clayton directors, thus

surprised some observers. See *Shamrock's Polaroid Bid is Dealt a Blow As Court Upholds Employee Stock Plan*, Wall St. J., Jan. 9, 1989, at A4, col. 2. Vice Chancellor Berger reconsidered *Polaroid I* in *Polaroid II* and affirmed the result.

A second case worth considering is *TW Services, Inc. Shareholders Litigation*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334 (Del. Ch. 1989) (Allen, Chancellor). The court refused the bidder's request for a mandatory injunction requiring the target board to lift a poison pill. The all cash offer for all of the outstanding shares was heavily subscribed by the target shareholders and financing commitments had been obtained by the bidder. The offer was, however, conditioned on, among other things, approval by the target board and the execution of a merger agreement. Because of those conditions, the court treated the offer as an offer to merge, and target board's response as a decision not to accept the offer. In that context, the target board's response is judged by the business judgment rule, and the more stringent requirements of *Unocal* are not relevant. The court further found that the target board was fully informed and disinterested; its determination was therefore protected.

89. 535 A.2d 1334 (Del. 1987).

90. 519 A.2d 103 (Del. Ch. 1986).

91. *Id.* at 114.

92. *Id.*

constituting a breach of the duty of loyalty. Therefore, the directors had the burden of demonstrating the intrinsic fairness of the maneuver, a burden that, according to the Chancellor, they did not meet. The opinion thus prevents maneuvers that preclude the tender offeror from competing with the target and marks the first indication that the Chancery courts might be moving toward an auction model.

Several subsequent cases decided by the Chancery courts confirm this view of *Anderson, Clayton & Co.* In *Grand Metropolitan PLC v. Pillsbury*,⁹³ a late 1988 decision, retired Justice Duffy, who was sitting by designation, ordered the target, Pillsbury, to redeem its poison pill or otherwise exempt its effects from the pending offer of Grand Metropolitan. The court also restrained Pillsbury from proceeding with a proposed restructuring. Grand Metropolitan's offer had been pending for nearly three months when the opinion came down and during that period no other offers had emerged other than the restructuring plan proposed by Pillsbury. The tender offer, an all-cash offer for all of Pillsbury's outstanding stock, was heavily subscribed. The "threat" posed by the offer—it was allegedly inadequate—did not justify the preclusive defensive maneuvers taken by the directors. For these reasons, Justice Duffy concluded that the Pillsbury board was acting unreasonably in proposing the restructuring, leaving the poison pill in place, and otherwise precluding its shareholders from accepting the Grand Metropolitan offer. The poison pill had outlived its purpose.⁹⁴

Two other recent Chancery court opinions disapproved of preclusive defensive maneuvers adopted in response to noncoercive offers that were alleged by the target's board to be inadequate. In *City Capital Associates Ltd. Partnership v. Interco, Inc.*⁹⁵ the court ordered the target to redeem a poison pill, and in *Robert M. Bass Group, Inc. v. Evans*⁹⁶ a preclusive restructuring was enjoined. In each case, the court held that the target acted unreasonably in not permitting the shareholders to choose the proposed offer.

In the aggregate, these cases suggest that the shareholders ought to be able to consider noncoercive offers, at least at some point. They also provide an interesting contrast to pre-*Unocal* cases, such as *Marshall Field v. Panter*, discussed above, and some post-*Unocal* cases from other

93. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,104 (Del. Ch. 1989).

94. *Accord* *Southdown, Inc. v. Moore McCormack Resources, Inc.*, 686 F. Supp. 595 (S.D. Texas 1988) (applying Delaware law).

95. 551 A.2d 787 (Del. Ch. 1988).

96. 552 A.2d 1227 (Del. Ch. 1988).

jurisdictions that defer to the directors' judgment that the target ought to remain independent.⁹⁷ Under the Chancery courts' cases, it is no longer sufficient to demonstrate that the directors had motives other than maintaining their positions. If the defensive maneuver has an entrenchment "effect," which surely could be said of the defensive acquisitions in Marshall Field, the protections of the business judgment rule may be unavailable. This approach suggests greater protection for the bidder.

Anderson, Clayton, Pillsbury, City Capital, and *Robert M. Bass* are easy to square with the auction model; the court enjoined a defensive maneuver in each case. In addition, there are several decisions of the Chancery court denying relief to bidders that also might be read as supporting the auction model. In *Doskocil Cos. Inc. v. Griggy*,⁹⁸ for instance, the court noted that the poison pill might have the effect of enhancing the auction process. In both *Nomad Acquisition Corp. v. Damon Corp.*⁹⁹ and *Tate & Lyle PLC v. Staley Continental, Inc.*¹⁰⁰ the court noted that the market price of the target securities exceeded the tender offer price, suggesting that the market anticipated additional bidding for the target and suggesting that the poison pill was not, at that stage in the process, inhibiting an auction for the target. Similarly, the Chancery court refused to order redemption of the poison pill in *Facet Enterprises, Inc. v. The Prospect Group, Inc.*,¹⁰¹ noting that bidding was proceeding and that with the poison pill in place a higher bid might emerge.

Another recent pronouncement of the Chancery court in this area, *MAI Basic Four, Inc. v. Prime Computer, Inc.*,¹⁰² confirms these observations. The fact pattern is typical of the cases noted in the preceding paragraph: A hostile tender offer is followed by the adoption of anti-takeover measures, including a poison pill, and then litigation by the bidder challenging the measures. The Vice Chancellor refused to issue the requested mandatory preliminary injunction, finding that the anti-takeover measures were reasonable because the tender offer price represented only a small premium over the market price and relatively few shareholders had tendered into the offer. The court noted, however, that in the litigation

97. See, e.g., *Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289 (N.D. Ill. 1988) (Applying Delaware law, the court upheld a poison pill, deferring to the directors' decision to assure continued independence for the company.).

98. Civ. Ac. No. 10,095 (Del. Ch. Oct. 7, 1988) (LEXIS, State cases library, Delaware file).

99. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040 (Del. Ch. Sept. 16, 1988).

100. [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,764 (Del. Ch. May 9, 1988).

101. Civ. Ac. No. 9746 (Del. Ch. Apr. 5, 1988) (LEXIS, State cases library, Delaware file).

102. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179, at 91,632 (Del. Ch. Dec. 20, 1988).

before it the takeover was at an "early stage,"¹⁰³ implying that it thought further bidding or other events would arise giving it another opportunity to rule on the defensive maneuvers. This inference is supported by this seemingly gratuitous statement near the end of the opinion:

[I]f the present stalemate continues indefinitely the stockholders of Prime will be denied an opportunity to make their own investment judgment whether they should accept a tender offer because the anti-takeover mechanisms are so burdensome that no prospective tender offeror could afford to buy the shares so long as they are in place.¹⁰⁴

The court is stating the obvious, probably to send a message to the target that the "stalemate" ought not to continue indefinitely. *Pillsbury*, decided just days before *MAI Basic*, makes it clear that such a stalemate cannot continue indefinitely.

These cases from the Chancery court, favoring the auction model, should be considered in light of the fact that the Delaware Supreme Court has never held that a defensive maneuver was unreasonable in relation to the threat posed. It is unclear whether the Delaware Supreme Court would agree with the trend that appears to be emerging in the Chancery opinions. As noted above, the Delaware Supreme Court has issued only one opinion directly applying *Unocal*. In *Ivanhoe*, the court affirmed a lower court decision denying a preliminary injunction sought by the bidder, Ivanhoe, against a large cash dividend issued by the target, Newmont, that helped finance a "street sweep" by Newmont's largest shareholder.¹⁰⁵ The effect of this maneuver was to allow this shareholder to acquire almost one-half of Newmont's stock, thus practically blocking the tender offer.

The Newmont board claimed that the "threat" posed by Ivanhoe's tender offer was two-fold: it was both "inadequate" and "coercive" because it was not adequately financed and might be followed by a lower, noncash merger. The court accepted this reasoning despite Ivanhoe's assurance that it was fully financed and would provide the same consideration in a cash merger for the remaining shares following the tender offer. More importantly, the court held that these threats justified a maneuver that precluded the success of Ivanhoe's offer. No auction was possible if nearly one-half of the shares were held by a single shareholder.

There are several possible readings of the court's opinion in *Ivanhoe*. A cynical reading would note the presence of T. Boone Pickens as the

103. *Id.* at 91,635.

104. *Id.*

105. *See supra* note 28.

key player in Ivanhoe Partners. Mr. Pickens is a notorious "green-mailer,"¹⁰⁶ as the court noted in its opinion,¹⁰⁷ and thus unlikely to evoke much sympathy from the Delaware courts. Indeed, he was the principal in the group that bid for Unocal, where the Delaware Supreme Court approved a preclusive defensive maneuver—a self-tender by Unocal that, by its terms, precluded the Pickens group from accepting the offer.¹⁰⁸

A second reading of *Ivanhoe* would focus on the potentially coercive aspects of the tender offer. The Delaware Supreme Court characterized the Ivanhoe offer as a coercive, two-tier offer, although, in reality, it was less than classic. Ivanhoe did not threaten to squeeze-out the nontendering shareholders in a merger with a lower price than the tender offer. In fact, it promised a merger at the same price and in cash. Perhaps the court chose to characterize the Ivanhoe offer as coercive because this would justify the harshest defensive maneuvers. Thus, the case may simply stand for the proposition that preclusive defensive maneuvers are justified, or "proportional to the threat posed,"¹⁰⁹ when the hostile tender offer is a coercive, two-tier offer at a price that the target board believes is inadequate. This view is echoed in Justice Duffy's opinion in *Pillsbury*: "In the principal, [if] not in all, Delaware cases validating the Pill, it is apparent that the purpose thereof was to create a 'defense' against hostile, coercive acquisition techniques."¹¹⁰

A third possible reading of *Ivanhoe* would focus on the discretion that the court allowed the target directors. Once they have made a judgment, in good faith and after reasonable investigation, that the offer is not in the best interests of the target shareholders, their actions will be clothed with a presumption of propriety. This reading finds support in the language of the opinion. It ends with a now-familiar recitation of the business judgment rule and sounds very much like pre-*Unocal* cases:

The . . . defensive scheme . . . accomplished the two essential objectives of thwarting the inadequate coercive Ivanhoe offer, and of insuring the

106. The term "greenmailer" refers to a corporate raider who acquires a stake in a target and threatens a hostile takeover as a means of coercing the target to repurchase its holdings at a profit to the raider. See *Heckman v. Ahmanson*, 168 Cal. App. 3d 119, 123 n.1, 214 Cal. Rptr. 177, 180 n.1 (1985).

107. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1342 (Del. 1987).

108. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

109. See Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to the Proportionality Review?*, 44 BUS. LAW. 247 (1989); *Grand Metropolitan PLC v. Pillsbury*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,104, at 91,193 (Del. Ch. 1988) ("This balancing or proportionality element refers to the effect of the takeover bid 'on the corporate enterprise'. . .").

110. *Grand Metropolitan*, at 91,195.

continued interest of the public shareholders in the independent control and prosperity of Newmont. Under the circumstances, the board's actions taken by a majority of independent directors, are entitled to the protection of the business judgment rule.¹¹¹

In any event, the Delaware Supreme Court seems more tolerant of target management and less solicitous of bidders than does the Chancery court. Whether the former will be less tolerant of preclusive defensive maneuvers in other instances awaits a case in which the offer is not coercive and the offeror is not Mr. Pickens. The Delaware Supreme Court might also be influenced by changes in the Williams Act limiting some bidder tactics, if any are enacted.¹¹² It might also be influenced by decisions, such as those discussed in the next section, that recognize the interests of the bidder more directly.

IV. REPLACING THE BUSINESS JUDGMENT RULE: A NEW LOOK AT OLD LEARNING

Eighteen years ago, in *Schnell v. Chris-Craft Industries*,¹¹³ the Delaware Supreme Court held that a corporation could not, at the eleventh hour, change the date of the annual shareholders' meeting to thwart the efforts of the plaintiff, a dissident group that was planning a proxy contest. The opinion was clear and concise. Because the directors acted for the purpose of perpetuating themselves in office, a purpose counter to "established principles of corporate democracy," the action could "not be permitted to stand."¹¹⁴

In *Schnell*, the Delaware Supreme Court did not discuss whether the directors breached a fiduciary duty to the plaintiffs, nor did the business judgment rule merit even a passing reference by the court. The opinion was grounded on good, old-fashioned equitable principles. Responding to the defendant's argument that it complied strictly with the provisions of Delaware corporate law, the court said that "inequitable action does not become permissible simply because it is legally possible."¹¹⁵

111. *Ivanhoe*, 535 A.2d at 1345.

112. *See supra* note 13.

113. 285 A.2d 437, 439 (Del. 1971).

114. *Id.* at 439. *See also* Lerman v. Diagnostic Data, Inc., 421 A.2d 906 (Del. Ch. 1980) (applying *Schnell* test in the context of a by-law amendment).

115. *Schnell*, 285 A.2d at 439.

Though often cited in cases that do not involve tender offers,¹¹⁶ the forthright approach of *Schnell* has not had a significant impact in shaping the outcome of recent cases that seem to call for its application. The modern equivalent of the fact pattern in *Schnell* is the adoption by directors of defensive maneuvers in response to a hostile takeover attempt that render the offer impractical.¹¹⁷ The legality of those defensive maneuvers could be tested under a *Schnell* formula: Have the directors acted inequitably with regard to the bidder? Instead, as noted above, the courts have opted for a complicated application of the business judgment rule.¹¹⁸

Despite the predominance of the business judgment rule analysis, some recent cases can be read as sympathetic to the *Schnell* approach. The Chancery opinions noted above might be read in such a manner. More significant, however, are a pair of 1986 opinions by the Seventh Circuit arising from the struggle for control of CTS Corporation.¹¹⁹ The first of these involved a shareholders' rights plan adopted by CTS to defeat a tender offer by Dynamics Corporation to increase its holdings in CTS from 9.6% to 27.5%. Under the CTS plan, when any shareholder acquired 15% or more of CTS's outstanding stock, all other shareholders would be entitled to purchase from CTS a securities package consisting of CTS stock and debentures for 25% of the current market price of the package. If the tender offer were successful and the plan were allowed to stand, the effect of the plan would be to reduce Dynamics' percentage ownership in CTS from 27.5% to 20.7% and inflict a substantial capital

116. A typical, recent example is *Blasius Industries, Inc. v. Atlas Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,965 (Del. Ch. 1988). In *Blasius*, the defendant board was faced with a shareholder consent statement that added eight directors to the board, giving the insurgent group a majority on the board. In response, the directors appointed two of their own nominees. If that action were permitted to stand, the insurgents would lose their majority. The Chancery court held the board's election must be set aside when board action affects the allocation of power between itself and the shareholders. In such a situation, the business judgment rule is inapplicable and the board bears "the heavy burden of demonstrating a compelling justification for such action." *Id.* at 90,485. The defendant board was unable to meet that burden in this case.

117. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986) is a good example. In response to AC's tender offer at \$56 cash per share for 100% of Anderson shares, Anderson countered with a self-tender for 65% of its stock at \$60 per share. *Id.* at 104. The expiration date for the self-tender preceded that of the AC offer, and the AC offer was conditioned upon (a) Anderson's abandonment of its offer and (b) AC'S receiving at least 51% of the outstanding stock. *Id.* Thus Anderson shareholders were "coerced" into tendering into the self-tender, because they could not take the chance that the self-tender would fail and AC would take up their shares. For this reason, the Chancellor held that the self-tender was not a reasonable response to the AC offer. *Id.* at 114. Before reaching such a result, the Chancellor was obligated, under Delaware precedent, to plod through the business judgment rule and *Unocal* tests.

118. See *supra* notes 23-41 and accompanying text.

119. *Dynamics Corp. of America v. CTS Corp.*, 805 F.2d 705 (7th Cir. 1986) [hereinafter *Dynamics IV*]; *Dynamics II*, 794 F.2d 250 (7th Cir. 1986).

loss on it.¹²⁰ In short, Dynamics could not proceed unless the plan were set aside.

The district court did just that.¹²¹ Applying Indiana law, which the court said meant looking to Delaware decisions, the court entered a preliminary injunction, holding that Dynamics might be able to show that the CTS board was motivated by a desire to entrench itself in office and that the action taken by the board was not reasonable in relation to the threat posed by Dynamics. The Seventh Circuit affirmed with an opinion, by Judge Posner, that was refreshing in its approach.¹²²

Like the district court, the appellate court cited all of the key Delaware precedents in the area, but the appellate court opinion broke form from past decisions and applied a novel analysis. Rather than starting out with a recitation of the business judgment rule and its various presumptions, Judge Posner first reviewed the standards for granting a preliminary injunction and then discussed the economic effect of defensive maneuvers, such as the shareholder rights plan or poison pill adopted by CTS in this case. The opinion notes the importance of the hostile tender offer as a device for maintaining a market for corporate control and the possible deleterious effects of the presence of a poison pill. The opinion also reviewed the economic literature on the effect on shareholder wealth of defeating a tender offer by defensive maneuvers. This portion of the opinion concluded with a note of skepticism: “[The arguments for defensive maneuvers] strike us as giving too little weight to the effect of ‘defensive’ measures in rendering shareholders defenseless against their own managements.”¹²³

With this information, rather than abstract principles of corporate law, as background, the opinion considers the legality of the CTS poison pill, first examining the process by which it was adopted and then moving on to the effect on CTS if the pill is triggered. As to the former, while the opinion concludes that the Dynamics’ tender offer “was not evaluated in a cool, dispassionate, and thorough fashion,”¹²⁴ this shortcoming was apparently not the basis for upholding the lower court’s decision. Rather, the appellate court’s decision seems to turn on the unfairness of the pill, the adverse effect on Dynamics if the CTS shareholders exercised their rights under the pill, and the lack of compelling reason behind the

120. *Dynamics II*, 794 F.2d at 258.

121. *Dynamics I*, 637 F. Supp. 406 (N.D. Ill. 1986).

122. *Dynamics II*, 794 F.2d at 250.

123. *Id.* at 255.

124. *Id.* at 257.

pill. Without citing any doctrine or case authority, the court concluded this portion of the opinion by saying, quite simply, that "the poison pill was properly enjoined."¹²⁵

One is left with the strong impression that the outcome in this case turns more on the effect of the action taken by the CTS board than on the process by which its decision was reached. Of equal importance is the presence of a discussion of how the defensive action affects the financial investment and expectations of the bidder, Dynamics. By comparison, most earlier decisions tended to focus on the good faith and due care of the target board. The first CTS case is, thus, a good example of an approach that does not get bogged down in a business judgment rule analysis that ignores the bidder's interest.

Soon after the district court's decision setting aside its poison pill, the CTS board adopted a new plan—a plan that formed the basis of a second round of decisions in the district court and Seventh Circuit. Here, however, the two courts reached different conclusions: the lower court held that the new plan was legal,¹²⁶ while the appellate court disagreed.¹²⁷

Under the new plan, each CTS shareholder had the right to exchange his or her CTS shares for one-year notes with a principal amount of \$50 and bearing interest at the rate of 10% per annum. The rights became exercisable if any person acquired ownership of 28% or more of the outstanding CTS stock, and the 28% holder was excluded from the rights offering. Dynamics' tender offer for 18% of the outstanding CTS shares at \$43 per share was pending at the time the plan was implemented. Because the plan had the effect of prohibiting Dynamics from increasing its ownership above 28% unless it was prepared to pay at least \$50 per share, it sued to enjoin the plan. Dynamics also argued that the plan had an adverse effect on its ability to wage a proxy contest for the control of CTS.

The CTS directors were more careful this time around. Before adopting the new plan, they formed a special committee of outside directors and retained an independent legal counsel to advise that committee on how to deal with the Dynamics offer. These steps increased the board's credibility and influenced the district court's view of the matter. The defendant directors convinced the district court that they acted in

125. *Id.* at 259.

126. *Dynamics III*, 635 F. Supp. 1174 (N.D. Ill. 1986).

127. *Dynamics IV*, 805 F.2d 705 (7th Cir. 1986).

good faith following a reasonable investigation.¹²⁸ The court was also persuaded that the new plan was a reasonable response to the "threat" identified by the CTS board—the possibility that Dynamics would gain control of CTS and implement a second-step merger at an unfair price.¹²⁹

The appellate court reversed in another opinion by Judge Posner.¹³⁰ As in the first go-around, the appellate court's opinion stands in contrast to the lower court's opinion. While the district court was willing to defer to the judgment of the "independent committee," the Court of Appeals was skeptical. Posner's opinion examined closely the purported rationales for the second pill and concluded that the record was inadequate to support those rationales.¹³¹ He doubted that either the triggering event, ownership of 28% by one person or group, or the conversion price, \$50 per share, was justifiable. In short, the appellate court would not approve the pill unless it was clear that the pill was consistent with the goal of maximizing shareholder values and maintaining a market for corporate control.¹³²

The Court of Appeals decision, while not expressly embracing the auction model, is consistent with it. By comparison, the Second Circuit decision in *Hanson* and the Delaware Supreme Court's opinion in *Ivanhoe*, both discussed above, do not expressly examine the board's defensive action with a view toward the effect on shareholder values or the bidder's interests. The focus in these cases is on the board's deliberative process, on whether the business judgment rule would insulate the board's decisions from judicial scrutiny. While the *Hanson* opinion notes that the price of the optioned assets was likely too low, it is the process, not the price, that provided the rationale for setting aside the option.

An appropriate standard by which to measure director conduct in the face of a hostile tender offer must take into account the important interests that the bidder represents. Therefore, I would propose that the following standard apply:

A person who, in good faith, makes a bona fide tender offer for all or a portion of the outstanding securities of a company thereby creates a protected economic expectation in the acquisition. Upon receiving the offer, the target board of directors has a fiduciary duty to its shareholders to review the offer to determine whether its terms represent

128. *Dynamics III*, 635 F. Supp. at 1178-80.

129. *Id.* at 1180-82.

130. *Dynamics IV*, 805 F.2d 705 (7th Cir. 1986).

131. *Id.* at 716.

132. *Id.*

fair value for the company's securities. If the target board of directors determines in good faith and after reasonable investigation that better terms can be obtained for the company, it may take reasonable measures to realize those terms from the original bidder or another person. It shall be per se unreasonable if those measures materially disadvantage the original bidder vis-à-vis any other bidder or have the effect of precluding the original offer from going forward.

The proposed standard applies whenever a bona fide tender offer is made for the company's securities. The limitation that the offer be bona fide is intended to give the target board more flexibility in dealing with a bidder that does not intend to purchase the shares it has offered to buy. Obviously, this limitation might be abused by the target directors, who might label any offer as being not bona fide. If the bona fides of an offer were at issue, it might be appropriate to place the burden on the board to prove that the offer was not bona fide.

The standard would not disturb the current law regarding director evaluation of merger offers or offers for the purchase of the corporation's assets. A board decision to accept or reject such offers would be subject to the traditional business judgment rule analysis.¹³³ Once a potential bidder decides to go directly to the shareholders, however, the board's ability to interfere is limited. While a hostile tender offer, like a negotiated merger or sale of assets, results in a change of control of the target, that similarity does not mean that role of the target board ought necessarily be the same.¹³⁴ As a preliminary matter, corporation statutes expressly assign a role to the board in mergers and sales of assets, while they are silent when the transaction is a hostile tender offer.¹³⁵ In addition, offerors forego access to confidential information, the advantages of a smooth and orderly transfer of control, and some financing options

133. *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980); *Enterra Corp. v. SGS Assocs.*, 600 F. Supp. 678 (E.D. Pa. 1985). See also *Johnson & Siegel, Corporate Mergers: Redefining The Role of Target Directors*, 136 U. PA. L. REV. 315 (1987) (arguing for statutory changes that would assign to independent directors the authority to pass upon merger offers).

Because the standard proposed here applies only after a tender offer has been or is about to be made, lock-up options and similar devices that a board might use in a negotiated transaction in the absence of a hostile tender offer would be unobjectionable. *Hastings-Murtagh v. Texas Air Corp.*, 649 F. Supp. 479 (S.D. Fla. 1986).

134. Some writers have argued that the "equivalence" between a negotiated sale or merger, on the one hand, and a tender offer, on the other, is such that the board's role should be the same in each. See, e.g., Steinbrink, *Management's Response to The Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978); Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 61 CH. B. REC. 152 (1979). A counter argument, set forth in detail in *Structural Approach*, *supra* note 7, at 848-52, is summarized in the text.

135. See REVISED MODEL BUSINESS CORP. ACT §§ 11.01, 11.03, 12.01, & 12.02 (1984); *Structural Approach*, *supra* note 7, at 850-51.

when they do not or cannot negotiate directly with target management.¹³⁶ Finally, the hostile tender offer serves as a check on management that is intent on entrenching itself in office.¹³⁷

The standard provides some protection for target directors who decide to oppose an offer on the basis of inadequate price. The directors' decision on that matter would be entitled to the protections of the business judgment rule. Unlike the current law, however, the proposed standard dramatically limits the acceptable response. By expressly recognizing that the bidder has an economic expectation, it incorporates state tort law concepts and case law relating to interference with prospective economic advantage.¹³⁸ In general, that tort has the following elements: (1) intentional interference by the defendant, (2) with an economic expectancy of the plaintiff, (3) of which the defendant knew or should have known, (4) resulting in the expectancy being lost, and (5) the plaintiff being damaged.¹³⁹ In appropriate circumstances, the interference might be the basis for injunctive relief.¹⁴⁰

Under this standard, one is privileged to interfere with another's prospective economic advantage in the course of competition, provided that competition meets a standard of fairness.¹⁴¹ Directors, as fiduciaries, are privileged to interfere with offers made to their beneficiaries (the shareholders) if the directors determine that the offer is not in the best interests of the shareholders.¹⁴² If the directors of a target corporation have a fiduciary duty to the shareholders in relation to tender offers, they

136. A share-for-share exchange, for instance, is far easier to accomplish in a negotiated transaction than in a tender offer setting.

137. *Structural Approach*, *supra* note 7, at 850.

138. See generally W. PROSSER & W. KEETON, LAW OF TORTS § 131 (W. Keeton 5th ed. 1984); RESTATEMENT (SECOND) OF TORTS §§ 762-774A (1965); *State Law*, *supra* note 28. Under this tort, one may interfere with another's prospective economic advantage in the course of competition, provided that competition meets a standard of fairness. *Frandsen v. Jensen-Sundquist Agency, Inc.*, 802 F.2d 941, 947 (7th Cir. 1986) ("[W]hile competition is not a defense to a charge of interfering with an existing contract . . . , it is a defense to a charge of interfering with prospective contractual relations, provided it is fair competition."). If the directors of a target corporation have a fiduciary duty to the shareholders in relation to tender offers, they would be privileged to interfere with offers that they believed were not in the best interests of the shareholders. *State Law*, *supra* note 28, at 506-14. What is argued here is that the fiduciary duties of the target board should be altered so that, under no circumstances, does the board have a duty to preclude the shareholders from accepting a tender offer that the board disfavors. With that duty removed, the privilege of the board to interfere with a tender offer is similarly limited. It can encourage an auction, but it cannot preclude the offer from going forward without violating its privilege.

139. *State Law*, *supra* note 28, at 499.

140. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221, 246 (S.D.N.Y. 1975).

141. *Frandsen*, 802 F.2d at 948.

142. See *id.* at 506-14.

would be privileged to interfere with offers that they believed were not in the best interests of the shareholders. The argument here is that the fiduciary duties of the target board should be altered so that under no circumstances will the board have a duty to preclude the shareholders from accepting a tender offer that the board disfavors. With that duty removed, the privilege of the board to interfere with a tender offer is similarly limited. It can encourage an auction, but it cannot preclude the offer from going forward without violating its privilege.

Thus, many of the defensive maneuvers now so prevalent in contests for corporate control would be tortious vis-à-vis the hostile bidder under the standard suggested here. Poison pills that render a bid uneconomical,¹⁴³ lock-up options¹⁴⁴ and corporate restructurings¹⁴⁵ that alter the nature of the target, transfer of stock to an employee stock ownership plan,¹⁴⁶ self-tenders that coerce the shareholders into tendering,¹⁴⁷ and sales of a target's key assets¹⁴⁸ would fail to pass muster under the standard. Other tactics, such as a noncoercive self-tender or offering to pay certain reasonable and limited expenses to induce a bidder to enter the fray, should be allowed, so long as the effect is not to bar the first bidder from the competition.¹⁴⁹

V. CONCLUSION

Early cases judging the legality of defensive maneuvers to tender offers tended to favor target management. The reasons for this are unclear, but may relate to the courts' distrust of the tender offer tactic. In any event, the jurisprudence that has developed has relied primarily

143. *E.g.*, *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988) (requiring redemption of poison pill); *In re Damon Corp. Stockholders Litigation*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040 (Del. Ch. 1988) (upholding poison pill on the basis of traditional business judgment rule analysis); *Dynamics II*, 794 F.2d 250 (7th Cir. 1986).

144. *E.g.*, *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Mills Acquisition Co. v. Macmillan, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,072 (Del. 1988), *rev'g*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988).

145. *E.g.*, *City Capital Assocs.*, 551 A.2d 787 (1988); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988); *British Printing v. Harcourt Brace*, 664 F.2d 1519 (S.D.N.Y. 1987); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986).

146. *E.g.*, *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984); *Frantz Mfg. Co. v. EAC Indus., Inc.*, 501 A.2d 401 (Del. 1985).

147. *Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829 (D. Minn. 1986), *aff'd*, 811 F.2d 414 (8th Cir. 1987); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986).

148. *Carter Hawley Hale Stores, Inc. v. The Limited, Inc.*, 587 F. Supp. 246 (C.D. Cal. 1984); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982); *G.M. Sub. Corp. v. Liggett Group, Inc.*, 415 A.2d 473 (Del. 1980).

149. *E.g.*, *Yanow v. Scientific Leasing, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,660 (Del. Ch. 1988).

on the business judgment rule, a rule that often serves to protect the directors' actions. As tender offers have become more prevalent, however, the courts seem to be less trustful of target management. At the same time, scholarly writing appearing in the past few years argues persuasively that the hostile tender offer plays an important role in maintaining a market for corporate control, a market worth protecting.

The business judgment rule cases, however, do not provide the courts with doctrine to set aside defensive maneuvers that unduly interfere with this market or appear unfair in regard to the interests of a good faith bidder for corporate control. As a result, the Delaware courts have modified the business judgment rule as it applies in tender offer cases, and other courts have manipulated or largely ignored the doctrine. Close examination of the doctrine that has developed in these cases reveals that it has lost any persuasive powers it once had. In its place, I have proposed a rule that recognizes the interests of the bidder, yet retains a role for target management. This change, if accompanied by a change in the Williams Act lengthening the minimum time that a tender offer must remain open, should enhance shareholder returns, while protecting the legitimate expectations of the bidder.

