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INTRODUCTION

Ferocious battles for corporate control continue to dominate the attention of the corporate world. When institutions as large as Gulf Oil and as prominent as Walt Disney Enterprises become the targets of takeovers, even the popular press takes notice. The ingenuity of investment bankers and lawyers has grown apace, and the tactics of both raiders and targets have become more complex.[1] The two-tiered tender offer and greenmail, two tactics used by raiders in these battles, have sparked considerable comment.

Many recent tender offers have been two-tiered offers.[2] First, the raider tenders for just over fifty percent of the target at a high cash premium. Then if the tender offer is successful, the raider merges the target into the raider, and the remaining target shareholders usually receive securities of the raider worth less than the first step cash price. Some have argued that this practice is unduly coercive, distorts the choice of tendering shareholders, particularly harms unsophisticated investors, and unfairly distributes the control premium of the target company.

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* Associate Professor of Law, Rutgers University School of Law, Camden, New Jersey. Northwestern University, B.S.S., 1971; J.D., 1974. Invaluable research assistance was provided by Mark Burton, Rutgers-Camden Class of 1986.

[1] The example of the recent takeover battle for Carter Hawley Hale (CHH) demonstrates the complexity. The Limited initially made a two-tiered offer for CHH. CHH responded with a variety of defensive tactics. It repurchased over 50% of its outstanding shares on the open market, issued General Cinema a major block of convertible preferred stock for $300 million, and granted General Cinema an option to buy one of its most valuable divisions, Waldenbooks, for $285 million. Both The Limited and the Securities and Exchange Commission challenged the defensive tactics in litigation—to date unsuccessfully. SEC v. Carter Hawley Hale Stores, Inc., [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,456 (C.D. Cal. May 9, 1984); Carter Hawley Hale Stores, Inc. v. The Limited, Inc., 587 F. Supp. 246 (C.D. Cal. 1984). The tender offer was defeated.

[2] *See* Comment, *The Front-End Loaded, Two-Tiered Tender Offer*, 78 NW. U.L. REV. 811, 812 (1983).

In another type of takeover practice, the raider takes substantial positions in the common stock of putative targets through the open market or through privately negotiated purchases before commencing a tender offer. This "beachhead position" increases the chances that the tender offer will be successful and allows the potential raider to assess the market conditions and the attitudes of target management before beginning a full-scale raid. The beachhead position also benefits the raider in a potential proxy fight. To prevent a battle for control, target management may buy out the beachhead position at a significant premium over the current market price. This practice is called greenmail. Greenmail is a substantial phenomenon. Between 1979 and 1984, firms spent $5.5 billion in targeted share repurchase transactions, with an aggregate premium over market price of more than $1 billion.[3] Arguably, the practice serves to protect the interests of only the current managers of the target, not those of the target shareholders, and unfairly allocates the control premium of the target corporation. Responding to the criticisms of two-tiered offers and greenmail, Congress is considering legislation limiting both practices.[4] Modifications of stock exchange rules have been suggested.[5] In addition, at least ten states have recently passed legislation that makes two-tiered offers more difficult to accomplish.[6]

This Article first examines the current regulatory environment

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[3] G. Jarrell & M. Ryngaert, The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices 1 (Sec. and Exchange Comm'n Office of Chief Economist Sept. 11, 1984) (citing unpublished survey by Kidder, Peabody, and SEC).

[4] Several bills were introduced in the 98th Congress, *see, e.g.*, H.R. 5693, 98th Cong., 2d Sess. (1984); H.R. 5694, 98th Cong., 2d Sess., 130 CONG. REC. H.4360 (daily ed. May 22, 1984), but no legislation was enacted. *See infra* note 248. However, tender regulation will continue to be the subject of House and Senate activity. Sen. Alfonse M. D'Amato and Rep. Timothy E. Wirth appear to be planning extensive hearings on the subject for the 99th Congress. *See* 17 SEC. REG. & L. REP. (BNA) 45 (1985). Senator Donald Riegle reintroduced antigreenmail legislation in the ninety-ninth Congress. *See* S. 286, 99th Cong., 1st Sess. (1985). Legislation has also been introduced that attempts to limit two-tiered tender offers and greenmail with tax disincentives. *See* H.R. 1003, 99th Cong., 1st Sess. (1985); S. 420, 99th Cong., 1st Sess. (1985); S. 476, 99th Cong., 1st Sess. (1985).

[5] *See* 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). *See infra* note 234.

[6] *See infra* pp. 296-306; *see also* Note, *Second Step Transactions in Two-Tiered Takeover Bids: The Case for State Regulation*, 19 GA. L. REV. 343 (1985) (arguing that state legislation is needed to provide adequate protection to investors from the coercive effect of two-tiered bids).

for two-tiered tender offers and greenmail under federal and state law. Under federal law, so long as there is full disclosure, the practices are essentially unregulated. The Securities and Exchange Commission has made modest efforts at regulating two-tiered offers by lengthening the proration period for such offers beyond the statutorily mandated period of ten days. The rules promulgated in this effort, however, may exceed the Commission's authority. State law generally scrutinizes greenmail under a business judgment standard which gives target company directors almost unreviewable discretion to repurchase shares. Two-tiered tender offers, assuming full disclosure, are legal in most states; the second step offer is subject to review only in an appraisal proceeding for the second step merger. Some states attempt legislatively to limit two-tiered offers. The analysis of the Supreme Court in *Edgar v. MITE Corp.*[7] raises serious questions, however, about the constitutionality of these laws. Under state law, intracorporate efforts to limit two-tiered offers through article or bylaw amendments are, on the other hand, presumptively legal.

The Article next examines the economic arguments concerning the two practices, starting from the premise that encouraging an active market for corporate control is sound public policy. While inefficient managers can be disciplined by several forces—the product market, the employment market, and the shareholder-initiated regulation through proxy fights or legal mechanisms—, the market for corporate control is an important ingredient in insuring that society's resources are used to their fullest potential. An active market for corporate control encourages the replacement of inefficient managers and creates synergies between firms. More important, however, this market bridges the gap between the divergent interests of shareholders and managers. Sound management leading to solid firm performance creates a high share price and reduces the risk of takeover. Because of the utility of the market for corporate control, public policy proposals that raise the cost of takeovers should not be implemented without substantial countervailing benefit since such cost-increasing policies reduce incrementally the risk of takeover.

Limiting two-tiered offers increases the cost of takeovers, and greenmail, because it reduces risk for potential raiders, reduces the

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[7] 457 U.S. 624 (1982).

cost. Elimination of the practices would not create significant countervailing benefits. Two-tiered offers do not unfairly coerce shareholders to tender. The major argument against allowing such offers presumes that shareholders with a higher-than-market value for the target's shares will tender despite the comparatively low offering price. As the analysis below shows, either these shareholders do not exist in large numbers or the offer itself creates the new increase in value. If the latter is true, the offeror should be compensated for his investment in the information which created the new value. Similarly, in greenmail transactions, the formation of beachheads creates significant new information and facilitates control transactions. The ability of target management to enter into greenmail transactions makes beachhead formations more likely, and, thus, the community of shareholders gain. This Article therefore concludes that proposals limiting two-tiered offers should be rejected and the practice of greenmail should be allowed to continue. The cost- and risk-reducing effects of two-tiered offers and greenmail can alleviate the negative impact of the present legal environment which allows managers to undertake potent cost of and risk-increasing tactics against takeovers.

I. Legal Environment of Two-Tiered Tender Offers and Greenmail

A. *The Federal Law Issues*

The basic federal statute regulating tender offers is the Williams Act,[8] which amended the Securities Exchange Act of 1934.[9] The Williams Act regulates the timing of tender offers and the disclosures that must be made in connection with an offer.[10] By administrative regulation, a tender offeror must disclose its intent to make a second step acquisition.[11] Other statutory provisions of the Act

[8] Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454 (amending the Securities Exchange Act of 1934 §§ 12-14, 15 U.S.C. §§ 78m(d)-(e) & 78n(d)-(f) (1982)).

[9] 15 U.S.C. § 78a-kk (1982).

[10] The literature on the legal environment created by the Williams Act is exhaustive. For a general overview of the disclosure and timing requirements created by the Act and the regulations promulgated by the SEC, see Pitt & Heistand, *Tender Offers*, in Hostile Battles for Corporate Control 545 (1983).

[11] Schedule 14D-1, Item 5(a), 17 C.F.R. § 240.14d-100 (1984). A failure to disclose such plans is a typical claim of management litigating under the Williams Act. *See, e.g.*, Weeks Dredging & Contracting, Inc. v. American Dredging Co., 451 F. Supp. 468 (E.D. Pa. 1978);

and rules promulgated by the Securities and Exchange Commission particularly affect two-tiered offers. Section 14(d)(6) states that until the tenth calendar day of the tender offer, if the offer is for less than all of the shares of the target, the raider is obligated to take all tendered shares on a pro rata basis.[12] This section thus establishes the statutory minimum time period that a partial offer must remain open.

A second important provision of the Williams Act, section 14(e), prohibits fraudulent, manipulative, or deceptive acts in connection with any tender offer.[13] In 1970, the SEC received statutory authority to adopt regulation to enforce the substantive provisions of section 14(e).[14] In 1979, the SEC adopted Rule 14e-1, extending the time period for tender offers to remain open to a minimum of twenty business days.[15] In promulgating Rule 14e-1, the Commis-

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General Host Corp. v. Triumph Am., Inc., 359 F. Supp. 749 (S.D.N.Y. 1973). A violation of the disclosure rules, however, can also be predicated on overstating the definiteness of plans to merge.

[12] Securities Exchange Act of 1934 § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1982). The section provides:

> Where any person makes a tender offer . . . for less than all the outstanding equity securities of a class, and where a greater number of securities is deposited pursuant thereto within 10 days after copies of the offer or request or invitation are first published or sent or given to security holders than such person is bound or willing to take up and pay for, the securities taken up shall be taken up as nearly as may be pro rata, disregarding fractions, according to the number of securities deposited by each depositor. The provisions of this subsection shall also apply to securities deposited within 10 days after notice of an increase in the consideration offered to security holders.

Id.

[13] Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1982). This section provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Id.

[14] Act of Dec. 22, 1970, Pub. L. No. 91-597, 84 Stat. 1497 (amending Securities Exchange Act of 1934 §§ 13(d)-(e), 14(d)-(e), 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(e) (1982)).

[15] 17 C.F.R. § 240.14e-1 (1984). The Commission announced the adoption of the rule in SEC Securities Act Release No. 6158, Securities Exchange Act Release No. 16,384 (Nov. 29, 1979), *reprinted in* [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,373.

sion did not intend to facilitate competing offers. Rather, it asserted that the additional time for the offer to remain open would allow shareholders to make complex investment decisions. Additionally, the SEC claimed that the extended time period would insure a uniform federal rule rather than a variety of state rules. Finally, the SEC claimed that a short tender offer period increased the possibility of fraudulent, deceptive, or manipulative practices.[16]

In 1982, again pursuant to its supposed section 14(e) and general regulatory authority, the Commission adopted Rule 14d-8, extending the proration period to the full period for which the offer is open.[17] When the rule was proposed, the Commission cited section 14(e) as the source of its authority.[18] The Commission reasoned that a longer proration period was necessary to further the disclosure goals contained in Rule 14e-1. It pointed to the anomaly that, after the adoption of Rule 14e-1, an investor had longer to consider whether to tender in an any-and-all offer than in a partial or two-tiered offer.[19] This section considers two issues: whether the SEC has the authority to promulgate Rules 14e-1 and 14d-8 and whether a two-tiered tender offer, fully disclosing the offeror's intent, by itself can ever be fraudulent, manipulative, or deceptive.

1. The SEC's Authority. Analysis under the conventional norms of administrative law does not support the Commission's

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[16] 17 C.F.R. § 240.14e-1 (1984).

[17] *Id.* § 240.14d-8. Since Rule 14e-1 requires a tender offer to remain open for 20 business days, the effect of Rule 14d-8 is to extend the minimum proration period to 20 business days.

[18] For the SEC's view of its authority to promulgate the rule, see SEC Securities Exchange Act Release No. 18,761 (May 25, 1982), *reprinted in* [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,222, at 85,140 [hereinafter cited as Proposed Rule]. The SEC also cited its general statutory power to promulgate "rules and regulations as may be necessary and appropriate," which is contained in § 23(a) of the 1934 Act. Section 23(a), however, should not be used to contradict specifically mandated legislative solutions. *See* 3 L. LOSS, SECURITIES REGULATION 1943 (1961) ("Presumably the 'as may be necessary' phrase [of § 23(a)] does not import a general power to legislate, but is to be interpreted in the light of the more specific language which follows.").

[19] Proposed Rule, *supra* note 18, at 85,144. The SEC noted that Rule 14e-1 gives the shareholder 20 days to decide whether to sell in a tender offer for all the target's shares, while a 10-day proration period practically required an investment decision within 10 days so that the shareholder could fully participate in the proration pool. The anomaly occurs, however, only as a consequence of the extension of the offering period contained in Rule 14e-1. The statutory limit on minimum offering periods for any-and-all offers is seven days as a consequence of the withdrawal period contained in § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1982).

position in adopting Rule 14d-8 or 14e-1.[20] Any administrative agency has only derivative rule-making authority. In promulgating a rule the agency should rely on a specific grant of congressional authority.[21] Even where Congress has given the agency broad authority to make judgments, those judgments should be consistent with the specific language or the legislative intent of the statute creating the agency.[22] In this instance the Commission's rules are inconsistent with both the specific language of the statute and its legislative history.

The starting point of any inquiry into agency power is the language of the statute.[23] Here, the language of the Williams Act unambiguously states that the proration period for partial tender offers shall be ten days.[24] The legislative history of the Act fully supports its plain language.[25] First, when the bill that ultimately became the Williams Act was initially introduced, it reflected a promanagement bias.[26] This bias invoked criticism from some of

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[20] For a complete analysis of the timing rules, see Comment, *SEC Tender Offer Timing Rules: Upsetting a Congressionally Selected Balance*, 68 CORNELL L. REV. 914 (1983) [hereinafter cited as Comment, *Timing Rules*]; *see also* Comment, *Front-end Loaded Tender Offers: The Application of Federal and State Law to An Innovative Corporate Acquisition Technique*, 131 U. PA. L. REV. 389 (1982) (questioning the authority of the SEC to promulgate the rule) [hereinafter cited as Comment, *Tender Offers*].

[21] *See* United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982); Rowan Cos. v. United States, 452 U.S. 247 (1981).

[22] *See* United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982); Rowan Cos. v. United States, 452 U.S. 247 (1981).

[23] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring) ("The starting point in every case involving construction of a statute is the language itself."); FTC v. Bunte Bros., 312 U.S. 349, 350 (1941) ("While one may not end with the words of a disputed statute, one certainly begins there.").

[24] *See supra* note 12 and accompanying text.

[25] Originally the SEC proposed withdrawal and proration rights throughout the entire tender offer period. *See Full Disclosure of Corporate Equity Ownership In Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 38 (1967) (statement of Manual F. Cohen, Chairman, SEC) [hereinafter cited as *1967 Senate Hearings*]. The House version of the bill adopted these proposals. H.R. 14,475, 90th Cong., 1st Sess., 113 CONG. REC. 36,665 (1967). The original Senate bill limited withdrawal rights to seven days from the commencement of the tender offer and after 60 days from the date the offer commenced. The original Senate bill did provide for proration throughout the offering period. *1967 Senate Hearings*, *supra*, at 11-12. In addition the bill would have required that the disclosure statement concerning the tender offer be filed with the SEC five days before the offer could commence. The deletion of these provisions in the legislation as enacted supports the argument that the SEC has overstepped its authority with its present rules.

[26] Delay and early disclosure allow management distinct advantages in countering the

those commenting on the legislation.[27] In response, the drafters of the Act attempted to pass a statute which was scrupulously neutral as between management and raiders and thus adopted the time limits contained in the statute.[28] Second, Congress recognized that the tender offer process was fragile and that even minor attempts at regulation could place significant antitakeover weapons in the hands of managers.[29] The legislative history shows that Congress was aware that delay might tip the tender offer balance toward management, and it therefore chose the statutory time periods included within the Act.[30] Third, the SEC asked Congress for authority to adjust the proration period if the public interest so required.[31] The request was denied. The only purpose of the Williams Act as passed was to protect shareholders by providing information and *stated* waiting periods to digest the material.

Besides ignoring legislative history, the Commission's reasoning in adopting Rule 14d-8 or 14e-1 departs from consistent judicial interpretations of the securities acts. The Supreme Court has found that the Act is concerned only with disclosure and that the balance between the raider and management deserves special consideration in determining the legislation's scope.[32] Interestingly the Commission itself has noted that delays in connection with tender offers upset the balance between target and raider.[33]

Given the statutory language, legislative history, judicial interpretations, and its own statements, what authority does the SEC

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takeover by engaging in defensive tactics.

[27] *See, e.g., 1967 Senate Hearings, supra* note 25, at 62 (statement of Samuel Hayes, III, Professor of Finance, Columbia University).

[28] S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967). The Committee also eliminated the predisclosure requirement and created the seven day withdrawal period stated in the statute.

[29] *See* Comment, *Timing Rules, supra* note 20, at 924-27.

[30] *See 1967 Senate Hearings, supra* note 25 (statement of Samuel Hayes, III, Professor of Finance, Columbia University). His testimony was persuasive. S. REP. No. 550, *supra* note 28, at 3.

[31] *1967 Senate Hearings, supra* note 25, at 38.

[32] *E.g.*, Edgar v. MITE Corp., 457 U.S. 624, 645 (1982); Piper v. Chris-Craft Indus., 430 U.S. 1, 29 (1977); *see also* San Francisco Real Estate Investors v. Real Estate Inv. Trust of Am., 692 F.2d 814, 818 (1st Cir. 1982) ("Congress drew the line between the interest in more information and the interests of the offeror in obtaining a quick decision when it established a minimal ten day proration period in the Williams Act.").

[33] Brief for Securities and Exchange Commission as *Amicus Curiae* at 9, Edgar v. MITE Corp., 457 U.S. 624 (1982).

cite in support of the rules? The Commission relies primarily on the addition of the second sentence to section 14(e) in 1970.[34] The sentence provides that the SEC has rule-making authority "for the purposes of this subsection, . . . to define, and prescribe means reasonably designed to prevent, such acts as are fraudulent, deceptive, or manipulative."[35] The 1970 amendments were designed to "add to the Commission's rulemaking power and enable it to deal promptly and with flexibility with . . . the rapidly changing [tender offer] problem."[36] This amendment amounted to a broad delegation of rule-making authority to an expert agency. But at the same time, Congress extended the reach of the Williams Act to cover insurance company tender offers and stock-for-stock tender offers under the ten day proration provision of the 1968 legislation, indicating some congressional desire to retain the stated statutory period.[37] Moreover, the 1970 legislative history does not indicate that Congress intended the balance between management and the raider to shift or that the Commission should ignore the specific and unchanged statutory language.[38]

2. The Meaning of Manipulation and Deception. To invoke section 14(e) as support for the SEC's power to enact these rules

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[34] *See supra* notes 13-14 and accompanying text.

[35] S. 3431, 91st Cong., 2d Sess. (1970) (codified at 15 U.S.C. § 78n(e) (1982)). For citations to the SEC's reliance on the language, see Proposed Rule, *supra* note 18, at 85,142; SEC Securities Exchange Act Release No. 19,336 (Dec. 15, 1982) (adopting the Rule), *reprinted in* [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,306, at 85,560 [hereinafter cited as Pro Rata Rule].

[36] *Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen, Hearings Before the Senate Subcomm. on Securities of the Comm. on Banking and Currency on S. 336 and S. 3431*, 91st Cong., 2d Sess. 2 (1970) (statement of Sen. Williams) [hereinafter cited as *1970 Senate Hearings*].

[37] S. 3431, 91st Cong., 2d Sess. (1970) included equity securities of insurance companies in § 14(d)(1) and struck the exemption in § 14(d)(8) for exchange offers. Moreover, the House Committee report accompanying the legislation contained an SEC memorandum stating that a specific purpose of the bill was to extend the 10-day proration period to the new types of offers. H.R. REP. No. 1655, 91st Cong., 2d Sess. 4 (1970).

[38] In his dissent from the adoption of Rule 14d-8, Commissioner Treadway stated: "The legislative history of Section 14(e) does not address specifically its effect on or relation to Section 14(d)(6) and the express, unambiguous 10 day period contained therein." Pro Rata Rule, *supra* note 35, at 85,654. The 1968 legislative history also discusses § 14(e) as "an obligation to make full disclosure of material information." H.R. REP. No. 11, 90th Cong., 2d Sess. (1968). The 10-day proration requirement is obviously well known and fully disclosed to investors. Nor were any of the vices that the SEC cited in its request for rule-making authority related to extension of the statutory time periods. *1970 Senate Hearings*, *supra* note 36, at 12.

requires the judgment that a ten day proration period is the equivalent of fraudulent, deceptive, or manipulative activity. The *Hochfelder-Santa Fe-Piper* line of cases provides powerful support to the contrary. The Supreme Court first considered the meaning of the phrase "manipulative or deceptive device or contrivance" in *Ernst & Ernst v. Hochfelder.*[39] In *Hochfelder* the issue was whether section 10(b) of the 1934 Act and Rule 10b-5 were violated absent an allegation that the defendant acted with scienter. The Supreme Court recognized that one could interpret the language of at least subsections (b) and (c) of Rule 10b-5 to permit recovery under a negligence standard but held that, even as a catch-all provision, the language of the statute and its legislative history would not support that interpretation.[40] In particular, the Court stated that the word "manipulation" was a term of art in the securities acts, referring to behavior such as matched or wash sales that were intended to create the false or deceptive appearance of trading activity.[41] The Court thus relied on the specific language of the statute to require an allegation of scienter.[42]

In *Santa Fe Industries v. Green,*[43] the Court used similar reasoning to determine if fiduciary fraud stated a cause of action under section 10(b) and Rule 10b-5. The Court held that an allegation of deception or manipulation, in the sense of a term of art, was necessary to state a claim. Again the Court relied on the language of section 10(b) to hold that misrepresentation or nondisclosure is an essential part of a manipulative scheme and that there cannot be manipulation without deception.[44] Even if a "freeze-out" merger violated the fiduciary principles of state law, no violation of the federal securities laws occurred so long as there was adequate

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[39] 425 U.S. 185 (1976).

[40] Section 10(b) makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j (1982). The Court in *Hochfelder* reasoned that the use of the words "manipulative or deceptive" in connection with "device or contrivance" strongly suggested that § 10(b) was intended to reach only intentional or knowing conduct. 425 U.S. at 197. But there was nothing in the legislative history to indicate that manipulation, even as a catch-all section, could mean negligent conduct. *Id.* at 203.

[41] 425 U.S. at 199 n.21.

[42] *See id.* at 201-06.

[43] 430 U.S. 462 (1977).

[44] *Id.* at 476.

disclosure.

The same theme recurred in *Piper v. Chris-Craft Industries.*[45] In *Piper*, the defeated competing offeror sued, but the Court refused to imply a private cause of action for damages under section 14(e). The Court declared that the primary purpose of the Williams Act was to assure disclosure for the benefit of the shareholder.[46] The Court noted the importance of length of the proration period in the legislative history and legislative solution.[47] The Court implied that the precise statutory solutions to problems like proration were the only areas where Congress reached shareholder concerns other than disclosure. Under this analysis, the Williams Act gives the SEC only limited power to regulate perceived questions of fairness.[48]

Most lower courts have adopted the Supreme Court's limited definition of manipulation and deception in interpreting section 14(e).[49] The only opinion that challenges this position is the Sixth Circuit's opinion in *Mobil Corp. v. Marathon Oil Co.*,[50] in which the court took an extremely broad view of the definition of manipulation. Marathon had granted two contractual "lock-up options" to United States Steel, a competing tender offeror of Mobil. One

[45] 430 U.S. 1 (1977).

[46] *Id.* at 30-35.

[47] *Id.* at 23.

[48] Most commentators support a narrow reading of § 14(e). *See, e.g.*, Hochman, *The Marathon Case*, 14 REV. SEC. REG. 827 (1981); Nathan, *Lock-Ups and Leg Ups: The Search for Security in the Acquisitions Marketplace*, 13 INST. ON SEC. REG. 1, 31 (1982); Prentice, *Target Board Abuse of Defensive Tactics: Can Federal Law Be Mobilized to Overcome the Business Judgment Rule?*, 8 DEL. J. CORP. L. 337, 353-58 (1983); Herzel & Collins, *Limits on Takeover Defenses*, Nat'l L.J., Mar. 29, 1982, at 25, col. 1; Nathan, *Novel Legal Questions Explored*, Nat'l L.J., Mar 29, 1982, at 25, col. 4; Bialkin, *Court Costs Cloud over Option Tactic in Takeovers*, Legal Times of Wash., Jan. 11, 1982, at 19, col. 1; *id.* at 27, col. 3. *But see* Junewicz, *The Appropriate Limits of Section 14(e) of the Securities Exchange Act of 1934*, 62 TEX. L. REV. 1171 (1984) (misrepresentation not essential to § 14(e) action); Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982) (Supreme Court decisions support a broad interpretation of § 14(e)); Comment, *Target Defensive Tactics as Manipulative Under Section 14(e)*, 84 COLUM. L. REV. 228 (1984) (historical definition of manipulative conduct supports restraining conduct of targets).

[49] These opinions look to the *Hochfelder* line of cases as determinant authority. As the Seventh Circuit stated, §§ 10(b) and 14(e) are "coextensive in their antifraud provisions and differ only in their 'in connection with' language" and "are therefore construed *in pari materia* by the courts." Panter v. Marshall Field & Co., 646 F.2d 271, 282 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981).

[50] 669 F.2d 366 (6th Cir. 1981).

clause gave U.S. Steel the option to buy Marathon's most important asset if any other bidder defeated U.S. Steel's bid. The second clause granted to U.S. Steel the right to buy a substantial block of Marathon stock at an extremely advantageous price. The Sixth Circuit accepted the premise that "manipulation," while a term of art, could be broadly construed to cover any technique which artificially affects securities prices.[51] The court determined that the options were intended solely to defeat other offerors.[52] The court held the options manipulative because they greatly discouraged competing offers and placed an artificial cap on the price of Marathon stock.[53] The court reached its decision in spite of complete disclosure to Marathon shareholders of the terms of the options.[54]

The *Mobil* court's broad construction of manipulation has been rejected by every other court considering the issue.[55] The Second Circuit, for example, specifically rejected the *Mobil* approach as inconsistent with *Piper* and *Santa Fe* and held that manipulation requires some misrepresentation of market activity to deceive investors.[56] Tactics undertaken during a tender offer are intended to

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[51] *Id.* at 374.

[52] *Id.*

[53] *Id.* at 375. The court believed the lock-up option made it economically unfeasible for other potential offerors to compete with U.S. Steel. *Id.*

[54] Judge Engel decided that "to find compliance with section 14(e) solely by the full disclosure of a manipulative device as a *fait accompli* would be to read the (manipulative acts and practices) language completely out of the Williams Act." *Id.* at 377.

[55] *See* Schreiber v. Burlington Northern, 731 F.2d 163 (3d Cir.) (withdrawal of a tender offer and the substitution of a new offer which disadvantaged shareholders did not state an action under the Williams Act unless there was deception that had a causal link to the shareholders' claimed injury), *cert. granted,* 105 S. Ct. 81 (1984); Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983) (unsuccessful challenge to an option to purchase shares given to a white knight; exercise of the option would have given the white knight control over the target), *cert. denied,* 104 S. Ct. 1326 (1984); Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757 (2d Cir.), *cert. denied,* 104 S. Ct. 550 (1983). In *Buffalo Forge,* a successful offeror sued to rescind a treasury stock sale and stock option granted by the former management of the target. The court held the sale and option neither violated state fiduciary obligations of directors nor amounted to fraud, deception, or manipulation under the Williams Act. The Maryland district court has followed the Second Circuit approach in Martin Marietta Corp. v. Bendix, 549 F. Supp. 623 (D. Md. 1982) (two-tiered PAC-MAN tender offer not manipulative).

[56] Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757 (2d Cir.), *cert. denied,* 104 S. Ct. 550 (1983); Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983), *cert. denied,* 104 S. Ct. 1326 (1984). The Second Circuit's analysis of the legality of tender offers under state law, however, appears unsettled. *See* Norlin Corp. v. Rooney Pace, Inc., [Current Binder] FED. SEC. L. REP. (CCH) ¶ 91,564 (2d Cir. 1984); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse-Hinds Co. v. Inter North, Inc., 634 F.2d 690 (2d Cir.

give one side an advantage over the other. Many of these tactics are intended to and do directly affect the market price of the stock of the participants and, therefore, would fall within the *Mobil* definition of artificial price-affecting behavior. Rejection of this approach is necessary to prevent making all aspects of tender offer battles the subject of federal regulation. More important, for analysis of Rules 14d-8 and 14e-1, the SEC's reliance on section 14(e) is misplaced unless *Mobil* is followed. Section 14(e) requires some nexus between the regulation and the misrepresentation or nondisclosure. Extending the proration and offering period by regulation instead deals with perceptions of fairness and constructive fraud. Thus the Commission does not appear to have the power to adopt the two rules.

The meaning of the phrase "fraudulent, deceptive, or manipulative acts or practices" contained in section 14(e) also precludes any direct attack of two-tiered offers under the Williams Act. The criticism that such offers are unduly coercive, and thus manipulative or fraudulent, depends on full disclosure of their coercive effect. The courts that have considered the issue typically rely on the *Hochfelder* line of cases to reject section 14(e) challenges to two-tiered tender offers. For example, the district court in *Martin Marietta Corp. v. Bendix*[57] held that two-tiered offers do not violate section 14(e) if there is no deception. Moreover, in *Radol v. Thomas*,[58] decided after *Mobil*, the Southern District of Ohio not only cited *Hochfelder* to support the legality of two-tiered offers but also noted that both the SEC rules and the Williams Act contemplated two-tiered offers. In *Jacobs v. G. Heileman Brewing Co.*,[59] the district court determined that fully disclosed use of multiple proration pools that were a consequence of raising the tender offer price was not manipulative since the language and legislative history of section 14(d)(6) permitted them. The court rejected the plaintiffs' argument that the SEC proposal of Rule 14d-8, then pending, demonstrated that such practices fit within section

1980).

[57] 549 F. Supp 623 (D. Md. 1982); *see also* Dan River, Inc. v. Icahn, 701 F.2d 278 (4th Cir. 1983) (court refused to enjoin bidder from exercising its shareholder voting rights because of the likelihood that management's claim of manipulation would fail under § 14(e)).

[58] 534 F. Supp. 1302 (S.D. Ohio 1982).

[59] 551 F. Supp. 639 (D. Del. 1982).

14(e).[60]

In addition to the statutory interpretation questions, Commissioner Shad's dissent from the adoption of Rule 14d-8 demonstrates why the current rules are not sound public policy.[61] A twenty business day proration period coupled with a fifteen day withdrawal period gives arbitrageurs an advantage over the unsophisticated investor, the intended beneficiary of the rules. This extension increases uncertainty and may reduce the amount of premium that reaches the hands of the nonprofessional investor. Moreover, the present scheme gives management significant additional time to mount defensive strategies and tip the balance between management and raider.[62]

The premise that shareholders need extended time periods to decide whether to tender in two-tiered or partial tender offers is strained. Because tender offers create substantial opportunities for arbitrage,[63] the amount of trading in a tender offer situation is significant and the market is particularly efficient. The risk arbitrageurs invest considerable resources to produce information on

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[60] *Id.* at 643-44. One commentator has suggested that where the second step price is below the pre-tender price, a claim of manipulation might be stated. Comment, *Tender Offers*, *supra* note 20, at 402. As an empirical matter, in the vast majority of cases the second step price is set above the pre-tender price. A failure to offer a higher second step price would make competing tender offers an attractive possibility, and the failure to offer at least the pre-tender price in the second step might be deemed a violation of fiduciary duty under state law. As a matter of federal law, however, there should be no claim available because no deception and therefore no disclosure violation has occurred.

[61] *See* Pro Rata Rule, *supra* note 35, at 85,652-54. Shareholders must now wait longer to know how many of their shares will be taken. Under the old rule shareholders could begin to sell their shares after 10 days. Bidders must now wait longer to begin purchasing the shares tendered, increasing the risk that management will frustrate the offer. Extending the proration period beyond the withdrawal period eliminates the advantage of withdrawal rights. The risk to first bidders is substantially increased, although it is still possible to proceed with a two-tiered offer.

[62] *See generally* Comment, *Timing Rules*, *supra* note 20, at 924-25 & n.81 (any delay "can unbalance market forces" and significantly impede bidders). An alternative would be to end the proration period at the fifteenth day when the withdrawal period ends. *See* Comment, *Tender Offers*, *supra* note 20, at 412.

[63] Risk arbitrageurs are market professionals who buy substantial numbers of a target's shares on the open market. These market actors are betting that the tender offer or some other control transaction will go forward at a price above the current market price. For a description of the role of risk arbitrageurs in tender offers, see 1 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS 85 (Supp. 1979). For a critical view of the role of these market actors, see Comment, *Should Tender Offer Arbitrage Be Regulated?*, 1978 DUKE L.J. 1000. *See generally* DeMott, *Current Issues in Tender Offer Regulation: Lessons From the British*, 58 N.Y.U. L. REV. 945, 998-1003 (1983).

whether the offer will be subject to significant legal obstacles, whether management's defensive tactics will be successful, and whether white knights will enter the fray. Any investor can take advantage of these efforts and trade on the information produced, shifting the risk to the arbitrageurs.[64] The trading induced by the arbitrageurs quickly moves the target stock price toward a consensus judgment, reflected in the price, as to whether and at what price the offer will go forward.[65] Thus for any investor who does not expend the search costs, the price signalling mechanism simplifies the investment decision significantly.[66]

In sum, an offeror must disclose the intent to make a second step transaction, but the federal securities laws presently do not place absolute restrictions on two-tiered tender offers. The SEC has attempted to make partial and two-tiered offers somewhat less

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[64] As a consequence of arbitrageur activity, the price of the target's shares sometimes rises above the tender offer price in anticipation of another higher bid.

[65] This consensus about price is just a special case of the efficient market model's price signalling mechanism. The efficient market model suggests that movements in the price of a security directly or indirectly signal the impact of new information as traders absorb and act on that information. *See infra* notes 145-46 & 208-16 and accompanying text.

[66] The amount of risk arbitrage then might be reduced by a free-rider problem, if these market actors could not be compensated for the risk they take. *See supra* note 63 & *infra* note 230. A free-rider problem arises when a market actor can profit from the investments of others without expending similar resources itself. The presence of a significant free-rider problem can reduce the incentive of first investors to continue their investments.

The market sophistication of risk arbitrageurs has created regulatory issues. To gain a larger fraction of the first tier price, the risk arbitrageurs developed the practice of short tendering, or tendering more shares than they actually own. This practice was in part a consequence of another regulatory problem. Unless a trade is a cash trade, delivery of purchased shares generally takes five days, an eternity in a tender offer battle. Short tendering is currently prohibited. Rule 10b-4, 17 C.F.R. § 240.10b-4 (1984). Risk arbitrageurs then developed the technique of "hedged tendering," or buying shares in the market, tendering all the shares so purchased, then selling into the market the estimated number of shares subject to proration. The SEC has responded by prohibiting a shareholder from tendering shares he does not presently own and requiring him to be in a net long position, that is, own at the end of the proration period the amount of the securities tendered at the end of the proration period. Multiple tendering where competing partial tender offers are underway has also been banned. *Id.*

The new SEC rule was supported by the SEC Advisory Committee on Tender Offers. The SEC's new rule is controversial. While it may spread the proration risk more broadly, the prohibition also reduces the interim price available to shareholders selling into the market during the proration period. The rule thus operates as a wealth transfer to tendering shareholders from shareholders who wish to shift the risk inherent in the tender offer situation to the risk arbitrageurs. For a criticism of the rule, see Commissioner Cox's dissent from the adoption of the amended rule, SEC Securities Exchange Act Release No. 20,779 (Mar. 29, 1984), *reprinted in* [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,601, at 86,711.

attractive for offerors by extending the offering and proration periods. It remains to be seen whether these regulations will stand if challenged.

B. State Law Issues

1. Two-Tiered Offers. State law confronts two-tiered offers in several ways. Most states directly restrict partial or two-tiered offers only by requiring disclosure and pro rata acceptance of shares tendered for some portion of the tender offer period.[67] To the extent that the pro rata requirements differ from those required by the Williams Act or SEC regulations, these regulations might be prohibited under the commerce clause analysis of *Edgar v. MITE Corp.*[68] Recently several states have adopted statutes intended to

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[67] Some states require pro rata acceptance of shares tendered within the first 10 days as required by § 14(d)(6) of the Williams Act. *See, e.g.*, ARK. STAT. ANN. § 67-1264.4(3) (1980); IDAHO CODE § 30-1506(3) (1980); KAN. STAT. ANN. § 17-1278 (1981); KY. REV. STAT. § 292.590 (1981); MD. CORPS. & ASS'NS CODE ANN. § 11-905(c) (Supp. 1984); MINN. STAT. ANN. § 80B.06(3) (West Supp. 1984); MISS. CODE ANN. § 75-72-11(2) (Supp. 1984); NEV. REV. STAT. § 78.3772(3) (1983); N.H. REV. STAT. ANN. § 421-A:7(II) (Supp. 1983); OHIO REV. CODE ANN. § 1707.041(C) (Baldwin 1979); UTAH CODE ANN. § 61-4-6(4) (1978) (repealed by Laws 1983, ch. 335, § 3). Other states require pro rata acceptance for the full length of the offer as required by Rule 14d-8 promulgated by the SEC. *See, e.g.*, ALASKA STAT. §§ 45.57.010-.120 (Supp. 1980) (noted to be unconstitutional, Supp. 1984); COLO. REV. STAT. § 11-51.5-103(d) (Supp. 1983); CONN. GEN. STAT. § 36-463(c) (Supp. 1984); FLA. STAT. ANN. § 517.353(4) (1979) (repealed by Laws 1979, ch. 79-381, § 13); ILL. ANN. STAT. ch. 121-½, § 137.51-137.70 (Smith-Hurd 1981) (repealed by Pub. Act 83-365, § 1, 1983); IND. CODE ANN. § 23-2-3.1-6.5 (Burns 1984); IOWA CODE ANN. § 502.213(11) (West Supp. 1984); LA. REV. STAT. ANN. § 51:1504(B) (West Supp. 1984); ME. REV. STAT. ANN. tit. 13, § 809(2) (Supp. 1984); N.J. STAT. ANN. § 49:5-9(b) (West Supp. 1984); S.C. CODE ANN. § 35-280(4) (Law Co-op. Supp. 1983); S.D. CODIFIED LAWS ANN. § 47-32-6.1(4) (1983); VA. CODE § 13.1-530(c) (Supp. 1984).

[68] 457 U.S. 624 (1982). In *MITE* a majority of the Court held the Illinois Business Take-Over Act unconstitutional as an undue burden on interstate commerce. The majority found that the delay caused by the state's requirement that any takeover offers be registered with the Illinois Secretary of State, who could then call a hearing to determine the fairness of the tender offer, would unduly deter tender offers. A free market for tender offers promotes better management, more efficient allocation of economic resources to their highest valued use, and allows shareholders the chance to sell their shares at a premium. *Id.* at 643.

Justices White and Blackmun and Chief Justice Burger also found that the Illinois rule was void under the supremacy clause. The state legislation frustrated the purpose of the Williams Act, which was intended to protect shareholders without favoring either management or bidders. The Illinois law, by requiring a bidder to register his offer with the secretary of state's office 20 days before the offer becomes effective, gives management the advantage of being able to disseminate information about the takeover to the shareholders and to develop a defense strategy, upsetting the "delicate balance" decreed by Congress. Moreover, Illinois residents can cause indefinite delays in the takeover process by requesting the secretary of state to hold a hearing. These delays harm both bidder and shareholder while change the dynamics of partial or two-tiered offers. Some states attempt to alleviate the claimed coercive effect by regulating the first stage or partial tender offer. Other states aim their efforts at controlling the terms of the second step offer explicitly through the appraisal proceeding or through application of common law fiduciary principles. This section describes both types of state responses and evaluates their effect on two-tiered offers.

Of the states which regulate the first step or partial tender offer, only Hawaii expressly prohibits tender offers for fewer than all of the target's outstanding shares.[69] Ohio and Wisconsin require that a defined threshold number of shareholders of the target corporation, excluding the shares owned by the raider, approve the first step transaction by a majority vote.[70] One purpose of the limitation is to minimize the supposed whipsaw effect of a two-tiered offer.[71] Ohio and Wisconsin corporations may exclude themselves from the limitations of the provisions.[72] Pennsylvania requires that any shareholder obtaining thirty percent of the outstanding shares of a corporation must notify the other shareholders.[73] The other share-

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favoring management. For further discussion of the *MITE* opinion, see *infra* notes 81-89 and accompanying text.

If the SEC's attempt to extend the proration period for the full length of the offer succeeds, then any state effort to permit proration for only the first 10 days of an offer would presumably fail.

[69] HAWAII REV. STAT. § 417E-2(3) (1976). Massachusetts barred partial tender offers from 1976 until 1981 when it changed to its present requirement of pro rata acceptance of shares for the entire period of the offer. MASS. GEN. LAWS ANN. ch. 110c, § 7 (West Supp. 1984).

[70] The Ohio and Wisconsin "control share acquisition" statutes regulate open market purchases and block purchases as well as tender offers. When any acquisition, except a merger otherwise regulated by state law, would result in the acquiring person gaining control of the voting securities at three defined thresholds, then majority shareholder approval is required. OHIO REV. CODE ANN. § 1701.831(e)(1) (Page 1983); 1983-1985 WIS. LEGIS. SERV. 200, § 7 (West) (to be codified at WISC. STAT. § 180.69(4)(b)(1)). The thresholds are 20%, 33%, and 50%. Minnesota has adopted a similar statute. *See* MINN. STAT. § 302A.671 (1984). The thresholds requiring a non-affiliated shareholder vote in Minnesota are 10%, 20%, 30%, 40%, and 50%.

[71] Both the Ohio and Wisconsin acts point to the removal of a claimed coercive effect of tender offers as one purpose of the legislation. OHIO REV. CODE ANN. § 1701.832(3) (Page 1983); 1983-1985 WIS. LEGIS. SERV. 200, § 1 (West) (legislative declaration).

The "whipsaw" supposedly occurs because, while shareholders might independently maximize gains by not tendering, the shareholders' best collective response without coordination is to tender.

[72] OHIO REV. CODE ANN. § 1701.831(a) (Page 1983); 1983-1985 WIS. LEGIS. SERV. 200, § 7 (West).

[73] PA. STAT. ANN. tit. 15, § 1910c (Purdon 1984). The statute draws no distinction as to the method of gaining control.

holders may then seek to have their interest in the corporation cashed out at a defined "fair value,"[74] which includes any "increment representing a proportion of any value payable for acquisition of control of the corporation."[75] This section seems to require the payment to nontendering shareholders of any premium offered to the tendering shareholders in the first step.[76] Pennsylvania corporations may also opt out of this statutory provision.[77]

Indiana, Wisconsin, and Maryland have passed legislation concerning the second step transaction. For two years after the initial stake is created, Indiana allows a second step transaction only if the second step offering price equals the compensation given in the first step.[78] Maryland and Wisconsin require a supermajority vote of the nonaffiliated shareholders of the target to accomplish the second step transaction.[79] This requirement does not apply, however, if the compensation offered in the second step equals the highest price offered in creating the affiliation.[80]

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[74] *Id.* § 1910d.

[75] *Id.* § 1910e. The fair value is determined as of the day prior to the date when the 30% threshold was reached.

[76] *See id.* A tender offer premium is construed as a payment for the acquisition of control.

[77] *Id.* § 1910a. The statute applies unless the articles specifically provide otherwise or the corporate by-laws were amended within 90 days of the statute's enactment on December 23, 1983. The statute also allows directors and officers to consider the interests of employees, suppliers, customers, and the communities in which the corporation is located in discharging their duties, *id.* § 1048, thus granting managers of Pennsylvania corporations expanded authority to defend against takeovers. The act also restricts the voting rights of interested shareholders and directors in certain types of transactions, including mergers. *Id.* § 1311. For a complete description of the operation of the Pennsylvania statute, see Newlin & Gilmer, *The Pennsylvania Shareholder Protection Act: A New State Approach to Deflecting Corporate Takeover Bids*, 40 BUS. LAW. 111 (1984).

[78] IND. CODE ANN. § 23-2-3.1-8.4 (Burns 1984). For the act to apply the target company must be incorporated in the state, have its principal place of business within the state, and have substantial assets within the state. *Id.* § 23-2-3.1-1. Hawaii has adopted a similar provision. *See* HAWAII REV. STAT. § 417-19 (Supp. 1983). Since Hawaii bans two-tiered offers, this section is intended to protect shareholders who do not tender in an any-and-all offer, when the acquirer desires to engage in a mop-up merger.

[79] MD. CORPS. & ASS'NS CODE ANN. § 3-602 (Supp. 1983); 1983-1985 WIS. LEGIS. SERV. 200 (West). Both statutes provide that any merger or consolidation with a shareholder holding 10% or more of the voting securities of the acquired firm must be approved by 80% of the outstanding voting securities and two-thirds of the voting securities of the acquired firm, not counting the shares of the acquiring firm.

[80] MD. CORPS. & ASS'NS CODE ANN. § 3-603 (Supp. 1983); 1983-1985 WIS. LEGIS. SERV. 200 (West). If the consideration offered in the second step is equal in amount and type to the highest of (1) the highest price paid by the tender offeror for two years prior to the offer; (2) the tender offer price; or (3) the market value of the stock on the day the tender offer is

These state statutes were initially passed or amended after the Supreme Court's opinion in *Edgar v. MITE Corp.*[81] In *MITE* the Court voided the Illinois Business Take-Over Act.[82] A majority of the Court held that the Illinois law imposed an undue burden on interstate commerce as compared to the local interests protected by the act.[83] The Illinois statute had substantial extraterritorial effect, and the Court rejected the proffered explanations of regulatory interests of Illinois.[84] The proponent claimed a state interest in protecting local investors, but the Court reasoned that the extra delays caused by the act and the statute's exclusion for corporate self-tenders undermined the state's claimed interest in shareholder protection.[85] In addition, the state claimed an interest in regulating

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commenced or concluded, the supermajority requirements do not apply. These statutes thus place all the risk of fluctuations in market value on the offeror.

Recently three more states have adopted statutes based on the Maryland approach: Connecticut, Michigan and Kentucky. *See* Act of June 4, 1984, § 5, 1984 Conn. Legis. Serv. 595, 601-04 (West); 1984 Mich. Legis. Serv. 88 (West) (to be codified at MICH. COMP. LAWS §§ 450.1775-.1784); KY. REV. STAT. §§ 271A.396-.398(2) (1984). The Maryland approach is described in detail in Scriggins & Clarke, *Takeovers and the 1983 Maryland Fair Price Legislation*, 43 MD. L. REV. 266 (1984).

[81] 457 U.S. 624 (1982).

[82] The Illinois law applied to takeovers where Illinois shareholders owned 10% of the target's shares or if the target was incorporated in Illinois and either had its principal place of business or 10% of its stated capital and paid-in surplus in Illinois. *Id.* at 627.

The Illinois Act required a tender offeror to notify the Illinois Secretary of State and the target company of its intent to make a tender offer and to disclose terms of the offer 20 days before the offer became effective. During this period the secretary of state could hold a hearing on the substantive fairness of the offer. The statute required such a hearing if the target's outside directors or Illinois shareholders owning 10% of the target's shares requested it. The secretary of state could prevent the offer from going forward on either disclosure or fairness grounds.

[83] *Id.* at 643. A majority of the Court consisting of Justice White, the Chief Justice, Justice Powell, Justice Stevens, and Justice O'Connor applied the balancing test from Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970). The Court in *Pike* held that when a state statute indirectly regulates interstate commerce, any burden on interstate commerce must be balanced against the local interests served by the statute.

[84] 457 U.S. at 643. The Court stated that the statute's burden on interstate commerce gave Illinois the power to block nationwide tender offers. The Court found this burden to be substantial: depriving the target's shareholders of the tender offer premium, hindering the efficient reallocation of resources, and reducing the incentive for management to perform in the shareholder's interest. The Court adopted the analysis based on the market for corporate control, discussed *infra* pp. 308-19. The Court also rejected the notion that Illinois had an interest in protecting nonresident shareholders. 457 U.S. at 644.

[85] 457 U.S. at 644-45. The Court noted that the Williams Act provided essentially the same protections as the Illinois law with respect to withdrawal rights, proration, and equal consideration. Any additional claimed disclosure protections could provide no benefit be-

the internal affairs of a corporation formed under the laws of the state.[86] The Court rejected this concern in one sentence: "[T]ender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company."[87] Separate pluralities of the Court also would have voided the Illinois act as a direct restraint on interstate commerce and as a violation of the supremacy clause.[88] Subsequent efforts to void the state regulatory attempts under Illinois-type statutes have focused on the extraterritorial impact arguments.[89]

All of the post-*MITE* statutes attempt to ameliorate the *MITE* constitutional problems. The amended Hawaii statute strengthened the jurisdictional requirements for triggering the no-partial-tender-offer rule.[90] These closer connections, however, will not completely solve the *MITE* problem; the state act can still block the sale of securities pursuant to a partial tender offer between nonresidents of Hawaii.[91] The Ohio and Wisconsin first step "share control acquisition" statutes attempt to bring all defined control acquisitions, including tender offer acquisitions, within the general state corporate law.[92] This approach attempts to resurrect the state's interest in regulating the internal affairs of local corporations. It remains to be seen whether the approach sufficiently responds to the Supreme Court's view that tender offers do not implicate traditional state interests in issues of corporate governance.[93] The first step share control acquisition statutes also

cause of the harm created by additional defensive tactics.

[86] *Id.* at 645.

[87] *Id.*

[88] Justice White, joined by the Chief Justice, Justice Stevens, and Justice O'Connor, believed that the statute presented a direct restraint on interstate commerce and thus was void regardless of any state interest. Justice White, the Chief Justice, and Justice O'Connor also stated that the Williams Act preempted the Illinois law under the supremacy clause.

[89] *E.g.*, Martin-Marietta Corp. v. Bendix Corp., 690 F.2d 558 (6th Cir. 1982); National City Lines v. LLC Corp., 687 F.2d 1122 (8th Cir. 1982); *see also* Comment, *The Unsung Death of State Takeover Statutes:* Edgar v. MITE Corp., 24 B.C.L. REV. 1017 (1983).

[90] HAWAII REV. STAT. § 417E-1(5) (Supp. 1983) (incorporation and significant contacts required).

[91] The Hawaii act has nationwide effect for corporations meeting § 417E-1(5).

[92] OHIO REV. CODE ANN. § 1701.832 (Page Supp. 1983) states a legislative purpose of adopting an *in loco parentis* responsibility for shareholders of Ohio corporations, even with respect to third party transactions. For a similar provision, see 1983-1985 WIS. LEGIS. SERV. 200 (West).

[93] Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).

do not ameliorate the extraterritorial concerns. In the case of a partial tender offer for thirty percent of a corporation's outstanding shares, thirty percent of the shareholders, all residing out of state, may wish to tender, but the transaction could nevertheless be blocked by the fifty percent voting requirement.[94] The potential delay created by requiring a meeting of shareholders could trigger the Supreme Court's concern that delay unduly benefits target management.[95]

The Pennsylvania law, giving shareholders the right to seek fair value after control shifts, presents a more difficult question. The law does not directly regulate a tender offer, since a tender offer can proceed under the Williams Act without any additional delay or direct limitation on the ability of out-of-state shareholders to tender. But because the offeror is required to purchase all shares at the first tier price, some offers might never be launched. Thus the Pennsylvania approach would be problematic only if the full Court were to adopt the neutrality-supremacy clause theory of Justice White's plurality opinion in *MITE*.[96] Similarly, the Maryland and

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[94] *See supra* note 70 and accompanying text. The example in the text shows that the statutes would give Ohio and Wisconsin the power to restrict the rights of out-of-state shareholders to tender, one of the elements of the Illinois statute that the Court struck down in *MITE*.

[95] The Ohio and Wisconsin statutes require a special meeting of shareholders within 50 days of the filing of the "acquired person statement." The board of the target determines the date. The Minnesota statute requires a meeting between 35 and 55 days. The *MITE* majority doubted that similar delays would benefit shareholders and deflated the states' claim of a regulatory interest in shareholder protection. Moreover, if the supremacy clause argument of the Chief Justice and Justices White and O'Connor in *MITE* is accepted, then the 20-day minimum contained in Rule 14e-1 potentially conflicts with the delays that the rule creates. *See* Kreider, *Fortress Without Foundation? Ohio Takeover Act II*, 52 U. CIN. L. REV. 108, 119-20 (1983); Sargent, *Do the Second-Generation State Takeover Statutes Violate the Commerce Clause*, 8 CORP. L. REV. 3 (1985). *But see* Profusek & Gompf, *State Takeover Legislation after* MITE*: Standing Pat, Blue Sky, or Corporate Law Concepts?*, 7 CORP. L. REV. 3 (1984) (Ohio statute offends neither commerce clause nor supremacy clause).

[96] Edgar v. MITE Corp., 457 U.S. 624, 633 (1982). Justice White's supremacy clause analysis examined the legislative history of the Williams Act, finding that one objective of the Act was to avoid favoring target management by discouraging tender offers through delay. In addition, the plurality opinion noted the power of the Illinois Secretary of State to block tender offers with "inequitable terms." Justice White stated that any protections shareholders received under state law should not come at the expense of letting shareholders determine the merits of the offer. Any state law which substantially frustrates the objectives of neutrality and shareholder decisionmaking power might be preempted, according to the plurality. Because of the cash-out provision, a raider might not go forward with an offer for a covered firm, frustrating both objectives. *See* Newlin & Gilmer, *supra* note 77.

Wisconsin second step supermajority statutes and the Indiana equal payment for second step acquisitions statute would only raise federal law questions if the Williams Act were construed as creating a preemptive requirement of neutrality in all types of state regulatory efforts.[97]

All of the state statutory provisions have analogues in intracorporate efforts at restricting partial and two-tiered offers. Corporations may adopt supermajority provisions for business combinations with affiliated persons.[98] They may also waive the supermajority provision if a specified premium is paid in the second step transaction, join the second step premium requirement with a supermajority requirement, or create a right of redemption where a control relationship is created in the first instance.[99] Most state statutes apparently permit these intracorporate approaches. The few cases considering the issue support the validity of the provisions.[100] Thus, assuming adequate disclosure of their effect[101] in

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[97] The supermajority provisions of the Maryland and Wisconsin laws on the second step transaction also have no direct effect on the ability of a firm to make the first step partial offer. The same type of interference with shareholder autonomy as discussed *supra* note 96 is, however, created. On balance the commentators conclude that statutes regulating only the second step pass muster under all theories considered in *MITE*. *See* Newlin & Gilmer, *supra* note 77; Sargent, *supra* note 95; Scriggins & Clarke, *supra* note 80.

[98] For a complete catalog of intracorporate devices limiting partial and two-tiered offers, see Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982) (supermajority requirements on the second step acquisition have some power in deterring initial offers); *see also* Black & Smith, *Antitakeover Charter Provisons: Defending Self-Help For Takeover Targets*, 36 WASH. & LEE L. REV. 699 (1979) (supermajority vote, elimination of shareholders' power to call meetings, and majority vote requirements are popular charter provisions to help prevent takeovers); Hochman & Folger, *Deflecting Takeovers: Charter and By-Law Techniques*, 34 BUS. LAW. 537 (1979) (listing techniques to keep raiders from controlling the board of directors before and after annual meetings and techniques to dilute raiders' stock ownership, prevent squeezeouts, and deter tender offers). *See generally* A. FLEISCHER, TENDER OFFERS (1981) (describing ways to prevent tender offers and to retain corporate control when tender offers occur).

[99] Gilson, *supra* note 98, at 786-88.

[100] *E.g.*, Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1980); Seibert v. Milton Bradley Co., 405 N.E.2d 131 (Mass. 1980). Professor Gilson, however, argues that shark repellents are inconsistent with shareholders' interests in public corporations and should be invalid. Gilson, *supra* note 98. Professor Carney disagrees, suggesting that shark repellents that allow a coordinated shareholder response to two-tiered offers are economically valuable. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RESEARCH J. 341, 342. The debate is discussed *infra* pp. 319-31.

[101] The SEC requires the disclosure of the antitakeover effect of shark repellents in proxy

the proxy materials advocating the proposal, such intracorporate provisions are likely legal under state law.

Another principal aspect of the regulation of the second step transaction is the state corporate law appraisal remedy.[102] A state equity proceeding based on either an unfairness or a failure of disclosure theory may be another available remedy.[103] In both the appraisal and the unfairness or disclosure actions, the primary issue is whether the price offered to the remaining shareholders of the target is adequate.[104] In Delaware for several years, courts also inquired into the business purpose of the freezeout transaction.[105] In *Weinberger v. UOP, Inc.*[106] the Delaware Supreme Court refused to require the parent to have an acceptable business purpose for the second step transaction and retreated to the fairness test.[107] The Delaware court now requires the plaintiff to prove specific acts of fraud, misrepresentation, or other misconduct.[108] The burden

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materials. *E.g.*, Securities Exchange Act Release No. 15,230 (Oct. 13, 1978), *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,748, at 80,874.

[102] For those shareholders who dissent from the second step merger, appraisal rights are available unless the market listing exception to appraisal exists. *Compare* DEL. CODE ANN. tit. 8, § 262 (1983) (second step shareholders may have shares appraised by Court of Chancery) *with* ALI-ABA MODEL BUS. CORP. ACT §§ 80, 81 (1978) (dissenting shareholders who do not get fair value may sue in state court for an appraisal). *See generally* H. HENN & J. ALEXANDER, LAW OF CORPORATIONS 997-101 (3d ed. 1983) (the scope of the state appraisal remedy should affect the decisionmaking process of management in structuring transactions and the decisionmaking process of shareholders in determining whether to tender in the first step).

[103] While the right to appraisal is the exclusive remedy in some states, there is often an exception to exclusivity where the actions of the acquiring firm are fraudulent. *See, e.g.*, ALI-ABA MODEL BUS. CORP. ACT § 80(d) (1978); *see also* H. HENN & J. ALEXANDER, *supra* note 102, at 1004-05 (listing state statutes and cases).

[104] *See, e.g.*, Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981), *overruled on other grounds in* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980). The court opinions generally analyze fair price and fair dealing separately, but the fairness violations relate to whether shareholders had been adequately compensated for their interest in the corporation. The granting of rescissionary damages in *Lynch* was an effort to avoid the then-prevailing narrow view of the reach of the Delaware appraisal statute. The *Weinberger* decision overruled *Lynch* "to the extent that it purports to limit a stockholder's monetary relief to a specific damage formula." *Weinberger*, 457 A.2d at 704.

[105] Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979); Singer v. Magnovox Co., 380 A.2d 969 (Del. 1977); Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977).

[106] 457 A.2d 701 (Del. 1983).

[107] The *Weinberger* court adopted the fairness test from Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952).

[108] *Weinberger*, 457 A.2d at 703.

then shifts to defendants to prove complete fairness.[109] Even if the allegations of the plaintiff's complaint shift the burden to defendants, the plaintiff must use the statutory appraisal remedy.[110] Within the appraisal proceeding, however, the chancellor can award rescissionary as well as compensatory damages for breach of the duty of fairness.[111]

The standard for determining the adequacy of the price offered in the second step transaction is unsettled. In Delaware, for example, the traditional measure of value of the remaining shares was the block method, which weighs the asset, earnings, and market value of the acquired shares to reach the total value.[112] The *Weinberger* court abandoned the block method of valuation in favor of the more flexible standard of considering "any techniques or methods which are generally considered acceptable in the financial community."[113] In particular the court will now consider discounted cash flow analysis to determine fair price.[114] Moreover, the court may require some sharing of the gains arising from the transaction, despite a statutory mandate to ignore such factors in the appraisal process.[115] The *Weinberger* court stated "elements of future value . . . which are susceptible of proof as of the date of the merger and not the product of speculation may be considered."[116]

With respect to the propriety of disclosures, the *Weinberger* court suggested a "supermateriality" test for the disclosure required to accomplish the second step transaction. The Supreme Court in *TSC Industries v. Northway, Inc.*[117] established the test of materiality under federal law. To show that a statement is mate-

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[109] *Id.* Entire fairness includes both fair dealing and fair price, questions of process and economic value. *Id.* at 711.

[110] *Id.* at 714.

[111] *Id.*

[112] *E.g.*, Universal City Studios, Inc. v. Francis I. duPont & Co., 334 A.2d 216 (Del. 1975); Gibbons v. Schenley Indus., Inc., 339 A.2d 460 (Del. Ch. 1975).

[113] Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

[114] *Id.* at 712.

[115] DEL. CODE ANN. tit. 8, § 262(h) (Supp. 1982); *see* Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980).

[116] *Weinberger*, 457 A.2d at 713. *See generally* Burgman & Cox, *Reappraising the Role of the Shareholder in the Modern Public Corporation:* Weinberger's *Procedural Approach to Fairness in Freezeouts*, 1984 WIS. L. REV. 593, 619-22 (synergy premiums may now be considered in appraisal proceedings because of both the requirement of full disclosure and the courts' inclination to compensate dissenting shareholders).

[117] 426 U.S. 438 (1976).

rially misleading, a shareholder must prove a substantial likelihood under all the circumstances that the omitted or misstated fact assumed actual significance in the deliberations of the shareholder and that it would have affected the total mix of information available.[118] The federal cases interpreting this test are not consistent. Some courts require proof that the omitted or misstated information was not part of the publicly available information concerning the firm.[119] Others find material misstatements or omissions even though the data in question had been disclosed and digested by the market.[120] This latter phenomenon is particularly prevalent in the controlled merger context where several courts have assessed the fairness of a transaction in the guise of a materiality determination.[121]

The *Weinberger* court apparently followed the second approach. The parent company was accused of not disclosing material information concerning the transaction to all the directors and shareholders of the controlled subsidiary.[122] The information in question was a report prepared by common directors of the parent and the subsidiary and used by the parent to reach a price to be offered the subsidiary's shareholders.[123] Yet the information included in that report did not appear to be inside information. The report discussed possible synergies and perceived financial benefits for the parent which would result from the transaction. These data were available from the public record or were speculative information that any financial analyst could produce for any merger.

The *Weinberger* case creates considerable contradictions and significant uncertainties. While the case limits the objecting shareholder to the appraisal remedy for the second step transaction, it includes the "entire fairness" test as part of the appraisal process.[124] Adequate disclosure should be part of the entire fairness

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[118] *Id.* at 449.

[119] *E.g.*, Seaboard World Airlines v. Tiger Int'l, 600 F.2d 355 (2d Cir. 1979); Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974).

[120] *E.g.*, Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

[121] *E.g.*, Gould v. American-Hawaiian S.S. Co., 535 F.2d 761 (3d Cir. 1976); Valente v. PepsiCo, Inc., 454 F. Supp. 1228 (D. Del. 1978).

[122] *Weinberger*, 457 A.2d at 711-12.

[123] *Id.* at 708.

[124] *See* Burgman & Cox, *supra* note 116, at 614. They argue that the tensions in the case result in part from unreconciled views of the role of shareholders in public corporations. These tensions are most important when attempting to determine the expectations of share-

inquiry, but the Delaware court's view of materiality is not sufficiently connected to the market-based valuation standard.

2. *Greenmail.* The state judicial approach to greenmail mirrors the general state statutory treatment of defensive tactics.[125] So long as the managers of the target justify their activities in terms other than preservation of control, the courts have allowed targets to repurchase shares from a putative raider. In the leading case of *Cheff v. Mathes*,[126] the Delaware Supreme Court stated that if the "sole or primary motive" for the share repurchase was to perpetuate the board in power, then the repurchase was improper.[127] If, however, the repurchase occurred because there was a policy difference between the raider and current management, then using corporate funds to terminate the interest of the raider was legitimate and protected under the business judgment rule. The board must, however, show good faith and reasonable investigation. In *Cheff*, the target management met its burden on dubious evidence. The board had some basis to believe that the raider might liquidate the company or change the methods of distributing the company's product. The potential raid was also allegedly damaging employee morale. Application of the "sole or primary motive" test in *Cheff* shows that virtually all share repurchases in Delaware should be

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holders in the second step transaction. *Id.* at 623.

[125] Absent a failure to adequately disclose, a greenmail transaction does not raise federal securities law issues. With full disclosure, a greenmail payment at best raises state law questions of fiduciary fraud, but Santa Fe Indus. v. Green, 430 U.S. 462 (1977), precludes relief only for fiduciary fraud. Federal tax law, however, now creates some disincentives to beachhead formation. Under prior law, when a corporation borrowed funds to create a beachhead, it could deduct the interest and exclude from income 85% of any dividends paid by the target, making beachhead formation financially attractive. The Tax Reform Act of 1984 now provides that, to the extent funds were borrowed to purchase securities, the amount of dividends excluded from income must be reduced by the percentage of debt attributed to the purchase.

[126] 199 A.2d 548 (Del. 1964); *see* Crane Co. v. Harsco Corp., 511 F. Supp. 294 (D. Del. 1981); Kors v. Carey, 158 A.2d 136 (Del. Ch. 1960). *See generally* Nathan & Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, 35 BUS. LAW. 1545, 1550 (1980) (management is likely to have a mix of motives for repurchase, but on balance its motives must appear fair); Nathan & Ziegler, *Issuer Stock Repurchases*, 14 REV. SEC. REG. 925 (1981) (management may justify defensive actions by showing good motive for the repurchase or a clear threat to the business); Tobin & Maiwurm, *Beachhead Acquisitions: Creating Waves in the Marketplace and Uncertainty in the Regulatory Framework*, 38 BUS. LAW. 419 (1983) (explaining the business judgment rule and the growth of manipulation claims by raiders under § 14(e)).

[127] 199 A.2d at 554. The test established by *Cheff* has been adopted for a wide range of defensive tactics. *See infra* note 135 and accompanying text.

legal. In almost all takeover situations, management will have some policy difference with the raider or be able to claim disruption of employee morale. Not surprisingly, in the few cases where the issue has been litigated after *Cheff*, the decision of management to repurchase has been approved.[128]

Another suggested solution to the targeted repurchase of shares problem is having the target company purchase all shares pro rata. This argument is a variant on the gain sharing theories with respect to control premiums; control is a corporate asset which all shareholders must share.[129] Except in extraordinary cases, courts have not accepted the control-as-corporate-asset theory[130] and have rejected it specifically in the share repurchase context.[131] There is no requirement of equal treatment in negotiated share repurchases; such repurchases do not require pro rata offers, and the corporation is entitled to pay a premium above market price.

Application of the *Cheff* "sole or primary motive" test in contexts other than share repurchase is more common.[132] Since *Cheff*, despite significant academic criticism, the courts have persisted in giving target management great latitude in fending off the putative raider. For the most part, courts have applied the business judgment rule, or something close to it, to test the response of managers to control contests. Cases such as *Northwest Industries, Inc. v. B.F. Goodrich Co.*[133] suggest that "management has the responsibility to oppose offers which, in its best judgment, are detrimental

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[128] Heine v. The Signal Cos., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898 (S.D.N.Y. 1977); Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977).

[129] While the insurgent's repurchased shares presumably did not carry any significant present control power, the *Cheff* court construed the repurchase premium as a control premium. For an analysis of the economic arguments on this point, see *infra* pp. 338-39; for an example of the argument that control can be a corporate asset, see M. EISENBERG, THE STRUCTURE OF THE CORPORATION 16 (1976).

[130] *See generally* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 699 (1982) (giving examples of how forced sharing of gains reduces the likelihood that there will be gains to share).

[131] Heine v. The Signal Cos., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898 (S.D.N.Y. 1977).

[132] The literature on the legal status of defensive techniques is extensive. For general summaries of the available techniques, see E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL (1977); A. FLEISCHER, TENDER OFFERS (1981).

[133] 301 F. Supp. 706 (N.D. Ill. 1969).

to the company or its stockholders."[134] Even if perpetuation of control is one of management's motives, the actions of management are protected so long as this motive is not the single motive.[135] Under this approach, tactics such as purchasing assets which create antitrust obstacles,[136] lock-up options,[137] issuance of new shares,[138] and sale of assets[139] have been approved. In sum, with minimal effort any greenmail transaction will pass muster under state corporate law.

II. Economic Analysis of Two-Tiered Tender Offers and Greenmail

A. The Economics of Tender Offers

Tender offers are a relatively new phenomenon of American corporate life.[140] Economic analysis of corporate law problems using the techniques of modern financial theory, such as the efficient market model, is of the same vintage. The seminal work using this mode of analysis is Henry G. Manne's 1965 article, *Mergers and the Market for Corporate Control*.[141] Professor Manne was the first to argue that the link between relative share prices and managerial efficiency is of fundamental importance in analyzing corporate law problems. Manne pointed out that apart from the stock

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[134] *Id.* at 712.

[135] Panter v. Marshall Field & Co., 646 F.2d 271, 293-94 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Crouse-Hinds Co. v. Inter North, Inc., 634 F.2d 690, 703-04 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). The latitude given managers is not complete. *See* Norlin Corp. v. Rooney Pace, Inc., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,564 (2d Cir. 1984). In *Norlin* the Second Circuit separated the business purpose of the defensive tactics from the validity of the opposition of target management, holding that defensive tactics must have independent business legitimacy.

[136] Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

[137] Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse-Hinds Co. v. Inter North, Inc., 634 F.2d 690 (2d Cir. 1980).

[138] Marshall Field & Co. v. Icahn, 537 F. Supp. 413 (S.D.N.Y. 1982); *see* Moran v. Household Int'l, Inc., 17 Sec. Reg. & L. Rep. (BNA) 219 (Del. Ch. 1985); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 Harv. L. Rev. 1964 (1984).

[139] Whittaker v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982).

[140] E. Aranow & H. Einhorn, Tender Offers for Corporate Control (1973).

[141] Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965). Manne's original article was not primarily about the then nascent hostile takeover phenomenon but rather focused on all methods of transferring control.

market there are no objective measures of managerial efficiency. A stock price relatively below that of other companies in the same industry or the market as a whole probably reflects managerial inefficiency: that is, other available corporate strategies would increase the firm's worth.[142] Changes in corporate control are often attempts to impose new methods of efficient management on the firm, rather than attempts to create market power or to purchase the perquisites of management's position. Manne concluded that the market for corporate control was not only important in replacing inefficient management but in increasing incentives for managers of all publicly traded companies to act in shareholders' interests so that share prices remain high and reduce the risk of takeover. The market's monitoring function reduces the separation between the interests of managers and shareholders in the modern public corporation.[143]

1. The Efficient Capital Market Model. In recent years a plethora of scholarly articles have built on Professor Manne's insights.[144] The Williams Act and the fiduciary duties of managers

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[142] A sophisticated view of managerial efficiency had already been adopted by Manne, *supra* note 141. Not only should operational efficiencies be considered but all management decisionmaking, including the decision to withdraw assets from one use to be invested in another use, are part of the efficiency equation.

[143] Recognition of the separation of ownership and control in the modern public corporation originated with A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). For an insightful intellectual history of this important work, see Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 J. L. & ECON. 273 (1983).

The law and economics literature contains several suggestions besides the market for corporate control for bridging the gap. *See* Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983); Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) [hereinafter cited as Fama, *Agency Problems*]; Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). These suggestions focus on establishing compensation systems which tie firm profitability more closely to managerial compensation. The market for managers, the product market in which the firm operates, and the legal system through the device of the derivative suit also serve to mesh the interests of managers and shareholders.

[144] The leading advocates of the market for corporate control as a tool to encourage managerial efficiency and to discipline inefficiency are Professors Easterbrook and Fischel. *See* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Easterbrook & Fischel, *supra* note 130; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter cited as Easterbrook & Fischel, *The Proper Role*]. Easterbrook and Fischel argue that shareholders are best served if management undertakes no efforts at fending off takeover bids. Other authors writing in the law and economics tradition argue that managers should be allowed to coordinate auctions for the target. For articles advocating the auction rather than the complete passivity model of management behavior, see *infra* note 150.

imposed by state law in battles for corporate control have been analyzed using the efficient capital market model as a starting point. The efficient market model posits that all public information is reflected in the share price of a particular firm.[145] This model portrays the operation of the stock market as an information exchange. The aggregate behavior of the market represents a competitive equilibrium created by numerous buyers and sellers producing and processing information. Individual investors may not have all the information available to the market and may not properly evaluate the relevant data, but the competition of the market produces an equilibrium price which represents an unbiased estimate of value based on current information.[146]

The efficiency of management is an integral part of the mix of data known about the firm.[147] The value of a particular firm as measured by the market has two components—the value of the firm under current management and the discounted value of a potential takeover at a premium price. Raiders must believe that by placing the assets of the target firm under more efficient management the aggregate value of these two components will be increased. The target firm is only undervalued in that present managers of the company are not likely to undertake other methods of management which might create gains for the firm. There are several sources of the potential gain. Economies of scale or other operational synergies might be created. The target might have liquid resources, including tax benefits, which the raider could more prof-

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The arguments for an unfettered market for corporate control are also summarized in COUNCIL OF ECONOMIC ADVISORS, ANNUAL REPORT 187-216 (1985).

[145] I have recently collected and analyzed the economic literature on the efficient capital market model. *See* Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373 (1984). This Article builds on my prior effort. In addition, my understanding of the operation of the securities markets as an information exchange was significantly enhanced by Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). They point out that market efficiency is a function of both the initial distribution of any piece of information and the costs attending the production of that information.

[146] Dennis, *supra* note 145; Figlewski, *Information Diversity and Market Behavior*, 37 J. FIN. 87 (1982); Gilson & Kraakman, *supra* note 145; Mayshar, *On Divergence of Opinion and Imperfections in Capital Markets*, 73 AM. ECON. REV. 114 (1983).

[147] Easterbrook & Fischel, *The Proper Role*, *supra* note 144, at 1167; Manne, *supra* note 141, at 112-13. For an empirical study of the relative effect of economy-wide, industry-wide, and company-specific information on share prices, see King, *Market and Industry Factors in Stock Price Behavior*, 39 J. BUS. 139 (1966).

itably use. Finally, the raider might be replacing inefficient managers. Bidders thus are not trying to beat the consensus judgment of the market about the value of the target under current conditions but are changing a fundamental factor of value by changing the control structures of the target.[148]

As a consequence of this line of argument, writers using the efficient market model as their mode of analysis advocate limiting management's role in takeover situations. One approach would deny management the opportunity to undertake any defensive tactics.[149] Advocates of this position argue that shareholders as a community benefit most from complete management passivity, which supposedly increases the absolute number of takeover bids, maximizes the return to shareholders as a class, and maximizes the monitoring power of the market for corporate control. Another approach would allow managers the limited role of facilitating auctions for the target.[150] This approach maximizes the gains to the specific shareholders of the target once a takeover battle has commenced. Any decrease in the total number of takeover bids arguably would be offset by gains derived from auctions. Also, auctions would benefit society because assets would end up in the hands of the firm which values them most. The debate between the two approaches is essentially an empirical one.[151] How much is gained by

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[148] *See, e.g.*, Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Easterbrook & Fischel, *The Proper Role*, *supra* note 144, at 1168-73; Manne, *supra* note 141, at 113. This view has been challenged by several commentators. *See, e.g.*, Harrington, *If it Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids*, 34 SYRACUSE L. REV. 977 (1983); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983); Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. 882 (1978). These arguments are considered in detail, *infra* notes 153-72 and accompanying text. For a critique of the market for corporate control from the perspective of the critical legal studies movement see Frug, *The Ideology of Bureaucracy*, 97 HARV. L. REV. 1276, 1355-68 (1984). Professor Frug argues that the stock market does not capture the conflicting desires of shareholders.

[149] *See* Easterbrook & Fischel, *supra* note 130; Easterbrook & Fischel, *The Proper Role*, *supra* note 145.

[150] *E.g.*, Bebchuk, *supra* note 148, at 1054; Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982); *see also* Carney, *supra* note 100, at 373 (management should be allowed to propose certain types of shark repellent charter amendments to encourage offers for all the shares of the target at a high premium).

[151] The debate is well summarized in Coffee, *supra* note 5. Professor Coffee's article combines the analytic method of the neoclassic law and economics approach with more eclectic industrial organization models of managerial behavior. He focuses not only on recognized

auctions? How many tender offers, at what premium, are deterred by the potential for an auction? In addition, how would the auction rule be implemented without giving management the effective power to prevent takeovers?[152] Both schools, however, would prohibit management from undertaking such tactics as antitrust litigation, lock-up options, and issuing "poison-pill" preferred stock. Such tactics only reduce the monitoring power of takeovers.

This theory of the utility of tender offers has been attacked on several grounds. First, critics challenge the efficiency-enhancing effect by examining specific transactions,[153] citing individual case studies to show the less than sterling results of several contested takeovers. Their argument misconstrues the basic thrust of the economic utility arguments for tender offers. The economic argument in favor of an active market for corporate control is not that raiders never make mistakes. Rather, the utility of tender offers is best seen in the benefit that is created for all firms from the monitoring effect in aggregate of all takeovers. Moreover, the ill-conceived tender offer amounts to self-deterring conduct. It places the raider at risk in the market for corporate control as a consequence of poor performance and signals other potential raiders to devote resources to search and assess the appropriate level of the premium.[154]

Similar to the case study attack on tender offers is the argument that tender offers encourage "empire building" takeovers.[155] The

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benefits of an active market for corporate control but on the perceived diseconomies associated with control transfers of all sorts. Professor Coffee believes the claimed diseconomies would be increased by a legal system which encouraged low premiums, with a higher level of hostile takeovers than occurs today. Two major policy prescriptions relate to his article: first, we adopt some form of the British model, requiring that offers for over 30% be offers for all the shares of the target, and second, we prohibit greenmail. Professor Coffee does recognize that stock price studies, cited *infra* note 175, indicate that gains created for both raiders and targets by hostile transactions are real. I believe these studies deserve more weight than Professor Coffee accords them. *See infra* notes 175-77 and accompanying text. While I disagree with Professor Coffee's policy prescriptions on two-tiered offers and greenmail, his article is an excellent, comprehensive description of the current debate over regulation of tender offers that explains the competing positions and their arguments.

[152] A serious administrative problem would exist under the auction-only model since management could claim any defensive measure aimed at creating an auction.

[153] *E.g.*, Lipton, *supra* note 148, at 101; Lowenstein, *supra* note 148, at 249.

[154] Easterbrook & Fischel, *The Proper Role*, *supra* note 144, at 1185.

[155] The leading advocates of this position are Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LIT. 32 (1980); *see also* Coffee, *supra* note 5, at 1224-34. Professor Coffee recognizes that on balance takeovers might result in more efficient

economic literature does contain evidence that some firms seek to maximize growth rather than profits.[156] This effect derives from agency monitoring costs and the separation of ownership and management, coupled with the diseconomies of scale[157] in managing large organizations. Even if managers wished to maximize profits in the interest of shareholders, the difficulties of communication in large organizations may make such goals difficult to achieve.[158] The separation of ownership and control may further attenuate the desire to maximize profits to the exclusion of other managerial goals.

Managers may have a stake in corporate growth due to its positive effect on their compensation. Empirical evidence suggests that executive salaries are more closely correlated with sales than with the annual level of profits.[159] Salaries are even more closely related to asset size; firm size is a critical compensation variable.[160] But increases in compensation are also systematically related to increased profits,[161] especially when the total compensation scheme includes stock options and other benefits tied to profitability. In sum, the studies show that managers do benefit from increased profits, but that they may also profit from growth for its own sake.

2. *The Temporary Dislocation Theory.* Some commentators,

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managers winning more often. He argues, however, that public policies resulting in the payment of high premiums would induce a higher percentage of efficiency-producing transactions.

[156] *See generally* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 29-41 (2d ed. 1980) (summarizing the studies on the goals of managers and the strength of the profit-maximizing motive).

[157] Leibenstein, *Allocative Efficiency vs. "X-Efficiency,"* 56 AM. ECON. REV. 392 (1966). X-efficiency relates to firm motivation to increase profits, as calculated by reference to competitive pressure. Unless so motivated, firms do not seek or use new information to increase growth when the anticipated growth is slight.

[158] R. REICH, THE NEXT AMERICAN FRONTIER 140-72 (1983). Reich criticizes the takeover phenomenon for creating inefficient intrafirm structures and for causing managers to focus on short-run growth rather than long-run profitability.

Professor Williamson's work also discusses communication within a firm and attempts to establish control mechanisms within the large conglomerate as a central concern of industrial organization theory. O. WILLIAMSON, MARKETS AND HIERARCHIES (1975); Williamson, *Hierarchical Control and Optimum Firm Size,* 75 J. POL. ECON. 123 (1967).

[159] *See* F. SCHERER, *supra* note 156, at 35-37 (providing a summary of the studies).

[160] *Id.*

[161] The growth of stock options and stock rights as a major form of executive compensation has strengthened this connection. *See* Fama, *Agency Problems, supra* note 143, at 297-98 (arguing that it is unnecessary to account for lack of entrepreneurial incentives in management through wage reduction because adequate incentive exists in the management market).

the temporary dislocation theorists, challenge the basic premise that the stock market accurately values firms.[162] They take the position that raiders look for potential targets which the market undervalues, even in the hands of present management. These commentators argue that the raider either produces new information that such an undervalued firm exists or exploits a known temporary exogenous dislocation in the price of the target firm.[163] Despite data supporting the efficient market model, these commentators argue that a separate market exists with respect to the control value of a firm in the hands of present management, which differs from the stock market trading value, and that the latter is not efficiently priced.[164] As a consequence of structural dislocations in the stock market, whole classes of firms are supposedly inefficiently priced. Certain shareholders perceive that market value departs from intrinsic value. Because of the coercive nature of the lower second step price, however, these shareholders might nevertheless tender.

Louis Lowenstein suggests that as a consequence of the structural dislocation problem, the intrinsic value of a firm to a single stockholder is separate from the value of that firm's capital as traded on a stock exchange, management competence aside.[165] In support he cites the recent growth in leveraged buyouts and "going

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[162] Harrington, *supra* note 148, at 981-83, 1008-11; Lipton, *supra* note 148, at 108-09; Lowenstein, *supra* note 148, at 276-96, 305-06.

[163] As Professor Coffee notes, the argument that the stock market inefficiently prices firms only rebuts those advocating an active market for corporate control if the market specifically undervalues efficient firms more often than inefficient firms or if erratic price movements cause some efficient firms to sell routinely at lower prices than inefficient firms. Coffee, *supra* note 5, at 1170-73. There is no evidence supporting either condition. For a more complete discussion of the valuation problem and its effect on tender offer regulation, see *infra* notes 187-200 & 208-20 and accompanying text.

[164] *E.g.*, Lowenstein, *supra* note 148, at 274-75.

[165] *Id.* Professor Lowenstein relies heavily on an anecdotal analysis of an apparently well-run machine tool company that was purchased at a high premium and that was selling before the tender offer at only four times earnings. Even if anecdotal evidence were determinative, this anecdote would not resolve the issue. The plausible explanation of the market pricing of the target before the tender offer was substantial uncertainty about the short-and long-run health of the machine tool industry, a highly cyclical industry that depends on the manufacturing sector and faces growing competition from Japanese machine tool manufacturers. *See* N.Y. Times, Aug. 17, 1984, § D, at 4, col. 1. The industry has remained a troubled one even in a vigorous domestic recovery. The explanation for the transaction then was not the hope of stealing an undervalued firm but rather the hope (albeit possibly a mistaken hope) of creating synergies between raider and target.

private" transactions.[166] Such transactions occur at a premium price but leave the firm in the hands of current management. Professor Lowenstein maintains that this shows that the efficiency-producing or synergy basis for premiums is misguided. Lowenstein further cites the series of oil company mergers and the purchases of several other companies in "temporarily depressed" industries as support for his theory.[167] He argues that the institutional traders, the makers of today's stock market, are overly focused on short-run factors. These traders thus ignore fundamental factors such as long-run industry profits or asset values, factors not ignored by tender offerors.

Lowenstein's argument in favor of the public/private value distinction is not persuasive. He discounts the possibility that the reason for going private or for a leveraged buyout is the attempt of managers to profit from inside information. Because such transactions are the subject of intense scrutiny, an insider information motive involves a high risk of manager liability which minimizes, without eliminating, the chances of such a motive.[168] Since managers might be in a better position to evaluate subtle inside information,[169] a small number of going-private transactions or leveraged buyouts probably are the consequences of insider trading motives.

Moreover, managers may wish to pay more than the current market value for their firm for reasons other than trading on inside information. The regulatory costs of being a public firm are not trivial.[170] The ability to deal more flexibly with corporate opportunities appears greater in a nonpublic company. If access to capital is available without the attendant regulatory costs, then managers might seek to capture those savings. A leveraged buyout might be a preemptive strike against a takeover, where managers are capi-

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[166] Lowenstein, *supra* note 148, at 295-97. Professor Coffee also examines the relationship of leveraged buyouts and tender offers and concludes one reaction to a possible takeover bid is the leveraged buyout. Coffee, *supra* note 5, at 1195-98. I agree. *See infra* p. 316.

[167] Easterbrook & Fischel, *supra* note 130, at 730-31. For a general discussion of going private transactions, see Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183 (1979).

[168] Easterbrook & Fischel, *supra* note 130; Hetherington, *supra* note 167.

[169] Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141, 1147-48 (1976). Trading on inside information also arises in litigation over the adequacy of disclosure in controlled transactions. *See* Dennis, *supra* note 145, at 397-400, 403-05.

[170] One example is the not inexpensive obligation to continuously make financial and other disclosures under the 1934 Act.

talizing their continued control in the premium offered.[171]

The short-range focus of investors is also an overstated reason for the occurrence of tender offers at a premium. The argument is made that the recent spate of tender offers for natural resources companies is the consequence of different time horizons for some investors seeking control versus other investors.[172] I think not. For example, the claimed asset value of the oil companies was well known to market analysts. The uncertainties were the future demand for petroleum products, the environmental constraints under which the industry would operate, and the amount of oil that OPEC would place on the market. Because of these questions, substantial discounting of the theoretical in-ground value of oil was not surprising. The range of investors' vision was not limited. Rather the market reached an appropriate consensus as to the present value of the assets under uncertain conditions.

Finally, even if the raider does produce valuable information concerning hidden value, there is no reason not to compensate the raider for that effort. The market as a whole becomes more efficient as there are fewer mispriced firms. And the temporary dislocation argument rests on an even thinner reed. The basis for the temporary dislocation argument is usually the public information about a firm, such as book value, claimed underlying asset value, and future industry prospects.[173] For the dislocation theory to

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[171] *See* Lowenstein, *supra* note 148, at 274-75.

[172] Professor Lowenstein argues that the makers of today's stock market, institutional investors, overly focus on short-run factors, causing management to focus also on short-run growth to the detriment of more beneficial long-run growth strategies. Lowenstein, *supra* note 148, at 297-304. On the supposed diseconomy of short-run managerial decisionmaking, see sources cited in Coffee, *supra* note 5, at 1223; Lipton, *supra* note 148, at 105. *But see* Easterbrook & Fischel, *The Proper Role*, *supra* note 144, at 1183-84 (management insecurity spurs best performance, including long-range planning). As Scherer points out, there is no agreement in the empirical or normative economic literature on what time frame managers should or do consider. F. SCHERER, *supra* note 156, at 30-31. It is likely, however, that managers should and do discount future uncertain profits. *Id.* at 234-35. For antitrust professors and practitioners this debate focuses on the likelihood of strategic behavior, such as predatory pricing, and the way firms operating under uncertainty weigh short-run losses versus the possibility of long-run gain. A gross generalization would be that the law-and-economics approach teaches that such conduct is highly unlikely. For a comprehensive description of the debate, see Brodley & Hay, *Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards*, 66 CORNELL L. REV. 738 (1981). There is no significant body of empirical evidence which shows that, outside the preservation of market power context, seeking to maximize short-run gain routinely leads to long-run losses.

[173] The recent number of takeovers of natural resources firms and retailing firms are cited

work, one must accept that not only is the market irrational in the short run but also that the irrationality persists for long periods of time.[174] If that is the case, presumably the target's shareholders should be willing to take the bird in the hand, a sure premium, rather than the potential two birds in the bush, the hope that the irrational market gains its senses and that this produces increased value in excess of the current premium plus the time value of money.

3. *Empirical Evidence.* In any event, quantitative evidence provides support that the market for corporate control leads to real gains for target shareholders and bidders.[175] Gains to bidders show some synergy effect while gains to target shareholders come

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as examples of the dislocation problem. In fact, the market's valuation of such firms appears rational considering the uncertainties of the industries involved. *See infra* note 226.

[174] *See* ADVISORY COMM. ON TENDER OFFERS, U.S. SEC. & EXCHANGE COMM'N, REPORT AND RECOMMENDATIONS 118-19 (July 8, 1983) (statement of Frank H. Easterbrook & Gregg A. Jarrell) [hereinafter cited as SEC TENDER OFFER STUDY].

[175] The studies of the nature of the target and raider and the post-tender consequences of tender offers are now voluminous. These studies are collected in Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983); *see also* F. SCHERER, *supra* note 156, at 37-39 (listing structural, conduct, and performance criteria that writers have suggested for judging the "workability of competition"); Easterbrook & Fischel, *The Proper Role, supra* note 144, at 1187-88 (both tendering and nontendering shareholders, as well as bidders, gain from tender offers). The studies show that shareholders of the target gain substantially (16.9% to 34.1%—weighted average 29.1%) and that these gains persist for the remaining outstanding shares of the target if all shares are not purchased. Moreover, a study by Easterbrook and Jarrell recently demonstrated that shareholders of firms whose managers defeated takeover bids would have been substantially better off if the offer had succeeded and the shareholders reinvested the proceeds in a portfolio of equity securities. Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984).

The evidence with respect to shareholders of the raider is more mixed, averaging a gain of 4%. The gain for mergers is less. Thus in some transactions the raider's shareholders actually suffer a loss as a consequence of the takeover. On net, however, the transactions produce an increase in combined firm worth, indicating that at least the stock market views the transaction as creating new value. *See* Bradley, Desai, & Kim, *The Rationale Behind Interfirm Tender Offers*, 11 J. FIN. ECON. 183 (1983); Malastesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155 (1983). *But see* Carney, *supra* note 100, at 354 n.58 ("total welfare is diminished when gains to one party, such as the bidder, are less than the losses suffered by the other party, such as target shareholders"). Professor Coffee critiques use of stock market studies by noting that survey evidence, the clustering of acquisitions in particular industries, and accounting data show that the disciplining of inefficient management may be only a small part of the takeover phenomenon. Coffee, *supra* note 5, at 1206-15. The source of the gain in takeovers is diverse by all accounts. Yet the gain is real. Thus Professor Coffee's argument is not responsive because without the takeover, society would not have that gain, whatever its source.

in part from disciplining inefficient managers and from synergy effects. Firms which have relatively lower earnings as compared to others in their industry or whose ratio of stock values to book values is lower than comparative firms have a statistically greater chance of being the target of takeover bids. Since this statistical relationship is weak, the capital market is not a perfect policing agent.[176] This lack of perfection is undoubtedly because of the transaction costs involved in tender offers and the relatively competitive nature of the market for corporate control. Not only does the bidder pay a substantial premium over market price, but it also pays substantial legal fees and investment banking expenses. Thus raiders must anticipate substantial return before embarking on a takeover.[177]

Empirical evidence also shows that regulation of tender offers increases the cost of such transactions. As regulation has increased the time frame for tender offers and the amount of required disclosure, the amount of the premium paid has increased.[178] These increased costs presumably reduce the number of tender offers and weaken the market for corporate control. The goal of policy analysis in the area must be to evaluate whether these costs and any new regulatory costs are justified. The market for corporate control has an incrementally beneficial effect and should not be weakened without concomitant benefit; any cost imposed upon the market must be evaluated to ascertain if those costs exceed the recognized

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[176] Raiders sometimes make mistakes and even in consensual transactions the integration of previously separate enterprises is a difficult task. *See* F. SCHERER, *supra* note 156, at 132-41; Coffee, *supra* note 5, at 1166 n.46 (raiders find that anticipated synergy "seldom materializes in the form of higher profits").

[177] This effect is exacerbated by evidence showing that an unsuccessful tender offeror defeated by a second raider suffers a significant drop in its stock price. Bradley, Desai, & Kim, *supra* note 175. The unsuccessful bidder who has acquired 10% of the target's shares also faces potential § 16(b) liability for profit on short-swing sales. 15 U.S.C. § 78p(b) (1982). *Compare* Texas Int'l Airlines v. National Airlines, Inc., 714 F.2d 533 (5th Cir. 1983) (no § 16(b) exception for cash sales by frustrated bidders), *cert. denied*, 104 S. Ct. 1326 (1984) *with* Hublien, Inc. v. General Cinema, 722 F.2d 29 (2d Cir. 1983) (frustrated bidder exception recognized), *cert. denied*, 104 S. Ct. 1416 (1984).

[178] SEC TENDER OFFER STUDY, *supra* note 174, at 113-14 (statement of Frank H. Easterbrook & Gregg A. Jarrell); *see also* Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J. L. & ECON. 371, 389-90 (1980) (Williams Act increased premiums by 20% and state regulation increased premiums by an additional 20%). The passage of the Williams Act in 1968 also seems to have reduced the number of takeover bids. *See* SEC TENDER OFFER STUDY, *supra* note 174, at 11 n.3.

benefits.[179]

B. Two-Tiered Offers

Even among those who believe in the general outlines of the arguments made from modern financial theory concerning tender offers—that tender offers generally should be encouraged and that management's role in defending against raids should be restricted—, the front-end loaded, two-tiered offer remains a controversial technique.[180] The supposed unfairness of two-tiered offers is presented as the only justification for a variety of defensive techniques.[181] Some argue that courts would scrutinize defensive tactics more readily without this justification. The criticism of two-tiered offers caused Congressman Timothy Wirth to introduce legislation, H.R. 5694, that would require any person purchasing more than

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[179] A standard model of economic regulation analysis requires careful definition of the problem to be addressed and the nature of the market failure that created the perceived problem. The available regulatory tools should be considered and it should be recognized that regulation often brings with it a set of well-known regulatory failures. Recognizing this, legislators should attempt to assess the benefits and costs of proposed regulation. *See generally* Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92 HARV. L. REV. 547, 584-604 (1979) (pre-regulation considerations should be whether the market is really defective, what the usual regulatory schemes and their drawbacks are, and what alternatives exist).

[180] The first comprehensive attack on partial and two-tiered offers appeared in Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 337 (1974) [hereinafter cited as Brudney & Chirelstein, *Fair Shares*]; *see also* Bebchuk, *supra* note 148 (considering the beneficial effects of the two-tiered tender offer); Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072 (1983) (unequal sharing of gains between two groups of shareholders unfairly defeats their expectations); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) (freezeouts may be necessary as a temporary step, but newer, more equitable procedures should follow); Carney, *supra* note 100 (although some shareholders are unable to protect themselves, their plight teaches greater awareness); Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RESEARCH J. 69 (some two-tiered mergers are inefficient). *See generally* Burgman & Cox, *supra* note 116 (exploring fairness as an objective in freezeout situations); Coffee, *supra* note 5 (addressing costs and benefits of tender offers and various regulatory solutions); Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647 (1984) (advising against regulating two-tiered offers without first determining relative economic trade-offs); Mirvis, *Two-Tier Pricing and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485 (1983) (two-tiered bidders risk the dissatisfaction of second step shareholders and possible suits under Delaware's entire fairness standard); Comment, *Tender Offers*, *supra* note 20 (proposing federal reforms to better protect second step shareholders).

[181] Lipton, *supra* note 148, at 101-04; Lowenstein, *supra* note 148, at 307-09.

ten percent of any class of voting securities of a company registered under the Securities Exchange Act of 1934 to make the purchase only by exchange or tender offer for all the outstanding shares of common stock of the issuer.[182] Another proposed regulatory disincentive to two-tiered offers is to further extend the offering period beyond that required for any-and-all offers.[183]

Practitioners recommend the two-tiered technique because it reduces the acquisition cost of the raider and induces early tenders.[184] The usual argument made in defense of two-tiered offers by scholars using the efficient market model is that the premium offered those tendering in the first tier compensates for the risk undertaken and for the facilitation of the transfer of control.[185] The counterargument is that such offers distort the shareholder's decisionmaking process, result in an unfairly disproportionate division of the acquisition price, and possibly allocate resources inefficiently.[186] Critics claim that two-tiered offers harm two separate classes of shareholders: (1) shareholders who believe that the corporation has an independent value above the offering price, and (2) shareholders who did not tender because they did not have the opportunity.[187] This section describes the two-tiered tender offer phenomenon and considers these two classes of investors, the arguments concerning their supposed injuries from two-tiered offers, the arguments made in favor of two-tiered offers, and the merits of H.R. 5694.

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[182] H.R. 5694, 98th Cong., 2d Sess., 130 CONG. REC. H.4360 (daily ed. May 22, 1984). This proposed legislation adopts the suggestions of Martin Lipton. The committee drafting the SEC Tender Offer Study proposed another method of limiting two-tiered offers. It recommended that the minimum offering period for partial and two-tiered offers be 14 days longer than the minimum offering period for full tender offers. SEC TENDER OFFER STUDY, *supra* note 174, at 26. The committee's recommendation is analyzed *infra* at note 228.

[183] SEC TENDER OFFER STUDY, *supra* note 174, at 261 (Recommendation 16).

[184] Greene & Junewicz, *supra* note 180; Lederman & Vlahakis, *Pricing and Proration in Tender Offers*, 14 REV. SEC. REG. 813 (1981); Comment, *Tender Offers*, *supra* note 20.

[185] Easterbrook & Fischel, *supra* note 130, at 727. The major focus of my discussion is not aimed at the risk-bearing argument. Rather I believe that two-tiered offers can be defended because every shareholder has an equal opportunity to tender and shareholders have reasonably homogenous pre-tender valuations for the target. *See infra* notes 207-22 and accompanying text.

[186] *See supra* note 180; *see also* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics to Tender Offers*, 33 STAN. L. REV. 818, 859-62 (1981) (shareholders acting with self-interest injure shareholders as a whole).

[187] *See* Comment, *supra* note 2, at 813.

1. *Empirical Framework.* The SEC recently released a study comparing the terms of any-and-all offers, two-tiered offers, and pure partial offers.[188] During the study period there were 148 successful offers. Of these, thirty-two were two-tiered offers while twenty-five were pure partial offers. The targets of two-tiered or partial offers tended to be larger than the targets of any-and-all offers. In all types of offers, the mean premiums were substantial. For any-and-all offers, the mean premium was 63.4% while the mean blended premium for two-tiered offers equaled 55.1%.[189] For two-tiered offers the mean premium offered in the first tier equaled 63.5% while the mean premium for the second step equaled 47.1%. In nearly three-fourths of the two-tiered offers, the difference between the first and second tier premiums was less than 20%. Moreover, where there were competing bids, the presence of a two-tiered offer did not appear to distort the bidding process. The higher valued offer, whether any-and-all or two-tiered, prevailed.[190]

These data establish the parameters of the debate concerning two-tiered offers. Regulatory disincentives for two-tiered offers would particularly affect offers for the largest firms—firms where, for shareholder wealth, the importance of the market for corporate control may be greatest.[191] The relatively unregulated market had created significant gains for target shareholders for both the first and second tier transaction, and the spread between the tiers is not large, limiting the force of the claims of coercion.[192] The empirical

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[188] SEC Release No. 34-21079, 16 SEC. REG. & L. REP. (BNA) 1119 (June 29, 1984). The data in the study have not been corrected to reflect the beta effect of any stock price movements.

[189] The premium for pure partial tender offers was 45.9%. An imputed second step premium of 18.6% was calculated. This means that uncorrected for beta effects the remaining shareholders in pure partial tender offers all gained, but not as much as shareholders receiving compensation in second step transactions. *Id.* at 1129.

[190] This result negates the theoretical argument that the supposed whipsaw effect of two-tiered offers can cause a lower valued offer to win.

[191] For the largest firms, the other pressures on managers to maximize profit—the product market, the market for managers, and the possiblity of a successful proxy fight—seem to be relatively attenuated.

[192] The reason the unregulated market produces a narrow spread between the tiers is that an auction could induce another two-tiered offer or an any-and-all offer which is more attractive, reducing the risk of a low second tier price while offering a higher blended premium. For a contrary view, see Lederman, *Tender Offer Bidding Strategy*, 17 REV. SEC. REG. 917 (1984).

data supports the argument that the debate concerning two-tiered offers does not involve protecting target shareholders from absolute losses but rather is a debate concerning the distribution of the substantial gain created by the takeover between the shareholders of the raider and the shareholders of the target.

2. *Premises of the Debate*. The leading academic defenders of two-tiered offers are Professors Frank Easterbrook and Daniel Fischel.[193] They take the position that shareholders should prefer legal rules that maximize the value of all their holdings *ex ante* in the aggregate over rules which require *ex post* equal treatment but which may reduce the number of gain sharing transactions.[194] They argue that unequal gain sharing might be necessary to accomplish many control transactions.[195] Unequal sharing might be the only mechanism to reduce the aggregate acquisition price to levels potentially profitable to the acquirer or the only way to avoid a free-rider problem that prevents the acquisition from occurring.[196] Thus so long as a shareholder is not hurt by unequal treatment, a two-tiered offer involves no fiduciary problems even though the gain from the transaction is not shared equally. Under the Easterbrook-Fischel model, pretransaction market value is the sole measure of whether a shareholder receives adequate compensation for her investment. A shareholder must receive at least this amount of consideration in any second step transaction.[197]

As noted, a major premise of the attack on two-tiered offers is that many shareholders may place a value on the target firm which substantially departs from the market price of the firm. A shareholder might have an "independent value" for the firm in excess of the market price, or the blended two-tiered price. This nonmarket value may include the value attributed to the possibility of an any-and-all bid which would be more attractive but for the two-tiered

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[193] Easterbrook & Fischel, *supra* note 130; Easterbrook & Fischel, *The Proper Role*, *supra* note 144.

[194] Easterbrook & Fischel, *supra* note 130, at 703-04.

[195] *Id.* at 708-11.

[196] If a shareholder believed the transaction would create significant gains, he might decide not to tender in the hope that those gains would somehow be shared through continued ownership or in a higher second step takeout merger.

[197] Professor Carney believes even this protection is not necessary so long as the shareholders can coordinate their response to an offer through the adoption of a shark repellent corporate charter. Carney, *supra* note 100. Professor Carney's proposal is evaluated *infra* note 220.

bid.[198] Yet because of the coercive effect of two-tiered offers, that shareholder might nevertheless tender. If this premise about two-tiered offers is correct, the Easterbrook-Fischel argument that a lower second step price can be "Pareto optimal" fails.[199]

How does the two-tiered offer coerce a shareholder who believes the value of the corporation exceeds the pre-tender market price or the blended offering price? If the tender offer is successful, any shareholder maximizes gain by tendering during the proration period.[200] This pressure exists for all successful partial takeovers whether or not structured as two-tiered.[201] Unless the remaining shares are bought at higher than tender price, an unlikely event, a shareholder at least loses the time value of money by not tendering in the first instance.[202] Even if the individual shareholder believed the value of the target firm exceeded the higher first-tier price, a shareholder expecting the offer to be successful would tender. The claim is that this pressure is exacerbated in the two-tiered situation.

Paradoxically, a good deal of uncertainty surrounding the suc-

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[198] *E.g.*, Carney, *supra* note 100; Lowenstein, *supra* note 148; *see also* Burgman & Cox, *supra* note 116, at 636-43 (all shareholders' valuations should be considered in evaluating fairness).

[199] If shareholders routinely have pre-tender valuations of the target in excess of the market price, they might maximize their profit by rejecting an offer below that price with the hope that a higher offer is forthcoming. This higher-priced, later offer would presumably cause the assets of the target to end up in the hands of a more efficient user than the first offeror.

[200] The incentive to tender early has been reduced by the extension of the proration period as required by Rule 14d-8. While this rule may seem to limit the supposed coercive effect of two-tiered offers, the rule creates its own problems. *See supra* notes 61-66 and accompanying text.

[201] Where an offeror makes a partial offer without announcing plans for a second step, a target shareholder faces the uncertainty of whether and at what price her shares will be mopped up. Empirical evidence shows that where an immediate second step transaction is not undertaken, the remaining shares of the target trade at less than the first tier price but usually more than the pre-tender price, indicating a real gain even for the remaining target shareholders. Bradley, *Interfirm Tender Offers and the Market For Corporate Control*, 53 J. Bus. 345 (1980). The subsequent discounted price for the controlled subsidiary's shares is not, in my view, a serious problem. This price, so long as the target remains publicly traded, is not routinely distorted by the control relationship. *See* Dennis, *supra* note 145, at 392 n.82.

[202] If the takeout is accomplished through formal merger, several months are necessary for the consummation of the transaction. *See* Freund & Greene, *Substance Over Form S-14: A Proposal to Reform SEC Regulation of Negotiated Acquisitions*, 36 Bus. Law. 1483 (1981).

cess of the offer increases the shareholder's incentive to tender. On the other hand, if uncertainty is equated with fewer shares being tendered during the proration period, the tendering shareholder proportionately gains more of the higher first-tier premium.[203] It is argued that this establishes a situation not unlike the prisoner's dilemma, a "whipsaw effect."[204] While a majority of shareholders might independently reject a bid as being below their independent valuations of the firm, shareholders as a group might tender enough shares for the offer to be successful to protect against having their shares taken in the lower priced second step transaction.

3. Independent Value Question. Understanding the debate over two-tiered offers involves considering several problems. First, the plausibility of shareholders having an independent value for the target higher than the pre-tender market price must be evaluated. The question arises as to how an independent value in excess of the current market price originates? Two different types of claims are made. The tender offer might cause shareholders to reevaluate the worth of the target,[205] or shareholders may place a higher-than-market-price value on the firm prior to the tender offer.[206] This preexisting valuation might arise from (1) the stock

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[203] For one calculation of a blended offering price, see Comment, *Tender Offers*, *supra* note 20, at 406. As the number of a shareholder's shares taken in the first step increases, the blended offering price for that shareholder increases. For example, an offer structured for 50% plus one share is taken in the first step at $100, with a second step cash out at $75. If all shareholders tender, the blended offering price is $87.50. If, however, only 75% of the shares are tendered, the blended price for the tendering shareholder is $91.65.

[204] Bebchuk, *supra* note 148, at 1040 n.59; Brudney & Chirelstein, *Fair Shares*, *supra* note 180, at 337; Carney, *supra* note 100, at 349-50. A prisoner's dilemma occurs when return to the players is maximized by coordination, but because of the inability to coordinate, each player maximizes her individual gain by taking a lower valued option.

[205] *E.g.*, Carney, *supra* note 100, at 347, 350. Much of the debate focuses on a definitional problem. The shareholder who received a lower second-step price (and a price lower than the reevaluated price) but a price higher than the pre-tender price only loses if by definition the increment between the reevaluation price and the second-step price belongs to that shareholder. The nontendering shareholder only loses absolutely (and a true prisoner's dilemma is created) if the second-step price is below the pre-tender market valuation. The number of cases where an immediate takeout occurs at a price below the pre-tender price is insignificant. Of course, if there was a distant takeout rather than an integrated second-step takeout, then the price in the distant takeout might be below the pre-tender price. This lower price, however, would most often reflect only post-tender changes in the aggregate price level of stocks or industry or firm-specific events properly factored into the share price by the price signalling mechanism. For a similar critique of Professor Carney's argument, see Coffee, *supra* note 5, at 1169 n.61.

[206] *E.g.*, Lowenstein, *supra* note 148, at 307-09.

market's masking variant views as to the current value of the firm, (2) the presence of inside information, or (3) the manager-shareholders' capitalizing the perquisites of control in their calculation.

Once the market is informed that at least one actor values the target firm more highly than its current price, then others might reevaluate the total mix of information, including the possibility of future bids at greater premiums, and come to a new consensus concerning price. If this caused the departure of value of the stock from its pre-tender price, the offeror produced that increase in value.[207] Allowing profits commensurate with the investment risk to those investing in producing information maximizes the incentive to invest. An attack on two-tiered tender offers, as well as the attack on the general utility of tender offers, should not succeed if based on the argument that the discovery profits belong to the original investors rather than to the producer of the information. Shareholders as a class should prefer the opposite rule because the increased number of premiums paid in first step transactions maximizes their investment.

Moreover, the assertion that significant differing pre-tender valuations exist also fails. Research into the operation of the stock market suggests that wide variation in the valuation of a particular stock cannot long persist.[208] It is not a major premise of the efficient market model that all shareholders have identical information concerning the firm's prospects.[209] Rather, the aggregate views of traders establish the market price. Trading by market professionals is the primary mechanism of market efficiency.[210] These professionals intensely examine the public information concerning firms and routinely produce new information through contacts with company executives.[211] Some information is distributed to all traders simultaneously, for example, when the affected firm makes announcements over the Dow Jones wire or makes disclosures in

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[207] Moreover, this gain has been produced at considerable risk to the offeror. For example, there is the possibility that a defeated offeror's market valuation will be adversely affected. *See supra* note 177.

[208] *See supra* notes 145-46 and accompanying text.

[209] *See* Dennis, *supra* note 145, at 378-80.

[210] *Id.* at 414-15; Gilson & Kraakman, *supra* note 145, at 569-72.

[211] STAFF OF SENATE COMM. ON FINANCE, 95TH CONG., 1ST SESS., REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECURITIES EXCHANGE COMM'N 11-14, 66-68 (Comm. Print 1977).

public filings with regulatory agencies. Even if only professional traders used these data, their trading informs the market of its import.[212] Other information is less widely distributed. Although these data are not simultaneously available to the market, they also affect trading and, ultimately, the price.[213] Producing information about firms incurs costs, which leads to some noise in the price signalling mechanism.[214] This noise, however, does not seem to lead to significant mispricing of securities in the long run.[215] The opportunities for arbitrage among traders having different views of the worth of a particular firm are too great, even if the market is not perfectly efficient with respect to all data.[216]

Professor William J. Carney, however, believes that empirical evidence demonstrates that a nontrivial number of shareholders do place a pre-tender value on firms that is higher than the market price. He cites two types of data. First, in all tender offers, including any-and-all offers, a significant number of shareholders do not tender.[217] Factors not relating to any preexisting or newly formed view of firm value may explain this phenomenon. Some shareholders are neither vigilant nor sophisticated; they just miss the opportunity to tender.[218] Second, Professor Carney cites the high level of premiums offered as showing the existence of independent value.[219] He argues that if offerors believed the elasticity of supply at the market price was perfect, the premiums offered would be much smaller. Yet, the large premiums are better explained by the ability of managers to undertake defensive measures, the market effect of the announcement of the offer, and the opportunity for auctions because of regulatory delay in closing the transaction.[220]

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[212] As Gilson and Kraakman point out, the volume of trading by professionals alone assures a rapid dissemination of such data through the price signalling mechanism. Gilson & Kraakman, *supra* note 145, at 569-72.

[213] The influence of less widely disseminated data occurs from the information leakage phenomenon, trade decoding, and price decoding.

[214] *E.g.*, Grossman & Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980); Grossman, *On the Efficiency of Competitive Stock Markets Where Traders Have Diverse Information*, 31 J. FIN. 573 (1976).

[215] Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

[216] *Id.*

[217] Carney, *supra* note 100, at 356-57.

[218] *See* Comment, *supra* note 2, at 813-14.

[219] Carney, *supra* note 100, at 357.

[220] Jarrell & Bradley, *supra* note 178, at 385-86. A preemptive strike by a raider at a high

Another argument concerning individual idiosyncratic values of the target is that shareholders might have different views toward a particular premium because of their peculiar tax status.[221] In fact, the availability of a second step with securities as the consideration, even at a nominally lower price than the first step cash price, may benefit a shareholder with a high potential tax liability. Under complex statutory and regulatory provisions, the second step transaction might qualify as a tax-free exchange allowing the shareholder to defer gain, while the first step transaction for cash would be fully taxable immediately. In contrast, depending on the premium offered, a shareholder receiving cash in the first step might not receive less than the current market price after paying the tax.[222] This shareholder might prefer unequal treatment.

Another possible explanation of variant views as to the value of a particular firm is the presence of inside information: data known to manager-stockholders which has not yet been released for strategic business reasons.[223] Within the context of a hostile takeover, it seems unlikely that such fundamental data would remain long only in the hands of disadvantaged managers. The SEC regulations require management to disclose its views on the tender offer.[224] The business-judgment strategy of the tender offer defense calls

price might forestall an auction, substantially reducing the risk of being a first offeror. Professor Carney suggests that shareholders can protect against a prisoner's dilemma scenario by adopting shark repellent charter proposals which will ensure equal treatment for all shareholders and increase the total consideration paid. But as Professor Coffee notes, this proposal is suspect. Informed institutional investors routinely oppose such amendments. When coupled with other potential management defensive measures, shark repellent amendments substantially enhance the possibility that management will be able to entrench itself in office. Coffee, *supra* note 5, at 1189; Gilson, *supra* note 186, at 865-75.

[221] Burgman & Cox, *supra* note 116, at 660.

[222] Tax Reform Act of 1984, Pub. L. 98-369, § 1001(a)(1), 98 Stat. 1011 (1984) (amending 26 U.S.C. § 1222 (1976)) (reducing the capital gains holding period from one year to six months); Economic Recovery Tax Act of 1981, Pub. L. 97-34, § 101, 96 Stat. 2365 (1981) (amending 26 U.S.C. § 1 (1976)) (reducing the marginal tax rates from 70% to 50%). The recent lowering of tax rates and shortening of the long-term holding period, coupled with the high premiums offered, make the possibility of netting less than the current market price unlikely.

[223] The classic example is a mineral strike, allowing the target to purchase surrounding land cheaply.

[224] Rule 14e-2, 17 C.F.R. § 240.14e-2 (1984). *See generally* Greene & Junewicz, *supra* note 180, at 682 (management's ability to respond may prevent looting and coercion); Comment, *supra* note 2, at 820-21 (target management must disclose its recommendations, its neutrality, or its inability to take a position concerning the offer).

for managers to trumpet their views that the firm is undervalued and the offer is an effort to steal the firm at a "low ball" price. Thus the inside information which creates a high independent price for manager-shareholders would usually become public during the tender offer battle. Manager-shareholders might also value the target firm more highly than the public shareholder because of management perquisites.[225] This idiosyncratic valuation, while real, raises directly the fiduciary question. The peculiar value of the agency relationship to the agent should not allow him to act contrary to the best interests of the principal.

In short, the major premise of the attack on two-tiered offers—that such offers unfairly coerce shareholders with a high independent value for the target's shares to tender—is fundamentally flawed. It is unlikely that such a body of shareholders exists before the tender offer.[226] If the tender offer creates a new valuation, then the offeror should be compensated for that effort and shareholders should encourage maximum investment in the search activity creating the new valuation. Moreover, management may encourage an auction in the present legal environment if the new valuation is higher than the offering price.

4. The Unsophisticated Investor Problem. The second challenge to two-tiered offers concerns the unsophisticated shareholder and the equal opportunity to tender. First, unsophisticated or nonvigilant shareholders may not become informed of a tender offer until late in the process nor be able to physically tender within the required time periods. This delay is particularly likely if shares are held in a street name.[227] Second, some argue that unsophisticated shareholders need additional time to make complex investment decisions. To protect these shareholders, the Rule 14d-8 proration period was extended and the LeBaron Commission recommended the forty-four day minimum offering period for partial offers.[228]

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[225] Carney, *supra* note 100, at 356; *see also* Burgman & Cox, *supra* note 116, at 660 (fairness should have reference to differing valuations, including management's valuation).

[226] Even if the stock market price masked variant views as to value, that would not change the analysis. This would be true even if the temporary dislocation argument was correct. Without an offer of some type, the shareholder with a variant view of value would be remitted to the even lower market price. From this perspective the two-tiered offer causes no injury, but rather creates a benefit.

[227] *See* Comment, *supra* note 2, at 813-14.

[228] SEC TENDER OFFER STUDY, *supra* note 174, at 24-26. The LeBaron Commission also recommended that any purchases over 20% be accomplished only through tender offer,

With respect to the need for time to make an intelligent investment decision, I have already argued in connection with the current tender offer rules that the arbitrage process solves the unsophisticated investor's data gathering and risk problem, so long as the investor monitors activities concerning her portfolio.[229] Even if the data gathering activities of the arbitrageurs gave these sophisticated investors a larger fraction of the acquisition price in the two-tiered or partial tender offer situation, this advantage is justified by the expense and risk undertaken by these market participants and the significant trickle down of information to all market participants.[230] Thus a timing problem in evaluating data cannot justify severely restricting or disadvantaging two-tiered or partial offers.

The regulatory issue of the unsophisticated investor is in my view a more narrow one—how much intervention in the market is needed to protect the unvigilant investor. Usually the premise of securities regulation is that the unregulated market will not produce enough appropriate information or that regulation of the production of information reduces collection costs.[231] Those premises do not directly apply here, since the market "failure" is of a different order. Regulation and the market have already produced the information. Yet the investor has not used the data. The serious question becomes whether the cost of intervention into the market is offset by the benefits of protecting the class of unsophisticated

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rather than allowing open market or privately negotiated sales. As almost all commentators note, this proposed solution does not respond to the asserted harm of undue coercion that it is supposed to address. Moreover, it has the disadvantage of locking in a dominant single shareholder who may want to sell at a premium. The proposal would also significantly increase the difficulties in creating a block of share ownership as a base for a proxy fight.

[229] *See supra* notes 64-66 and accompanying text.

[230] *See* SEC TENDER OFFER STUDY, *supra* note 174, at 52. This argument depends on the notion that risk arbitrage in the tender offer situation is socially valuable conduct, even if part of the effort revolves around speculation about other shareholder reaction to the bid. I believe risk arbitrageurs provide substantial benefits to the market in data gathering and in risk bearing, particularly in a world where defensive tactics and extended auctions create difficult investment decisions. The incentive to undertake these activities comes in part from the possibility of receiving a larger fraction of the first tier price. From this perspective the new SEC rule on hedged tendering might be counterproductive. *See supra* note 66.

[231] *See generally* Breyer, *supra* note 179, at 556 (government regulation can prevent dissemination of false information or stimulate unmotivated information holders to dispense their knowledge); Gilson & Kraakman, *supra* note 145, at 601 (disclosure requirements eliminate duplication of information gathering costs).

or nonvigilant investors. Where the unsophisticated investor can protect himself by hiring professional managers at no cost disadvantage, regulatory intervention does not seem justified.[232]

Moreover, the behavioral assumption supporting the attack on two-tiered offers for the protection of the unsophisticated investor is questionable. The behavioral assumption is that more time or the lack of the whipsaw effect will cause the unsophisticated investor to react appropriately. Yet the present evidence shows the completely unsophisticated investor may never react or may react for reasons unrelated to the likely results of the offer.[233] The number of shareholders who are unvigilant but who would benefit from the extended offering period may be trivial. In short, the unsophisticated investor problem is overstated, the suggested cure goes beyond the harm alleged, and as a normative matter the problem may not need remediation.

5. *The Proposed Legislation.* Finally, the proposed federal legislation eliminating two-tiered offers should be analyzed specifically. House Bill 5694 recommended a ceiling of ten percent on the amount of shares of stock that might be acquired by means other than a tender offer. In addition, the proposal would require that upon reaching the ten percent threshold, the purchaser who intends further purchases must make an offer for all the shares of a target.[234] The bill would further hinder the creation of beachheads by requiring the offeror to pay in a subsequent tender offer the highest price that the offeror paid within the twelve months prior to the offer.[235] This bill is modeled on the British approach, which requires that upon crossing the thirty percent ownership threshold, the offeror who wishes to make further purchases must usually make an offer for the remaining shares at the highest price paid to any stockholder within a set period.[236] Even if two-tiered offers

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[232] Mutual fund purchases are one method for the unsophisticated investor to seek protection.

[233] *See supra* notes 217-19 and accompanying text.

[234] The bill exempts purchases by the issuer and from the issuer. Existing holders of more than 10% of the outstanding voting securities can act in concert to mount a proxy fight without being required to make a tender offer.

[235] This requirement places the offeror at risk with respect to shifts in the market price of the target. Professor Coffee suggests a drafting solution which would correct the price needed to be offered to reflect general changes in the aggregate level of stock prices and would give some protection to existing block holders. Coffee, *supra* note 5, at 1287.

[236] *See generally* DeMott, *supra* note 63. Professor DeMott points out that the limited

were pernicious, H.R. 5694 would present problems. As a consequence of choosing the ten percent limitation, it forces the putative raider to decide at a relatively early stage whether to seek complete ownership.[237] It reduces the possibility that beachheads will be formed to mount a proxy fight or sell to another putative raider, particularly considering the disadvantages associated with an inability to use equity accounting at low ownership levels.[238] These restrictions mean managers of the largest companies are further insulated from the discipline of the market for corporate control.[239]

C. *Greenmail*

Academic criticism of defensive tactics against tender offer bids has been almost uniform. The only significant debate has concerned whether management should be able to facilitate an auction.[240] Yet the courts have consistently allowed target management almost unreviewable discretion in the selection and execution of defensive tactics. Several legislative proposals would limit management's discretion. But in the present legal environment the first bidder faces substantial risk. Target management can attempt to defeat the bid outright or find a white knight. The bidder also faces the market risk that, even without target management assistance, market forces or another bidder will defeat the first bid. In as many as seventy-five percent of the cases where competing offers occur, the first bidder is unsuccessful.[241]

In light of these risks, greenmail serves a useful purpose for putative raiders. It allows a potential raider to take a position in a

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nature of appraisal rights in Britain makes the British shareholder subject to more potential abuse than does United States law. *Id.*; *see also* Lowenstein, *supra* note 148, at 320-21, 330-31 (though useful, British rule is too complicated and would not adapt to the federalist system).

[237] Ownership of a significant minority block with the enhanced capacity and incentive to monitor management would reduce the risk in determining whether to make a bid for all the shares of the putative target.

[238] AICPA, APB ACCOUNTING PRINCIPLES § 5131.17 (1973). Equity accounting entitles the block holder to report as income its share of the issuer's earnings.

[239] These objections to federal legislation on two-tiered offers and the attack on the premises of that legislation would also counsel against further state legislative interference with this acquisition technique. *But see* Note, *supra* note 6, at 369-75.

[240] *See supra* notes 155-56 (listing authorities).

[241] Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141, 147 (1983).

firm with some chance that, if the control bid fails, the position can be liquidated at a profit commensurate with the risk taken. The target serves as "the purchaser of last resort."[242] In the aggregate then, greenmail reduces the costs to bidders. A reduction in cost should result in more bids and potential bids. The ability of target firms to buy out a beachhead position thus increases the strength of the market for corporate control as a whole, particularly in a world where defensive tactics are generally permitted. *Ex ante* then shareholders as a community should approve of greenmail. Even if in a particular instance, the greenmail payment reduces the possibility of a full-scale takeover bid and the value of the target's stock at the time the payment is made, these losses are offset by the gains to the shareholders of the unsuccessful raider, the increased monitoring power of the market for corporate control, and the market informing effect of the initial formation of the beachhead with the consequent increase in the value of the target's shares at that time. In contrast, other defensive tactics are intended to defeat the raider by raising the cost of a bid, rather than reducing the bidders' potential costs.

Even though greenmail reduces the costs of potential bidders, commentators usually criticize the practice.[243] They argue that such purchases should be flatly prohibited,[244] that shareholder approval should be required,[245] or that managers should be forced to purchase all shareholders' stock pro rata.[246] The critics of greenmail are responsible for the SEC proposals contained in H.R. 5693.[247] These proposals would prohibit an issuer from purchasing at a premium from any holder who has held three percent of the

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[242] My terminology in this section follows Coffee, *supra* note 5, at 1289-96. Professor Coffee's article is the most comprehensive discussion of the current debate over greenmail and this section primarily responds to that discussion. *See also* Greene & Junewicz, *supra* note 180, at 706-07 (greenmailer's threats of proxy fights or tender offers force management to buy back shares); Lipton, *'Greenmail' Is a Corporate Disgrace*, N.Y. Times, Apr. 15, 1984, § 3, at 2, col. 3 (advocating a 10% limit on accumulations, with buyers who want more than 10% required to make an offer of one price to all shareholders).

[243] *See, e.g.*, Greene & Junewicz, *supra* note 180.

[244] Lipton, *supra* note 242, § 3, at 2, col. 5.

[245] Coffee, *supra* note 5, at 1292; Greene & Junewicz, *supra* note 180, at 732.

[246] Coffee, *supra* note 5, at 1292.

[247] H.R. 5693, 98th Cong., 2d Sess. (1984). The LeBaron Commission recommended that repurchase of blocks held for two years at a premium should not be allowed unless the repurchase offer is made to all shareholders. SEC TENDER OFFER STUDY, *supra* note 174, at 46.

class of securities to be purchased for less than two years, unless there was shareholder approval or the offer was made to all holders of that class of securities.[248]

1. The Entrenchment of Management Argument. The first criticism of greenmail, based on the notion that an active market for corporate control should be encouraged, is that society would be better off if inefficient management were replaced, rather than entrenched by the buyout.[249] A crucial assumption is that the defeated raider would have replaced target management, or sold to another firm that would have, if the greenmail transaction had not occurred. But a change of management does not invariably occur. Moreover, other defensive tactics might make it impossible for a raider to succeed. The first criticism also discounts that the total number of successful bids and other control transactions could be increased by the greenmail phenomenon.[250] Since increased risk raises costs, risk-reducing practices should increase the number of control transactions. Greenmail reduces risk. The number of successful takeovers encouraged by the possibility of greenmail might exceed the number of takeovers which do not occur because of a greenmail purchase that engenders no other attempt at wresting control from current management.

Moreover, the greenmail transaction may not entrench current management. The displacement of management partially depends on the nature of the distribution of the holdings in the putative target. Where management directly controls a significant number of shares, for example, through family ownership, employee pen-

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[248] Congress adjourned without passing any anti-greenmail legislation. House Bill 5693 was reported out of the House Committee on Energy and Commerce on September 7, 1984. H.R. REP. No. 1028, 98th Cong., 2d Sess. (1984). Other aspects of the bill relating to minimum offering periods, defense tactics, and noneconomic disclosure caused the SEC to oppose the legislation. Before Congress adjourned, the Senate passed an anti-greenmail bill as a rider to a major legislative effort at banking reform, S. 2851, the Financial Services Competitive Equity Act, § 1006. This rider was added in markup by Senator Donald Riegle. No banking bill ever passed the House and thus no conference committee could consider the greenmail legislation. Senator Riegle has reintroduced the same antigreenmail legislation. *See* S. 286, 99th Cong., 1st Sess. (1985). Legislation has also been introduced that would place an excise tax of 50% on greenmail payments. *See* H.R. 1003, 99th Cong., 1st Sess. (1985); S. 420, 99th Cong., 1st Sess. (1985); S. 476, 99th Cong., 1st Sess. (1985).

[249] Coffee, *supra* note 5, at 1292.

[250] This argument and the defense of greenmail generally is a variant on the *ex ante* versus *ex post* analysis of Easterbrook and Fischel. For a discussion of their work, see *supra* note 144.

sion funds, or foundations, buying up publicly held shares does reduce the "float," shares held by outsiders and available to other raiders for purchase.[251] Even in this case the act of greenmail might in the short run reduce the price of the target shares so that the target remains an attractive takeover candidate. If, however, management holds a small number of shares,[252] as in many publicly traded corporations, its percentage of shares does not significantly increase with the payment of greenmail. A tender for control should be as easy to accomplish after a greenmail transaction as before.

The entrenchment argument does not adequately contemplate the market informing effect of the beachhead purchase/greenmail scenario.[253] Establishing the beachhead informs the market that at least one actor believes new management structures could enhance the value of the target. A significant number of other potential purchasers may now reevaluate their decision to make a tender offer bid. In many instances as part of the potential raider's strategy, it must or does make disclosures concerning possible future plans for the target.[254] These plans often include the selling off of unprofitable operations or the partial liquidation of a firm whose assets are more valuable than its value as a going concern. If the plans are credible, others in the market may believe they can act similarly to increase the value of the target.

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[251] Students of tender offers recognize that the size of the float relative to the number of shares outstanding is a variable in whether a tender offer will be successful. E. ARANOW & H. EINHORN, *supra* note 140, at 38-40. Professor Carney argues that this shows variant views with respect to the pre-tender valuation of the target. Carney, *supra* note 100, at 357. I believe this argument misses the mark. *See supra* text accompanying note 225.

[252] For a general description of the profile of share ownership in various types of firms, see M. EISENBERG, *supra* note 129, at 9-69.

[253] Bradley, *supra* note 201; Kirkland, *When Paying Off A Raider Benefits the Shareholders*, 109 FORTUNE 154 (Apr. 30, 1984) (citing an unpublished study by Mikkelson & Ruback). *But see* Bradley & Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 J. FIN. ECON. 301 (1983) (managers repurchase to advance their own interest, at a loss to shareholders); Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 J. FIN. ECON. 275 (1983) (wealth loss for remaining shareholders). The difference between the studies could be a consequence of measuring from when the beachhead is first established versus measuring from shortly before the beachhead is liquidated. The value-increasing effect of greenmail may occur at the time the beachhead is first announced.

[254] Schedule 13D, item 4, 17 C.F.R. § 240.13d-101 (1984). Overstating the definiteness of future plans for the target does, however, create potential liability for the raider under the Williams Act.

Anecdotal evidence supports the argument that the entrenching effect, if any, does not stop subsequent building of beachheads or takeover bids. In recent months two firms participating in greenmail transactions have been the subject of subsequent takeover activity. St. Regis Corporation, the target, repurchased two large blocks from potential raiders and undertook other defensive measures; then a third suitor, Rupert Murdoch, went forward with a bid for control of the corporation.[255] Similarly, Walt Disney Productions undertook to defeat a potential takeover by Saul Steinberg by engaging in a series of defensive tactics which culminated with the repurchase of Steinberg's shares.[256] Subsequently, Irwin L. Jacobs, another noted takeover specialist, established a significant position in Disney, raising the specter of another attempt to gain control. Jacobs developed his interest in Disney partly because of the probable effect of the previously undertaken defensive tactics.[257] Jacobs then sold his interest to the Bass brothers, who now own twenty-five percent of the firm's voting securities. This interest creates considerable incentive for direct monitoring and efficient management activity that inures to the benefit of all Disney shareholders.

2. *Economic Studies of Greenmail.* There have been four systematic economic studies of greenmail using stock price movements.[258] All the studies show that the stock market immediately reacts negatively to targeted share repurchases in the potential takeover context.[259] Such repurchases result in a loss for the remaining target shareholders at the time of repurchase, because in-

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[255] N.Y. Times, July 19, 1984, § D, at 1, col. 3. Murdoch's bid engendered the search for a white knight. Ultimately, Champion International obtained control of St. Regis.

[256] N.Y. Times, June 12, 1984, § D, at 1, col. 6.

[257] Bus. Wk., Aug. 20, 1984, at 35. Jacobs's objections to a defensive merger caused Disney to abandon the transaction.

[258] Bradley & Wakeman, *supra* note 253; Dann & DeAngelo, *supra* note 253; G. Jarrell & M. Ryngaert, *supra* note 3; R. Ruback & W. Mikkelson, Corporate Investments in Common Stock, Alfred P. Sloan School of Management, Mass. Inst. Tech. (Mar. 1984) (working paper).

[259] Bradley & Wakeman, *supra* note 253 (minus 5.5% where shareholder repurchase associated with takeover termination); Dann & DeAngelo, *supra* note 253 (minus 1.76% for premium repurchases); G. Jarrell & M. Ryngaert, *supra* note 3 (minus 5.2% for all share repurchases, minus 6.8% where the repurchase ended a control contest); R. Ruback & W. Mikkelson, *supra* note 258 (minus 2.01%). In contrast, the effect of nontargeted share repurchases has been uniformly reported to be positive. *See* Jensen & Ruback, *supra* note 175, at 39 (collecting studies).

vestors are now aware of the impossibility of a takeover by that specific raider and because the premium payment effects the firm's financial position. The signalling function of the greenmail payment may cause a further devaluation. It is a particularly vivid signal to the community of shareholders that the current managers of the target are opposed to a takeover. In some instances this may be news for the investment community and under the efficient market model would factor into the price of the target's shares. From this perspective the greenmail payment precipitated the release of the antitakeover information, but the new information was responsible for some of the price drop regardless of the payment.[260] Moreover, a complete study of the effect of greenmail should account for the abnormal gain created at the initial formation of the beachhead and the abnormal price drop at the liquidation of the beachhead. Much of the positive effect of the beachhead occurs when the purchase is initially announced in a 13D filing and may be offset by intervening events and by the price drop resulting from the greenmail payment.[261]

There have been two studies of the longitudinal effects of the initial purchase and the subsequent greenmail payment. The results, however, are mixed. The study of Richard S. Ruback and Wayne H. Mikkelson shows that the value of targets' stock does not drop back completely to the price existing before the beachhead was formed, even considering abnormal price movements as the consequence of intermediate announcements concerning the target.[262] The study by Gregg A. Jarrell and Michael Ryngaert also shows that the initial gains created at the formation of a beachhead are larger than the abnormal losses on repurchase. The latter study, however, also shows that a significant portion of the initial abnormal gain is dissipated during the interim period between initial beachhead formation and greenmail repurchase.[263] Jarrell and Ryngaert conclude that considering the interim loss, the net out-

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[260] I am indebted to Michael Ryngaert for his discussion of this point with me.

[261] G. Jarrell & M. Ryngaert, *supra* note 3; Kirkland, *supra* note 253; R. Ruback & W. Mikkelson, *supra* note 258.

[262] R. Ruback & W. Mikkelson, *supra* note 258 (minus 1.68% abnormal return to target shareholders considering effect of purchase of the initial block and its subsequent sale to the target).

[263] G. Jarrell & M. Ryngaert, *supra* note 3 (minus 7.1% abnormal return during interim period).

come for target shareholders is negative.[264]

The differences in the results of the two studies might be explained in several ways. First, differences in sample selection technique and size may account for some of the differing results. Second, and more significantly, explanations for the markedly different amount of negative abnormal return in the interim period are available. The Jarrell and Ryngaert study admittedly only selects for bad outcomes. It does not attempt to select out other exogenous bad news in the interim period unrelated to a potential takeover. Thus the study may overstate the negative returns during the interim period, which would overstate the net loss. Even if the net outcome for target shareholders is negative, as suggested by Jarrell and Ryngaert, the effect is relatively small and does not measure the benefits of greenmail *ex ante* considering the likelihood that the practice may strengthen the market for corporate control. In sum, if the Ruback and Mikkelson study accurately measures the net effect of beachhead formation/greenmail repurchase combination, the practice is unambiguously in the interest of shareholders. The Jarrell and Ryngaert study does create some uncertainty about the practice but does not purport to measure all the benefits which accrue from greenmail.

3. *The Pseudo-Bidding Argument.* Some critics of greenmail concede that a rule limiting the practice would at least reduce the level of purchases by "pseudo-bidders"—those who purchase without the capacity to gain ultimate control but who hope to sell out either to a firm with the capacity to gain control or to the issuer.[265] For such purchasers the inability to sell to the issuer makes taking beachhead positions more difficult because these purchasers should be particularly sensitive to risk. Limiting pseudo-bidding may be desirable because they may misidentify potential targets, and one method of inducing more careful search for attractive targets is to raise the cost of misidentification.[266] The argument continues that when misidentification occurs, the putative target's assets may end up in less efficient hands, such as those of a white knight seeking to maximize its own growth rather than profitability.

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[264] *Id.* (overall return to target shareholders minus 3.7%; minus 6.0% for control contest subsample). Of course, this outcome is after the fact.

[265] Coffee, *supra* note 5, at 1292; *see also supra* note 66 (discussing risk arbitrage).

[266] Coffee, *supra* note 5, at 1292.

The first step in the pseudo-bidding argument is troubling. While empirical evidence is unavailable, the premise that many actors who take substantial equity positions never participate in a control transaction seems overstated. An investor's calculus includes the value attributed to the ability to undertake three possible strategies: to sell to another raider, to sell to the company, and to go forward with a bid or proxy fight for control. The raider must follow one of those three strategies because a sale of the beachhead position in the open market would presumably force the price of the stock below the purchase price. The requirement to disclose in section 13D reveals the source and ability of the raider to fund the investment. If this disclosure and other market intelligence reveals to the target a potential raider's inability to make a run at control or create a bidding contest through the market informing effect or mount a proxy fight, then the target should not make the greenmail payment. An investor taking a beachhead position must appear to have the capacity to obtain control or its investment strategy would seem irrational. Thus it seems unlikely that "psuedo-bidding" aimed at no shift in control is a widespread phenomenon.[267]

The second step in the argument that psuedo-bidding causes many targets to end up with firms seeking only growth is also implausible. Although acquisitions for the sake of growth cannot be completely dismissed as a phenomenon, the important issue is whether psuedo-bidding, at whatever level it occurs, induces subsequent empire building transactions. A psuedo-bid followed by a real bid is probably the least likely scenario for an empire building transaction. Even the empire builder will look for transactions with substantial potential for gain. The initial holder of the beachhead, however, has driven up the price of the putative target's stock by building a beachhead, limiting gains to be made by a later entrant. This limitation will make the empire builder particularly unwilling to enter the fray since this second potential purchaser presumably had no clear preexisting understanding of target management's inefficiency or of synergies to be created by the transaction.

4. *The "Control Premium."* Another attack on greenmail asserts that such a transaction unfairly allocates the target's control

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[267] Schedule 13D, item 3, 17 C.F.R. § 240.13D-101 (1984), discloses future plans the purchaser has for the target.

premium on a non-pro rata basis.[268] This objection is again based on the notion that control is a corporate asset that stockholders should share equally. Moreover, even if a control premium need not generally be shared, a premium is arguably not appropriate in the greenmail situation because control does not actually shift. If anything, a blockage penalty[269] might be assessed against the beachhead seller. The law appropriately rejects the notion that control is a corporate asset, since the allocation of a control premium to the party creating the gain facilitates the transaction and strengthens the market for corporate control as a whole.

The lack of a shift in control to support the premium and the blockage penalty argument are more substantial problems. In part the blockage penalty might be explained away by the ability of the current owner to sell the beachhead to another potential raider. To that purchaser a premium over current market could still produce a block price below what it would take to independently reproduce the block. Thus rather than purchase at a below market price, the subsequent beachhead builder might be willing to pay a premium. The present holder of the block would seek from the issuer the discounted present value of the possibility of selling to another potential raider. The lack of the shift in control supporting the premium can be explained by the principal argument supporting greenmail. Ultimately an empirical question is raised. Does the payment of greenmail overall increase or decrease the monitoring strength of the market for corporate control? In the end the payment of greenmail strengthens the market for corporate control generally and may strengthen that market with respect to the target specifically.

5. *Evaluating Greenmail.* Greenmail should be evaluated in the context of the debate among those believing that management should be able to facilitate an auction when a first bid occurs versus those who advocate complete management passivity. If the legal rule were that management could only facilitate an auction, then greenmail would be an appropriate response. The auction-only rule would create the type of market risk for first bidders that exists today, with perhaps some decrease in the magnitude of risk.

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[268] Coffee, *supra* note 5, at 1292-93.

[269] A substantial block of stock sold on the market could temporarily disrupt the market causing the block to sell at some discount.

A principal aspect of the facilitating auctions position is, however, that uncertainty is useful because it allows assets to move to their highest use. This effect, whatever its magnitude, must be weighed against a decrease in the number of bids made. Greenmail can ameliorate the reduced incentives to be a first bidder in an auction market. To induce position taking and subsequent first bids, the opportunity to receive greenmail would enhance both incentives to search for targets and investment in the market for corporate control. It would provide a second way for searchers to be compensated for their risk and would operate as an opportunity to hedge with respect to the expected compensation for producing information.

But greenmail should also be evaluated in the context of the complete management passivity rule, the most difficult circumstance in which to defend greenmail. The risks of being a first bidder would here encompass only the possibility that the target shareholders believed the bid was too low or that a higher offer could be organized within the shortened time frame. The requirements of other regulatory frameworks, such as the preacquisition notification of the federal antitrust enforcement agencies[270] and the SEC decisions on waiting periods in the management passivity environment, would still leave a window for other bidders to organize an auction. Presumably the number of auctions would decrease from the number that presently occurs, but not to zero. First bidders should, however, be able to assess more easily whether to terminate or raise their bid if a second bid occurred.

The issue then becomes whether first bidders still need the hedge possibilities of greenmail to induce an appropriate level of search and position taking. There is no simple answer. Even before the Williams Act and sophisticated defensive tactics, substantial premiums were offered first bidders.[271] This fact indicates that the

[270] The Hart-Scott-Rodino Antitrust Improvement Act, 15 U.S.C. § 18a (1982), requires pre-consummation notification and a waiting period for large acquisitions. The waiting period can be extended when either the Justice Department or the FTC seeks additional information. While the antitrust enforcement agencies have been sensitive to the problems of competing tender offers, the notification process adds some delay to the process. In Mobil's attempt to take over Conoco, the Justice Department's request for additional information apparently played a significant role in defeating Mobil's offer, which was valued at $1 billion more than the competing offers. Ruback, *The Conoco Takeover and Stockholder Returns*, 23 SLOAN MAN. REV. 13 (1982).

[271] Jarrell & Bradley, *supra* note 178.

market risk of being a first bidder, even in a relatively favorable legal environment, is not insubstantial. Thus if the single goal of public policy were to induce the most investment in the market for corporate control, then greenmail could be defended even applying the management passivity rule. Nevertheless, not allowing greenmail might induce more careful search or termination of the raider's position by sale to a holder who values the stock more highly.

CONCLUSION

The present legal environment generally takes a benign view of two-tiered tender offers and greenmail. The practices have been challenged on a variety of grounds, mostly concerned with fairness, but a critical examination shows these attacks are based on faulty economic premises. Both two-tiered tender offers and greenmail benefit the market for corporate control, particularly where corporate control contests are fraught with substantial risk. Neither practice in the long run injures shareholders as a class. A regulatory cost-benefit analysis thus suggests that the legislative and other proposals limiting the practices should be rejected.

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