September, 1989

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I. INTRODUCTION

Corporate America will remember the 1980s as a decade of guerilla warfare fueled by junk bonds and other financial innovations, as an era when even the largest corporate giants found themselves vulnerable to attack. The battles were fought in equal measure on the floors of the nation's securities exchanges and in the courtrooms of America, as raiders and targets alike cast about for any measure that would shift the balance of power between them. While the market determined the fiscal desirability of these new financial devices, the courts were constantly conscripted to adjudicate the legitimacy of the multitude of legal devices—both the self-help and the legislative measures—that became so central to the ongoing conflict. Not surprisingly given its major commercial centers and its Rust Belt location, the Seventh Circuit has been a frequent, important player in those courtroom skirmishes.

This article explores five crucial Seventh Circuit takeover opinions: *MITE Corp. v. Dixon*;[1] *Panter v. Marshall Field & Co.*;[2] *Dynamics Corp. of America v. CTS Corp. (CTS I)*;[3] *Dynamics Corp. of America v. CTS Corp. (CTS II)*;[4] and *Amanda Acquisition Corp. v. Universal Foods Corp.*[5] As the earlier Seventh Circuit opinions demonstrate, the debate over the legitimacy of target management behavior was characterized at the outset of the 1980s by traditional constitutional and corporate doctrinal analysis. With the passage of time, however, the debate was dramatically refocused by an infusion of economic analysis. With Judges Easterbrook and Posner—two leading generals of the Law & Economics ("L&E") school—among its members, the Seventh Circuit played a pivotal role in

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The authors wish to thank Professor Patrick Ryan for helpful comments on earlier drafts. The normal caveats apply.

1. 633 F.2d 486 (7th Cir. 1980), *aff'd sub nom.* Edgar v. MITE, 457 U.S. 624 (1982).
2. 646 F.2d 271 (7th Cir.), *cert. denied,* 454 U.S. 1092 (1981).
3. 794 F.2d 250 (7th Cir. 1986), *rev'd in part,* 481 U.S. 69 (1987).
4. 805 F.2d 705 (7th Cir. 1986).
5. 877 F.2d 496 (7th Cir.), *cert. denied,* 110 S. Ct. 367 (1989).

the resulting restatement of the law of hostile takeovers. For this reason alone, the Circuit's takeover opinions merit review as the decade comes to a close.

The Seventh Circuit's later opinions also merit close review because their often contradictory text demonstrate the obstacles confronting the jurist who attempts to apply economic analysis to the legal issues of corporate control contests. In part, the Seventh Circuit's difficulties reflect its position in the judicial hierarchy. As an intermediate federal court of appeals, the Seventh Circuit finds its analysis of the constitutionality of state antitakeover legislation bounded by the pronouncements of the Supreme Court. At the same time, the Seventh Circuit's analysis of management's self-help measures is cabined by state court rulings. In part the court's opinions also may reflect the political realities of opinion writing. Even within the circuit court, the differing views of more traditional decision makers such as Judge Cudahy, and the economic approach of Judges Posner and Easterbrook likely played a role in the formulation of the strangely tentative blend of analysis found in these decisions.

Most importantly, the court's opinions reflect turmoil and conflict within the L&E school itself. Because proponents of economic analysis generally prefer market discipline over government regulation, they tend to condemn attempts to heighten judicial review of management's decisionmaking and to applaud state attempts to compete for corporate charters by offering innovative governance rules. Suspicious of the courts' use of fiduciary duties to regulate corporate governance matters, L&E scholars defend broad application of the Business Judgment Rule, and condemn decisions like *Smith v. Van Gorkom*[6] as mistaken attempts to "judicialize" corporate decisionmaking.[7] Yet paradoxically, because the market for control plays so crucial a role in the market's oversight of aberrant managerial behavior, most leading L&E scholars, including both Judges Posner[8] and Easterbrook,[9] recognize a need for some limit on management's attempts to disarm the market for control. While a few couch their proposals to limit managerial behavior in broad *per se* terms,[10] most L&E scholars propose regimes which envision a limited

6. 488 A.2d 858 (Del. 1985).

7. *E.g.*, Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985).

8. R. POSNER, ECONOMIC ANALYSIS OF THE LAW 385-88 (3d ed. 1986).

9. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) (championing the passivity theory which would prohibit managerial adoption of any defensive tactics).

10. Easterbrook and Fischel's articles, *supra* note 9, describe their proposals to limit managerial behavior in the face of a hostile takeover.

role for incumbent management in fending off raiders and which hence inevitably call for some degree of judicial review. The Seventh Circuit's opinions evidence the difficulty of formulating an appropriate test for guiding the courts in undertaking that review.

The Seventh Circuit's takeover opinions also reflect the somewhat conflicting attitudes of L&E scholars toward legislation, federalism, and constitutional adjudication. L&E scholars generally view legislative interpretation and constitutional litigation from a perspective that often leads to a deferential treatment of state regulatory efforts. In particular, they applaud competition among the states, arguing that market forces will tend to drive out poor lawmaking.[11]

The L&E's school's general deferential tendencies, however, are called into sharp contradiction when the purpose of state legislation is to disarm the international market for corporate control. If that market were disabled, corporate participants would surely be driven back to the courts for protection, a result L&E scholars would disdain. Thus, L&E scholars often are sharply critical of legislative attempts to regulate the market for control and do support some rules intended to empower courts to strike particularly offensive legislation.[12] At the same time, because they recognize a strong role for competition among the states for corporate charters, a number of L&E scholars call for deference to at least some state attempts to experiment with antitakeover legislation, even if those states appear to permit incumbent managers some degree of insulation.[13] But allowing courts to search for "good" and "bad" state takeover legislation invariably arms the judiciary with a degree of discretion most L&E scholars would prefer they not be given.

From the standpoint of the L&E scholar, the solution lies in fine tuning the role courts are to play in reviewing self-help defensive tactics and antitakeover legislation. Judicial review requires courts to employ rules of decision which necessarily implicate a role susceptible to judicial abuse. The difficult task for the L&E scholar/jurist is to formulate appropriate rules and standards to govern such review. At the onset of our

11. *See* Fischel, *From MITE to CTS: State Anti-Takeover Statutes, the Williams Act, the Commerce Clause, and Insider Trading*, 1987 SUP. CT. REV. 47; Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). Both of these articles are cited by Judge Easterbrook in Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989), one of the opinions we discuss in detail. See *infra* notes 327-54 and accompanying text.

12. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 128-31 (1987).

13. *E.g.*, Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985).

critique of the Seventh Circuit's decisions we hypothesized that given the current state of the antitakeover debate within the L&E community it was unlikely that the Seventh Circuit's takeover jurisprudence would reveal a magic bullet to solve that difficult task. Lamentably, as the discussion below demonstrates, we were correct.

II. THE SEVENTH CIRCUIT AND MANAGEMENT DEFENSIVE TACTICS TAKEN IN RESPONSE TO HOSTILE TAKEOVER BID

The Seventh Circuit has played an important role in the development of the law of defensive tactics, albeit one in which its freedom to act has been restricted in that it has been called upon to speculate about how the state courts would eventually rule. In *Panter v. Marshall Field & Co.*,[14] the court, applying Delaware law, staked out the highly promanagement position courts were to take in the first half of the decade.[15] Although the primary stage for later developments has since shifted to the Delaware courts themselves,[16] the Seventh Circuit's subsequent decisions in *Dynamics Corp. of America v. CTS Corp.*[17] on the legality of the "poison pill"[18] defense under Indiana law have added significantly to the continuing body of the law on that particular defensive measure. The evolution in the courts' analysis from *Panter* to *CTS I* and *CTS II* underscores the analytical shift the Seventh Circuit, and indeed corporation law in general, has undergone in addressing questions of corporate governance. Moreover, this evolution highlights the divergent forces in operation when jurists endeavor to apply the insights of economic analysis to questions of corporate law, particularly to those involving the market for corporate control.

The importance of the court's *Panter* and *CTS* decisions is best understood against the backdrop of fiduciary law. The traditional model of

14. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). For discussions of *Panter*, see Comment, Panter v. Marshall Field & Company, *A Tender Offer Field's Could Refuse*, 58 CHI.-KENT L. REV. 1151 (1982); Note, *The Misapplication of the Business Judgement Rule in Contests for Corporate Control*, 76 NW. U.L. REV. 980 (1982).

15. *See supra* notes 11-14 and accompanying text.

16. *See supra* notes 6-10 and accompanying text.

17. Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986), *rev'd in part*, 481 U.S. 69 (1987) [hereinafter *CTS I*]; Dynamics Corp. of America v. CTS Corp., 805 F.2d 705 (7th Cir. 1986) [hereinafter *CTS II*]. For the history of the CTS litigation, see Latimer, *Poison Pill Takeover Defenses: A Review of* Dynamics Corp. of America v. CTS Corporation, *(1986-1987)*, 14 MONASH U.L. REV. 1 (1988). *See also* Note, *Recent Developments in the Use of the Poison Pill Antitakeover Defense: Limiting the Business Judgment Rule*, 31 ST. LOUIS U.L.J. 1083 (1987); Note, Dynamics Corp. of America v. CTS Corp.: *Posner's Plan for Poison Pills*, 1987 WIS. L. REV. 711.

18. For a description of "poison pill" defenses generally, see P. RICHTER, CORPORATE ANTI-TAKEOVER DEFENSES: THE POISON PILL DEVICE (1988). *See also* Note, *Shareholder Rights Plans: Shields or Gavels?*, 42 VAND. L. REV. 173 (1989).

the corporation is that of a form of organization in which shareholders employ professionals to manage their pooled resources. The resulting centralization of management enables shareholders to earn profits from specialization, but only at the risk that managers may abuse their power to benefit their own interests.[19] Property rules, the common law's traditional tool for assuring efficient use of property, are insufficient to protect shareholder interests given the separation of ownership from control.[20]

The courts, therefore, intervened early to combat potential abuse by declaring that corporate directors and officers are fiduciaries,[21] and as such, owe their corporation and its shareholders both a duty of care[22] and a duty of loyalty.[23] Traditionally, the former is said to require directors and officers to act as would a reasonable person in like position under similar conditions.[24] That statement of the rule is misleading, however, in that it implies that corporate fiduciaries—like other professionals—may be held personally liable should they act negligently in performing their activities. In fact, courts have always been extremely reluctant to hold directors or officers personally liable for mere negligence.[25] Instead they effectively have required the plaintiff to prove that the directors or officers were grossly negligent.[26]

To avoid the "after the fact" review of the wisdom of a director's or officer's conduct that a conventional duty of care analysis would require, the courts have traditionally invoked the Business Judgment Rule. As

19. *See, e.g.*, A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). For a critical reappraisal of the Berle-Means model of the corporation, see Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 J.L. & ECON. 273 (1983).

20. *See* BERLE & MEANS, *supra* note 19, at 304-05.

21. Pepper v. Litton, 308 U.S. 295 (1939); Charitable Corp. v. Sutton, 26 Eng. Rep. 642 (1742). For an extensive discussion of the fiduciary relation of the corporate manager, see D. BAYNE, THE PHILOSOPHY OF CORPORATE CONTROL: A TREATISE ON THE LAW OF FIDUCIARY DUTY (1986).

22. *E.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981).

23. *E.g.*, Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939); Litwin v. Allen, 25 N.Y.S.2d 667 (1940).

24. *E.g.*, Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981); REVISED MODEL BUSINESS CORP. ACT § 8.30(a) (1984).

25. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968). Bishop likened research for cases imposing personal liability on corporate directors and officers for breach of their duty of care to "a search for a very small number of needles in a very large haystack." *Id.* at 1099.

26. *E.g.*, *Van Gorkom*, 488 A.2d at 873 ("[d]irector liability is predicated upon concepts of gross negligence"); Spering's Appeal, 71 Pa. 11, 24 (1872) (holding that directors were liable "for gross inattention and negligence," but not "for mistakes of judgement"). *See generally* Special Project: Director and Officer Liability, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgement Rule*, 40 VAND. L. REV. 605 (1987). Professor Carney has described the "negligence" rule as a conduct rule, and the "gross negligence" rule as a decision rule. Carney, *Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?*, 66 WASH. U.L.Q. 239, 264-65 (1988). The former rule is aspirational while the latter informs the courts as they go about resolving actual cases.

the Seventh Circuit itself noted in *Panter*, the Business Judgment Rule provides that "[w]hen [directors] act in good faith, they enjoy a presumption of sound business judgment . . . which courts will not disturb if any rational business purpose can be attributed to their decisions."[27] That is, the rule ensures that courts will intervene only in those rare instances in which they can discern no rational purpose for defendant's behavior or when they find that defendant acted in so hasty a fashion as to indicate rash, grossly negligent behavior.[28] In all other instances, a plaintiff's claim is destined for quick, unproductive resolution.

There are several traditional justifications for the Business Judgment Rule's "hands off" approach. Courts frequently announce that they are reluctant to review the acts of directors because they lack the expertise to evaluate the wisdom of business decisions. The courts fear that subjecting individuals to personal liability would deter qualified individuals from serving as directors or officers. Courts also explain their standoffish response by asserting that shareholders have "assumed" the risk of unproductive management in electing the incumbents, or by arguing that increased scrutiny will force directors and officers to adopt overly conservative business policies.[29] Whatever their reasoning, the courts, by the time of *Panter*, had reduced the threat of personal liability to a director or officer of personal liability for violating her duty of care to a hortatory, but virtually empty gesture.[30]

In contrast, courts traditionally have been substantially more receptive to a plaintiff's claim that an officer or director breached her duty of loyalty. Although courts initially sought to prevent all such conflicts by applying a *per se* void or voidable rule,[31] they subsequently softened the

27. 646 F.2d 271, 293 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (citing with approval the trial court's formulation of the Business Judgment Rule at 486 F. Supp. 1168, 1194 (N.D.Ill. 1980)).

28. One might restate the question presented by the Business Judgment Rule as an inquiry into whether a particular managerial decision so deviates from that which one might expect a faithful servant to arrive at as to suggest strongly that in making it corporate managers were motivated by interests other than maximizing shareholder wealth. For general discussions of the Business Judgment Rule, see D. BLOCK, N. BARTON & S. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS (3d ed. 1989); and E. BRODSKY & M. ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES, ch. 2 (1984 & Supp. 1989).

29. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 14 (1984).

30. Bishop, *supra* note 25, at 1095 (describing actions to impose personal liability for failure to exercise due care as much like the proverbial shearing of the pig—much squealing, little wool). *But see* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981).

31. *E.g.*, Cumberland Coal & Iron Co. v. Parish, 42 Md. 598 (1875). For a discussion of the evolution of the void or voidable rule, see Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

rule to permit corporations to deal with their directors and officers so long as the transactions are "fair."[32] But as "fairness" is a notoriously nebulous concept, the revised rule created an enormous potential for fiduciary abuse. To prevent such abuse, the courts universally took the position that once the plaintiff demonstrated that the defendant officer or director had engaged in self-dealing or otherwise was subject to a conflict of interest when approving the transaction in question, the court would shift the burden of proof to the party (usually the defendant) seeking to sustain the action in question to prove the intrinsic fairness of the action.[33] That shift was often fatal. At the very least, it assured that plaintiffs in loyalty cases would rarely be nonsuited.

The important point is that the traditional model of the corporation viewed fiduciary duty rules as crucial conduct rules devised and applied by the courts to protect shareholders from managerial abuse. More recent theorizing about the corporation rejects that view. In the last decade theorists associated with the L&E school have popularized the contract model of the corporation.[34] That model, which views the corporation as a nexus of contracts, treats common law and state statutory provisions as implied terms of a contract[35] by which both managers and shareholders seek to reduce the agency costs[36] associated with centralized management.[37] In contrast to the traditional model, the contract model does not treat fiduciary rules as the primary tool for reducing agency costs because they require costly judicial intervention. The model

32. Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918). *See also* Marsh, *supra* note 31.

33. Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976); Woodroof v. Howes, 88 Cal. 184, 26 P. 111 (1891).

34. For discussions of the contract model of the corporation, see, *e.g.*, Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99 (1989); Easterbrook & Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Honabach, *Consent, Exit, and The Contract Model of the Corporation - A Commentary on Maryland's New Director and Officer Liability Limiting and Indemnification Legislation*, 18 U. BALT. L. REV. 310 (1989); and R. POSNER, *supra* note 8, at 369-72. *But see* Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); and DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (each rejecting the contract model as a rhetorical rather than analytical tool).

35. Easterbrook & Fischel, *supra* note 34, at 1444-45. ("Corporate law—and in particular the fiduciary principle enforced by courts—fills in the blanks and oversights [of corporate participants] with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance.")

36. The seminal article on the application of agency costs analysis to matters of corporate governance is Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For a general discussion of "agency costs," see W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE 157-58 (2d ed. 1986).

37. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Fischel, *supra* note 34, at 1264.

postulates that corporate participants instead rely primarily on market forces, most importantly the market for control,[38] to discipline ineffective managers.[39]

Conceptualizing the corporation as a nexus of contract provides several important insights. First, because fiduciary rules are implied contract terms, corporate participants should be generally free to vary their content or to waive their application altogether.[40] Arguments in favor of invariable fiduciary rules should be viewed suspiciously and may be thought to reflect rent seeking activities by individuals often not party to the corporate contract.[41] Second, because states compete for corporate charters, state variations in corporate law should be permitted and indeed encouraged as a form of product innovation which leads ultimately to superior governance rules.[42] Finally, lawmakers should be careful not to interfere with or permit others to interfere with the market forces that provide the bulk of the discipline necessary to reduce agency costs efficiently.[43]

Some theorists associated with the L&E school even reject the validity of corporate law's traditional bifurcation of fiduciary duties into a duty of care and a duty of loyalty.[44] In particular, these theorists main-

38. Dean Henry Manne first coined the phrase "market for control" in his path breaking 1965 article, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

39. Honabach, *supra* note 34, at 344-46; Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Manne, *supra* note 38.

40. *E.g.*, Butler & Ribstein, *Free at Last? The Contractual Theory of the Corporation and the New Maryland Officer-Director Liability Provisions*, 18 U. BALT. L. REV. 352, 360-65 (1989).

41. *E.g.*, N. WOLFSON, THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION 72 (1984) ("Essentially, corporate law doctrine on the duty of loyalty is a tool used by the legal profession to displace the free market process.").

42. Baysinger & Butler, *supra* note 13; Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1981).

43. *E.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, *supra* note 9, at 1169-74; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offer Defenses*, 33 STAN. L. REV. 819 (1981).

44. *E.g.*, N. WOLFSON, *supra* note 41; Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 262-63 (1986); *Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law & Economics*, 71 CORNELL L. REV. 357, 368 (1986) (remarks of Prof. Fischel). *But see* Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375 (1988) (criticizing proposals to make the duty of loyalty optional as raw majoritarian rule unchecked by adequate market forces); Sargent, *Two Cheers for the Maryland Director and Officer Liability Statute*, 18 U. BALT. L. REV. 278, 296-300 (1989) (criticizing the recent Maryland director and officer liability limiting legislation for blurring the distinction between the duty of care and duty of loyalty). Section 13.1-692.1 of the Revised Virginia Stock Corporation Act already may permit shareholders to opt out of imposing liability in some situations in which the directors of a Virginia corporation did not act in good faith. *See* Honabach, *All That Glitters: A Critique of the Revised Virginia Stock Corporation Act*, 12 J. CORP. L. 433, 474 (1987); *see also* Demott, *Limiting Directors' Liability*, 66 WASH. U.L.Q. 295, 297 (1988).

tain that the distinction between care and loyalty issues is primarily one of quantity rather than quality. They assert that a fiduciary's failure to exercise due care—"shirking"—is simply one form of self-serving behavior. As they see the problem, the director who chooses to spend the afternoon on the bay rather than in the boardroom is no different than the director who pads an expense account or the director who diverts a corporate opportunity. All that differs is the amount appropriated.[45]

The claimed homogeneity of care and loyalty issues has important consequences for the corporate governance debate. For example, if care and loyalty issues are treated as one and the same, one can hardly justify dramatically different rules for care and loyalty cases. Nor can one argue that judicial intervention in loyalty cases is somehow especially worthwhile. Even if loyalty cases present courts with disputes they can resolve more easily,[46] judicial intervention often may not be worthwhile because such cases rarely involve substantial amounts of money.[47] Most importantly, if care and loyalty claims indeed present courts ultimately with the same issue, judicial attempts to construct elaborate schemes for distinguishing between care and loyalty cases are futile and doomed to fail precisely when the claimed distinction is most likely to matter.

Notwithstanding the L&E theorizing, however, the courts and legislatures have generally continued to apply the traditional care/loyalty regime.[48] The difficulty confronting the Seventh Circuit in *Panter* and later in *CTS*, as it sought to apply fiduciary duty rules to defensive takeover actions, is that such action arguably always involves elements of both

45. Most commentators believe that care and loyalty claims present different issues. In support of the distinction, they contend: (1) some deference should be given to the fact that courts have found the distinction useful for a long period of time; (2) the distinction is useful in achieving the law's aspirational goals; and (3) the distinction between loyalty and care rules may reflect the ability of the courts and market to discipline particular types of managerial misbehavior. Specifically, loyalty cases involve misbehavior which will come to light only if monitors actively ferret it out. Sargent, *supra* note 44, at 298-99. In particular, the commentators argue that were liability unlikely (as would be the case were loyalty claims treated like care claims), shareholders—and their attorneys—would have little incentive to diligently police managerial behavior. *Id.* at 299. Professor Branson perhaps best sums up the conventional wisdom: "In contrast [to the duty of care], the duty of loyalty deals with purposeful conduct of a venal, opportunistic sort." Branson, *supra* note 44, at 384.

46. *See, e.g.*, Scott, *The Role of Policy Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley*, 71 CORNELL L. REV. 299 (1986). *See also* Sargent, *supra* note 44, at 298.

47. In fact, care cases—in which the courts rarely intervene—often involve great loss to shareholders while loyalty cases frequently involve relatively trivial amounts in terms of overall corporate wealth.

48. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1983 & Supp. 1988) (permitting shareholders in Delaware corporations to opt out of personal liability for corporate directors subject to a broad exclusion for actions violating the director's duty of loyalty); N.J. STAT. ANN. § 14A:2-7(3) (West 1990) (permitting shareholders of New Jersey corporations to opt out of imposing personal liability on directors and officers for breaching their duty of loyalty which is defined as "an act or omission which that person knows or believes to be contrary to the best interests of the corporation or its shareholders in connection with a matter in which he has a material conflict of interest").

care and loyalty. On the one hand, managers argue that some bids, even bids at substantial premiums, are wealth decreasing. To the extent that is true, directors and officers would be exercising good business judgment in calling for shareholders to reject such bids.[49] On the other hand, even when a bid enhances shareholder wealth, it threatens corporate directors and officers with possible removal and the resultant loss of income and prestige. Corporate officers, in particular, are at risk because as a group they tend to make firm-specific investments in the corporation.[50] As a result, the natural response of corporate officers and (perhaps to a lesser degree) directors is to take steps to stave off the takeover, no matter how desirable the offer might be from the standpoint of their shareholders.[51]

Quite expectedly, courts find that determining management's motivation for undertaking defensive action is a difficult task, particularly because two stories can be told to explain why defensive measures might enhance shareholder wealth. Each builds on the argument that the centralization of control of the public corporation in the hands of corporate management reflects shareholder response to the insurmountable information and coordination costs shareholders would face if they were compelled to initiate or respond individually to most fundamental corporate transactions. Hence, the argument begins, the contract among shareholders gives the board plenary power to initiate such fundamental transactions as dissolution or merger.[52] Precisely because a hostile takeover tender bid bypasses the board, the first argument maintains, it may enable a bidder to take advantage of such coordination costs to structure a bid which succeeds not on its merits, but rather on its ability to stampede shareholders into accepting an unwise offer.[53] Those arguing for mana-

49. The empirical evidence shows that in the current market for corporate control the premiums given to target shareholders are substantial and that most of the gain from takeovers is already captured by target shareholders. *See* Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Shares Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988). Thus, market forces insure that few bids, if any, are actually wealth decreasing from the perspective of target shareholders. Unless bidders offer a significant premium above market, their bids are doomed for failure. Of course, the current legal regime helps ensure this result.

50. *E.g.*, Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 416-18; Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 17-19 (1986). Such firm-specific investments are desirable from the corporation's perspective; they remain valuable to the officers, however, only so long as the officers are employed by the target corporation.

51. We do not intend to suggest that management is always brazenly indifferent to the plight of their shareholders; in fact, managers likely often themselves genuinely believe that their motives are pure and their actions in warding off the "raider" beneficial to shareholders. Nevertheless, their actual, perhaps subconscious, motivation for adopting antitakeover measures may often be to entrench themselves or at least vindicate their professional judgments. *See generally* Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1473 (1989).

52. *E.g.*, DEL. CODE ANN. tit. 8, §§ 251, 275 (1983 & Supp. 1988).

53. In part, this view reflects an empirical judgment which conflicts with event studies of the

gerial power contend that two-step transactions in which bidders seek control in the first step of the transaction, intending to take out the remaining shareholders for less valuable consideration at a later date, represent the archetype coercive takeover.[54]

Second, some argue that even when an offer is not coercive, concerted action is desirable because it enables shareholders to capture more of the gain in the transaction.[55] That is, if shareholders can resist the first bid for the corporation, they may convert what initially appears to be a bilateral negotiation into an auction which would yield them a higher price.[56] Some justify defensive tactics as benefiting shareholders because those tactics permit managers in such a scenario to conduct an orderly auction.

While theorists continue to debate when, if ever, defensive tactics are appropriate, no one contends that managers should be permitted to thwart every hostile bid. The modern corporate organization necessarily imposes agency costs on shareholders.[57] Direct monitoring of managerial behavior and judicial enforcement of fiduciary duties are costly and imperfect tools for reducing those costs. Fortunately, the shareholders of publicly held corporations find the market for control a much more effective, efficient tool.[58] The threat of a takeover deters at least some forms

market for corporate control. *See* Kraakman, *supra* note 49. *See also* Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985). *But see* Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281 (1985).

54. *E.g.*, Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635, 1640-43 (1988); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974); Osterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53 (1985). *But see* Easterbrook & Fischel, *supra* note 37, at 723-32 (suggesting that higher premium paid in first stage of transaction represents normal control premium).

55. *E.g.*, Booth, *Is There Any Valid Reason Why Target Managers Oppose Tender Offers?*, 14 SEC. REG. L.J. 43, 48 (1986).

56. *See, e.g.*, Osterle, *supra* note 54, at 63.

57. *See* W. KLEIN & J. COFFEE, *supra* note 36; Jensen & Meckling, *supra* note 36.

58. In his comment, Professor Branson maintains that the statement in the text applies, if at all, only to a relatively limited number of large, publicly traded, closely followed corporations, and not to corporations traded in the "many nooks and crannies of the over-the-counter market." Branson, *A Corporate Paleontologist's Look at Law and Economics in the Seventh Circuit*, 65 CHI.-KENT L. REV. 745 (1989)[hereinafter Branson, *A Corporate Paleontologist*]. Moreover, he argues that "the market for corporate control is at best only a rough hewn tool." *Id.* at 749.

Professor Branson is correct on both counts. The market for control is at best only an imperfect monitor of managerial behavior. In some instances, particularly when the offensive behavior is engaged in by a controlling shareholder-manager, it may be no check at all. *See, e.g.*, Honabach, *supra* note 34, at 342-46. That said, however, it does not follow, as Professor Branson seems to imply, that fiduciary duty rules provide needed, or even desirable interstitial protection. Judicial enforcement of fiduciary duties is itself imperfect and costly. We would permit shareholders, at least those in widely traded, publicly owned corporations, to decide whether the benefits of judicially enforced fiduciary rules are worth their costs, provided, of course, the procedures by which shareholders decide enable of managerial misbehavior. Shareholders who couple that protection with appropriate diversification of their portfolio minimize the cost of managerial misbehavior.[59] Were managers free to erect barriers which repelled all hostile bids, shareholders would lose the protection of the market and would be compelled to substitute more expensive protection techniques or to tolerate less diligent performance by their managers.

Nonetheless, managers quite naturally seek shelter from market discipline.[60] With the Supreme Court's apparent closing of the statehouse's doors in *Edgar v. MITE,*[61] managers turned more aggressively to self-help tactics. Creating defensive "shark-repellents" (and the colorful video-militaristic jargon of takeover lore) became a lucrative skyscraper industry. The courts in turn, unwilling to adopt the theory that managers confronted with a hostile bid should remain passive (the "passivity theorem"),[62] found themselves saddled with the task of defining how the law of fiduciary duty applied to such defensive action.

At the time that *Panter*, the first of the Seventh Circuit's three important opinions on defensive tactics, wound its way up to the court, the primary statement of the Delaware Supreme Court on how it would evaluate the lawfulness of defensive tactics was *Cheff v. Mathes*.[63] In that 1964 decision the Delaware Court had held that in challenges to defensive tactics, management bore the initial burden of showing that it had

them to exercise an informed, uncoerced choice. We recognize that devising such procedures is a formidable task.

59. *See, e.g.*, Honabach, *supra* note 34, at 342. For a full discussion of the role portfolio diversification plays in limiting shareholder loss, see Butler & Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 39-42 (1990). Professor Branson takes issue with the notion that governance rules should be fashioned under the assumption that shareholders will minimize their risk of loss by diversifying their portfolio, correctly noting that for various reasons not all shareholders will do so. Branson, *A Corporate Paleontologist*, *supra* note 58, at 747-48. He maintains that "the law should have in place some substantive rights and remedies to protect them." *Id.* at 748. Whether the law should protect those shareholders who do not diversify is a thorny issue, especially as such protection is subsidized by those shareholders who do diversify their portfolios. On the whole, we prefer rules which do not penalize those shareholders who do diversify. We acknowledge, however, that a case can be made that for the opposite conclusion.

60. Managers, to be sure, do not necessarily desire totally unchecked discretion because such protection would increase the agency costs associated with the corporate form of doing business. Were managers granted total shelter from market discipline, they would find that over time shareholders would respond to such increased agency costs by bargaining down managerial compensation by an amount that offset at least in part the increased costs. Nevertheless, those managers faced with the possibility of an imminent takeover (and the prospect of unemployment) apparently are willing to trade off the costs of decreased compensation in return for job security. Moreover, they are likely to find that trade off especially beneficial as its costs are likely to be borne by all managers generally (including those not threatened by a takeover), and, in particular, by future managers.

61. 457 U.S. 624 (1982). For a full discussion of *MITE* and its aftermath, see *infra* notes 238-71 and accompanying text.

62. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, *supra* note 9. For criticisms of the passivity theorem, see Osterle, *supra* note 54.

63. 41 Del. Ch. 494, 199 A.2d 548 (1964).

reason to believe that the bid represented a danger to corporate policy.[64] Once management had met that burden, the court had continued, the burden shifted to the plaintiffs to show that management's response was unreasonable.[65] The court had explicitly noted that defendants need not prove the intrinsic fairness of their action (as would have been true were the case treated as one involving a conflict of interest); they need only negate plaintiff's allegation that their actions were motivated solely by self-interest.[66]

Despite the nominal imposition of an initial burden of proof on defendants, *Cheff* actually imposed little restraint on management.[67] The reasonably astute counsel could always suggest ways in which the hostile bidder might disrupt corporate policy.[68] Consequently, the effect of *Cheff* was more or less to require courts to apply the basic Business Judgment Rule to takeover defenses, albeit only after an obligatory managerial tale or two.

A. Panter v. Marshall Field & Co.

In *Panter v. Marshall Field & Co.*,[69] the Seventh Circuit was called upon to opine whether it believed the Delaware courts' treatment of defensive tactics had changed in the seventeen years since *Cheff* and to predict how it believed the Delaware Supreme Court would respond to specific species of defensive behavior, including "show stopper" litigation. The dispute in *Panter* arose out of an aborted attempt by Carter Hawley Hale ("CHH") in 1977 to acquire control of Marshall Field & Co.[70] Both corporate players in the drama operated retail department stores. CHH was not Marshall Field's first suitor. The latter had been approached on several occasions in the late 1960s and mid-1970s. In each instance its management had rejected the overtures despite relatively poor operating results.[71] Management rejected CHH's overtures as well. CHH, however, did not go away. CHH pressed its interests and

64. *Id.* at 504-05, 199 A.2d at 554-55.

65. *Id.*

66. *Id.* at 506, 199 A.2d at 555.

67. Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 249-50 (1989).

68. *See, e.g.*, Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979). *See also* R. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 723-27 (1986).

69. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

70. *Id.* at 277-81.

71. At the time, Marshall Field, a Delaware corporation, was the eighth largest department store chain in the United States. It operated thirty-one stores, including fifteen in Chicago where it was headquartered. CHH, on the other hand, operated retail department, specialty, and bookstores nationwide including its Neiman-Marcus department stores in Texas and the southeastern United

when Field's management continued to spurn its advances, CHH commenced a hostile bid.

Marshall Field's management responded by undertaking defensive measures aimed at thwarting CHH. It filed an antitrust suit, expanded into a Houston shopping center, and approved the acquisition of five stores in the Pacific Northwest.[72] Marshall Field also issued a series of press releases announcing that it had rejected the CHH offer, declaring the bid "illegal, inadequate, and not in the best interest of [the company]."[73]

CHH withdrew its offer of $42 per share.[74] After CHH's announcement, the market price of Field's shares dropped to $19;[75] Field's shares had been trading at about $22 just prior to CHH's initial overtures.

Plaintiff shareholders sued Marshall Fields and its directors, alleging that the directors had violated federal securities law,[76] had unlawfully interfered with their contractual advantage,[77] and, most importantly for purposes of this discussion, had breached their fiduciary duties to the shareholders. The basis of the latter claim was plaintiffs' allegation that Field's directors, in furtherance of a policy of indepen-

States. At the time CHH approached Marshall Field, it was contemplating entering into direct competition with Marshall Field in the Chicago area. *Id.* at 277-79.

In the years just prior to CHH's bid, Marshall Field had experienced poorer than anticipated operating results, and had been the subject of several merger discussions. In an effort to reverse its fortunes the corporation had hired Angelo Arena away from CHH's Neiman-Marcus division in 1976 to become the president of Marshall Field, a position he officially assumed in 1977. *Id.* (While there is no indication in either the district court or the Seventh Circuit's opinions that Marshall Field's hiring of Arena in anyway initiated or affected CHH's bid for Marshall Field, it seems likely that such action in some way affected the nature of the dealings between the parties.) CHH made informal contacts with Marshall Field at the same time expressing an interest in a friendly merger. *Id.* at 279.

72. Although Field had been considering the expansion for two years, the timing of the decision to proceed suggested that it was partially a response to CHH's bid. *Id.* at 291.

Whether targets have standing to challenge takeovers is controversial. *See* Cargill, Inc. v. Monfort of Colorado, Inc., 479 U.S. 104 (1986); Carter Hawley Hale Stores, Inc. v. The Limited, Inc., 587 F. Supp. 246 (C.D. Cal. 1984).

73. 646 F.2d at 280. Marshall Field later accused CHH of securities law violations in the making of its offer as well. *Id.*

74. CHH stated that Marshall Field's expansion program had created too much doubt about Marshall Field's earning power. *Id.* at 281.

75. *Id.* The decision of Marshall Field's board to reject CHH's bid was quite costly to its shareholders. Four years after CHH withdrew its bid of $42 per share, B.A.T. successfully offered $30. Marshall Field & Co. v. Icahn, 537 F. Supp. 413, 420 (S.D.N.Y. 1982). Professors Gilson & Kraakman estimate that taking into account reinvestment income, the decision cost Marshall Field's shareholders approximately $27 per share. Gilson & Kraakman, *supra* note 67, at 271 n.76.

76. Plaintiffs alleged that defendants had violated the anti-fraud provisions of the 1934 Act, specifically section 14(e) of the Williams Act, 15 U.S.C. § 78n(e) (1976) and SEC Rule 10b-5. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1980). The Seventh Circuit affirmed the district court's dismissal of both claims. 646 F.2d at 285-88.

77. 646 F.2d at 283-85. The Seventh Circuit affirmed the district court's dismissal of the claim, holding that plaintiffs had failed to prove that the board's action was wrongful. *Id.* at 285.

dence whatever the costs, had commenced the antitrust suit solely as a "show stopper," and had approved the expansion/acquisition program both to make the antitrust action more plausible and to make Field a less attractive target.[78] The plaintiffs contended that in doing so the directors sought to protect their positions, not to enhance shareholder wealth.

At the close of the plaintiffs' case, the district court granted the defendants' motion for a directed verdict on all counts.[79] Applying Delaware corporate law, it found that management had decided to resist CHH's overtures in good faith, and with a rational business purpose.[80]

The plaintiffs appealed.[81] Writing for the Seventh Circuit, Judge Pell began his analysis of the plaintiffs' fiduciary claims by declaring that the Business Judgment Rule was applicable in cases challenging the propriety of management's defensive tactics.[82] Citing *Cheff*, Judge Pell concluded that under Delaware law the plaintiffs could avoid application of the Business Judgment Rule only by proving that the defendants' self-interest was the sole or primary motivation for management's decisions to fend off CHH.[83] Judge Pell maintained that a mere allegation that the directors' actions were motivated by a desire to maintain control was insufficient to shift the burden of proving reasonableness to the defendants.[84] To hold otherwise, he implied, would render the Business Judgment Rule a nullity in reviewing takeover actions because directors' attempts to enhance corporate profits are always motivated by a desire to placate shareholders. Correctly anticipating what later would become a significant factor under Delaware takeover law,[85] Judge Pell buttressed his decision to apply the Business Judgment Rule by noting that the majority of the Marshall Field board were "independent directors" who derived no income from the corporation other than directors' fees and employee discounts, amounts he presumably believed too modest to un-

78. *Id.* at 295-98.

79. 486 F. Supp. 1168, 1195 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

80. *Id.* at 1194-95. The district court also rejected the plaintiffs' contention that the most important duty of corporate management was to assure shareholders opportunities to sell their shares at a premium. *Id.* at 1194.

81. 646 F.2d at 271.

82. *Id.* at 293. In doing so, Judge Pell foreclosed argument that the Business Judgment Rule was inapplicable whenever plaintiffs alleged that the directors' actions had been motivated by their interest in retaining control over the corporation. *Id.* at 293-94 (quoting Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980)).

83. *Id.* at 297.

84. *Id.*

85. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

dercut their independence.[86] He specifically rejected the plaintiffs' contention that two of the directors should not have been deemed independent because their investment banking firm and commercial bank respectively had substantial dealings with Marshall Field that were likely to be terminated should CHH succeed in its bid.[87]

Sensitive to the courts' reluctance to involve themselves too deeply in "Monday-morning-quarterbacking" of corporate decisionmaking, the plaintiffs attempted to provide the court with a lever with which to treat takeover decision as *sui generis*. They proposed that the court adopt a rule applicable only in takeover contexts which would place on the target's directors and officers the initial burden of establishing a compelling business purpose for any action which would have the effect of consolidating or retaining their control.[88] Plaintiffs' proposal would have deprived the defendants of the benefit of the Business Judgment Rule in virtually all cases challenging defensive tactics.

Judge Pell summarily rejected the argument. He affirmed the decision below, finding that the plaintiffs had not produced evidence sufficient to make a showing from which the trial court might have inferred that impermissible motive predominated in the directors' decisionmaking.[89]

Judge Cudahy vigorously dissented, proclaiming the majority had "moved one giant step closer to shredding whatever constraints still remain upon the ability of corporate directors to place self-interest before shareholder interest in resisting a hostile bid for control of the corporation."[90] Viewing the case as one initially raising questions of loyalty, Judge Cudahy disagreed with the majority's apparent willingness to apply the Business Judgment Rule to all defensive tactics.[91] He argued that

86. 646 F.2d at 294.

87. *Id.* at 294-95.

88. *Id.* at 295. The genesis of the proposal apparently was the Delaware Supreme Court's decision in Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), in which the court had held that controlling shareholders were required to show an independent business purpose to justify a freeze out merger. The Delaware Supreme Court quickly abandoned the business purpose test. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983). For a discussion of the "business purpose" doctrine, see Booth, *The Business Purpose Doctrine and the Limits of Equal Treatment in Corporation Law*, 38 SW. L.J. 853 (1984); *see also* Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990).

89. 646 F.2d at 299.

90. *Id.*

91. Many commentators concur with Judge Cudahy's assertion that the Business Judgment Rule is inapplicable in the defensive tactic context. This position is not limited to the views of L&E scholars. *See, e.g.*, Steinberg, *Tender Offer Regulation: The Need for Reform*, 23 WAKE FOREST L. REV. 1, 13 (1988) ("In the context of [defensive] maneuvers in tender offers . . . the rule serves as a sword to pierce legitimate shareholder interests rather than as a justifiable shield for management's conduct, and thus should not be applied."). The issue of the proper standard for managerial behav-

the majority's position immunized a target's board of directors against liability "provided a sufficiently prestigious (and expensive) array of legal and financial talent were retained to furnish *post hoc* rationales for fixed and immutable policies of resistance to takeover."[92]

Judge Cudahy contended that the theoretical justification for the Business Judgment Rule—courts should be reluctant to interfere when the expertise of directors is likely to be greater than that of the courts—was inapplicable when directors are subject to a conflict of interest.[93] In such instances, Judge Cudahy maintained, the courts have no rational choice but to closely scrutinize challenged director conduct and corporate action.[94] He rejected the majority's description of the Marshall Field board as one dominated by disinterested outside directors. Although troubled that both the director/investment banker and the director/commercial banker had lucrative ties to the incumbent management, Judge Cudahy stated that plaintiffs need not rely solely on those ties to negate the apparent independence of the board.[95] Instead, Judge Cudahy implies that structural bias effectively undercuts the board's independence, at least in the context of a hostile takeover. He emphasized that even the remaining outside directors "at the very least, [were] 'interested' in their own positions of power, prestige, and prominence."[96] Under such conditions, Judge Cudahy found "the slavish application of the majority's version of the good faith presumption . . . particularly disturbing."[97]

After undertaking precisely the kind of extensive review of the facts that the Business Judgment Rule was intended to foreclose, Judge Cudahy concluded that plaintiffs had introduced ample evidence that Marshall Field's management had adopted an unbending policy of independence, and in furtherance of that policy had made hasty defensive acquisitions and had hastily filed the antitrust suit to deter CHH.[98] Judge Cudahy thought that at the very least the trial court should have let the case go to the jury. By refusing to order the lower court to do so, Judge Cudahy concluded, the majority effectively had announced that "[shareholders] are on their own and may expect little consideration and

ior in the takeover context is central to the current debate over corporate governance. *See infra* notes 199-220 and accompanying text.

92. 646 F.2d at 299.

93. *Id.* at 300.

94. *Id.*

95. *Id.*

96. *Id.* at 300 n.4. Judge Cudahy noted that Marshall Field's directors had received annual fees ranging from $11,200 to $16,000 in 1977. *Id.*

97. *Id.* at 301.

98. *Id.* at 302.

less enlightenment from their board of directors when a tender offeror appears to challenge the directors for control."[99]

Judge Pell's opinion in *Panter* represented the zenith of the courts' promanagement approach to management's adoption of defensive tactics.[100] The Seventh Circuit's conclusion that Delaware courts would generally apply the Business Judgment Rule to test management's defensive tactics virtually assured the validation of such tactics in all but the most egregious cases for, as Judge Cudahy had noted, well-advised targets could easily document "threats" to corporate policy which justified some defensive behavior. In *Panter*, the Seventh Circuit had laid to rest any lingering fears that the courts might look unkindly on management's defensive tactics.

Panter remained the predominate statement on the law of defensive tactics until the Delaware Supreme Court's trilogy of decisions decided in 1985 and 1986: *Unocal Corp. v. Mesa Petroleum*,[101] *Moran v. Household International, Inc.*,[102] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[103] In these decisions, the Delaware court retreated from *Cheff*, announcing that it would apply the "enhanced Business Judgment Rule"[104] or so called "proportionality review"[105] to evaluate defensive tactics. Its new test placed the initial burden of proof on the directors to show that: (1) the takeover bid constituted a danger to corporate policy (the *Cheff* standard); *and* (2) the defensive tactic taken was "reasonable in relation to the threat posed."[106] Only then would the burden shift to the plaintiff to show a breach of fiduciary duty. To be sure, commentators have speculated about whether the new test actually will have any bite, noting that the Delaware court had itself toyed with a similar reformulation of management duties in *Singer v. Magnavox Co.* (albeit in a different context)[107] only to abandon the revised test as unworkable in

99. *Id.* at 312.

100. *Accord* Gilson & Kraakman, *supra* note 67, at 249 n.8.

101. 493 A.2d 946 (Del. 1985).

102. 500 A.2d 1346 (Del. 1985).

103. 506 A.2d 173 (Del. 1986).

104. The Delaware Supreme Court enunciated the "enhanced Business Judgment Rule" in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), stating that given "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the Business Judgment Rule may be conferred." *Id.* at 954.

105. The "proportionality test" label was originated by Professors Gilson & Kraakman, *supra* note 67.

106. *Unocal Corp.*, 493 A.2d at 955.

107. For a discussion of Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) (overruled by Weinberger v. VOP, Inc., 457 A.2d 701 (Del. 1983)), see note 88.

subsequent decisions.[108] At the very least, however, the new decisions signalled the unwillingness of the Deleware courts to continue to employ the *Cheff-Panter* straight Business Judgment Rule approach to evaluate defensive action.

B. Dynamics Corporation of America v. CTS Corp. (*CTS I & CTS II*)

At about the same time the Delaware Supreme Court was formulating its new proportionality test, the Seventh Circuit was confronted once again with an allegation that management had been motivated by self-interest rather than concern for shareholder welfare in undertaking defensive measures in response to a takeover bid. That assertion formed the basis for Dynamic Corporation's pendant state claims in the *Dynamics Corp. of America v. CTS Corp.* litigation in which, as discussed below, the most publicized issue was the constitutionality of Indiana's Control Share Statute.[109] The court's decisions on the pendent state law fiduciary claims, however, are equally important.

1. *Dynamics Corp. of America v. CTS Corp.* (*CTS I*)

The *CTS* litigation revolved around the attempt by Dynamics Corporation of America to take control of CTS Corporation. Dynamics, a 9.6% shareholder disgruntled by the poor operating results of CTS' in-

108. *E.g.*, Gilson & Kraakman, *supra* note 67, at 252; Johnson & Siegal, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 332-37 (1987).

The recent decision by the Delaware Supreme Court in Paramount Communications, Inc. v. Time, Inc., 571 A.2d. 1140 (Del. 1990) raises questions about the degree to which the "enhanced Business Judgment Rule" actually restricts managerial discretion. In *Time*, Paramount Communications and two other groups of shareholders sought to enjoin Time's tender offer for fifty-one percent of the stock of Warner Communication. The plaintiffs contended that the directors of Time had breached their fiduciary duty, *inter alia*, in that the agreement with Warner was not a reasonable response to Paramount's competing bid and, hence, was not a proper exercise of business judgment. In affirming the chancery court's refusal to enjoin the tender offer, the Delaware Supreme Court held that in responding to a hostile bid, managers of a corporation need not "abandon a deliberately conceived corporate plan for a short-term shareholder profit *unless there is clearly no basis to sustain the corporate strategy*." *Id.* at 1154 (emphasis added). One can assume that the managers of many, if not most, corporations will respond to the decision in *Time* by adopting a "long range" corporate plan to maximize shareholder value by remaining an independent entity. When faced with an unsolicited bid, those managers are likely to "just say no" and force the bidder to prove that "there is clearly no basis to sustain the strategy." *Id.* Meeting that burden of proof is likely to be particularly difficult given the Delaware Supreme Court's recognition in *Times* that the stock market price of corporate shares is not necessarily representative of the true value of the corporation's stock. *Id.* at 1150 n.12. The position of the Delaware Supreme Court seems to conflict with the standard of behavior suggested by the ALI reporters. *See* ALI Principles of Corporate Governance: Analysis and Recommendations § 6.01 (Tent. Draft No. 10, 1990). In view of the floor's rejection of the reporter's formulation, what form the ALI principles will take in this area is open to serious question.

109. *See infra* notes 275-326 and accompanying text.

cumbent management, had decided to purchase an additional 17.9% of CTS' outstanding shares. At the time CTS' shares were trading at $35; Dynamics bid $43 per share. Dynamics presumably believed that acquiring the additional shares would assure it victory in its pending proxy fight against CTS' incumbent managers.[110]

CTS' management responded to the bid the same day. Without studying the business or financial impact of the offer, or consulting with outside directors, it announced its opposition. The next day CTS' management retained Smith Barney as its investment banker to advise it on how to defeat Dynamics' bid for control. CTS' contract with Smith Barney provided that the latter would receive a $75,000 bonus if Dynamics lost the impending proxy fight.[111]

Eleven days later, Smith Barney presented CTS' board with a "fairness" opinion in which it concluded that Dynamics' offer was unfair although it did not opine on the fairness of the $43 price. Smith Barney proposed that the board respond by adopting a "flip-in, flip-over" poison pill. The board did so unanimously.

The "flip-in" portion of CTS' pill provided that once any shareholder acquired 15% or more of CTS' stock, all shareholders other than the acquiror would receive the right to buy a package of CTS securities at a price equal to approximately 25% of the then market price of the package. Assuming that all rights were exercised, the effect would have been to reduce Dynamics' holdings (as its tender offer was oversubscribed) from 27.5% to 20.7% and to dilute the value of Dynamics' investment to the tune of approximately $24,000,000. Exercise of the rights would also have saddled CTS with an additional $80,000,000 in new long-term fixed debt at a 13% interest rate. The new debt could have imperiled CTS' ability to meet current liabilities, and might have triggered a CTS default on other outstanding corporate securities, conceivably empowering CTS' creditors to call their debt and force CTS into bankruptcy.[112]

Contemporaneous with the announcement of its tender offer, Dynamics brought suit alleging that CTS had violated federal securities

110. Dynamics had first become a shareholder of CTS a year before the then incumbent management of CTS took office. During the incumbent's stewardship, CTS' rate of return had declined, due in part to a series of poor acquisitions to which Dynamics had objected. A restive, unhappy shareholder, Dynamics became embroiled in litigation with CTS. Dynamics coupled its tender with an announcement that it would field its own slate of candidates for election to the board of CTS at the upcoming directors elections. Given the premium over market, Dynamics' bid not surprisingly was eventually oversubscribed. 794 F.2d 250, 251 (7th Cir. 1986), *rev'd in part*, 481 U.S. 69 (1987).

111. CTS' chairman, again without consulting the board, wrote to CTS' shareholders urging them not to vote for the Dynamics' slate of candidates. *Id.* at 257.

112. *Id.*

laws. It then amended its complaint to allege that CTS management's adoption of the pill constituted a violation of its state fiduciary duties.[113] CTS counterclaimed, arguing that Dynamics' tender offer would result in a violation of the Clayton Act and that Dynamics had failed to disclose material information. Both parties moved for preliminary injunctions.

Applying the new Delaware "proportionality test," the district court found that Dynamics had shown that CTS' management had acted hastily and had failed to demonstrate that its adoption of the pill was a reasonable response to the threat posed by Dynamics' bid. The Court found that Dynamics had introduced sufficient evidence to demonstrate that it could succeed in proving that CTS' actions were motivated by the board's desire to entrench itself. Therefore, it granted the injunction.[114] CTS appealed.

The Seventh Circuit, in an opinion by Judge Posner, affirmed the grant of the injunction. As could be expected, Judge Posner's opinion differed dramatically in style from that employed by Judge Pell in *Panter* (and for that matter, from that adopted by Judge Cudahy whose two-tier review approach Judge Posner ultimately followed). Judge Posner began by reviewing the ongoing debate over defensive tactics. He recognized that some commentators viewed hostile bids as evil and presumably would permit management a wide range of responses,[115] while others—including Judge Easterbrook—viewed all resistance as bad because it undercut the market for control which assures that "corporate assets will be transferred, with a minimum of friction, to those who value them the most, as measured by the prices they offer."[116] Restrained because the issue before the court was one of state law, Judge Posner concluded that Indiana would likely reject either extreme.[117]

While he could not require passivity, Judge Posner evinced considerable dislike for defensive tactics. He emphasized that the market for control "plays a vital role in keeping management on its toes."[118] Judge Posner admitted that one could credibly argue that some tactics, including poison pills, might be defended as enabling shareholders to resist coercive bids or as empowering the board to conduct a wealth maximizing

113. When CTS' board elected to be governed by Indiana's "Control Share" statute, Dynamics amended its suit, claiming that the Control Share statue violated the supremacy and commerce clauses of the federal Constitution. *Id.* at 251. For a discussion of the constitutional aspects of Dynamic's action, see *infra* notes 274-315 and accompanying text.

114. 637 F. Supp. 406, 419 (N.D. Ill. 1986).

115. *See, e.g.*, Lipton, *Takeover Bids in the Target's Boardroom*, *supra* note 68.

116. 794 F.2d at 253.

117. *Id.* at 253.

118. *Id.* at 254.

auction. Judge Posner hinted, however, that he found those justifications wanting[119] because they gave too little weight to the fact that so-called "defensive measures" rendered shareholders defenseless against their own managers.[120] In particular, Judge Posner expressed grave doubts about the poison pill defense adopted by CTS because it made it profitable for a shareholder to refuse to tender so long as her fellow shareholders tendered, thereby effectively encouraging the shareholder to attempt to free ride.[121]

Only after making clear his general bias against defensive tactics did Judge Posner turn to the case before him. Judge Posner first rejected CTS' argument that its action was sheltered by the Business Judgment Rule. Instead, he explained, CTS' managers bore the initial burden of proving both the existence of a legitimate threat and the reasonableness of their response.[122] Judge Posner reviewed the process by which CTS had gone about evaluating Dynamics' bid. He noted that CTS' management had not considered Dynamics' bid in a cool, dispassionate, and thorough fashion before deciding to undertake defensive measures.[123] Judge Posner was also unpersuaded by Smith Barney's "fairness" opinion, noting that it had never addressed the fairness of the price.[124] He was especially concerned that Smith Barney had a vested interest (its contingent fee) in defeating Dynamics' proxy effort regardless of the value of the Dynamics' offer.[125] Judge Posner dismissed management's argument that it need not study Dynamics' bid because it already knew Dynamics well and knew that Dynamics was merely interested in the "quick buck."[126] Given CTS' recent dismal performance, he stated, CTS' management could hardly be certain that a Dynamics takeover would reduce shareholder wealth.[127] To the contrary, Judge Posner noted, the stock market had reacted favorably to Dynamics' bid.[128] Thus, he implied, CTS' management could not satisfy the initial prong of the proportionality test requiring it to support its conclusion that Dynamics' bid represented a genuine threat to CTS' shareholders.

119. *Id.* at 255.
120. *Id.*
121. *Id.*
122. *Id.* at 256. Judge Posner also noted that the Delaware courts had been "quite emphatic that . . . poison pills . . . are within the power of the board of directors of a target corporation." *Id.*
123. *Id.* at 257.
124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.* at 257-58.
128. The price of CTS' shares rose from below $36 to over $40 upon Dynamics' announcement. *Id.* at 257.

Even if Dynamics' bid were a genuine threat, however, Judge Posner concluded that the poison pill CTS adopted was not a reasonable response because it was not a plausible measure for maximizing shareholder wealth.[129] Given its 15% share ownership trigger, the pill would have had a devastating financial effect on Dynamics were its bid successful. Yet the small increase in ownership would not have empowered Dynamics to squeeze out other CTS shareholders. Judge Posner maintained that if the pill was intended to protect minority shareholders from back-end transactions, as CTS had argued, "it should be triggered by a transaction that creates a majority shareholder or that attempts to squeeze out minority shareholders, and it should give the minority [shareholders] the same price per share as the majority—not a higher price calculated to kill off the tender . . . ."[130] In contrast, CTS' pill precluded *any* hostile takeover; it effectively forced any bidder to buy out CTS' management.[131] Consequently, the Seventh Circuit let the injunction stand.

2. *Dynamics Corp. of America v. CTS Corp.* (*CTS II*)

With CTS' implementation of its initial poison pill enjoined, Dynamics proceeded with its tender offer, thereby increasing its ownership of CTS to the 27.5%.[132] It then commenced its proxy fight.[133] CTS' management responded by forming a committee of independent directors which after several days of deliberation recommended that the board adopt a second poison pill.[134] Its new "back-end" pill provided that should any shareholders obtain 28% of CTS' shares, the remaining shareholders would be entitled to exchange their shares for a $50 debenture, payable after one year, with interest at 10% per annum. The pill was to remain in effect for one year, and would be cancelled automatically if anyone made a cash tender offer of $50 or more for all outstanding shares. Additionally, CTS' board could cancel the plan at any time.[135] In effect, the new pill operated as a $50 reservation price.[136] Any would-be bidder had two choices: offer $50 or more in cash *or* deal with the incumbent managers.[137]

129. *Id.* at 258-59.
130. *Id.* at 259.
131. *Id.*
132. Dynamics Corp. of America v. CTS Corp., 805 F.2d 705, 707 (7th Cir. 1986).
133. *Id.*
134. *Id.*
135. *Id.*
136. A "reservation price" is the minimum price an owner is willing to accept in return for his property. *See* R. COOTER & T. ULEN, LAW AND ECONOMICS 193 (1988).
137. The full board adopted the plan on the same day that the Seventh Circuit affirmed the district court's enjoining of the original pill. At that time CTS' shares were selling at $38. The next

Dynamics sued to enjoin the new pill. This time the district court declined to grant the injunction.[138] The court focused on the procedure employed by CTS, noting that the pill had been adopted by a committee composed of outside directors after consultation with CTS' investment banker, Smith Barney.[139] It also found that CTS had arrived at the $50 per share price in good faith.[140]

With the injunction denied, the corporate election proceeded. CTS' incumbent management, campaigning on a platform of auctioning off the corporation for the highest bid, narrowly won re-election.[141]

Dynamics appealed the district court's refusal to enjoin implementation of CTS' new poison pill, advancing two arguments. First, Dynamics maintained that the pill was invalid because it violated the new provision of the Indiana corporate code which required that all shares of the same class have identical preferences, limitations, and relative rights.[142] In the alternative, it argued that CTS' management had breached its fiduciary duty in adopting the pill. It contended that CTS had set the trigger at 28% to prevent Dynamics from acquiring any additional shares with which to wage its proxy fight.[143]

In *CTS II*, the Seventh Circuit vacated the district court's decision, and remanded the case for further findings.[144] Judge Posner again wrote the opinion. Addressing first the fiduciary claim, Judge Posner noted that in adopting the second pill, CTS' independent committee had perceived two threats. First, the committee was concerned that were Dynamics able to increase its ownership, it might acquire a "blocking position" that would deter other would-be bidders.[145] Second, the committee expressed concern that if Dynamics were to acquire working control of CTS, it would be able to acquire additional CTS shares without paying the premium normally associated with the acquisition of con-

day, CTS announced adoption of the new pill, describing it as part of a strategy aimed at auctioning the corporation off at the highest possible price. The price of CTS' shares rose to $45, perhaps as a favorable response to the new pill, but also perhaps as a response to the circuit court's affirmation of the original injunction. 805 F.2d at 707.

138. 635 F. Supp. 1174 (N.D. Ill.), *aff'd on reh'g*, 638 F. Supp. 802 (N.D. Ill. 1986). While the district court again found that Dynamics "had shown fair ground for litigation," it concluded that "[Dynamics'] probability of success . . . is decidedly lower than was true in connection with the earlier rights plan, and . . . the balance of hardships does not weigh sufficiently in [Dynamics'] favor to justify injunctive relief." 635 F. Supp. at 1177-78.

139. 635 F. Supp. at 1176-77.

140. *Id.* at 1179.

141. 805 F.2d at 710.

142. IND. CODE ANN. § 23-1-25-1(a) (Burns Replacement Vol. 1989). Indiana was one of the first states to adopt the Revised Business Corporations Act.

143. 805 F.2d at 710.

144. *Id.* at 718.

145. *Id.* at 710.

trol.[146] Absent other facts, Judge Posner noted, the court would have affirmed the district court's refusal to grant the injunction.[147]

Judge Posner, however, surprisingly chose to review the facts carefully. He expressed concern about the "puzzling" relation between CTS and Smith Barney, whose independence he still doubted.[148] Judge Posner also questioned the disinterestedness of the outside directors, noting that if Dynamics' bid was successful, the outside directors would lose their directorships and their directors' fees.[149] Nevertheless, Judge Posner announced that he was unprepared to hold that the committee had employed improper procedures in adopting the second pill.[150] More serious, Judge Posner noted, was the relationship between the terms of the pill and the alleged threat to the welfare of CTS' shareholders.[151] Just as in *CTS I*, he questioned the reasoning of CTS in setting the trigger at 28%, a level which CTS had obviously selected to preclude Dynamics from acquiring additional shares for its proxy battle.[152] Judge Posner asserted that Dynamics "can no more block majority decisions with 49.99 percent of the company than with 27.5 percent."[153] While he admitted that CTS might be a less attractive target were Dynamics a larger shareholder,[154] Judge Posner maintained that the record was devoid of evidence that would justify setting the triggering percentage at less than an absolute majority.[155]

146. *Id.*
147. *Id.*
148. Judge Posner noted that CTS had not disclosed its compensation agreement with Smith Barney, thus casting doubt on Smith Barney's independence and hence its valuation. *Id.* at 710-11.
149. *Id.* at 711.
150. *Id.*
151. *Id.* at 711-12.
152. *Id.* at 712. Given the narrowness of CTS' subsequent victory, the importance of the additional shares Dynamics might have acquired probably loomed large in Judge Posner's mind.
153. *Id.* As the quotation in the text evidences, Judge Posner's discussion of the significance of Dynamics' acquisition of additional shares appears at times unusually formalistic and off the mark. For example, under the Indiana code, a shareholder need not hold an absolute majority of shares to control a shareholder vote; so long as a quorum of shareholders is present, any shareholder who controls the majority of the shares actually voting determines the outcome. IND. CODE ANN. § 23.1-30-6 (Burns Replacement Vol. 1989). That is, a proposal put to shareholder vote is deemed to be approved if more shares are cast in favor of the proposal than are cast against the proposal. Therefore, by increasing its ownership, Dynamics' increased the likelihood that it could control shareholder votes. Moreover, even under traditional voting rules, Dynamics' increase in voting control increased the likelihood that it would exercise working control of CTS. We speculate that Judge Posner engaged in such uncharacteristically formalistic reasoning because of his general disdain for antitakeover measures.
154. Judge Posner admitted that anyone who purchased a majority of CTS' shares might want to cash out Dynamics, that doing so would not be painless, and that the larger Dynamics' stake, the greater would be its incentive to play a vigorous role as corporate monitor. 805 F.2d at 712-13.
155. *Id.* at 712. Again we find peculiar Judge Posner's insistence that such evidence be found in the record. If poison pills are legitimate devices, they necessarily should be triggered at a much earlier stage in the would-be acquiror's acquisition program.

Judge Posner likewise rejected CTS' attempt to justify its second pill as a device for assuring that Dynamics would pay an appropriate "premium" for acquiring control.[156] He did not acknowledge that failure to pay a premium represented a threat of any sort. Rather, he implied that Dynamics' acquisition of a control block might well benefit the remaining CTS shareholders, noting that studies and cases had indicated that, in at least some instances, the existence of a large minority shareholder actually encouraged takeovers.[157] Judge Posner maintained that the record contained no evidence to explain that such was not the case in the Dynamics-CTS dispute.[158]

Finally, Judge Posner questioned the reasonableness of the $50 reservation price in light of management's proclaimed goal of auctioning off the company to the highest bidder.[159] He found the methodology by which Smith Barney had calculated the price "deeply flawed,"[160] as it had based its calculation on a capitalization of management's projections of earnings for the next year even though CTS had a history of overly optimistically projecting earnings.[161] Judge Posner also questioned the appropriateness of the capitalization rate Smith Barney had employed.[162]

Turning to Dynamics' challenge to the legality of the pill itself, Judge Posner admitted that the Delaware courts had refused to outlaw pills, but noted that in those cases the courts had considered the validity of pills adopted *before* the incumbent managers had decided to auction off the company.[163] Although he stated that the court need not speculate on whether the poison pill might be a reasonable element of a plan for a corporate auction,[164] his discussion suggests that he thought not. Judge Posner distinguished private auctions in which reservation prices are common on two grounds. First, he noted in private auctions the owner himself sets the reservation price whereas in the hostile takeover situation, management—whose interests might well be contrary to a sale—sets the price at which shareholders presumptively would be unwilling to sell.[165] Secondly, an owner generally resorts to sale at private auctions because he can find no ready market to establish a fair price for his

156. *Id.* at 712-13.
157. *Id.* at 713 (citing Schleifer & Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986)).
158. *Id.* at 713.
159. *Id.* at 713-16.
160. *Id.* at 715.
161. *Id.* at 716.
162. *Id.* at 714.
163. *Id.* at 716-17.
164. *Id.* at 717.
165. *Id.*

goods. Shareholders of publicly traded corporations do not confront that problem; the trading activity in the security establishes a readily ascertainable price.[166] Although it appeared that Judge Posner would have preferred to hold that under Indiana law incumbent managers could not employ a poison pill to establish a reservation price, he did not, stating that to do so would be premature.[167] But even if it were possible to use a pill for that purpose, Judge Posner noted management must set a reservation price that is reasonably related to the value of the corporation, and that in deciding to establish such a price and to use a poison pill, it must act in good faith and after proper consideration.[168] Judge Posner found that the record before the court left serious doubt as to whether CTS' management had satisfied that standard.[169]

Judge Posner appeared to foreshadow his position on the legitimacy of CTS' second pill relatively early in the opinion when he noted that the record left the court with considerable uncertainty about the basis on which the district court was able to reject the inference that the second pill was "in the end [designed so that] current management and directors would keep their jobs."[170] It was no surprise that in the end he remanded the case to the district court for further findings on the fiduciary duty issue.[171]

Judge Posner, it should be noted, did reject Dynamics' alternative theory that the poison pill was invalid under the Indiana corporation code because it discriminated among shares of the same class of stock in that the holder of 28% or more of the stock could not exercise its poison

166. *Id.* CTS' shares were traded on the New York Stock Exchange. Judge Posner noted that the market price may have reflected only the price for marginal shares, not for the company as a whole, but implied that market price made a reservation price less necessary. *Id.*

167. *Id.* That Judge Posner even raised the question was a strong signal of his general hostility to poison pills.

168. *Id.*

169. *Id.*

170. *Id.* at 715.

171. *Id.* at 718. Judge Posner also rejected as frivolous Dynamics' argument the Indiana statute violated the commerce clause if it permitted poison pills. *Id.*

Following Judge Posner's decision in *CTS II*, CTS' board redeemed the second poison pill and adopted in its place yet a third poison pill which mirrored the second pill but set the reservation price at $35. Dynamics again filed suit. While that action was pending, another bidder offered $35 per share. CTS and Dynamics then entered into negotiations which resulted in a settlement of all issues other than the question of the constitutionality of the Indiana Control Share statute then pending before the Supreme Court. *See* text *infra* notes 314-18. As part of the settlement, CTS gave Dynamics an option to purchase up to 35% of CTS' shares at the average closing price of those shares on the NYSE for the five days preceding the settlement ($29.63). Dynamics also secured three of the seven seats on CTS' board, and an agreement that fundamental changes would require at least an 80% vote for the one year period following the 1987 general meeting. CTS also agreed to reimburse Dynamics approximately $2,000,000 in legal fees. For a full discussion of the settlement, see Latimer, *supra* note 17, at 6-8.

pill rights.[172] Judge Posner thought it unlikely that the Indiana legislature had intended to outlaw poison pills at the same time that it had enacted a control share statute intended to facilitate defensive measures against takeovers.[173]

C. *The Meaning of* Panter *and* CTS I & II

That the Seventh Circuit's responses to plaintiffs' challenges of management's defensive tactics in *CTS I* and *CTS II* differed significantly from its earlier decision in *Panter* is in itself not remarkable for several reasons. First, in the five years between decisions, the hostile takeover market had blossomed, in part a result of the flowering of the junk bond market, and in part a response to the decision of the Supreme Court in *MITE* invalidating state antitakeover legislation.[174] At the same time, management's arsenal of self-help antitakeover measures had become increasingly sophisticated and potentially more devastating.[175] Both factors heightened the importance of the courts' review policies, and not surprisingly, increased the pressure on the courts to reconsider their prior decisions. Equally important, particularly for federal jurists like Judge Posner, the Delaware Supreme Court, the mother court of corporate law, had already announced its willingness to review defensive tactics more carefully.[176]

At one level, the course of the Seventh Circuit's decisions from *Panter* to *CTS* appears to track developments in Delaware takeover law. Judge Posner's *CTS* decisions, particularly *CTS II*, can be read narrowly as refinements on the developing proportionality test that do not bode well for the use of poison pills, particularly flip-in pills. Precluded from ruling that poison pills were illegal per se, Judge Posner faced a dilemma. He could either permit CTS' incumbent managers wide leeway in con-

172. 805 F.2d at 717-18. For decisions invalidating flip-in pills as discriminatory, see Bank of New York Co. Inc. v. Irving Bank Corp., 142 Misc. 2d 145, 536 N.Y.S.2d 923 (Sup. Ct. 1988); Amalgamated Sugar Co. v. NL Indus., 644 F. Supp. 1299 (S.D.N.Y. 1986), *aff'd*, 825 F.2d 634 (2d Cir.), *cert. denied*, 484 U.S. 992 (1987); and Aarco, Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985).

173. 805 F.2d at 717-18. Judge Posner noted that the Delaware courts had distinguished between discrimination between shares and between shareholders, holding the latter valid. *Id.* at 718 (citing Providence & Worcester Co. v. Baker, 378 A.2d 121, 123 (Del. 1977)). Dynamics attempted to distinguish those cases on the ground that the Indiana legislature had adopted as part of its recent revision of the corporate code a provision which specifically prohibits intraclass discrimination. Judge Posner rejected that distinction. *Id.* at 718.

174. *See* notes 264-72 and accompanying text.

175. For example, at the time that *CTS* came before the court the poison pill device employed by CTS was thought to be fatal to any unsolicited bid. But see Judge Easterbrook's opinion in Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 508 (7th Cir.), *cert. denied*, 110 S. Ct. 369 (1989), suggesting that antidote pills and the like might render some poison pills harmless. For a complete discussion of *Amanda*, see notes 327-54 and accompanying text.

176. *See supra* notes 101-08 and accompanying text.

structing what appeared to him to be a nearly fatal antitakeover defense, or he could utilize a revitalized fiduciary duty analysis to restrict their use of poison pills.[177] The former course would undercut the strength of the L&E argument that the market for control negates the need for close judicial supervision of most managerial behavior; the latter would concede that in at least some situations close judicial review of managerial behavior was both warranted and feasible. Although neither option could have been attractive, it is hardly surprising that Judge Posner relied on fiduciary duty analysis to author opinions which are among the least hospitable to management's use of defensive tactics.[178] As the opinions make clear, even jurists like Judge Posner, who otherwise might be expected to defer to managers and markets, will employ the rubric of fiduciary duty analysis to protect the market for control, at least when other routes of review are foreclosed by controlling state law precedents.

Although understandable given their context, Judge Posner's *CTS* opinions leave us with an uneasiness. Although Judge Posner rejected Dynamics' argument that *Van Gorkom* set the standard applicable to the case,[179] he nevertheless engaged in an analysis that appears hauntingly similar. In *CTS I*, Judge Posner emphasized the speed at which CTS' insiders decided to block the Dynamics' offer. "[J]udgment first, trial later," he characterized their response.[180] Coming from a more traditional scholar who emphasizes the role process plays (or should play) in evaluating managerial decisions,[181] such harsh words might well seem appropriate. L&E scholars, however, have been universally critical of the decision in *Van Gorkom* precisely because the Delaware court censured corporate decision makers in that case for acting too quickly.[182] Despite Judge Posner's announced intent not to judicialize corporate

177. Moreover, in writing his opinion Judge Posner undoubtedly was sensitive to the practical politics of the court. Given Judge Cudahy's presence on the panel and his earlier prominent role in *Panter*, Judge Posner surely sought an approach that both he and Judge Cudahy would find suitable. *See* text accompanying notes 90-99.

178. Whereas the Delaware courts have been generally receptive to the adoption of poison pills and have focused instead on the board's response to bids conditioned upon the target's willingness to redeem them, *e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985); City Capital Assoc. v. Interco Inc., 551 A.2d 787 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988), Judge Posner appeared ready to enjoin their adoption unless the corporation could truly demonstrate that its adoption was appropriate given the general threat to shareholder wealth posed by the outside bidders.

179. 805 F.2d at 711. He commented that *Van Gorkom* had been "so forcefully and cogently . . . criticized . . . ." *Id.*

180. 794 F.2d at 257.

181. *E.g.*, Christy, *Corporate Mismanagement as Malpractice: A Critical Reanalysis of Corporate Managers' Duties of Care and Loyalty*, 21 HOUS. L. REV. 105 (1984).

182. *See, e.g.*, Fischel, *supra* note 7.

decisionmaking,[183] all but the foolhearted practitioner likely will interpret his opinions as placing a premium on procedural regularity.[184] To that extent, Judge Posner's opinions place him in strange company.[185]

Similarly, Judge Posner's concern about the apparent independence, or more accurately the lack of independence, on the part of CTS' financial banker Smith Barney is unsettling. As discussed, in both *CTS I* and *CTS II* Judge Posner expressed concern that Smith Barney's fairness report was tainted by the compensation provisions of its arrangements with CTS.[186] He thought that CTS' directors could not rely on Smith Barney's evaluation because the banking firm would profit handsomely if CTS was successful in warding off Dynamics. His analysis on that issue is similar to the concern expressed by several courts—including the Delaware Supreme Court in *Van Gorkom*—that corporate managers create a paper trail of fairness to offset the claim that they were acting recklessly or in their own self-interest.[187] But one would hardly expect an L&E scholar to encourage such activity. Fairness reports are inherently suspect not only because they so often are rendered by participants who have a vested interest in satisfying their clients (usually the corporate managers who retain them), but also because the very definition of "fair value" is so nebulous once it is untied from market price.[188] Moreover, investment bankers have considerable discretion in determining value even when a common definition is used.[189] To the extent that Judge Posner can be interpreted as requiring such reports, he once again appears to have joined forces with odd allies.

Other portions of Judge Posner's *CTS* opinions could similarly be critiqued. The important point is that while consistent with the approach taken by others, including the Delaware courts, Judge Posner's *CTS* opinions hardly bear the earmarks of the "hands-off" approach to judicial review usually advocated by L&E scholars. Rather, forced to

183. 794 F.2d at 257 ("We do not mean to suggest that the board was obliged to accord due process to Dynamics . . . .").

184. *See, e.g.*, Note, *supra* note 18, at 203 ("In order to survive this [CTS'] heightened scrutiny, a board of directors' decision to adopt a poison pill plan must be supported by evidence of careful consideration of alternative defensive tactics . . . .").

185. For the argument that process plays a crucial role in the review of takeover tactics, see Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97 (1989); and Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665 (1988).

186. *See* notes 124-25, 160-62 and accompanying text.

187. Smith v. Van Gorkom, 488 A.2d 858, 876-78 (Del. 1985).

188. For a thorough discussion of the unreliability of "fairness opinions," see Bebchuk & Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27.

189. *Id.* at 29-30.

choose between granting management relatively unrestricted discretion to disarm the market for control and the alternative of liberating the fiduciary duty genie from her bottle, Judge Posner chose the latter. The tantalizing, indeed troubling, question is whether he can ever recapture her.

How might a jurist like Judge Posner employ economic analysis to decide cases like *CTS* were he not restrained by state law? That is, what rules would Judge Posner impose on corporate managers as the default provision of their contract with corporate shareholders? Judge Posner certainly would not choose unfettered managerial discretion. He might opt for some form of a *per se* rule such as the "no discrimination" rule advanced by Dynamics in *CTS II*.[190] Or he might opt for an approach which focuses on the structure of the offer, *e.g.*, defensive tactics would be permissible to thwart coercive bids only; or for an approach that focuses on the relation of the tactic to the "corporate contract."[191] The benefits of all such approaches are that they do not employ the language of fiduciary duty, and, therefore, their application need not affect the analysis of traditional fiduciary duty issues. Until the courts are prepared to adopt such analysis, however, the L&E jurist must either concede managers unfettered discretion or work within the rubric of fiduciary duty to fashion appropriate restraints. The dilemma is that those who support rigorous fiduciary analysis of all managerial decisions are likely to seize on such analysis to further their arguments.

We believe that Judge Posner's opinions in *CTS I* and *CTS II* imply an approach that would allow L&E jurists to restructure fiduciary analysis in a way which would permit courts to evaluate defensive tactics carefully without creating the polluting effect we find implicit in the opinions. Reconsider the rationale of both the majority and dissent in *Panter*. There both Judge Pell and Judge Cudahy employed the traditional bifurcation of fiduciary duties. Each accepted the proposition that in care cases the courts generally should be reluctant to intervene. In loyalty cases, on the other hand, each supported active intervention. Judges Pell and Cudahy disagreed only on the question of whether a challenge to a defensive measure should be presumptively designated an issue of care or

190. *See, e.g.*, Amalgamated Sugar Co. v. NL Indus. Inc., 644 F. Supp. 1229 (S.D.N.Y. 1986), *aff'd*, 825 F.2d 634 (2d Cir.), *cert. denied*, 484 U.S. 992 (1987); Asarco Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985); Bank of New York Co., Inc. v. Irving Bank Corp., 142 Misc. 2d 145, 536 N.Y.S.2d 923 (Sup. Ct. 1988). The SEC staff takes the position that the Commission's "All Holders" Rule invalidates "back-end" plans like that implemented in CTS' second pill. *See* Div. Corp. Fin., No-Action Letter, *Registration of Rights Issuable Pursuant to Stockholder Rights Plan*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 74,811 (Jan. 7, 1987).

191. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989).

loyalty. Pell treated the issue as one of due care; Cudahy, as one of loyalty.[192]

In its *Unocal-Moran-Revlon* trilogy, the Delaware Supreme Court essentially maintained the same classification. The court merely opted for an intermediate rule of review which, given recent decisions, ultimately may not turn out to be significantly different from the more traditional duty of care rule.[193] The Delaware court's focus continues to be one of distinguishing between those transactions motivated by the self-interest of corporate managers and those undertaken by managers in the (perhaps mistaken) best interests of their shareholders.

While Judge Posner's decisions in *CTS I* and *CTS II* ultimately employ similar analysis, they can also be read as support for abandoning the care-loyalty distinction. In particular Judge Posner's reinterpretation of the justification and application of the Business Judgment Rule in *CTS I* supports a subtle shift away from the traditional bifurcation of fiduciary duties.[194] There Judge Posner stated that the Business Judgment Rule reflects not only that "businessmen know more about business than judges,"[195] but also that "*competition in the product and labor markets and in the market for corporate control provides sufficient punishment for businessmen who commit more than their share of business mistakes.*"[196] That is, Judge Posner restated the rule in a fashion consistent with the economists' model of the corporation: Courts generally need not intervene to protect shareholders because market forces are sufficient to discipline incompetent and unfaithful managers.

Once unmoored from the judicial incapacity argument that has dominated legal opinions (including the Seventh Circuit's opinion in *Panter*), the Business Judgment Rule can be restated to support an expansion of the current regime in which courts generally refrain from evaluating managerial behavior to virtually all actions, including those now denominated loyalty cases to which the Business Judgment Rule would not normally apply. At the same time, the restated rule would have courts closely scrutinize the adoption of defensive measures *without regard to managerial motivation*.

192. *See* notes 82-97 and accompanying text.

193. See, *e.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990), discussed *supra* note 108.

194. 794 F.2d at 256. It is important to note that the bulk of Judge Posner's *CTS I* and *CTS II* opinions employ traditional duty-of-loyalty managerial entrenchment language. We believe that language reflects in large part the role Judge Posner played in these cases. That is, he sat as a federal judge speculating on how state courts would rule on matters of state corporate law. Consequently, he was compelled to fashion his opinions along the lines those courts would likely take.

195. *Id.*

196. *Id.*

Under such a revision of the Business Judgment Rule, the courts would divide cases into two categories—those that challenge actions which affect the market for control and those that do not. Courts would give short shrift to challenges to managerial decisions that do not threaten to displace the market for control, regardless of the presence of self-dealing. Shareholders, at least those of publicly traded corporations,[197] would be left to rely instead on the market, especially the market for control, to discipline undesirable behavior.[198] In contrast, courts would carefully review challenges to any managerial act that affects the market for control. The courts would not speculate about entrenchment motives nor assess the alleged independence of outside directors in a metaphysical attempt to categorize the decision as one to be tested under the rubric of care or loyalty. Rather, the courts would carefully review defensive actions to determine their actual impact on the market for control precisely and solely because such actions threaten to undercut the market discipline on which shareholders rely for protection.

The difference between the proffered analysis and the traditional care/loyalty approach can be illustrated by a hypothetical. Consider a case involving a dispute over whether a subcommittee of a board of directors has wrongfully attempted to terminate a derivative suit alleging that for personal reasons a number of the directors had hastily and carelessly approved a corporate expansion. Under traditional fiduciary norms, the crucial question is whether the board or subcommittee approving dismissal was sufficiently "disinterested" so as to make its decision an exercise of business judgment.[199] Defendants would predictably contend that it is. Plaintiffs, on the other hand, would argue that the apparent independence of the committee in taking such action is undercut by structural bias.[200]

197. For a discussion of the applicability of market discipline to nonpublicly traded corporations, see generally Honabach, *supra* note 44. *But see* Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1981).

198. Shareholders, of course, may impose additional restraints by private agreement (including amendments to the corporate charter). It is crucial to appreciate that by permitting shareholders to forego judicial regulation one does not deny them access to judicial review if they find such review desirable. To the extent that the current debate over mandatory governance rules equates opting out with denial of access, it misstates the crucial question. *See, e.g.*, Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989).

199. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("The function of the Business Judgment Rule is of paramount significance in the context of a derivative action."); Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988).

200. For a discussion of "structural bias" in the context of derivative action, see Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (Summer 1985). The potential for structural bias has led some courts to reject both the *Auerbach* and *Zapata* approaches. *See, e.g.*, Alford v. Shaw, 320 N.C.

Resolving such a dispute is difficult because just as in the case of defensive tactics, both plaintiffs and directors are often correct to some extent.[201] Derivative litigation can be harmful to shareholder interests.[202] Consequently, shareholders would prefer a rule that would enable them, or their representatives, the board, to forego pursuing even some claims in which liability is more or less certain.[203] That is, shareholders would prefer a rule that recognizes that as faithful agents acting in the best interests of the shareholders, directors may decide not to pursue some claims. On the other hand, shareholders do not want courts to grant directors unlimited discretion because they recognize that directors may be motivated by self-interest in deciding not to sue to some or all of their fellow directors and the officers who supported their election.[204]

Given that deciding which claims to pursue and which to forego is often a strategic business decision, many courts have taken an approach which empowers the board to dismiss derivative actions so long as the board entrusts the decision to disinterested decision makers.[205] The reviewing court focuses its attention on the independence of the decision maker. Presumably Judge Pell would approve of that result. On the other hand, Judge Cudahy might argue, as he did in *Panter,* that the conflict of interest is so pervasive that directors can not be unbiased in deciding whether to continue an action against some of them.

If the courts were to apply rules of decision implied by Judge Posner's dicta in *CTS I,* they would not investigate director motivation in handling derivative claims. Instead the courts would divide shareholder claims into two categories: those seeking to impose liability for taking or to enjoin implementation of defensive action, and those which would not. The courts would carefully evaluate the former; they would entrust the latter to the directors and, ultimately, the market. In reaching their decision the courts would be indifferent to the presence or absence of self-interest. In those cases not challenging impediments to the market for control, the courts would leave shareholders who were unhappy with the

465, 358 S.E.2d 323 (1987); Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709 (Iowa 1983). While the Delaware courts have rejected the structural bias argument absent a showing of specific facts, Aronson v. Lewis, 473 A.2d 805, 814-15 (Del. 1984), they have been willing to recognize the importance of such bias in specific cases. *See, e.g.*, Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985), *appeal denied*, 504 A.2d 571 (Del. 1986).

201. Posner, *supra* note 8, at 389-90.

202. Frivolous claims provide an obvious example.

203. Shareholders would prefer to litigate a claim only so long as the present value of the expected cost of doing so (including the cost of distinguishing among meritorious and frivolous claims and the cost of reputational effects) is less than the present value of the expected benefits of pursuing the claim.

204. Posner, *supra* note 8, at 389-90.

205. *See* authorities cited *supra* note 199.

behavior of their directors to their own devices. Disgruntled shareholders could either attempt to replace the directors or, more often, simply sell their shares.[206] If managers were egregiously inept, the market for control would discipline them. The important point is that unlike traditional fiduciary analysis, this "market for control"/"nonmarket for control" approach would not require the courts to adopt either the "hard look" procedure that loyalty analysis requires, nor the often seeming disingenuous search for "independence" that a care analysis often necessitates. In most cases the courts could simply defer to the market.[207]

It is beyond our purpose here to flesh out fully how the approach we derive from *CTS I* would operate.[208] What is important for this article, we believe, is to emphasize that so long as the courts refuse to adopt the passivity approach, they must either employ traditional fiduciary analysis (and risk polluting their analysis with overly intrusive doctrine) or devise an approach to analyzing defensive tactics that does not require them to determine the manager's motivation for undertaking the challenged behavior. We suggest that Judge Posner's opinions support a test under which courts would evaluate the effect of the tactic, not the motivation and good faith of corporate actors in undertaking it.[209] Were the courts

206. As noted above, *supra* note 59 and accompanying text, shareholder loss would be minimal even if management's decision were incorrect, particularly if shareholders hold a diversified portfolio of securities.

207. We are not the first to suggest alternative approaches which would permit courts to review defensive tactics without inquiring into the motivation of the decision makers. For example, Professor Ribstein proposes that courts abandon the fiduciary approach to regulating antitakeover actions in favor of a contract based analysis. If a court finds that the corporate contract does not permit the particular tactic, he would have it strike the defense without further inquiry into whether management breached its fiduciary duty in undertaking the tactic, or inquiry into whether the defense is in the best interest of the shareholders. On the other hand, if the court finds that the tactic in question is authorized by the corporate contract, Professor Ribstein would have the court subject the tactic only to the light scrutiny of the traditional Business Judgment Rule. *See* Ribstein, *supra* note 191, at 119.

Applying Professor Ribstein's approach is difficult. For example, he would have courts strike poison pill defenses because he believes the corporate contract does not authorize the board to adopt such plans. *Id.* at 125-27. It is unclear, however, how he supports that conclusion. He appears to rely on the proposition that any board-approved tactic which actually deters a takeover is ultra vires unless explicitly authorized by the corporate code or by an explicit shareholder vote. *Id.* at 99-101. Professor Ribstein treats those decisions in which the courts have found that the particular state code authorizes poison pills as either wrongly decided and/or decisions which actually stand for the proposition that a "board can threaten to use the pill but cannot actually use it." *Id.* at 126. While we applaud Professor Ribstein's efforts, we find unpersuasive his attempt to characterize particular tactics as clearly permitted by or clearly contrary to the corporate contract.

208. We note, however, that our approach would differ significantly from Professor Ribstein's in that it would require close scrutiny of all takeover defenses even though, as Professor Ribstein correctly notes, any attempt to make such distinctions among defensive tactics necessarily requires courts to tread on uncertain ground. *Id.* at 120-21.

209. The law of intentional torts provides a somewhat roughly analogous set of rules. There the issue is whether the defendant intended the unlawful touching, not whether his motivation was harmful or evil. Vosburg v. Putney, 80 Wis. 523, 50 N.W. 403 (1891). In the case of defensive

to adopt such an approach, they would not need to worry that their willingness to scrutinize defensive tactics carefully will spill over into their review of other "fiduciary" cases.[210]

We recognize that whether a reorientation of fiduciary analysis along a "control"/"noncontrol" axis would be desirable is a controversial question. The effects of such a restatement would be two-fold. First, it would effectively make fiduciary duties elective in that shareholders and managers would be subject to traditional fiduciary restraints only if they choose to "contract" for such duties. Second, such a restatement would reverse the existing default rule. Both changes would likely be objectionable. Many commentators believe that traditional fiduciary duties capture core values in the shareholder-manager relationship that are, or at least should be, nonvariable.[211] Others who would permit limited variation, nevertheless, would carve out fundamental pockets of nonvariable terms, and would require that variations of other fiduciary rules only be made subject to procedural and substantive restrictions.[212] Even some who would permit wavier of all fiduciary duties would question the propriety of permitting shareholders in existing corporations to modify corporate charters, at least absent unanimous explicit or implied consent.[213] Finally, several of the commentators who stridently reject notions of core values and mandatory terms may nevertheless find judicial (as opposed to shareholder) modification of existing relationships objectionable on both theoretical and constitutional grounds.[214]

tactics, management almost always intends to interfere with the market for control; the only issue would be whether it in fact has done so. Its motivation would be irrelevant. Similar questions of intent arise in antitrust litigation, particularly with respect to intent in predatory pricing cases. *See* Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 231 (1st Cir. 1983); 3 P. AREEDA & P. TURNER, ANTITRUST LAW sec. 710-11(d), at 148-54 (1981).

210. Ironically, Judge Posner has suggested elsewhere that corporate managers not be given unreviewable discretion to dismiss derivative suits so long as they can unilaterally institute antitakeover defenses. Posner, *supra* note 8, at 389-90.

211. Branson, *A Corporate Paleontologist*, *supra* note 58; Branson, *supra* note 44, at 391 ("In corporation law, fiduciary duty, or some part of it, is this irreducible minimum or care that even a supermajority cannot take away."). *See also* DeMott, *supra* note 34, at 891; Eisenberg, *supra* note 51, at 1471-81; Sargent, *supra* note 44, at 297-302.

212. *See e.g.*, Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1664-76 (1989).

213. *E.g.*, Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1831-32 (1989); Honabach, *supra* note 34, at 340-44.

214. *E.g.*, Butler & Ribstein, *State Anti-Takeover Statutes and The Contract Clause*, 57 U. CINN. L. REV. 611, 656 (1988) (arguing that state antitakeover statutes are unconstitutional because they impair shareholder rights without requiring shareholders to opt-in and without providing a sufficient time which would permit shareholders to force their directors to reincorporate elsewhere before the new rules become effective). *But see* Rotunda, *The Impairment of Contracts Clause and the Corporation: A Comment on Professors Butler's and Ribstein's Thesis*, 55 BROOKLYN L. REV. 809 (1989) (arguing that Professors Butler and Ribstein read the contracts clause too broadly).

Because we believe that few shareholders would freely opt for a regime of no fiduciary duty whatsoever, we reject the notion that the crucial issue is whether shareholders should be permitted to place themselves beyond all *ex post* settling up tribunals. Instead we perceive the crucial questions to be two-fold. First, to what extent should shareholders be permitted to determine the content of the behavioral rules which regulate their relationship?[215] Second, to what extent should shareholders be permitted to choose to have decision makers other than the courts determine whether participants have complied with those rules?[216] We tend to side with those who would permit shareholders *ex ante* to vary existing rules. At the same time, we are wary of post formation modifications, especially those imposed by the state. To the extent that the proposed reorientation of fiduciary duties defeats existing expectations, we would disfavor it.

Finally, we note that if Judge Posner's opinions portend a radical reclassification of fiduciary duty cases into those that affect the market for control and those that do not, interesting practical questions lay ahead. Consider, for example, the effect of a liability limiting charter provision adopted pursuant to Delaware General Corporation Law section 102(b)(7).[217] That section permits shareholders of a Delaware corporation to adopt a charter provision relieving directors of monetary liability for certain breaches of their fiduciary duty.[218] It is explicitly inapplicable, however, to directors' breaches of their duty of loyalty. It is unclear how a court employing our reformulation of fiduciary duty rules might apply that section to a case in which management wrongfully thwarted a tender offer that would have been highly profitable to shareholders, but that has now been foreclosed by a dramatic downturn in the

215. Existing statutes which permit shareholders to opt out of liability for breaches of one's duty of care, *e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1983 & Supp. 1988), present an obvious example of such shareholder freedom of choice. Less obvious examples, perhaps, are decisions in which the courts determine the content of one's fiduciary duty in a particular case by reference to shareholder expectations. *See, e.g.*, Burg v. Horn, 380 F.2d 897, 900-01 (2d Cir. 1967) (determination of existence of corporate opportunity dependent upon facts of situation indicating initial understanding of the parties).

216. Similar choices have been upheld elsewhere despite claims that plaintiffs were entitled to a judicial resolution of their claims. For example, in Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989), and Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), the Supreme Court essentially concluded that parties may agree *ex ante* that certain securities claims alleging fraudulent behavior, including some categories of shareholder-manager disputes, will be resolved by arbitration rather than litigation.

217. DEL. CODE ANN. tit. 8, § 102(b)(7) (1983 & Supp. 1988) (permitting shareholders in Delaware corporation to opt out of personal liability for corporate directors subject to a broad exclusion for actions violating the director's duty of loyalty).

218. For a critical review of Delaware's liability limiting provision, see Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L.J. 919 (1988).

market. Should a court prepared to impose liability on managers for interfering with the market for control find such a liability limiting provision applicable? The court could find no easy answer (unless it were willing to undertake a separate care/loyalty analysis for purposes of applying the statute) because its original decision to impose liability would not have turned on a finding that the defendant had breached her duty of loyalty to the corporation or its shareholders. The terminology of the statute and the revised rule of decision simply would not coincide.

We emphasize that we are merely speculating as to how Judge Posner might have gone about analyzing Dynamics' claims in the absence of controlling state precedent. We do not maintain that in either *CTS I* or *CTS II,* Judge Posner intended to reformulate fiduciary duties entirely along the "market for control"/"nonmarket for control" lines we discuss above. In fact, as the recounting of his opinions above suggests, his opinions—particularly his discussion of the alleged independence of Smith Barney—echo traditional loyalty analysis.[219] We suggest only that Judge Posner's opinions point the way for such a development and contend that such a restatement of fiduciary duties would actually be more consistent with the way that a policymaker and L&E scholar, like Judge Posner, might approach the issue than was Judge Posner's actual analysis in *CTS I* and *CTS II.*[220]

III. THE SEVENTH CIRCUIT AND STATE TAKEOVER STATUTES

In addition to the part the Seventh Circuit has played in the determination of the validity of self-help defensive tactics, the court has also played a pivotal role in the development of the law regarding the legitimacy of state legislation regulating takeovers. In those cases the court addressed the questions of whether state legislative efforts violated the commerce and supremacy clauses of the United States Constitution. As such, the opinions raised fundamental issues of federalism. By the mid-1960s, target companies were busy lobbying Congress for amendments to the Securities Exchange Act of 1934 that would limit hostile takeovers.[221] The Securities Exchange Commission ("SEC") and several

219. *See supra* notes 124, 125, 148, and accompanying text.

220. The discordant themes in Judge Posner's opinion might well reflect the politics of the bench (it is worth noting that Judge Cudahy who applied the more traditional loyalty approach in *Panter* joined in Posner's opinions) as well as the tenacity of paradigms upon our reasoning. We do believe, however, that Judge Posner's opinions contain the seeds for a revolutionary restatement of fiduciary duty issues.

221. A comprehensive legislative history of the Williams Act is presented in Johnson & Millon, *Misreading the Williams Act,* 87 MICH. L. REV. 1862, 1889-97 (1989). *See also* Booth, *The Problem with Federal Tender Offer Law,* 77 CALIF. L. REV. 707, 710-13 (1989).

commentators, in turn, argued that a vigorous market for corporate control was in the interest of shareholders and the economy as a whole and counselled Congress that any federal legislation should not unduly restrict takeovers.[222]

As enacted, Congress' amendments to the 1934 Act, the Williams Act, established minimum time periods for which tender offers must remain open.[223] The act also required certain mandatory disclosures and substantive deal terms.[224] While these regulations raised the cost of tender offers,[225] their effect on takeovers was comparatively modest. Indeed, a modest effect appears to have been all that Congress intended.[226] Having achieved its sole stated purpose of enhancing shareholder autonomy by giving shareholders information and time to rationally determine whether to accept the tender offer, Congress did not intend the act to effect any further change in the balance between raiders and target management.

Those groups favoring a more substantive regulation of hostile tender offers than that contained in the Williams Act then turned to the states. Their efforts were successful. Ultimately thirty-seven states passed first generation of post-Williams Act state takeover legislation.[227] Two subsequent waves of state statutes have followed.[228] Such legislation employs a wide variety of statutory solutions directed at hostile transactions.[229] The general effect of these statutes, regardless of exact pattern, has been to make hostile acquisitions more expensive and, therefore, to deter at least some would-be acquirors.[230]

222. Johnson & Millon, *supra* note 221, at 1893 n.126.

223. Offers must now remain open at least twenty business days. 17 C.F.R. § 240.14e-1(a) (1989).

224. For example, both offerors and targets are required to prepare and disseminate disclosure documents. *Id.* § 240.14d-3, 14e-2. Proration is required for the length of the offer. *Id.* § 240.14d-8. Offers are now also subject to an all-holders, best price requirement. *Id.* § 240.14d-10.

225. Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J. L. & ECON. 371 (1980).

226. Johnson & Millon, *supra* note 221, at 1893-97.

227. Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell*, 42 OHIO ST. L.J. 689, 690 n.7 (1981).

228. These waves of statutory activity have occurred largely in response to the Supreme Court's decisions in *MITE* and *CTS*. Sargent, *The Historical Evolution of State Takeover Regulation* in STATE TAKEOVER REGULATION TODAY (ALI-ABA Course of Study Materials 3, 5 (1988)).

229. State takeover statutes impose several types of regulation affecting offers. Some states impose disclosure requirements beyond those mandated by federal law. Other states regulate second-step transactions by requiring pre-first-step approval or an equal price between steps. Some provide for appraisal in connection with tender offers. Other states require shareholder approval of acquisition of voting power over a control block. For a description of the various state statutes see Booth, *supra* note 54, at 1635; Dennis, *supra* note 53.

230. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 487-88 (collecting studies). *See also* Romano, *supra* note 198; Note, *Second Generation State Takeover Statutes and Shareholder Wealth: An Empirical Study*, 97 YALE L.J. 1193 (1988).

Several controversial policy bases support state-based regulation of tender offers. As in the case of self-help measures like the poison pill, proregulation commentators argue that some takeovers are coercive and that at least certain types of state takeover statutes are appropriate because they create mechanisms for a coordinated shareholder response.[231] Supporters of the state legislation contend that given the increasing sophistication of bidders, the new legislation is necessary to preserve the legitimate role of management in responding to a proposed change in corporate control.[232] In addition, some supporters of state legislation have increasing argued that state legislation is justified because of what they perceive to be adverse effects of hostile takeovers on local economic interests, including the effect on labor and local service professionals.[233] Finally, some commentators have pointed to the competition among states for incorporations as yet another reason for the acts, contending that new legislation is necessary to prevent local corporations from reincorporating in another jurisdiction with a statute more to the liking of the relevant decision makers.[234] (Not surprisingly, several state statutes have been adopted in response to a particular proposed hostile takeover of a specific local firm.)[235]

The resulting dual federal-state legislative regulation of control transactions has sparked a spirited debate about the propriety of competing systems. In particular, while would-be targets applaud the new legislation, would-be acquirors vigorously maintain that the new state legislation harms shareholders by disarming the market for control. Consequently, opponents of the new legislation, seeking to invalidate the acts, have challenged the constitutionality of the state acts under the supremacy clause and the commerce clause.

Two of these challenges have reached the Supreme Court, *Edgar v. MITE*[236] and *CTS Corp. v. Dynamics Corp. of America*.[237] Both involved appeals from Seventh Circuit decisions. A third recent Seventh

231. *E.g.*, Booth, *supra* note 54.

232. Lipton, *Takeover Bids in the Target's Boardroom*, *supra* note 68 (managers should play the same role in hostile and consensual control transactions). *But see* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); M. EISENBERG, THE STRUCTURE OF THE CORPORATION 239 (1976).

233. *See* Proxmire, *What's Right and Wrong About Hostile Takeovers?*, 1988 WIS. L. REV. 353. *Cf.* Coffee, *supra* note 50; Romano, *supra* note 198.

234. This motivation may partially explain Delaware's adoption of a second-step statute and is in part supported by the interest group theory of statutory interpretation. *See* Macey & Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

235. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365.

236. 457 U.S. 624 (1982), *aff'g* MITE Corp. v. Dixon, 633 F.2d 486 (7th Cir. 1980).

237. 481 U.S. 69 (1987), *rev'g* 794 F.2d 250 (7th Cir. 1986).

Circuit opinion decided after *CTS*, *Amanda Acquisition Corp. v. Universal Foods Corp.*,[238] also considers the issue. The three Seventh Circuit opinions present striking examples of the effect of L&E scholarship on the style of argument in judicial decisions in corporate and securities law and on the art of judging in areas where members of the court have in other contexts staked out strong positions on the same issues.

In *MITE*, the Seventh Circuit addressed the constitutionality of the first generation state statute adopted by Illinois.[239] The Illinois statute was typical of the early expansive state statutes as it had a broad jurisdictional reach. The statute applied to target corporations that met two of the three following criteria: incorporation in Illinois, principal executive office in Illinois, or situs of at least 10% of a corporation's state capital and paid-in surplus in Illinois.[240] The act also covered any corporation in which at least 10% of the outstanding shares were held by Illinois residents.[241] The Illinois act required an offer to be on file with the state for 20 days before it could commence.[242] Moreover, it empowered the Illinois secretary of state to hold hearings on whether the offer was substantively fair.[243] In effect, the statute placed the power to require such a hearing was placed in the hands of management. Moreover, it imposed no time period within which such a hearing had to be concluded.

MITE, as the earliest of the three Seventh Circuit opinions, is the most conventional in its approach to the constitutional issues. In his unanimous opinion, Judge Cudahy invalidated the Illinois statute on both supremacy and commerce clause grounds. As was true in *Panter*,[244] the court was not influenced greatly by an external review of the business environment and economics of takeovers, as the parameters of the debate concerning takeovers had not yet been influenced by vigorous input from L&E scholars.[245] Instead, the court relied on orthodox legal materials, including Supreme Court and other judicial opinions, legislative texts and histories, and conventional non-L&E legal scholarship.

238. 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S.Ct. 367 (1989).

239. ILL. REV. STAT. ch. 121 ¶ 1/2 137.51-.70 (1979) (repealed 1983).

240. *Id.* ¶ 137.52-10.

241. *Id.*

242. *Id.* ¶ 137.54.E.

243. *Id.*

244. 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). For a discussion of *Panter*, see notes 69-99 and accompanying text.

245. At the time, the legal academic literature on the market for corporate control was sparse. The few articles such as Fischel, *Efficient Capital Market Theory, The Market for Corporate Control and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); and Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965), that viewed takeovers from the law and economics perspective were not yet part of courts' discourse on the subject.

In determining that the Williams Act preempted the Illinois statute, Judge Cudahy concluded that Congress was affirmatively committed to maintaining a regulatory evenhandedness between target management and raiders.[246] The linchpin of Judge Cudahy's preemption analysis, also significantly linked to his commerce clause analysis,[247] was his conclusion that there is a necessary link between the goals of investor autonomy and protection and regulatory balance. In reaching this conclusion, Judge Cudahy implicitly adopted a method of legislative interpretation that reflects the "liberal purposive" technique.[248] That is, he employed a mode of statutory analysis which holds that in interpreting legislation a court should not limit itself to the statutory text. Rather, Judge Cudahy reasoned, a court should be informed by an expansive review of the legislative context in which the act was passed as well as the structure, purpose, and history of the statutory scheme. Such a broad based review, he believed, is necessary if the court is to discover the complete intent of Congress.

A basic assumption of the "liberal purposive" approach to statutory interpretation is that when the legislature acts, it does so with a reasonable purpose. As a result, statutes are (or at least, are intended to be) structurally consistent and coherent. Therefore, in going about its interpretive task, the court should use the statutory text only as a jumping off point. A common result of employing an expansive notion of congressional purpose to supplement the actual text is that it frequently suggests a conflict between federal and state law. As Judge Cudahy's opinion in *MITE* illustrates, the effect of using the "liberal purposive" approach often is to expand the reach of federal law at the expense of individual state solutions.[249]

Judge Cudahy's application of the purposive approach to interpreting the Williams Act led him to conclude that the Williams Act's neutrality was not a mere byproduct of the regulatory approach adopted by Congress. He based his holding on an expansive enquiry into the legisla-

246. 633 F.2d at 495-96.

247. When Congress has acted, the analyses under the dormant commerce clause and the supremacy clause raise essentially the same issues—does the state legislation overly intrude on matters in which Congress has expressed a national policy? *See* Maltz, *How Much Regulation Is Too Much—An Examination of Commerce Clause Jurisprudence*, 50 GEO. WASH. L. REV. 47 (1981).

248. For a description of the broad purposive style of interpretation, see Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 424-36 (1989). Styles of legislative interpretation play an important role in determining constitutional questions regarding state takeover statutes. Whether under the supremacy clause the Williams Act preempts state law is largely one of statutory construction. Thus, shifting styles of statutory interpretation have caused much of the doctrinal movement from broad to narrow preemption.

249. As an interpretive style this approach conflicts with notions that federalism values should protect state regulatory authority. *Id.* at 469.

tive history of the Williams Act.[250] Judge Cudahy reasoned that "maintenance of an equitable balance between the contending sides is perceived as a principal means of investor protection . . . . Congress was necessarily committed to maintaining, where appropriate, the basic capability of offerors to make successful tender offers . . . . "[251] As had other lower federal court judges,[252] Judge Cudahy concluded that Congress had determined that substantial delay would unduly hinder the tender offer process. He noted that delay might have two adverse impacts: first, offers actually made would be defeated, and second, potential offers would be deterred. Taking the congressional judgment on the effect of delay as a given, Judge Cudahy held that the Illinois Act was preempted by the Williams Act because its pre-offer notification, lengthy hearings, and substantive regulatory review created the risk of substantial delay.

Judge Cudahy also undertook a traditional dormant commerce clause analysis of the legitimacy of the Illinois statute using the approach taken by the Supreme Court in *Pike v. Bruce Church, Inc.*[253] He purported to weigh the local regulatory benefits of the Illinois legislation against the burdens it imposed on interstate commerce. Judge Cudahy identified two local interests—protection of local investors and regulation of the internal affairs of a locally incorporated entity.[254] He discounted the possibility that investor protection was the goal of the Illinois act. Judge Cudahy reasoned that given the Williams Act regulation, the Illinois Act could only have a very marginal beneficial effect on the amount of disclosure and the time investors had to determine whether to tender.[255] Moreover, as he had found in his preemption analysis, Judge Cudahy thought the additional disclosures and delay might actually harm rather than protect investors.[256]

Judge Cudahy similarly rejected the internal affairs justification.[257] For the purposes of argument, Judge Cudahy assumed that states could invoke the internal affairs doctrine to justify their attempts to regulate

250. We note that this view of the legislative history, particularly when viewed through the lens of subsequent business and legal developments, is troublesome. *See infra* notes 316-20 and accompanying text.

251. 633 F.2d at 496.

252. *E.g.*, Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1275-79 (5th Cir. 1978), *rev'd on venue grounds sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979).

253. 397 U.S. 137 (1970).

254. 633 F.2d at 500-01.

255. *Id.* at 500.

256. *Id.*

257. *Id.* at 501-02. In his Supreme Court opinion, Justice White picked up this theme. Edgar v. MITE Corp., 457 U.S. 624, 637-39 (1982) (citing Great W. United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978), *rev'd on venue grounds sub nom.* Leroy v. Great W. United Corp., 443 U.S. 173 (1979)).

shifts in control that might occur as a result of successful tender offers for locally incorporated entities.[258] In the specific case, however, he concluded that Illinois' interest in regulating shifts in control was not significant.[259] Judge Cudahy noted that the broad jurisdictional basis of the statute allowed Illinois to regulate many business entities that were not organized under the law of Illinois and, indeed, that might not even have their principal place of business in Illinois.[260] At a minimum, Judge Cudahy believed, the internal affairs doctrine could not justify a state's attempt to regulate corporations that did not have at least such connections to the state. Judge Cudahy argued that under its Act, Illinois could regulate transactions executed entirely outside Illinois involving only non-Illinois entities. He added that the adverse impact of such extraterritorial effect was exacerbated by the potential for a number of states to assert regulatory authority over a single tender offer. Judge Cudahy believed that confronted by a plethora of possibly conflicting regulations, an offeror might well choose to forgo making the offer entirely.[261] As a result, Judge Cudahy demanded proof of a distinctive corporate law based regulatory interest, such as prevention of looting, relating to the specific tender offer. Because no such evidence had been presented, Judge Cudahy found that the burdens on interstate commerce were substantial, and clearly outweighed any tenuous local regulatory interest.

The result the Seventh Circuit achieved in *MITE* was conventional in the best sense. Judge Cudahy's opinion is carefully crafted. It considers all the relevant arguments that were then part of the legal discourse concerning state takeover statutes. Judge Cudahy adopted an approach which assumed that the courts could infer from the structure of the federal securities laws Congress' willingness to displace a significant amount of state corporate law. Given that he and his fellow jurists had accepted an expansive notion of federal purpose in enacting the securities laws (including the Williams Act), the outcome is unexceptionable.

The most significant criticism of Judge Cudahy's opinion then can only be with the broad purposive mode of statutory construction he employed, a criticism which gains much of its force from changing notions of statutory interpretation that were not wholly apparent in 1980.[262]

258. 633 F.2d at 501. For a general discussion of the internal affairs doctrine, see Beveridge, *The Internal Affairs Doctrine: The Proper Law of a Corporation*, 44 BUS. LAW. 693 (1989).

259. 633 F.2d at 501.

260. *Id.* at 502.

261. *Id.*

262. The burst of interest in statutory interpretation is part of a larger effort of rethinking modes of interpretation of legal texts. *See generally* Eskridge, *Public Values in Statutory Interpretation*, 137 U. PA. L. REV. 1007 (1989); Sunstein, *supra* note 248.

From the perspective of those who believe that statutes like the Williams Act contain a logical, coherent, rational public policy basis, employing purposive modes of interpretation to protect that internal logic is desirable. In the context of the hostile takeover debate, the logic of federal regulatory evenhandedness can be protected only if promanagement state law is invalidated. The purposive approach, however, insufficiently accounts for changing circumstances, most particularly the dramatic growth in the market for corporate control, that were not anticipated by the 1968 enacting Congress. The decade of dramatic change in the business and legal environment of takeovers leaves Judge Cudahy's basic background assumptions debatable. Also, at least as employed to evaluate state takeover statutes, the broad purposive approach might be criticized as being insufficiently sensitive to federalism values and overly deferential to unenacted subjective intent. When a court employs the liberal purposive approach to invalidate a state statute that regulates subjects traditionally relegated to state law, it significantly shifts the balance between federal and state regulation. One might argue that a court should reach such a result only in light of explicit statutory language and not solely on its own assumptions concerning implicit purpose.

The "liberal purposive" method adopted by Judge Cudahy conflicts sharply with the "interest group" approach employed by L&E scholars. The latter approach views legislation as the product of compromise among competing interest groups. L&E scholars do not believe that such competition naturally leads to rational, coherent decisions or invariably to legislation which is wealth enhancing from a societal viewpoint.[263] Consequently, they do not share Judge Cudahy's belief that it is appropriate for a court to attempt to use the text merely as a starting point in filling out the entire "statutory" scheme. L&E scholars instead maintain that the appropriate role for a court is to enforce the bargain reflected in the text of the act lest they unwillingly give an affected party an advantage it had conceded at the negotiating table. In contrast to Judge Cudahy's approach, L&E scholars believe that competition among the states provides optimal lawmaking and ameliorates the rent-seeking effects sought from lawmakers.[264]

263. This view of legislation derives from public choice theory and is supported by the academic writing of both Judges Posner and Easterbrook. Posner, *Statutory Interpretation—in the Classroom and in the Courtroom*, 50 U. CHI. L. REV. 800 (1983); Posner, *supra* note 8, at 496-99; Easterbrook, *Statutes' Domain*, 50 U. CHI. L. REV. 533 (1983); Easterbrook, *The Supreme Court, 1983 Term—The Court and the Economic System*, 98 HARV. L. REV. 4 (1984).

264. The L&E approach is well summarized by Judge Easterbrook in Easterbrook, *Antitrust and the Economics of Federalism*, 26 J. L. & ECON. 23 (1983).

The Supreme Court affirmed *MITE*.[265] For the most part its opinion tracks that of the Seventh Circuit. A majority of the Court invalidated the Illinois statute on a commerce clause basis. A plurality also concluded that the statute was preempted by the Williams Act. The plurality's supremacy clause/preemption holding adopted the approach used by the Seventh Circuit. Like Judge Cudahy, Justice White read the Williams Act legislative history as requiring neutrality between target and raider in both federal and state law. Justice White also adopted Judge Cudahy's appraisal of how the Illinois statute violated the neutrality principle.[266]

The Supreme Court's commerce clause doctrinal analysis followed the dormant commerce clause analysis of *Pike v. Bruce Church, Inc.*, the doctrine that the Seventh Circuit itself had also explicitly embraced.[267] Adopting Judge Cudahy's evaluation of Illinois' regulatory interest, the Court concluded that little benefit was created by the state regulatory scheme.[268] It believed that investor protection was not appreciably enhanced by the Illinois statute,[269] and that the internal affairs doctrine did not provide a basis for a legitimate Illinois regulatory interest.[270] On the other hand, the Court thought that the federal interest in maintaining an active market for corporate control was significant. Justice White conceived of the tender offer process as an uniquely important mechanism for efficient resource reallocation and a major tool of corporate governance.[271]

The only significant difference between Judge Cudahy's opinion and that of the Supreme Court was Justice White's reliance on L&E scholarship to support the assertion of a federal interest in maintaining an active market for corporate control. That L&E analysis had become central to the debate itself is a reflection of the remarkable intellectual revolution that had occurred in the time period between the two opinions. In 1981, Frank Easterbrook (then a professor) and Daniel Fischel had published *The Proper Role of a Target's Management in Responding to a Tender*

265. Edgar v. MITE Corp., 457 U.S. 624 (1982).

266. *Id.* at 630-36.

267. *Id.* at 640-46.

268. *Id.* at 644.

269. *Id.* Self-tender offers raise many of the same issues of claimed coercion. Thus the exclusion for self-tenders reduced the legitimacy of the assertion of an investor protection motive.

270. *Id.* at 645. It is important to note that Justice White conceived of tender offers as not implicating any corporate act. He viewed the shift in control as only an incidental effect of what are in essence third party transactions to which the corporation was a stranger. Obviously, state legislatures have reached an opposite policy conclusion. Restrictions on share transferability have been a traditional subject of state law. *See, e.g.*, Rafe v. Hindin, 29 A.D.2d 481, 288 N.Y.S.2d 662, *aff'd*, 23 N.Y.2d 759, 244 N.E.2d 469, 296 N.Y.S.2d 955 (1968); DEL CODE ANN. tit. 8, § 202 (Michie 1990).

271. *Id.* at 643.

Offer.[272] Using modern financial theory and an agency cost view of corporate rulemaking, Easterbrook and Fischel had argued that the market for corporate control is a unique tool in encouraging managerial efficiency and disciplining inefficiency. The Easterbrook and Fischel approach is significant because it is a central focus of Justice White's opinion in *MITE*.[273] Their article was the only significant source Justice White employed that was not used by the Seventh Circuit in its opinion.

MITE left a number of questions unanswered; questions which became crucial as state after state passed new takeover legislation intended to circumvent the constitutional difficulties Illinois had encountered. Would use of a more limited jurisdictional basis for the attempt at state regulation affect the viability of state rulemaking? Would state legislative efforts directed at the corporate law aspects of tender offers give more force to the internal affairs argument supporting state regulation? Could the states successfully regulate other aspects of the market for corporate control that might affect the economic viability of a control transaction commenced by tender offer?

The Seventh Circuit faced some of these questions in *Dynamics Corp. of America v. CTS Corp. (CTS I)*.[274] *CTS* involved a constitutional challenge to the Indiana control-share[275] acquisition statute as well as the challenge to the self-help tactics discussed above.[276] The statute required acquirors of control blocks[277] to seek shareholder approval to restore voting rights to the acquired shares[278] at a meeting which would generally be held fifty days after the commencement of offer.[279] If shareholder approval was not obtained, the block of stock acquired became nonvoting.[280] While the statute did not prevent an offeror from purchasing shares pursuant to an interstate tender offer, it effectively eliminated the

272. 94 HARV. L. REV. 1161 (1981).

273. 457 U.S. at 643-44.

274. 794 F.2d 250 (7th Cir. 1986), *rev'd in part*, 481 U.S. 69 (1987).

275. IND. CODE ANN. § 23-1-42-1 to 11 (Burns 1989). The statute was an opt-in provision for its first 17 months of effectiveness, then it became mandatory unless the corporation opted out by a provision in its articles of incorporation by-laws. *Id.* § 23-1-42-215.

276. The case and related litigation also involved an evaluation under state corporate law of the use by target management of the poison pill defensive tactic. In that portion of the opinion Judge Posner heavily relied on law and economics scholarship to structure his decision. That aspect of *CTS* is discussed above. See *supra* notes 174-220 and accompanying text.

277. The act had three triggers—20%; 33%; and 50%. IND. CODE ANN. § 23-1-42-1 (Burns 1989).

278. *Id.* § 23-1-42-9. For voting purposes interested shares are excluded. *Id.* § 23-1-42-3.

279. *Id.* § 23-1-42-7. The expenses of the meeting are to be borne by the offeror. *Id.* In addition to the federal and state tender offer rules, the transaction would now also be subject to proxy solicitation rules.

280. *Id.* § 23-1-42-9.

acquiror's interest because obtaining control or the possibility of control through voting is an essential feature of the offer.

Unlike the Illinois statute challenged in *MITE*, the Indiana statute applied only to Indiana corporations that had their principal place of business in Indiana as well as a significant number or percentage of shareholders in Indiana.[281] Judge Posner, nevertheless, invalidated the Indiana statute on both commerce clause and supremacy clause grounds. These outcomes, in and of themselves, were not remarkable as they were consistent with other courts' invalidations of control share acquisition statutes[282] and fit well with the Seventh Circuit's prior approach in *MITE*. Rather, just as in the case of Judge Posner's affirmance of the district court's enjoining of CTS' poison pill,[283] the intriguing aspect of Judge Posner's opinion lies in his attempt to reconcile the conflicting policies of L&E analysis.

By the time he authored his *CTS* opinions, Judge Posner had written numerous scholarly articles on subjects relevant to the *CTS* litigation. As noted above, he had embraced the contract model of corporate law with the attendant view that tender offers play a crucial role in corporate governance.[284] In addition, Judge Posner had played a key role in developing use of modern financial theory as a basis for legal rule formation.[285] More important from the standpoint of Dynamics' challenge to the constitutionality of the Indiana statute, Judge Posner had been equally prolific on questions of legislative interpretation. He has rejected the liberal purposive approach Judge Cudahy used in *MITE*. Instead, Judge Posner subscribes to the interest group/public choice theory of legislation.[286] That is, he views legislation as the product of competition among interest groups seeking to purchase "products" from the legislature. Consequently, he believes statutes often reflect irrational, incoherent compromises, at least when viewed from a societal perspective. Judge Posner maintains that the proper role of a court in statutory interpretation should be to enforce the deal reached between the relevant interest groups and the legislature. Judge Posner would have a court

281. *Id.* § 23-1-42-4 (defining an "issuing public corporation").

282. *E.g.*, Fleet Aerospace Corp. v. Holderman, 796 F.2d 135 (6th Cir. 1986), *vacated and remanded sub nom.* Ohio v. Fleet Aerospace Corp., 481 U.S. 1003 (1987); Icahn v. Blunt, 612 F. Supp. 1400 (W.D. Mo. 1985).

283. Dynamics Corp. of America v. CTS Corp., 637 F. Supp. 406 (N.D. Ill. 1986).

284. Posner, *supra* note 8.

285. Langbein & Posner, *Market Funds and Trust Investment Law* (pts. I & II), 1976 AM. B. FOUND. RES. J. 1; 1977 AM. B. FOUND. RES. J. 1.

286. Posner, *Statutory Interpretation—In the Classroom and in the Courtroom*, *supra* note 262.

imaginatively reconstruct how the enacting legislators would have wanted the statute applied considering the deal that was struck.

Under Judge Posner's approach, statutory text takes on a preeminent importance. The actual text of a statute, the legislature's stopping point, is the best indication of the bargain reached among the contending parties. That approach differs dramatically from Judge Cudahy's treatment of the text. For example, while judges employing the liberal purposive mode of interpretation have been receptive to claims that they should imply private remedies for various violations of the securities act, scholars like Judge Posner tend to reject such claims. They view the omission of such a private right of action as a reflection of a compromise between those favoring enhanced federal regulation and those who wish no statute to be passed.

Additionally, Judge Posner's interpretative approach reflects his strong economic-based view of the value of federalism. Judge Posner favors dispersion of political decisionmaking among multiple centers rather than a single national decision for several reasons. First he believes competition among the states tends to reduce the impact of inefficient governmental actions. Moreover, he believes that multiple decision centers allow for experimentation as well as protecting against some diseconomics of scale in governmental management. On the other hand, Judge Posner recognizes that an interest group may find it easier to secure passage of a statute which effects an inefficient income transfer at the state level than to secure similar federal legislation,[287] particularly as the federal system provides an opportunity for a single state to create exploitive externalities in that the benefits of regulation may be located within the single state while its costs are spread throughout the national economy.

While Judge Posner did not rely explicitly on any of his own academic views in fashioning his constitutional analysis,[288] he was faced in writing his opinion with the difficult task of reconciling the various strains of his scholarship. Judge Posner's corporate scholarship suggests he would support an activist approach which would invalidate the Indiana statute; his legislative and federalism scholarship, in contrast, implies he would favor a restrained response. Not surprisingly, he explained his conclusion in an opinion that is revealingly hesitant in its analysis if not in its result.

287. Posner, *supra* note 8, at 600.

288. There are no cites in the opinion to Judge Posner's own work and few cites to other law and economics literature. In addition there is no discussion of legislative interpretation theory.

Despite his views as to the benefits of takeovers, Judge Posner began with a more restricted view of the reach of the Williams Act than did Judge Cudahy in *MITE*.[289] Judge Posner did not accept Judge Cudahy's assumption that the Williams Act was intended to impose a regulatory balance between raider and target management at the state level.[290] Instead, Judge Posner turned to L&E literature to show that the Williams Act itself, even as modified by the legislative process, had an antitakeover purpose and effect.[291] As an empirical matter, he noted, the Williams Act has raised the cost of offers and in this regard is pro-target management rather than neutral.[292] Judge Posner stated that given a federal statute with an antitakeover purpose and effect, courts ordinarily ought not find that the supremacy clause forbids states from imposing additional restrictions. Moreover, Judge Posner viewed the legislative history of the act as expressing little, if any, judgment concerning state power.[293] In short, it seems clear that had he been writing on a clean slate, Judge Posner might well have found that nothing in the Williams Act preempted Indiana law.

Judge Posner could easily have employed his view of legislation as resembling a market in equilibrium to support his conclusion that Congress had not intended the Williams Act to have a broad preemptive impact. He might have pointed out that corporate managers had fiercely lobbied Congress to adopt a stringent antitakeover statute while the securities community had clamored for a relatively unfettered market for corporate control. He might have noted that for the most part, the SEC, siding with its core constituency, the securities professionals, had only favored an approach which increased the sphere of its traditional regulation of corporate disclosure. Given that the ensuing legislation was generally tentative, Judge Posner easily might have argued that Congress had chosen to address only the disclosure issues, and had left to other decisionmakers the broader policy decisions relating to the relative roles of raiders, target managers, shareholders, and other constituencies.[294] He might have credibly maintained that Congress had adopted a federal-

289. This language was cited by the Supreme Court in its reversal of the Seventh Circuit opinion. 481 U.S. 69, 77 (1987).

290. CTS did not ask the court to reevaluate its *MITE* preemption analysis. 794 F.2d at 260-61.

291. Judge Posner cites Jarrell & Bradley, *supra* note 225 for this proposition. *See also* Fischel, *supra* note 244.

292. The statute does allow time for auctions to occur, and from that perspective may benefit target shareholders.

293. 794 F.2d at 262.

294. This argument would have been consistent with the general reluctance to federalize state corporate law through expansive readings of the 1933 and 1934 Acts. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

ism perspective, believing that competition at the state level—at least absent an externality effect—is the appropriate method for resolving such issues because over time such competition would create a presumption of legitimacy. But Judge Posner would likely have been uncomfortable with that conclusion for such an interpretation would have empowered the states to go far in disabling the market for corporate control, a centerpiece of Judge Posner's corporate governance system.

Judge Posner neatly avoided that conflict. He suggested that his own doubts about the preemptive, neutrality-based thrust of the Williams Act were "stilled by the weight of precedent."[295] (In so stating he also may have been influenced heavily by circuit politics, given the strong prior commitment of the Seventh Circuit to state-based neutrality—especially as Judge Cudahy was a member of the *CTS* panel.)[296] Having accepted state-based neutrality as a Williams Act norm, Judge Posner's decision to invalidate the Indiana statute became "straightforward."[297] He reasoned that "[v]ery few tender offers could run the gauntlet that Indiana has set up."[298] Thus, Judge Posner concluded, the Indiana statute violated the neutrality principal, and hence was invalid under the supremacy clause.

In the commerce clause section of his opinion, Judge Posner started from an apparently equally bashful position concerning the reach of federal law. In the face of enactment of specific federal legislation, Judge Posner questioned whether a *Pike* dormant commerce clause review was appropriate.[299] In his view, because Congress had actually legislated in the area, a reviewing court's approach considering a commerce clause challenge should be somewhat similar to its supremacy clause analysis. That is, Judge Posner thought that a court should hold that so long as a state does not discriminate against interstate commerce, the state may legislative aggressively in ways that affect interstate commerce, subject only to federal preemption. Despite this framework, Judge Posner proceeded from the premise that, at a minimum, the Williams Act was not intended to "insulate such [state antitakeover] statutes from complaints that they unduly burden interstate commerce."[300] Once having made

295. 794 F.2d at 262.

296. An ultimately forceful reading of *MITE* is not startling in light of Judge Cudahy's participation on both panels. Moreover, if the court had adopted a radically different reading, Circuit Rule 40(f) might have required the opinion to be circulated among the judges of the circuit for consideration of an en banc hearing.

297. 794 F.2d at 262.

298. *Id.* at 263.

299. *Id.*

300. *Id.*

this leap, Judge Posner proceeded along the lines adopted by Judge Cudahy and the Supreme Court majority opinion in *MITE*. Judge Posner believed that the Indiana Act created substantial burdens on interstate commerce, particularly with respect to its potential to delay offers and to prevent nonresident shareholders from tendering to nonresident offerors.[301] The delay and the potential that the shares acquired will be deemed nonvoting obviously made offers more expensive and risky.

On the other hand, Judge Posner thought the benefits allegedly devolving on Indiana residents to be slight. The only potential benefit Judge Posner recognized—and then only in an off-handed reference—was Indiana's claim that the statute prevents shareholders from being "stampeded."[302] That Judge Posner did not meaningfully discuss the claim that statutes such as the Indiana statute benefit shareholders by giving target management a significant negotiating role[303] is odd as he is well aware that the debate concerning the benefits and burdens of defensive tactics centers on the validity of the negotiating model and the collective action problem.[304] Judge Posner dismissed Indiana's asserted "benefit" as illegitimate, declaring that Indiana had no interest in protecting nonresident target shareholders from offers by nonresident raiders. Judge Posner implied that the major purpose of the statute was to protect local managerial and employee interests at the expense of the target's shareholders.[305]

Judge Posner might well have characterized the Indiana legislation as an exit barrier intended to reduce the likelihood that a takeover would cause assets and employment opportunities to leave the state. To the extent the statute succeeded in preventing a successful takeover, its benefits would inure to Indiana and her citizens while the costs—in the form of continued inefficient management—would be borne by shareholders, most of whom lived elsewhere. Had Judge Posner so crafted his commerce clause analysis, it would have fit well with the anti-externality L&E view of federalism, particularly when the commerce clause issue is viewed in quasi-preemption terms.[306]

301. *Id.*

302. *Id.* This colorful description is another way of articulating the coercion problem.

303. *See supra* note 53.

304. *See supra* notes 48-57 and accompanying text.

305. Judge Posner's implication is consistent with Indiana's adoption of an "other constituencies" takeover statute and the specifics of the adoption of the Indiana control share acquisition statute. The control share statute was adopted in response to a specific threat to Arvin Industries, an Indiana corporation. Butler, *supra* note 235, at 374 n.29.

306. This conclusion is buttressed by Judge Posner's citation of Saul Levmore's *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563 (1983). Levmore distinguishes between state actions which are "exploitations" and state actions which are "interferences." Exploitations are

Curiously Judge Posner did not discuss arguments concerning the benefits from competition among the states for corporate charters even though a narrow commerce clause analysis would have allowed the market for charters to function more smoothly. His failure to do so may reflect the unique characteristics of the market for corporate control. The benefits derived from competition among states for corporate charters in large part depend on the market for control. To the extent that legislation like the Indiana control share statute insulates managers from the market for control, they need be less sensitive to shareholder interests when choosing the state of incorporation. Given the diminished likelihood of a hostile takeover, they need not seek out "superior" corporate rules. Hence, statutes like Indiana's actually reduce the values of federalism. In Judge Posner's model of corporate governance, such antitakeover statutes redistribute shareholder wealth by increasing the cost of displacing managers.

Another curious aspect of Judge Posner's opinion is his discussion of the relationship of the internal affairs doctrine to Indiana's attempt to limit the right-to-vote shares. Traditionally, courts have deemed governance matters relating to the right to vote to be subjects of general state corporate law as they do many other opt-out and opt-in aspects of corporate rulemaking, *e.g.*, cumulative voting[307] and staggered boards.[308] Such rules, of course, can be manipulated to have an antitakeover effect, and therefore might run afoul of the Williams Act if plaintiffs were required only to show a possibility of such abuse. If the courts were to interpret the Williams Act so broadly, it would displace a significant chunk of state corporate law. Judge Posner artfully skirted that potentially explosive issue, maintaining that the Indiana statute had a "direct, intended, and substantial" rather than "incidental effect" on the interstate market for corporate control, and therefore was invalid.[309]

In the constitutionality part of the opinion, Judge Posner did reach a

output reducing exercises of state market power which harm other states. Interferences are state actions which place the burdens of regulation outside the state while the benefits of the actions remain within the regulating state. Levmore suggests courts should disallow exploitations but should overturn interferences "only when the economic costs they create clearly exceed their benefits." *Id.* at 573. Interferences should be particularly suspect where congressional policies are implicated.

307. By giving a minority representation on the board, cumulative voting has the potential to modestly fragment a new controlling shareholder's power within the corporation.

308. A staggered board makes immediate transfer of control more difficult.

309. Although the statute regulated acquisition of control blocks by any means, Judge Posner characterized the statute as aimed at tender offers. This portion of the opinion harkens to the discredited direct-indirect dichotomy in commerce clause litigation. *See* Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp. v. Dynamics Corp. of America*, 101 HARV. L. REV. 96 (1987).

result consistent with his decision that CTS' self-help measures were invalid. His analysis of the constitutional claims assures that state legislatures are not empowered to interfere substantially with the market for corporate control. Recall that in the state law aspect of *CTS I*, Judge Posner had similarly held that CTS' poison pills placed too much power in the hands of management. He thought the creation of the pills was a premature response to a speculative coercion claim with respect to second-step transactions. The Indiana statute operates in a manner similar to a statutory poison pill.[310] Judge Posner was skeptical of the negotiating and coercion-prevention benefits that are said to arise from private solutions similar to control share statutes.[311] Private ordering[312] and the dynamics of the market for corporate control[313] make finding actual cases of coercion as unlikely as success in snipe hunting. As the gains from offers are clearly measurable (and were readily apparent in *CTS I*),[314] Judge Posner struck the balance in favor of invalidating a statute which created "trivial or even negative benefits."[315]

Judge Posner's consistency in result between the self-help and constitutional sections of *CTS I* comes at the apparent expense of his usual support of the values of federalism. Judge Posner's odd hiding of the real issues in the opinion is not totally unexpected, however, given the importance that L&E scholars attach to the market for corporate control. To be sure, Judge Posner might have more explicitly stated that state takeover statutes are inherently suspect because by their very nature they primarily have an external effect on interstate commerce. He might have pointed out that the state takeover statutes run afoul of federalism principle's because they are intended to reduce competition among the states for corporate chartering. But Judge Posner likely would have found writing such an opinion difficult. Given the institutional constraints of an intermediate appellate court, Judge Posner might have relied on a more conventional focus (including reliance on *MITE*) to reach a consensus among members of the court.

In a decision that surprised many commentators, the Supreme Court reversed Judge Posner, validating the Indiana statute against both

310. Booth, *supra* note 54, at 1663 n.86.

311. *See supra* notes 189-90 and accompanying text.

312. In addition to pills, intracorporate agreements such as fair price amendments, supermajority amendments and the like dilute the need for statutory solutions.

313. Competing third party offers and LBOs substantially reduce the likelihood that low priced bids will succeed.

314. Judge Posner cites stock market price movement studies to show the real gains to target shareholders arising out of takeovers. 794 F.2d at 257.

315. 794 F.2d at 264.

the supremacy and commerce clause attacks.[316] On the supremacy clause issue, the Court ostensibly followed the approach used by Justice White in *MITE*. But unlike Justice White, Justice Powell thought that legislation like the Indiana statute advanced the protection and autonomy goals of the Williams Act. He accepted the argument that the Indiana statute responded to a legitimate and at least empirically rational concern about coercion. Justice Powell found, therefore, that the Indiana statute was not preempted because it advanced notions of shareholder autonomy by allowing shareholders to respond to offers collectively. Justice Powell rejected arguments that the fifty day time period in which a meeting must be held created undue delay.[317] Moreover, he noted that regulation of share voting rights as well as a number of other substantive corporate rules regulating shifts in control were traditionally regulated by state law. Given the structure of the 1934 Act, which envisions a continued role for state law,[318] Justice Powell required a clearer indication of preemption than that contained in the Williams Act's generalized statements of purpose.

Justice Powell's analysis of preemption substantially differs from the *MITE* plurality and Judge Posner's *CTS* opinion in two fundamental respects. First, Justice Powell did not view his analysis of the preemptive reach of the Williams Act as constricted by the weight of precedent in the same way as Judge Posner did. Justice Powell took a much more restrictive, textually bound approach to interpreting the Williams Act. As a consequence, he viewed the Williams Act as not encompassing any broad congressional policy on tender offers. Instead, Justice Powell believed that in enacting the Williams Act Congress had left the states free to regulate takeovers within the ambit of traditional subjects of state corporate law including voting rules.[319] Second, Justice Powell did not accept the contention that tender offers were a distinctively important aspect of effective corporate governance. Unlike Justice White and Judge Posner, Justice Powell was clearly dubious about the utility of takeovers, even when viewing the process solely from the perspective of target shareholders.[320]

On the commerce clause issue, Powell's approach differed greatly

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

317. *Id.* at 84. The Court noted the possibility of conditional offers, a solution which is impracticable in light of the needs of having financing in place. *Id.*

318. The Court noted that section 28 of the 1934 Act was specifically intended to allow state law to remain in place. 481 U.S. at 86. This provision was previously thought to be directed at preserving the role of the states in Blue Sky administration.

319. 481 U.S. at 86.

320. *Id.* at 92 n.15.

from Judge Posner. He did not apply a *Pike v. Bruce Church, Inc.*[321] balancing test. Instead, he focused on the issue of discrimination against interstate commerce as the principle concern of a dormant commerce clause analysis. Justice Powell found that the Indiana statute did not impermissibly discriminate.[322] Moreover, Justice Powell found that because of its limited jurisdictional reach, the Indiana statute, unlike the Illinois statute considered in *MITE*, did not create the risk of multiple, inconsistent regulation of the same transaction.[323] Finally, and most significantly, Justice Powell again asserted his belief that the internal affairs doctrine gave Indiana considerable regulatory authority over its corporations.[324]

Justice Powell's opinion strongly harkens back to a formalist, concession view of state corporate law. He described corporations as "entities whose very existence and attributes are a product of state law."[325] Justice Powell thought that only in the rarest situation should a federal court employ the commerce clause to invalidate a state's intracorporate rules even though those rules necessarily affect interstate commerce.

That the Court reversed Judge Posner on both the supremacy and commerce clause grounds is not, of course, to suggest Judge Posner erred. In fact, Judge Posner had anticipated many of the shifts in analytic approach that the Court adopted.[326] Where Judge Posner parted company with Justice Powell is on the utility of tender offers and ultimately on his willingness to look at legislative purpose at both the federal and state level. Judge Posner believed the primary purpose of the Indiana statute was to protect nonshareholder local economic interests; Justice Powell thought the statute to be intended to advance legitimate shareholder interests. In the end, Judge Posner's belief in the importance of maintaining a vital market for corporate control outweighed his attraction to the narrower model of constitutional adjudication that Justice Powell adopted.

The third Seventh Circuit decision on state takeover statutes, *Amanda v. Acquisition Corp. v. Universal Foods Corp.*,[327] is in many ways the most interesting of the Seventh Circuit's decisions on the constitutionality question because Judge Easterbrook's opinion is the court's

321. 397 U.S. 137 (1970). *See supra* note 299 and accompanying text.
322. 481 U.S. at 87.
323. *Id.* at 89.
324. *Id.* at 91.
325. *Id.* at 89.
326. Indeed, as noted, the Court quotes the more tentative aspects of Judge Posner's opinion in its opinion. *Id.* at 77-78.
327. 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989).

most single-minded law and economics takeover decision. In his opinion, Judge Easterbrook attempted to reconcile the L&E view that takeovers are an essential feature of corporate governance with the deferential jurisprudential strain in L&E scholarship. In the end, he left the states free to do under statutory law what the Seventh Circuit had prevented private actors from doing in *CTS I* and *CTS II*. This seemingly anomalous result reflects the allure of federalism to L&E scholars who believe that competition among states over time will lead to optimal laws. Unlike Judge Posner, Judge Easterbrook is content to rely on such competition even though the legislation in question insulates firms from the market for control.

In *Amanda*, decided after the Supreme Court decision in *CTS*, Judge Easterbrook validated the Wisconsin takeover statute[328] against both supremacy and commerce clause attacks. Wisconsin's statute is a very strong version of a business combination state takeover statute. Its application is mandatory; it has neither an opt-in nor opt-out provision.[329] The statute regulates second-step transactions, prohibiting without exception, business combinations between interested shareholders and Wisconsin corporations in the three-year period following the creation of the "interested" relationship unless the board of directors of the target approved the business combination in advance of the creation of the interested relationship.[330] Moreover, even after the three year period, business combinations can proceed only if approved by a majority of unaffiliated shareholders.[331] The act thus effectively precludes hostile takeovers whenever the acquiror needs immediate unencumbered control over the target's assets.[332] The statute is particularly restrictive in that it effectively prevents transactions based on asset-backed debt financing and those in which substantial restructuring is contemplated.[333]

In upholding the Wisconsin statute, Judge Easterbrook began with a detailed discussion of the benefits of an active market for corporate control from the perspective of both the economy as a whole and shareholders in particular. This section of the opinion is a comprehensively drafted law and economics brief in favor of an unregulated control market. Judge Easterbrook attempted to show that the Wisconsin approach

328. WIS. STAT. ANN. § 180.726 (Supp. 1990).

329. *Id.* § 180.726(2).

330. *Id.*

331. *Id.* § 180.726(3)(b).

332. 877 F.2d at 499.

333. These transactions may be the most efficient, but create the greatest risk that local communities or other nonshareholder constituencies will be adversely affected.

is "economic folly."[334] He tracked, but did not cite, his *Harvard Law Review* article.[335] Instead, Judge Easterbrook cited numerous other scholarly economic and legal articles concerning the dynamics of the market for corporate control.[336] After reviewing the literature Judge Easterbrook concluded that tender offers benefit shareholders both *ex ante* and *ex post*. His analysis was standard L&E fare. The prospect of hostile offers causes managers to operate in the best interests of equity owners. The current market price of a firm represents a consensus judgment as to the value of the target in the hands of management. Firms are not routinely undervalued in the market. Premiums represent real gains to target shareholders and to society as a whole. Shareholder coercion is not a real problem in tender offers. Defensive tactics tend to harm shareholders in significant amounts. When offers are defeated, shareholders rarely receive even equivalent gains in increased prices as a consequence of the activities of current management or of future offers. But even if coercion is a real concern, consensual arrangements such as fair price charter amendments meet the coercion claim more directly. Even auctions can be harmful. State statutes like Wisconsin's are particularly offensive because unlike with privately adopted defensive tactics, neither shareholders nor management has any choice as to whether to adopt the Wisconsin solution. Stock market event studies show that state statutes like Wisconsin's are most significantly antishareholder in instances when investors might well have preferred a different model of managerial power.[337]

One might suspect that given these policy-based objections to the Wisconsin statute, and given his commitment to maintaining a vital market for corporate control, Judge Easterbrook would invalidate the statute. Instead, he wrote aggressively to uphold it.[338] On the supremacy clause issue Judge Easterbrook took two different tracks, each of which led him to find that the Wisconsin statute was not preempted. First, Judge Easterbrook adopted Justice Powell's narrow view of the preemptive effect of the Williams Act, noting that after the Supreme Court's *CTS* decision the " 'weight of precedent' " no longer supported the neu-

334. *Amanda*, 877 F.2d at 509 (quoting CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 97 (1987) (Scalia, J., concurring)).

335. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, *supra* note 9.

336. 877 F.2d at 501.

337. *See* Ryngaert & Netter, *Shareholder Wealth Effects of the Ohio Antitakeover Law*, 4 J. L. ECON., & ORGANIZATION 373 (1989).

338. Again the result is not the surprising aspect of the opinion. Other courts have upheld state takeover statutes after the Supreme Court opinion in *CTS*. None, however, take as narrow a reading of the force of the Williams Act as does Judge Easterbrook.

trality model.[339] He suggested instead that by enacting the Williams Act, Congress intended only that *its* statute be relatively neutral.[340] In contrast to Judge Posner, Judge Easterbrook held that the Williams Act left to the states the issue of whether further regulation of substantive aspects of the market for corporate control was necessary.[341]

Moreover, Judge Easterbrook concluded that even if the neutrality model were still good law, the Wisconsin statute was legitimate. He maintained that the Williams Act regulates only the *process* of the tender offer itself.[342] The Wisconsin statute, in contrast, affects only second-step transactions. Judge Easterbrook argued that the Wisconsin statute did not affect either the timing or disclosures of the tender offer process, the only subjects of federal regulation.[343] He maintained that the effect of the Wisconsin statute on tender offers is only indirect in that second-step transactions may be in many instances economically necessary for first-step tenders to proceed.[344] Because offerors have no federally protected right to make offers, nor do shareholders have the right to receive offers, however, Judge Easterbrook reasoned that the Wisconsin statute's indirect effect in potentially deterring offers was irrelevant to resolution of the preemption issue.[345]

Turning to the commerce clause claim, Judge Easterbrook also aggressively wrote to uphold the Wisconsin statute. First, he emphasized that while the dormant commerce clause jurisprudence properly may be directed at discrimination, the Wisconsin statute does not discriminate against nonresidents. Although it may in fact injure mostly non-resident investors, it applies to all offerors equally. Judge Easterbrook thought the effect on the likelihood of offers in interstate commerce an insufficient constitutional basis to overturn Wisconsin's empirical and policy judgments, even though they might differ from Congress's. He concluded that as a matter of dormant commerce clause doctrine, a state need not provide offerors a meaningful opportunity to succeed in making tenders.[346] He determined that so long as the subject of statute is a matter of corporate law, the state of incorporation is free to set the rules, just as it has always been free to set substantive rules regarding mergers.

At first glance L&E scholarship provides Judge Easterbrook seem-

339. *Amanda*, 877 F.2d at 503.
340. *Id.*
341. *Id.* at 503-04.
342. *Id.* at 503.
343. The SEC's "All Holders, Best Price" rule is also unaffected by the Wisconsin statute.
344. 877 F.2d at 504.
345. *Id.* at 504-05.
346. *Id.* at 508 (quoting BNS, Inc. v. Koppers Co., 683 F. Supp. 458, 469 (D. Del. 1988)).

ingly with a way to reconcile the two portions of his opinion. The author of leading law and economics articles supporting deference to the states and the limits of judicial rulemaking under uncertain conditions, Judge Easterbrook advanced the standard arguments for economic federalism, and for allocating the risk of error in rulemaking.[347] Maintaining that in the long run competition among the states will cause corporations to migrate to those states which offer the optimum corporate governance rules,[348] Judge Easterbrook asserted that ultimately such competition "grinds under"[349] bad state legislation. He thought judicial intervention undesirable because it would only disturb the competitive process and its self-correcting tendencies. He maintained that courts, like the state legislatures, may make incorrect judgments as to appropriate governance rules; and that changes in the business environment will overtake state imposed statutes.[350] Judge Easterbrook contended that competition among the states is the preferred process for revealing the desirable equilibrium. He added that if Congress thought a federal solution appropriate, it could always explicitly trump the state legislative decisions.[351] Absent such congressional action, he thought, the states remain free to experiment.

Despite its initial appeal, Judge Easterbrook's attempt to reconcile his reliance on an active market for corporate control to discipline managers with his model of judicial deference for reasons of federalism does not entirely succeed. The L&E belief that competition among states leads to optimum law is based on the premise that if a state adopts a suboptimal rule, shareholders will cause managers to propose reincorporation elsewhere. Incumbent management's incentive for doing so is obvious. A suboptimal rule will depress share prices. If management does not negate its effect, shareholders elect new managers who do, or alternately, sell their shares to a bidder who compels reincorporation to share the gain realized by reincorporation. Put simply, the ameliora-

347. Easterbrook, *supra* note 37; Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984).

348. In this regard Judge Easterbrook cited Fischel, *supra* note 11, at 84. 877 F.2d at 507. Fischel discounts the impact that antitakeover statutes have on the disciplining impact of the market for corporate control by taking a long run rather than short run perspective. Professor Fischel argues that because capital is extremely mobile over time, the short run effort of legislatures to protect specific firms is doomed to failure. Fischel, *supra* note 11, at 86. Fischel does recognize that current investors are damaged as the adverse effects of new law are impounded within share price. Professor Fischel would allow this effect because the state takeover statutes are neutral on their face.

349. *Amanda*, 877 F.2d at 508.

350. *Id.* at 507-08.

351. Professor Gilson suggests that Judge Easterbrook's strong affirmation of the Wisconsin statute was intended to be a call to Congress for a national solution. Gilson, *supra* note 68, at 538.

tive effects of the competition model is fundamentally dependent upon the existence of an active market for corporate control.

The problem inherent in Judge Easterbrook's reliance on competition among states to correct the economic folly of antitakeover statutes is that the very purpose of such statutes is to insulate managers from the market for corporate control. To the extent the statutes achieve that goal, they reduce the incentive for incumbent managers to reincorporate elsewhere. Thus, like most rent-seeking statutes, the very purpose of managers' lobbying efforts on behalf of state takeover statutes is to create a market failure which undermines the competitive process on which Judge Easterbrook relies. So long as incumbent managers need not access the capital market for funds, they would be foolish to abandon the shelter given them by the legislature. We know of no studies indicating significant emigration following passage of any state antitakeover legislation.[352]

We appreciate that a state's adoption of foolish antitakeover legislation might deter individuals from choosing to incorporate there in the first instance. To the extent an act had that effect, it eventually would erode the state's competitive position. We speculate, however, that, though real, the offsetting effect is likely to be trivial for two reasons. First, states which have not already enacted antitakeover legislation cannot credibly bond their commitment to not adopt such legislation at some future time.[353] Therefore, parties cannot rely on the absence of such legislation in selecting a state of incorporation. Secondly, as the recent scholarship on state antitakeover statutes suggests, state legislators are unlikely to be deterred by such distant effects for their primary purpose in enacting legislation is to maximize their own re-election prospects, even if they do so by enacting legislation at the expense of corporate shareholders.[354] In the short run, nonshareholders, *i.e.*, managers and workers, probably can affect the legislative process more readily than can the disorganized shareholder community. This effect is exacerbated if many shareholders reside outside the state of incorporation.

Given the apparent difficulties in Judge Easterbrook's opinion we find parts of his reasoning as curious and unsettling as Judge Posner's

352. Moreover, the corporation specific nature of many state antitakeover statutes strongly suggests that legislatures do not seem at this point to be focusing on long-run competition.

353. Only a contract clause analysis would prohibit states from changing governance rules *ex post*. *See, e.g.*, Butler & Ribstein, *supra* note 214.

354. The differing time frames may explain the willingness of legislators to enact other constituency statutes which permit, but do not require, directors to consider the effects of corporate decisions on other constituencies such as labor. *See, e.g.*, N.J. REV. STAT. § 14A:10A-2 (1988 & Supp. 1989).

CTS opinions. We offer several explanations. First, like Judge Posner, Judge Easterbrook does not write on a clean slate. The result he reached in *Amanda*, if not his reasoning, was largely ordained by the Supreme Court's *CTS* opinion. Having been reversed in *CTS* the Seventh Circuit in particular might have been sensitive to a strong reading of precedent. Moreover, like any judge with pride in his craft, Judge Easterbrook wants to get it "right." No judge wishes to set up the distinct possibility of reversal. Moreover, within the constraints of a required result, a scholar like Judge Easterbrook has a natural tendency to attempt to fashion a coherent opinion, even when substantially conflicting values are implicated. Nevertheless, notwithstanding his attempt to gloss over the difficulties, Judge Easterbrook cannot mask the deeper problem of unresolved conflict between the models which continues to plague judicial decision makers. Nor do we fault him for doing so. A tidy explanation of a complex system of dual regulation just might not be available.

IV. Conclusion

The Seventh Circuit has been a prominent court in the developing law of hostile takeovers. Its decisions are not, however, of one piece. In *MITE* and *Panter* the court applied traditional analysis to stake out positions which relegated state legislatures to the rear area while permitting corporate managers wide discretion to undertake whatever defensive measures they deemed appropriate. Those positions were to dominate the legal scene for the first half of the decade.

No one was happy with that result. Corporate managers and often state legislators called for increased protection from "corporate raiders" while L&E scholars advocated the adoption of rules mandating managerial passivity, or, at a minimum, decreasing managerial discretion. Those disparate criticisms combined with the continued growth of the hostile takeover market to create increasing pressure for the courts, including the Seventh Circuit, to reconsider their initial positions.

In *CTS I*, *CTS II*, and *Amanda* the Seventh Circuit once again addressed the questions of the propriety of managerial defensive tactics and state antitakeover legislation. Given the presence of two of the leading proponents of the application of economic analysis to legal issues, Judges Posner and Easterbrook, one might anticipate that the court's later opinions would have been paradigms of law and economic reasoning. Such was not the case. Instead, they offer their readers a curious blend of traditional and sometimes incomplete economic analysis which ironically reversed both of the earlier positions of the court. *CTS I* and *CTS II* narrowed the discretion of managers; *Amanda* increased the power of the state legislatures. L&E scholars likely find the result (if not the reasoning) of *CTS I* and *CTS II* desirable, while proponents of increased protection applaud the result in *Amanda*.

We appreciate that the somewhat surprising reversal of the Seventh Circuit's positions probably reflects, at least in part, its role as an intermediate federal court. Its decision on state matters were fixed somewhat by the Delaware Supreme Court while its decision on the constitutionality of state antitakeover legislation was bounded by the Supreme Court's decision in *CTS*. But those limitations present only part of the story. As we argue above, the Seventh Circuit's opinions also reflect tension within the L&E school itself. On the one hand, L&E scholars champion managerial discretion and deference to state legislation. On the other, they are wary of statutes and self-help measures intended to undercut the market for control. On the issue of state takeover law, those positions contradict. As the Seventh Circuit's *CTS* and *Amanda* opinions make clear, resolving that contradiction is not an easy task.