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# Tender Offers And The Business Judgment Rule

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# TENDER OFFERS AND THE BUSINESS JUDGMENT RULE

MATTHEW TAYLOR\*

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## I. INTRODUCTION

When a corporation's board of directors takes action to defeat a tender offer they often argue that they are acting in the best interests of the corporation and shareholders. When shareholders attempt to challenge the actions of directors through judicial action, the courts confer upon the latter the benefits of the business judgment rule and its presumption of loyalty and care on the part of the directors. The judicially created primary purpose approach (discussed *infra*) to the duty of loyalty, and the difficulty for shareholders in overcoming the presumption of care, calls into question whether the business judgment rule creates a presumption that shields director's actions from serious scrutiny.

In this article I examine whether it is appropriate for courts to apply the business judgment rule in reviewing management's actions that defeat a tender offer. The article begins with an analysis of the economic effects on shareholders of successful tender offers as opposed to those that are defeated by management. Having determined that the defeat of tender offers is generally contrary to the interests of shareholders, it is appropriate to question whether such actions by directors should be protected through the application of the business judgment rule. Consequently, I next look at

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the rule itself and review the development of case law as it has been applied in the takeover context. This is followed by a discussion of the reasons the rule should not be applied to management resistance and is illustrated by an examination of the judicial approach followed in the case involving the attempted takeover of Marshall Field & Co. in 1978.<sup>1</sup>

Finally, I propose a rule which would preclude management from using the business judgment rule as a shield to prevent scrutiny of its actions when challenged judicially. In support of this proposition I argue that a tender offer creates a contractual relationship between the bidder and the owners of the corporation to which management is not a party and in which it should not interfere. Furthermore, shareholders and management alike are afforded the protections of the Williams Act, state anti-takeover legislation, and shareholder approved shark repellent.

## II. ECONOMIC ANALYSIS OF TENDER OFFERS

In his 1979 article on takeover bids<sup>2</sup> Martin Lipton opens with reference to the "legal, moral and practical questions faced by the directors of a company that becomes the target of an unsolicited takeover bid."<sup>3</sup> Although his article is essentially an economic analysis of the role of target management in hostile takeovers it is peppered throughout with references to ethical and moral considerations. Early on, Lipton shows that his disdain for takeovers is at least partially based upon the idea that we should differentiate between those who invest in equity securities for short-term profit and those who are in it for long-term individual and collective gain (though just how such a differentiation could be made in practical terms is not made clear):

Many of the lawsuits and much of the agitation for changes in the existing rules come from certain arbitrageurs and professional investors . . . . [I]t would not be unfair to pose the policy issue as:

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<sup>1</sup> Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981), *cert denied*, 454 U.S.1092 (1981) [hereinafter Panter I].

<sup>2</sup> Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) [hereinafter Lipton].

<sup>3</sup> *Id.* at 101.

Whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares?<sup>4</sup>

Much of the opposition to hostile takeovers, and subsequent support for target management's resistance to tender offers, is based on the idea that takeovers are bad for virtually everyone except the raiders and arbitrageurs. A substantial amount of case law and literature is premised on the idea that shareholder welfare is harmed by takeovers—or at least that shareholders do not lose when management successfully defends against a takeover attempt.<sup>5</sup> Any analysis of target management's duties requires that this threshold issue be addressed.

The economic basis for Lipton's thesis is a study of thirty six defeated tender offers. Of those 36, over 50% were trading (at the time of his article) at a price higher than the original tender offer. This leads him to the conclusion that "the shareholders of more than 50% of the targets are better off today than if the defeated tender offer had succeeded."<sup>6</sup> As Lipton admits, the comparison does not take into account discounting for the time value of money and ignores dividends paid in the interim period.<sup>7</sup> This analysis also fails to make comparisons between the share price of defeated takeover attempts and the ultimate trading prices following successful tender offers (short-term or long-term). A subsequent study,<sup>8</sup> in support of the Lipton thesis "purports to show that the shareholders of between 45% and 97% of all targets did better, as a result of the defeat of the offer, than they would have done if the offer had succeeded."<sup>9</sup> This study takes the same basic approach as does Lipton but compares the prices after discounting for inflation. Both of these studies are fundamentally flawed in that they measure the wrong thing. The Lipton study views success as occurring if the investor can eventually receive more in the market than the tender price. The Kidder study merely requires that the

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<sup>4</sup> *Id.* at 104 (emphasis added).

<sup>5</sup> See e.g. Lucian Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); LIPTON, *supra* note 2; Richard Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630 (1985).

<sup>6</sup> Lipton, *supra* note 2, at 106-07.

<sup>7</sup> *Id.*

<sup>8</sup> Kidder, Peabody & Co., submitted to the SEC's Advisory Committee on Tender Offers (1983), *quoted in* Easterbrook and Jarrell, *Do Targets Gain From Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 281 (1984).

<sup>9</sup> *Id.*

investor eventually match the tender offer price after adjustment for inflation. This might be appropriate if the stock market merely reflected inflation. However, few, if any, would argue that matching inflation is the mark of successful investing. The correct analysis would compare the ultimate trading price with what the shareholder would have attained by selling at the tender offer and then reinvesting that money in a diversified equity portfolio. This approach recognizes the reality of investor behavior.

If a shareholder received \$50 per share in a tender offer two years ago and invested that amount in a diversified equity portfolio, the investor would have gained \$10 in that first year.<sup>10</sup> At the end of the second year the investment would be worth \$72. Lipton would regard as successful a value of \$50 at the end of the second year and the Kidder study would identify \$52.53 as not having lost any money.<sup>11</sup> The past two years have shown equity returns above the historical average and a CPI below average.

However, in an "average" year for both, the analysis would result in a smaller spread but the fundamental distinction would still hold true.

Three other studies on the effect on share price of defeating tender offers show evidence which sharply conflicts with the Kidder, Peabody & Co. study and that of Lipton. These studies developed a beta for the stocks of companies which were the target of tender offers. The betas were developed by comparing the movements in the stock's price relative to the market as a whole or within the given industry. Next, the studies compared the changes in prices before, during, and after tender offers to their betas (relative to the market as a whole) in order to determine the effects of the tender offer, auction, and the subsequent success or defeat by management.

In comparing the share prices, where the company was successfully auctioned, to the prices when the tender offer was defeated the studies found average losses of 15%<sup>12</sup>, 52%<sup>13</sup> and 29%<sup>14</sup> when management successfully defeated the offer. Although there is significant difference among the results of these studies, they all lend strong evidence to refute Lipton's position.

Another aspect of Lipton's thesis is that "experience and common sense prove that . . . tender offer bids are not so different from other major business decisions as to warrant a unique sterilization of the directors in

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<sup>10</sup> New York Stock Exchange earning 20% from 2/1/95-2/1/97.

<sup>11</sup> Annual Consumer Price Index of 2.5%.

<sup>12</sup> Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. FIN. ECON. 51 (1983).

<sup>13</sup> Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy*, 11 J. FIN. ECON. 183 (1983).

<sup>14</sup> Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, as quoted in Easterbrook and Jarrell, *Do Targets Gain From Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 283 (1984).

favor of direct action by the shareholder.”<sup>15</sup> Lipton fails to provide much argument for this position aside from “common sense.” He fails to take into consideration the inherent conflict of interest in directors’ efforts to block an action which will likely result in the loss of their jobs. In response to criticism of his economic analysis, Lipton responds by stating that as “long as the economic benefits of takeovers are debatable, rejection or acceptance of a tender offer should continue to be left to the business judgment of the target’s board.”<sup>16</sup> The extension of this logic (i.e. “debatable”) would forever preclude the questioning of the actions of a board of directors by courts.

Lipton uses the results of his study as the basis for the argument that target management should not be limited in defending against unsolicited tender offers and should be given the benefit of the business judgment rule.

However, a hostile tender offer at a premium price often results because the market has valued the corporation at a particular price (a function of assets and current management) and a raider believes that it is worth substantially more under different management; or possibly the assets alone are worth more than the assets as managed by current management. When a tender offer succeeds, shareholders receive a premium on their investment. They will typically reinvest that premium which, in turn, contributes to growth in the economy and in employment. Corporate management in general is disciplined when the threat of takeovers is significant and their ability to block them is limited. A rule that limits management’s ability to prevent or defeat tender offers—a contractual arrangement between the buyer and seller of a security— or at least provides for merit review, would benefit virtually everyone except incompetent officers and directors. Management would improve; shareholders would profit; the amount available to capital markets would increase; employment would increase and; consumers would benefit from increased competition and improved management.<sup>17</sup>

### III. THE BUSINESS JUDGMENT RULE

The business judgment rule creates a rebuttable presumption that the board of directors and officers have acted: 1) on an informed basis; 2) in good faith; and 3) in the honest belief that they are acting in the best

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<sup>15</sup> Lipton, *supra* note 2, at 103-04.

<sup>16</sup> Martin Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231, 1233 (1980).

<sup>17</sup> See Bebchuk, *supra* note 5; Booth, *supra* note 5; Frank Easterbrook & Daniel Fischel, *The Proper role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1164 (1981); [hereinafter Easterbrook and Fischel].

interests of the corporation and shareholders.<sup>18</sup> This presumed duty is generally divided into two parts: the duty of care and the duty of loyalty. The duty of care requires that directors be fully informed about the decisions made and the duty of loyalty requires that they not act in a self serving manner. The rationale for the rule includes the goals of: 1) providing management with the freedom to develop policy; 2) encouraging competent people to become directors (to "remove the fear of liability for honest mistakes") and; 3) to relieve the courts of second guessing "complex corporate decisions."<sup>19</sup> Although the duty is often expressed as a fiduciary duty, in the corporate context a less stringent application is envisioned—the shareholder is not viewed as *cestuis que trust*, as this approach would not be workable.<sup>20</sup> If directors were held to strict fiduciary duty a corporation could not conduct business because there is some level of self interest in every decision made by directors. A pure fiduciary is prohibited from any transaction that could be seen to involve a conflict of interest. As one court noted, "the business judgment rule seeks to alleviate this problem by validating certain situations that otherwise would involve a conflict of interest."<sup>21</sup>

In the takeover context the duty of care requires that the directors invest time for a thorough investigation of the proposal, thoroughly investigate any recommendations they receive, and conduct a thorough review of all documentation.<sup>22</sup> Disagreement arises over the applicability of the business judgment rule in the context of an unsolicited tender offer. Although it is possible for directors to fulfill their duty of care, their actions should almost always raise a question as to whether they have faithfully discharged their duty of loyalty to the owners of the corporation, namely, the shareholders. Many correctly argue that the application of the rule is appropriate in the conduct of ordinary business but not in the takeover context (see discussion *infra*).

#### IV. DEVELOPMENT OF CASE LAW

One of the early cases evaluating the actions of directors in the takeover context is *Bennett v. Propp*.<sup>23</sup> The case involved the ratification by the board of directors of the chairman's decision to repurchase some of the company's outstanding shares when faced with a raider offering to

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<sup>18</sup> See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

<sup>19</sup> David Schubert, *Unocal Corp. v. Mesa Petroleum Co: A New Era of Fiduciary Duty*, 38 BAYLOR L. REV. 687, 693 (1986) [hereinafter Schubert].

<sup>20</sup> *Id.* at 689.

<sup>21</sup> See *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980).

<sup>22</sup> See *Smith v. Van Gorkom*, 488 A.2d at 873.

<sup>23</sup> *Bennett v. Propp*, 187 A.2d 405 (Del. 1962).

purchase one share over 50% of those outstanding on a first-come first-serve basis.<sup>24</sup> After determining that the action was taken primarily in order to retain control, the Supreme Court of Delaware ruled this an improper purpose, citing earlier cases.<sup>25</sup> The court held that "the burden should be on the directors to justify such a purchase as one primarily in the corporate interest."<sup>26</sup> This sentence would lead to the "primary purpose rule" which courts have used to provide the protection of the business judgment rule so long as maintaining control was not the primary purpose of the director's actions. As a result, the jury is removed as the arbiter in the determination of which side is supported by the preponderance of evidence. Following this rule, courts can decide this as a matter of law and effectively bar consideration of the board's actions on the merits. The court in *Bennett* then went on to absolve most of the directors by finding that they had a reasonable basis for their actions. Deferring to their "business judgment" the court said that it would not second guess them in their decision to support the chairman, thus opening the door for wide latitude in director's actions to block a takeover bid.<sup>27</sup>

Two years later the same court returned to the issue in *Cheff v. Mathes*.<sup>28</sup> Citing *Bennett* the court approved the decision to purchase shares so long as the primary purpose was not to perpetuate control.<sup>29</sup> The burden was placed upon the board, because of the significant possibility of a conflict of interest, to prove that the action was primarily in the corporation's interest, that they had reasonable grounds to fear a danger to corporate policy and, that they acted in good faith (loyalty) and after reasonable investigation (care).<sup>30</sup> The court ignored the fact that there is *always* a danger to corporate policy in takeovers—this is the essence and rationale for most tender offers. Although the trial court determined that the directors had acted out of an improper purpose the Supreme Court, apparently deciding that there was evidence to the contrary, stated that "this question was a matter of business judgment" and overturned the lower

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<sup>24</sup> *Id.* at 406.

<sup>25</sup> *Id.* at 408; *see Macht v. Merchants Mortgage and Credit Co.*, 22 Del.Ch. 70, 194 A. 23 (Del.Ch. 1937) (use of corporate funds by dominating director to assist him in procuring his control is illegal); *see also Yasik v. Wachtel*, 25 Del.Ch. 247, 256, 17 A.2d 309 (Del.Ch. 1941) (general rule approved); *see also Andersen v. Albert & J.M. Anderson Mfg. Co.*, 90 N.E.2d 541 (Mass. 1950) (use of corporate funds by directors to purchase stock for themselves and for the corporation to obtain control is a breach of fiduciary duty).

<sup>26</sup> *See Bennett*, 187 A.2d at 408.

<sup>27</sup> *Id.*

<sup>28</sup> *See Cheff v. Mathes*, 190 A.2d 548 (Del. 1964).

<sup>29</sup> *Id.* at 554.

<sup>30</sup> *Id.*



court's decision.<sup>31</sup> This calls into question whether any significant and realistic limitations are placed upon management actions in the takeover context.

In 1972 the Tenth Circuit ruled on a share repurchase case involving the Denver Post in Colorado.<sup>32</sup> While recognizing a fundamental duty to shareholders on the part of directors, the court described the newspaper's duty as threefold: "to stockholders, to the employees, and to the public."<sup>33</sup> In support of this the court noted that "every state in the Union authorizes by statute corporate contributions for various purposes," thus introducing the idea that directors could take into consideration constituencies other than shareholders in defending against takeovers.<sup>34</sup> Although statutes allow for "contributions for various purposes," they do not provide that management can authorize contributions in disregard of shareholders. The court then inquired into the motives of management and found that the motive to retain control is no more "sinister" than the motive of the raider.<sup>35</sup>

This completely ignores the fact that the raider owes no fiduciary duty to the shareholders; management, on the other hand, does. Although the court referred to the duty owed to shareholders, the actions of the directors were apparently upheld because they argued they were considering the employees and the public by considering the quality of the newspaper itself.<sup>36</sup> The court did not consider whether control was the primary purpose and did not apply a balancing test to weigh the interests of employees and the public against those of the shareholders. This holding could be interpreted to mean that *any* detrimental effect on other constituencies may outweigh the concerns of shareholders. Finally, the court ruled that the directors' discretionary powers, "if exercised honestly and with reason is not subject to control by either the stockholders or the courts."<sup>37</sup> Although the court had reviewed the merits of the case, this assertion of the business judgment rule placed the burden clearly on the plaintiffs and, when combined with the broad discretion granted in serving constituents other than the shareholders, made it virtually impossible for the plaintiffs to succeed.

Three years after *Herald* the Delaware courts ruled on a case in which the plaintiffs sought an injunction against the selective redemption of preferred stock which would effectively maintain a 53% control of the

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<sup>31</sup> *Id.* at 556-57.

<sup>32</sup> See *Herald company v. Seawell*, 472 F.2d 1081 (10th Cir. 1972).

<sup>33</sup> *Id.* at 108.

<sup>34</sup> Lipton, *supra* note 2, at 106-07.

<sup>35</sup> *Id.* at 109.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 110.

company by board members following the expiration of a stock trust fund.<sup>38</sup>

After the plaintiffs alleged a primary purpose of maintaining control the court clearly stated such a purpose to be improper and balanced the evidence to find in favor of the injunction.<sup>39</sup> Although the corporate charter and bylaws expressly provided for the redemption, the court ruled that the action could be scrutinized.<sup>40</sup> At this point the contours of the law were less than clear and shareholders had some reason to believe that director's actions would be carefully scrutinized by the courts.

Two federal cases involving Delaware corporations clearly established the standard applicability of the business judgment rule in the takeover context.<sup>41</sup> In *Panter v. Marshall Field & Co.* the plaintiffs filed a class action suit against the directors of Marshall Field & Co. for federal securities violations and breach of fiduciary duty for their actions, including the filing of antitrust suits which the plaintiffs alleged were aimed primarily at maintaining control. At the outset the court announced that the business judgment rule applied in the takeover context to the same extent that it applied in other business decisions and that the initial burden of overcoming the presumption was squarely on the plaintiffs.<sup>42</sup> The standard to be applied for overcoming the presumption was "fraud, bad faith, gross overreaching or abuse of discretion."<sup>43</sup> The court then gave the justification for applying the primary purpose rule: "control is always arguably 'a' motive in any action taken by a director. Hence plaintiffs could always make this showing and thereby undercut the purpose of the rule."<sup>44</sup> Such a result would mean only that the plaintiffs could survive a directed verdict or motion to dismiss—not that they would win the case. Because a majority of Marshall's directors were "independent" the court held that the presumption of good faith was heightened and categorically rejected the plaintiff's contention that the board should be required to establish a compelling business purpose for its actions.<sup>45</sup>

In *Johnson v. Trueblood* the Third Circuit applied essentially the same reasoning and arrived at the same conclusions: the business judgment rule applied and the plaintiffs bore the burden of showing that the primary purpose of the directors' actions were to maintain control or that they had

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<sup>38</sup> See *Petty v. Penntech Papers*, 347 A.2d 140 (Del.Ch. 1975).

<sup>39</sup> *Id.* at 142.

<sup>40</sup> *Id.* at 143.

<sup>41</sup> See *Panter v. Marshall Field & Co.*, 646 F.2d at 271.

<sup>42</sup> See *Panter*, 646 F.2d at 292.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 294.

<sup>45</sup> *Id.* at 294-95.

acted out of "some sort of bad faith."<sup>46</sup> Furthermore, if the plaintiffs survived a directed verdict the defendant would merely be required to "show that the transaction in question had a valid corporate business purpose."<sup>47</sup> It is nearly impossible to imagine a scenario where directors could not put forth some kind of valid business purpose. Both *Johnson* and *Panter* had strong, well-reasoned dissents.

In 1982 a U.S. Supreme Court case indirectly called into question the legitimacy of taking actions that would prevent shareholders from accepting or rejecting a tender offer.<sup>48</sup> The case struck down an Illinois anti-takeover statute for violating the Commerce Clause of the U.S. Constitution. Among other rationales, the court stated that the statute interfered with the shareholders' right to obtain the highest price available for the company's stock.<sup>49</sup> The court also stated that tender offers relate to a stock transfer between a shareholder and a third party and did not concern the corporation's internal affairs.<sup>50</sup> Although the ruling could have been read to apply to a court's investigation of management's motives for actions concerning control issues (i.e. primary v. "a" purpose), it had no significant effect on the continued application of the business judgment rule.

In a 1982 shareholder derivative suit alleging corporate waste<sup>51</sup> the Delaware Supreme Court addressed the issue of whether a director is "disinterested" (independent) and the effect this has on the application of the business judgment rule. Their definition of disinterested was that which is applied in the ordinary business situation: "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing."<sup>52</sup> Although the court limited the protection of the business judgment rule to "disinterested" directors, its definition served to give that protection to virtually any director, absent fraud. Where such interest was found to exist, a majority of the remaining directors would have to approve the transaction.<sup>53</sup> That directors are ever considered disinterested or independent is a questionable proposition. The *Aronson* court essentially ignored the potential for conflict of interest in-

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<sup>46</sup> See *Johnson v. Trueblood*, 629 F.2d at 292-93.

<sup>47</sup> *Id.* at 293.

<sup>48</sup> See *Edgar v. Mite Corp.*, 457 U.S. 624 (1982).

<sup>49</sup> *Id.* at 635.

<sup>50</sup> *Id.* at 639-40.

<sup>51</sup> See *Aronson v. Lewis*, 473 A.2d 805 (Del. Super. Ct. 1984).

<sup>52</sup> *Id.* at 812.

<sup>53</sup> *Id.*

herent in the takeover context and placed the initial burden on the plaintiff, applying a standard of "gross negligence" in looking at the duty of care.<sup>54</sup>

Three months after *Aronson* the U.S. Court of Appeals for the Second Circuit ruled on a case in which shareholders sought an injunction prohibiting the board from issuing and voting a block of shares through a wholly owned subsidiary and Employee Stock Option Plan (ESOP).<sup>55</sup> The court applied the business judgment rule and required that the plaintiffs go forward with evidence that showed self interest on the part of directors: "Once a prima facie showing is made that directors have a self-interest in a particular corporate transaction, the burden shifts to them to demonstrate that the transaction is fair and serves the best interests of the corporation and its shareholders."<sup>56</sup> The court considered the ESOP to be "solely" a tool of self-perpetuation and went on to say that it "strains credulity to suggest that the retention of control over corporate affairs played *no* part in their plans"<sup>57</sup> Although not specifically enunciating the standard being used, it appears that the court applied a balancing test to the claims of the two sides and felt that the evidence supported the claim of plaintiffs more than the defendants and granted the injunction: there is a "strong inference that the purpose of the transaction was not to benefit the employees but rather to solidify management's control of the company."<sup>58</sup> The decision could easily be read to indicate that the court was going to scrutinize the actions of boards in defending against a hostile takeover. However, this decision was limited to a very narrow set of facts and did not stand as precedent for any general application.

In 1985 and 1986 the Delaware Supreme handed down three decisions that further refined and solidified the law regarding the rights and duties of directors in the takeover context. In *Smith v. Van Gorkom*<sup>59</sup> the board of directors approved a merger at a hastily convened meeting where the President proposed the plan and the corporation's Chief Financial Officer stated that the \$55 per share price proposed was within a "fair range."<sup>60</sup> The court held that directors are protected by the business judgment rule which creates a presumption that the board "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."<sup>61</sup> The burden was placed upon those attacking

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<sup>54</sup> *Id.* at 812-13.

<sup>55</sup> *See Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 (1984).

<sup>56</sup> *Id.* at 264.

<sup>57</sup> *Id.* at 266 (emphasis added).

<sup>58</sup> *Id.* at 265.

<sup>59</sup> *Smith v. VanGorkom*, 488 A.2d at 858.

<sup>60</sup> *Id.* at 867.

<sup>61</sup> *Id.* at 872 (quoting *Aronson*, 473 A.2d at 812).

the decision to show that the duty of care had not been satisfied.<sup>62</sup> The determination of whether a business judgment is an informed one turned on whether the directors had informed themselves "prior to making a business decision, of all material information reasonably available to them."<sup>63</sup> The majority of the court found that the directors had acted without knowledge of valuation data which they could have obtained and that, therefore, the business judgment rule should not protect their actions.<sup>64</sup>

Five months later the court handed down its decision in *Unocal Corp. v. Mesa Petroleum Co.*, one of the seminal rulings in the area.<sup>65</sup> In ruling on a discriminatory self-tender offer to fend off a hostile tender offer the court ruled that the board "has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment."<sup>66</sup> Although the duty may not be different, the context and possibility of self dealing certainly is. Because of the inherent possibility that the board might be acting in its own self interest "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."<sup>67</sup> The directors must show that they had a reasonable ground for the belief that there exists a danger to corporate policy.<sup>68</sup> As pointed out earlier, this is always the case in takeovers. However, the directors satisfy that burden "by showing good faith and reasonable investigation . . ."<sup>69</sup> The court defined good faith by applying the primary purpose rule (i.e. that the action was not solely or primarily out of a desire to maintain control) and added the further requirement that the response be reasonably related to the threat posed (proportionality requirement).<sup>70</sup>

The third in the "trilogy" of the mid-1980's Delaware cases involved the director's responsibilities when the sale of the corporation becomes inevitable.<sup>71</sup> After rejecting an offer for Revlon on the basis that the price was "grossly inadequate" the raider increased its bid.<sup>72</sup> Fearing that the

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62 *Id.*

63 *Id.*

64 *Id.* at 893.

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

66 *Id.* at 954.

67 *Id.*

68 *Id.* at 955.

69 *Id.* (quoting *Cheff*, 190 A.2d at 555).

70 *Id.*

71 *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

72 *Id.* at 172.

raider (Pantry Pride) would be successful, Revlon self-tendered for 30% of its outstanding shares and sought a white knight (granting the white knight a lockup option to purchase Revlon assets at favorable prices if another party acquired 40% of the company).<sup>73</sup> The court upheld the first rejection of Pantry Pride's offer and the self tender but invalidated the lockup agreement with the white knight. After first requiring that the board show that Revlon responded in good faith and with reasonable investigation to a danger to the corporation, the court determined that the directors had responded reasonably to a perceived threat to the corporate entity (thus meeting the *Unocal* requirement).<sup>74</sup> In refusing to apply the business judgment rule to the subsequent actions of the directors the court determined that at that time the ultimate demise of Revlon was no longer in question and that the director's duty had changed: "It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."<sup>75</sup> Finally, the court ruled that the board could consider constituencies other than the shareholders in making their decision but that there had to be "rationally related benefits accruing to the stockholders."<sup>76</sup>

In 1990 the same court applied the above rules to a case involving Time Inc., Warner Communications, Inc. and, Paramount Communications.<sup>77</sup> Time and Warner agreed upon a merger. During the negotiations there was no evidence that any other company was interested in a takeover of Time but the agreement made reference to the possibility and included "a panoply of defensive devices, including a staggered board, a 'poison pill' preferred stock rights plan triggered by an acquisition of 15% of the company, a fifty-day notice period for shareholder motions, and restrictions on shareholders' ability to call a meeting or act by consent."<sup>78</sup> Before the plan was consummated Paramount intervened and made a \$175 per share tender offer for Time (later increased to \$200). Time responded, after much consideration, by making its own tender offer for 51% of the shares of Warner at \$70 per share, thus assuming between \$7 and \$10 billion in

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<sup>73</sup> *Id.* at 178.

<sup>74</sup> *Id.* at 181.

<sup>75</sup> *Id.* at 182.

<sup>76</sup> *Id.*

<sup>77</sup> *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1990).

<sup>78</sup> *Id.* at 1144 (footnote 6).

debt.<sup>79</sup> The remaining shares were to be acquired later for a combination of cash and securities.

The court held that the original merger agreement was protected by the conventional business judgment rule because there was no threat of a hostile takeover at that time. The court then applied *Unocal's* enhanced business judgment rule to its tender offer for Warner. After determining that the board had satisfied its duty of thorough investigation (*Smith*) the court reviewed the board's actions and determined that it was reasonable for them to view Paramount's actions as a danger to the Time-Warner agreement.<sup>80</sup> The court then looked at Time's consideration of long-term approach to investor's interest versus short-term profits and concluded that the directors were not required to "abandon a deliberately conceived corporate plan for a short-term shareholder profit" so long as there was a proper business purpose.<sup>81</sup> The court applied the second *Unocal* test (proportionality) and found that the response was reasonable to the threat posed.<sup>82</sup> Accumulating between \$7 and \$10 billion debt, in the court's opinion, was apparently not so extreme that reasonable jurors could disagree over its appropriateness. Finally, the court applied the *Revlon* standard and determined that a takeover never became inevitable and, therefore, the board was under no obligation to seek the highest bid. Certainly, however, some sort of business combination was inevitable. In a telling line, the court noted that Time's actions were at least partly motivated by a desire to maintain Time's "corporate culture".<sup>83</sup> Because a takeover by an outside interest is virtually always going to change "corporate culture", this holding could open the way for unlimited rationales for resisting a tender offer.

Following *Paramount* Delaware's approach to director's duties in the takeover context is clearly discernible. The directors bear the initial burden of showing that they satisfied the requisite reasonable care in investigating the decision and that their response was reasonably related to the threat posed. Following such a showing the directors will be afforded the protection of the business judgment rule in defending the reasonableness and rationality of their decision. Their duty of loyalty is met by showing that their primary purpose was not to maintain control. The directors can consider constituencies other than shareholders so long as they can show benefits to the shareholders. As long as they can meet these requirements the board of director's actions will not be reviewed at the jury level.

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79 *Id.* at 1148-49.

80 *Id.* at 1152.

81 *Id.* at 1154.

82 *Id.* at 1155.

83 *Id.* at 1152.

## V. THE BUSINESS JUDGMENT RULE IN THE TAKEOVER CONTEXT

According to Henry Johnson, among others, the "purpose of the business judgment rule is the protection of directors in ordinary business."<sup>84</sup>

It is important that corporate management be able to make business decisions without the fear of being held liable. In publicly traded corporations there will virtually always be one or more shareholders who will disagree with any given decision, and corporate business would grind to a standstill if they were able to challenge ordinary management decisions in the courts without providing directors with the benefit of the business judgment rule. Although a number of scholars and courts believe it is proper to treat ordinary business and takeover defenses with the same deference to target management,<sup>85</sup> it is inappropriate to apply the business judgment rule in the takeover context. While some courts have agreed with this general proposition of treating the two situations equally, they often apply the rule because of "the weight of authority" and sheer inertia of precedent.<sup>86</sup> The best argument for the rule is that management is in the best position to make most decisions and courts are ill-equipped to analyze many business decisions. There are two very good reasons for not applying it in the takeover context, however. First, as suggested by Henry Johnson, "while it is true that the officers and directors of a corporation are in a unique position of 'expertise' and 'knowledge' in *corporate matters* it is far from clear that this expertise extends into the takeover decision."<sup>87</sup> The decision of whether to accept or reject an offer is precisely the type of decision tailor-made for the investor and not for corporate management. Furthermore, "the shareholder did not consult management when buying their shares, nor did management intervene in the purchase. Why, then should corporate management become directly (and expensively) involved in a potential transfer of shares between a buyer and seller"?<sup>88</sup> A tender offer is an offer to purchase stock from an investor. It is a contractual relationship to which management is not a party. If an investor sought to sell stock in an ordinary transaction on one of the markets it would be quite surprising to find a manager of the corporation attempting to intervene. The second reason is that there is *always* an inherent conflict of interest in the takeover context.<sup>89</sup> While many courts have recognized that the

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<sup>84</sup> Henry Johnson, *Anti-Takeover Actions and Defenses: Business Judgment or Breach of Duty?* 28 VILL. L. REV. 51, 56 (1982) [hereinafter Johnson].

<sup>85</sup> See e.g., Schubert, *supra* note 19, at 694.

<sup>86</sup> See *Minstar Acquiring Corp v. AMF Inc.*, 621 F.Supp. 1252 (S.D.N.Y. 1985).

<sup>87</sup> Johnson, *supra*, note 84, at 60; see also Easterbrook & Fischel, *supra* note 17, at 1164.

<sup>88</sup> *Id.* at 62.

<sup>89</sup> See Michael Keliher, *Anti-Takeover Measures—What Standard Should be Used to Evaluate Them*, 25 HOUS. L. REV. 419, 428 (1988) [hereinafter Keliher].



potential for abuse resulting from this conflict exists, they typically gloss over it.<sup>90</sup> In his blunt dissent in *Panter v. Marshall Field Co.*, Judge Cudahy pointed out this conflict of interest by stating that "the majority here moved one giant step closer to shredding whatever constraints still remain upon the ability of corporate directors to place self interest before shareholder interest in resisting a hostile tender offer for control of the corporation."<sup>91</sup>

Some courts restrict the application of the rule to "disinterested" directors.<sup>92</sup> The primary problem with this approach is that in defending against a takeover there are no truly disinterested directors. Again, Judge Cudahy addresses this issue in a less than subtle manner referring to the idea that directors are disinterested as "appallingly naïve": directors are "at the very least, 'interested' in their own positions of power, prestige and prominence (and in their not inconsequential perquisites) . . . in maintaining the public reputation of their own leadership."<sup>93</sup>

In *Bennett v. Propp* the court stated that the "directors are of necessity confronted with a conflict of interest, and an objective decision is difficult . . . Hence, in our opinion, the burden should be on the directors to justify such a purchase as one primarily in the corporate interest."<sup>94</sup> This holding was cited with approval in *Cheff*, but the court was satisfied that management believed there "there was a reasonable threat to the continued existence of [the company], or at least existence in its present form."<sup>95</sup> The director's rebutting of this burden has also been stated as "fairness of the transaction", "rational and proper purpose," and "valid corporate purpose."<sup>96</sup> As Michael Keliher has noted, this is no standard at all because "the fundamental nature of a takeover is that the business will cease to operate in its present corporate form."<sup>97</sup> This holding clouds the primary purpose rule and seems to stand for the proposition that directors:

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<sup>90</sup> But see *Norlin Corp v. Rooney, Pace Inc.*, 744 F.2d at 264; see also *Johnson*, 629 F.2d at 300 (J. Rosenn, concurring in part and dissenting in part).

<sup>91</sup> *Panter v. Marshall Field & Co.*, 646 F.2d at 299 (Judge Cudahy, concurring in part, dissenting in part).

<sup>92</sup> See e.g. *Aronson*, 473 A.2d at 812.

<sup>93</sup> *Panter*, 646 F.2d at 300 (Judge Cudahy, concurring in part, dissenting in part).

<sup>94</sup> *Bennett v. Propp*, 187 A.2d at 409.

<sup>95</sup> *Cheff v. Mathes*, 199 A.2d at 556.

<sup>96</sup> *Bennett*, 187 A.2d at 409; see also *Cheff*, 199 A.2d at 556.

<sup>97</sup> Keliher, *supra* note 89, at 438.

convinced that control is threatened by an outside interest which arguably would advocate some change classifiable with any verisimilitude as 'policy,' can decide *a priori* that such a change would not be in the best interest of all the shareholders. Having so decided, they may with impunity proceed to make substantial expenditures of corporate funds to acquire at premium prices sufficient shares to assure that the general body of shareholders will be deprived of all opportunity effectively to exercise their franchise.<sup>98</sup>

Some have argued that the primary purpose rule is no requirement at all because "hindsight and the advice of expert counsel can practically always set forth some rational and proper purpose to explain its conduct."<sup>99</sup>

## VI. THE MARSHALL FIELD & CO. CASE

A closer analysis of *Panter v. Marshall Field*<sup>100</sup> shows some of the shortcomings of applying the business judgment rule in the takeover context. In February 1978 Carter Hawley Hale (hereinafter CHH) announced it would make a tender offer for outstanding shares of Marshall Field & Company for cash and stock.<sup>101</sup> During the previous October CHH had proposed a merger with Marshall Fields. At a special meeting of Marshall Field's directors immediately following the first contacts, the board determined that "the proposed business combination *should not be considered*."<sup>102</sup> This decision, although the directors stated that the interests of the shareholders were being considered, was made without formal investigation of the proposal by the board. The board made this decision at the very same meeting at which it was proposed.<sup>103</sup> Making

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<sup>98</sup>     Israels, *Corporate Purchase of its Own shares—Are There New Questions?*, 50 CORNELL L. Q. 620, 624 (1965), as quoted in William Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW 1101, 1105. (1974).

<sup>99</sup>     Marc Steinberg, *Application of the Business Judgment Rule and Related Judicial Principles—Reflections form a Corporate Accountability Perspective* 56 N.D. LAWYER 903, 906 (1981) [hereinafter Steinberg].

<sup>100</sup>     The following discussion is taken from both the decisions of the United States District Court, 486 F.Supp. 1168 (N.D. Ill. 1980), and that of the United States Court of Appeals, 646 F.2d 271 (7th Cir. 1981), [hereinafter *Panter II*] to which the District Court's decision was appealed.

<sup>101</sup>     *Panter I* at 1172. In considering the defendant's motion for a directed verdict the District Court reviewed the facts as presented in the plaintiff's complaint. The standard applied by the court was that it must "view the evidence in the light most favorable to the plaintiffs; and all reasonable inferences which can be drawn from the evidence must be in their favor." *Id.* at 1174.

<sup>102</sup>     *Id.* at 1178 (emphasis added).

<sup>103</sup>     *Id.*

such a decision without more investigation is, *at the very least*, arguably a violation of the board's duty of care. The court found, however, that the board was entitled to a directed verdict. The jury was not even allowed to rule on what was essentially a factual question.

Marshall Field was considered by many to be vulnerable to a takeover "because of its accumulated worth, the strength of its balance sheet, its large cash reserves, and its borrowing potential."<sup>104</sup> Plaintiffs even argued that "investing shareholders studied Field's earning reports, researched its performance and determined that (Field in mid-1976) was a good company for a takeover."<sup>105</sup> It should be remembered that for the purposes of considering a motion for directed verdict the evidence must be considered in the plaintiff's favor. These facts hardly supports an argument that the board's anti-takeover actions were *primarily* in the shareholder's interests. Plaintiffs further provided evidence that Marshall Field had developed a consistent strategy for defeating takeover attempts before shareholders had an opportunity to act.

Marshall Field was the target of several proposed mergers during the 1970's. In 1970, when Associated Dry Goods Company proposed a merger with Marshall Field, the board approved the acquisition of stores that could create anti-trust complications for the proposed combination.<sup>106</sup> Plaintiff argued that the acquisition was designed to create just such complications.<sup>107</sup> Five years later Federated Department Stores proposed a merger with Marshall Field; the board responded by threatening an anti-trust action.<sup>108</sup> The following year, in 1976, the Dayton Hudson Company proposed a merger to Marshall Field's board, who then began making preparations for acquiring stores that were in competition with Dayton Hudson.<sup>109</sup> When Dayton Hudson withdrew its proposal the Marshall Field board dropped its interest in acquiring the stores.<sup>110</sup>

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<sup>104</sup> *Id.* at 1175.

<sup>105</sup> *Id.*

<sup>106</sup> Marshall Field "acquired Halle Brothers, a retailer with stores in Cleveland and other Ohio communities, and in Erie and West Erie, Pennsylvania. Associated had stores in the same cities." Panter I at 1177 (emphasis added). These acquisitions proved to be unprofitable. Panter II at 305 (Judge Cudahy, concurring in part, dissenting in part).

<sup>107</sup> That Marshall field had retained attorney Joseph Flom, "a lawyer whose expertise was in proxy contests, mergers and acquisitions, [and] tender offers" and who advised just such a policy for blocking takeover attempts, gives significant credence to the claim." Panter I at 1176.

<sup>108</sup> *Id.* at 1177. Much of the evidence regarding the board's actions was excluded on the ground that it was irrelevant. Panter II at 305-06, (Judge Cudahy, concurring in part, dissenting in part). Far from being irrelevant, it suggests a policy of independence without regard for the business merits of the proposal; specifically what the plaintiffs were arguing.

<sup>109</sup> The board "embarked on a program to acquire certain Liberty House stores in Portland, Oregon and Tacoma, Washington, a market area where there was an overlap between Dayton-Hudson

In 1978, when it became clear to Marshall Field directors that CHH would pursue an unfriendly takeover attempt, the board followed essentially the same course of conduct that it had on the previous occasions.<sup>111</sup> Marshall Field's opposition to any merger, whether friendly or hostile, was so consistent that two directors testified that they recalled "it being stated as a policy."<sup>112</sup> When such becomes a policy of a corporation without regard to the financial merits of a particular offer, there exists a significant likelihood that directors have breached their duty to the shareholders. By applying the business judgment rule, the court precluded consideration by the jury.

At the close of plaintiff's case the court granted defendant's motion for directed verdict. On appeal the U.S. Court of Appeals for the Seventh Circuit affirmed. Despite the strong case the plaintiffs made for breach of duty the Court of Appeals determined that there was "no basis on which reasonable jurors" could find such a breach.<sup>113</sup> The presumption created by the business judgment rule precluded, as it does in nearly every instance, a review by a jury of management actions in a situation where their continued employment is likely to depend on blocking a tender offer. In *Panter* the issue of whether directors violated their duties to the shareholders was easily a question upon which a jury could find for the plaintiffs. It is likely that the directors violated both the duty of loyalty and the duty of care owed to the shareholders.

## VII. A PROPOSAL FOR ABOLISHING THE BUSINESS JUDGMENT RULE IN THE TENDER OFFER CONTEXT

Professors Easterbrook and Fischel advocate a rule that target management should be required to remain entirely passive when faced with a tender offer.<sup>114</sup> In support of this they argue that defensive measures

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stores and those operated by Liberty House." *Panter* I at 1177 (emphasis added).

<sup>110</sup> *Id.*

<sup>111</sup> One month after CHH's intentions became clear, the board authorized the acquisition of a store in the Galleria (a Houston Texas shopping mall) and five stores in the Pacific Northwest. *Panter* I at 1182. CHH had stores in all of these locations, thus raising possible anti-trust problems with a merger. The District Court accepted, and the Circuit Court agreed, that this simply represented long-term expansion plans. *Panter* II at 296. However, no executive of Marshall Field had previous recollection of discussing Houston as an area for expansion. *Panter* I at 1182. Furthermore, the board attempted to purchase another competitor of CHH (Dillard's department store) when, two weeks earlier, the board did not even know whether the store was a "standard retailer or a discount operation." *Panter* II at 307, footnote 18.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* at 299.

<sup>114</sup> Easterbrook and Fischel, *supra* note 17, at 1198.

harm shareholder wealth.<sup>115</sup> They further argue that management is in no better position than shareholders to judge the merits of a tender offer;<sup>116</sup> that there "is no signal that separates intransigent resistance from honest efforts to conduct an auction for the shareholder's benefit";<sup>117</sup> and that such a rule would be easy to enforce—the only inquiry for the courts would be a determination of whether management had remained inactive.<sup>118</sup> To this, Professor Johnson, among others, has advocated that "management should be uniformly precluded from advocating corporate charter amendments" that protect against tender offers.<sup>119</sup> At the other end of the spectrum ARE Mr. Lipton and his supporters.<sup>120</sup> They advocate an active board and would oppose significant restraints that might be placed on management in defeating tender offers.<sup>121</sup> Aside from the economic aspects, this position is premised on the idea that a "takeover bid is no different than any other fundamental business decision."<sup>122</sup> There is, however, a significant distinction between "fundamental" decisions and the conduct of ordinary business. "Fundamental" decisions can affect the very structure, ownership, and purpose of a corporation. "Ordinary" business decisions, on the other hand, are typically related to *how* a corporation carries out its basic mission and functions. This distinction is evident from the fact that many, although not all, "fundamental" decisions require shareholder approval.

Although there is logic to the Easterbrook and Fischel total passivity approach, I propose abolishing the business judgment rule in the tender offer context instead. First, however, the reasons for not accepting their approach merit attention. Their proposal is simply not realistic. One reason is the large amount of state and federal statutory law that would have to be repealed. State corporate law and anti-takeover legislation, as well as the Williams Act and other federal securities legislation envision management involvement in various business combination processes whether friendly or hostile. Because these laws have withstood constitutional attack they would have to be altered or abolished through the legislative process. The widespread acceptance of the laws, and the tendency of state legislators to "protect" their constituencies and domestic

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<sup>115</sup> *Id.* at 1173.

<sup>116</sup> *Id.* at 1193.

<sup>117</sup> *Id.* at 1175.

<sup>118</sup> *Id.* at 1200.

<sup>119</sup> Johnson, *supra* note 84, at 74.

<sup>120</sup> See *supra* notes 2-4, 6-7 and 15-16, and accompanying text.

<sup>121</sup> Martin Lipton, *Takeover Bids in the Target's Boardroom; an Update After One Year*, 36 BUS. LAW. 1017, 1017-21 (1981).

<sup>122</sup> Lipton, *supra* note 2, at 120.

corporations from out-of-state attacks, makes the repeal of state legislation seem unlikely. Further, although those advocating passivity claim that such a rule would be easy to enforce because the courts would merely have to measure passivity, this is an over-simplification.<sup>123</sup> What they overlook is the difficulty of determining whether any given action by a board of directors is related to a potential takeover attempt or simply an act in conducting the ongoing business of the corporation. For example, if an entity expressed an interest in acquiring a corporation and the directors of that corporation subsequently made an acquisition which was in the best interests of the corporation's expansion plans but which created anti-trust problems for the would-be acquirer, the question of passivity would not be nearly as simple as Easterbrook and Fischel suppose. There are an infinite number of scenarios that could raise difficult questions as to whether management was resisting a takeover or merely carrying on the legitimate business of the corporation.

When individuals or business entities purchase stock, they are buying a piece of the company. This is true whether the purchaser intends on holding the stock in perpetuity or for a short time. Despite Professor Lipton's assertion that the two should be treated differently, such an approach is as inappropriate as it is unfeasible.<sup>124</sup> Shareholders, whether their view is short-term or long-term, are seeking a return on their investment and placing their money at risk in so doing. They are the owners of the company to the same extent as other entrepreneurs who risk their capital in starting up a small business venture. Where the sole proprietor hires a manager to oversee the daily operations of the business, shareholders hire a board of directors and officers to run the corporation. Directors and officers are the agents of shareholders. As such, they owe their primary duty to the shareholders in much the same way a store manager or employees owe a duty to the owner.

When a corporation offers its stock to the public it is offering to enter into a contractual relationship with the purchaser for the sale of a portion of the company. When an individual or business entity makes a tender offer they are offering to enter into a contractual relationship with the owners of the corporation for the sale of their property. The offer is not made to management. It would be hard to imagine a court affording a rule similar to the business judgment rule to a manager who attempted to prevent someone from making an offer to the owner of a sole proprietorship to purchase a part or all of the business.

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123See *supra* note 17.

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Lipton, *supra* note 2, and accompanying text.

As previous discussion makes clear, directors and officers sometimes intervene to block the offer or force the bidder to withdraw it before the shareholders have had an opportunity to accept or reject it. The business judgment rule has often shielded management from liability for actions, which in some circumstances could be considered tortious interference with a contractual relationship. Although strict neutrality may not be an appropriate response, the courts should adopt a rule which precludes the ability of management from using the business judgment rule in the takeover context where there is an obvious conflict of interest and where management's duty of loyalty is always called into question.

As discussed below, even without the benefit of the business judgment rule corporations, shareholders and, management would still be protected from predatory and unwanted attacks by provisions of the Williams Act, state anti-takeover legislation and, shareholder-approved defensive measures (shark repellent).

### VIII. THE WILLIAMS ACT

In 1968 Congress passed the Williams Act (amending the Securities and Exchange Act of 1934).<sup>125</sup> The Act requires potential bidders and large shareholders to disclose background information and any acquisition plans.<sup>126</sup> Regulation of tender offers are further governed by specific provisions.<sup>127</sup>

The disclosure requirements of section 13(d) and 14(d) insure that management and shareholders receive accurate information about the

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<sup>125</sup> 15 U.S.C. §§ 78m (d) & (e), 78n (d), (e) & (f), (1982).

<sup>126</sup> The Act requires any person or business entity that acquires more than 5% of a class of equity securities of a publicly traded corporation (and others falling within the statutory definition) to disclose, inter alia, information regarding that person's identification, background and, "if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure." This disclosure must be made to the issuer of the security, the exchange on which it is traded and, the Securities Exchange Commission. *Id.* at § 78m (d)(1)(a)-(c).

<sup>127</sup> *Id.* at § 78n (d) and (e). When a tender offer is made the bidder must file disclosure statements with the SEC, the target company and the exchange which include essentially the same information, plus financial statements, required by § 78m(d), (*supra*). Further, the bidder must publish a notice of the tender offer in a newspaper of general circulation in order to inform the shareholders of the offer and its contents. The tender offer must remain open for at least twenty days. The bidder must purchase shares on a pro-rata basis if purchasing less than 100% of the company's outstanding shares; must make the offer to all shareholders and; pay all shareholders the highest amount paid to any shareholder. Shareholders are allowed to revoke their tenders at anytime during the tender period. Finally, within ten days of the offer, target management is required to provide shareholders with their opinion of the tender offer (they may recommend acceptance, rejection, express neutrality or they may state that they are unable to offer an opinion).

tender offer. Although management may have better knowledge about the value of the corporation, for ownership purposes the value that matters is that which has been determined by the market. Shareholders have just as much expertise, if not more, in comparing this measure with the tender offer. The substantive provisions regarding the procedures to be followed in a tender offer provide protection to shareholders, and consequently weaken the rationale for management intervention. The price provisions protect shareholders from discriminatory offers; the time guarantees and pro-rata requirement provide shareholders with time to consider their decision with deliberation and increase the possibility for a bidding war—which would be lost if management intervened and; the ability to revoke their tenders further lessens any coercive effects that may exist in the offer.

The most important provision, from the perspective of actions by the board of directors, is the requirement that management make a recommendation to the shareholders. This provision allows the directors to make their arguments to shareholders if they believe the offer should be rejected. It could be argued that directors are unlikely to recommend rejection for fear that it would harm their chances to remain on the board should the bidder prove successful. Two points should be made in response to this. First, if directors honestly believe that acceptance is a bad idea and fail to recommend rejection, then they are in breach of their duty to shareholders—the very duty presumed by the business judgment rule to be satisfied in their actions were they to attempt to block the offer. Second, if a bidder is making a tender offer that includes a significant premium for shareholders, they have likely determined that the market has priced the stock low *because* of current management. Under these circumstances the directors will likely be voted out by the successful bidder regardless of whether or they recommended acceptance to the shareholders.

## IX. COERCIVE TWO-TIER TENDER OFFER AND STATE ANTI-TAKEOVER LEGISLATION

Target management often argues that in preventing a tender offer they are protecting shareholders from the negative effects of a two-tier takeover. Although there is merit to the argument, nearly every state has passed legislation which protects shareholders from the coercive effects of these takeovers.<sup>128</sup> In this type of tender offer the bidder makes a two part proposal. In the first, or front-end, the bidder makes a cash or valuable stock offer for a controlling (or dominant) percentage of the corporation's

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*See, e.g.*, DEL. CODE ANN § 203(a); N.Y.B.C.L. § 912; IND. CODE ANN. § 23-1 -41-2 et. seq.; WASH. REV. CODE ANN. § 23B.19.040(1); OHIO GEN CORP. LAW § 1701.59; WIS. STAT. ANN. § 180.726.



stock. In the back-end, or take-out merger, the bidder buys out the remaining shares for considerably less, often with low grade debt securities (junk bonds). The bidder can accomplish the back-end because at that point it owns a controlling percentage of the voting stock. Shareholders that do not tender their shares in the front-end risk having all of their shares converted, at lower prices, in the back-end. Therefore, they are often coerced into tendering in the front-end at a premium price and having their remaining shares purchased for significantly less in the back-end; they thus end up having to sell all of their shares at an average amount that may equal, or even be less, than the current market value.<sup>129</sup>

Many state laws have been passed to prevent coercive two-tier tender offers. Typically a law will state that when a bidder acquires a certain percentage of a corporation's shares the company is barred from corporate restructuring for a significant period of time. The Delaware statute prohibits "business combinations" for three years and includes mergers in the definition of business combinations.<sup>130</sup> Washington extends the limit to five years.<sup>131</sup> An exception is written into the law if the board of directors approves the merger prior to the bidder's acquisition of shares or if a super-majority of shareholders, other than the bidder, approve it.<sup>132</sup> These provisions force the bidder to negotiate with the board of directors prior to beginning its takeover attempt or to provide a take-out price that satisfies the shareholders, thus assuring a premium price for their shares. An additional exception is sometimes made where the bidder acquires more than 85% of the corporations shares.<sup>133</sup> This insures that the bidder will acquire the great majority of shares in the front-end of the tender offer. These laws have faced and survived constitutional challenges.<sup>134</sup>

Some states have also passed laws which allow directors to "give due consideration to the social, legal and economic effects on employees, customers and suppliers of the corporation and on the communities and geographical areas in which the corporation . . . operates."<sup>135</sup> As pointed out by former SEC Commissioner Bevis Longstreth, the "new constituencies approach are ill conceived . . . [the approach] would permit

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<sup>129</sup> For a discussion of a two-tier tender offer see *CTS Corporation v. Dynamics Corp. of America*, 481 U.S. 69, 74-76; Cindi Ingram, *An Overview and Economic Analysis of Tender Offers and Management's Response to takeover threats*, 54 MO. L. REV. 953, 958-60 (1989) [hereinafter Ingram]; David Schubert, *Unocal Corp. v. Mesa petroleum Co.: A New Era of Fiduciary Duty*, 38 BAYLOR L. REV. 687, 701-03 (1986).

<sup>130</sup> DEL. CODE ANN. § 203(a).

<sup>131</sup> WASH. REV. CODE ANN. § 23B.19.040(1).

<sup>132</sup> See e.g. DEL. CODE ANN. § 203(a).

<sup>133</sup> *Id.*

<sup>134</sup> See e.g., *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

<sup>135</sup> O.R.S. 60.357(5).

any action justifiable in terms of one of the many diverse constituencies."<sup>136</sup> This type of legislation is an example of why a judicial rule of strict passivity is not feasible. But, at the same time, it is illustrative of why directors should not enjoy the benefit of the business judgment rule.

By combining such legislation with the wide latitude provided to directors by the business judgment rule it is nearly impossible for shareholders to hold directors accountable for actions that may be contrary to the shareholder's best interests.

#### X. SHAREHOLDER APPROVED SHARK REPELLANT

An option that is available, and should be available, to shareholders that wish to prevent takeovers are various forms of shark repellent. These are amendments to corporate charters and bylaws that discourage tender offers in the first place. A rule such as that proposed by Professor Johnson (see *supra*) which prohibits management from advocating such amendments is inappropriate. There could be instances where failure to advocate such actions would constitute a breach of duty to shareholders. Rather than a rule which prohibits directors from advocating shark repellants, an appropriate rule would require that all such devices be approved by shareholders. Although shark repellants could be used by management to maintain control, they would have been voted on by the shareholders at a time when they were not under coercion. In instances where a provision, that was not approved by shareholders, does not fall under an accepted definition of shark repellent but appears to perpetuate management's control, courts should review the director's adoption of them with a heightened level of scrutiny. This would help to prevent directors from avoiding the shareholder approval requirement through creative drafting.

This discussion should not be read as an endorsement of the adoption of shark repellants; in general, they serve to insulate management from the kind of scrutiny which this paper argues they should be subject to. Rather, it is a recognition that shareholders should be free to adopt them if they so choose and that to limit a corporation's ability to use them would be to place a limitation on the owners of a corporation from maintaining control of their property. Another purpose for discussing shark repellants is to argue that there are options available to shareholders and management should they sincerely believe that it is in the best interests of a corporation to protect current management against outside control.

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<sup>136</sup> Quoted in Dennis Block and Yvette Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L. J., 44, 71 (1983).

One shark repellent option is to include a "fair price" provision in the charter or by-laws. This provision could require a bidder who is making a two-tier offer to pay the same amount in the take-out merger as is offered in the initial tender offer. As an alternative it could require a super-majority vote of shareholders, excluding the bidder, to approve a take-out merger. This latter alternative is similar to the state anti-takeover legislation previously discussed.<sup>137</sup> Another form of shark repellent is in the form of staggered elections for the board of directors. It would provide that only a portion of directors would be elected each year, or other length of time. For example, the amendment could provide that only one-third of the directors would be elected every two years. Although a raider could elect one-third of the directors at the next scheduled election, two additional years would have to pass before control of the board could be attained. A raider could have to wait nearly four years before taking actions that the initial board opposed. This requirement could deter many takeover attempts.

A third shark repellent approach is the poison pill.<sup>138</sup> Simply put, a poison pill is a provision that decreases the value of a corporation that becomes effective when a bidder acquires a predetermined percentage of the corporation's stock. The typical form is through the use of call options. The corporation issues short-term options, typically one year in duration, to its shareholders. The option is normally redeemable by management prior to any takeover. The option entitles the holder to purchase shares in the target company (a "flip-in" plan) or in the bidder's company (a "flip over" plan) at very low prices. The "flip over" poison pill can entitle the purchase of the bidder's stock as an obligation of the target if there is a merger—the obligations of the target are assumed by the surviving corporation by operation of law. A "flip-over" provision becomes effective following a merger; they have largely been upheld by courts.<sup>139</sup> A "flip-in" pill can become effective upon other conditions including self-dealing by the bidder; they may receive closer scrutiny by the courts.<sup>140</sup>

Shark repellents allow shareholders to prevent hostile takeovers from occurring. The provisions place the question of control where it belongs: with the owners of the corporation. They do so without raising the specter of conflict of interest and without the need for the application of the business judgment rule.

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<sup>137</sup> See *supra* notes 130-32 and accompanying text.

<sup>138</sup> For a discussion of poison pills see Leo Herzel and Richard Shepro, *The Changing Fortunes of Takeover Defenses*, 15 SEC. REG. L. J. 116,121-29 (1987); Ingram, *supra* note 129, at 969-72.

<sup>139</sup> See e.g., *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985).

<sup>140</sup> See e.g. *Minestar*, *supra* note 85; see also *Unilever Acquisitions Corp. v. Richardson-Vicks*, 618 F.Supp. 407 (S.D.N.Y. 1985).

## XI. CONCLUSION

In striking down an Illinois anti-takeover law in *Edgar v. Mite*, the U.S. Supreme Court stated that the statute allowed the Secretary of State to block a tender offer and deprive the shareholders "the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered."<sup>141</sup> That same year the U.S. Court of Appeals for the Sixth Circuit declared options granted by an oil company invalid because they were manipulative; "circumventing [the] natural forces of market demand" for share prices.<sup>142</sup> What these courts failed to derive from these rulings is that the protection afforded by the business judgment rule allows directors almost unfettered discretion in blocking tender offers, thereby manipulating the market price of the corporation's stock. The market price is what shareholders can receive for their shares at a given moment. When management deprives shareholders the opportunity to obtain that price it relegates them to the price they can then obtain on an exchange. The business judgment rule often deprives the shareholders of their ability to seek redress.

When a tender offer is made at a premium price the bidder has not identified a corporation that is undervalued in its current form. Rather, the bidder has identified inefficient management imposing agency costs on the owners; the market has valued the corporation as it exists under that management. As Ronald Gilson points out, when "management can use defensive tactics to obtain a degree of control over tender offers similar to that given it over mergers and sales of assets, then the corporate structure is fundamentally altered in a fashion which allows management effective monopoly power over corporate control."<sup>143</sup> The business judgment rule provides management with that "degree of control." By denying the application of the rule in the tender offer context a balance between management's freedom to operate the corporation and shareholder's rights can be struck.

The Delaware Supreme Court has stated that the shareholder's remedy lies in removing directors with which they are dissatisfied.<sup>144</sup> The court refuses to recognize that it is too late in closing the barn door after the horses have left; the premium offered by the bidder is long gone by the time the shareholders can learn of the action and vote the directors out.

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<sup>141</sup> *Edgar v. Mite Corp.*, 457 U.S. at 643.

<sup>142</sup> *Mobil v. Marathon Oil Co.*, 669 F.2d 366, 375 (6th Cir. 1981).

<sup>143</sup> Ronald Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 STAN. L. REV. 819, 846 (1981) [hereinafter Gilson].

<sup>144</sup> *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d at 946.

The court also fails to recognize the prohibitive costs and typical lack of success in waging a proxy contest for control of boards of directors. Following a defeated tender offer this remedy is totally ineffective.

Once directors know that courts will apply the business judgment rule to their actions, they know what steps to take—having previously decided to resist tender offers—to insulate themselves from liability. One author has suggested, after reviewing *Smith v. Van Gorkom*, that “Directors will not be able to satisfy this requirement (duty of care) by initiating a series of cosmetic decisional processes . . . merely parading a set of investment bankers, attorneys and accountants through corporate boardrooms will not be enough to protect corporate directors from potential liability.”<sup>145</sup> This is naïve. As previously pointed out, management can almost always protect itself: with “hindsight and the advice of expert counsel [it] can practically always set forth some rational and proper purpose to explain its conduct.”<sup>146</sup>

To establish a *prima facie* case against management, a plaintiff should be required to allege facts which support a claim that directors have breached either their duty of care, duty of loyalty, or both. The appropriate measure of the duty of care is that established by the Delaware Supreme Court in *Smith v. Van Gorkom*.<sup>147</sup> In order to shift the burden of proof onto the directors in relation to the duty of loyalty, the plaintiff should be required to present evidence that maintaining control was a purpose in their efforts to resist a takeover.

A directed verdict or summary judgment in favor of the directors should be rare in the takeover context. It should be granted only in circumstances where the plaintiff clearly fails to present credible evidence either that management failed to take reasonable care in deciding to prevent an offer or that maintaining control played any role in their decision. The primary purpose rule should not play any role in the court’s decision or in instructions to the jury. Management’s motivation is a purely factual question and the jury should be instructed to find in the plaintiff’s favor if it determines that, by the preponderance of evidence, control played any part in management’s decision or subsequent actions. The presumptions of the business judgment rule should not be applied because it tends to remove from the jury an ultimate question of fact. Because no directors are completely disinterested or independent, the presumptions of the business judgment rule should be denied to all directors.

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<sup>145</sup> Herbert Wander, Boardroom Jitters: Corporate Control Transactions and Today’s Business Judgment Rule, 42 BUS. LAW. 29, 40 (1986).

<sup>146</sup> Steinberg, *supra* note 99.

<sup>147</sup> See *supra*, notes 59-64 and accompanying text.

There is an inherent conflict of interest when management opposes a tender offer. Courts have regularly recognized this fact and have sometimes placed the initial burden on the board of directors to defend its actions "because of [the]omnipresent specter that a board may be acting primarily in its own interest."<sup>148</sup> Unfortunately their response has been the primary purpose test which, as one judge has pointed out, makes the "presumption virtually un rebuttable."<sup>149</sup> The ease with which courts have glossed over the duty of loyalty by applying this rule has all but removed it from consideration. The courts have instead focused on the duty of care as *the* standard by which to measure management's actions. As noted by Ronald Gilson, "the business judgment rule does not express the measure by which a court determines whether management has discharged its duty of care; rather, its application reflects a conclusion that the management action in question will not be reviewed at all."<sup>150</sup>

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<sup>148</sup> Unocal, 493 A.2d 946 at 954.

<sup>149</sup> Panter II at 299 (Judge Cudahy, concurring in part, dissenting in part).

<sup>150</sup> Gilson, *supra* note 143.

