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Finance Corporatism

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# CORPORATE GOVERNANCE IN THE AGE OF FINANCE CORPORATISM*


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## INTRODUCTION

Each generation must conduct the corporate governance debate within the parameters set by the prevailing manifestation of corporatism.[1] Each phase of corporatism is marked by a "distinctive set of problems to which the legal system has tried to respond by employing regulatory strategies" appropriate for that stage.[2] Satisfactory solutions to the current problems of corporate governance, therefore, cannot be created from abstract formalisms or idealized models of the corporation. Rather, to be effective, the corporate governance reforms proposed by this generation must address the problems and relationships that characterize the present state of American corporatism.

During the initial stage of corporatism, that of the nineteenth-century entrepreneur,[3] corporate governance posed few internal or external concerns for society. Most businesses were essentially local. Corporate managers were elected by, and responsible to, a concerned and cohesive body of stockholders, usually the members of one or a few founding families. Despite the rise of general incorporation, most states retained strict limits on the size and scope of corporate activity.[4]

During the final quarter of the nineteenth century, states began to remove restrictions on corporate size, and it became permissible to incorporate "for any lawful purpose."[5] Corporations grew in power and complexity. Local opinion and the invisible hand of the marketplace were no longer sufficient to ensure social well-being.[6] On the state

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[1] Throughout this Article, the term "corporatism" refers to the interaction between a corporation and its various constituencies. The current phase of this dynamic process is herein referred to as "finance corporatism." This can be distinguished from the concept of "finance capitalism" put forth by Professor Robert Clark. *See* Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises,* 94 HARV. L. REV. 561, 562-75 (1981). Clark's notion pertains to the "institutional arrangements for aggregating and channeling capital" that have changed over time in a series of "stage[s] of capitalism." *See id.* at 561-62. "Corporatism" refers not only to the development of capital-gathering arrangements, but also to the broader evolution of a corporation's relationships with its constituencies, such as shareholders, employees, and creditors, which are the proper subjects of any corporate governance debate.

[2] *Id.* at 562.

[3] *See id.*

[4] *See* Louis K. Liggett Co. v. Lee, 288 U.S. 517, 550-56 (1933) (Brandeis, J., dissenting) (discussing size and scope limitations in northeastern states); *see also* E.M. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 WITH SPECIAL REFERENCE TO MASSACHUSETTS (1954) (discussing early history of American corporations).

[5] *See* Clark, *supra* note 1, at 562 n.4 (quoting *Liggett,* 288 U.S. at 555); Cary, *Federalism and Corporate Law: Reflections upon Delaware,* 83 YALE L.J. 663, 664 (1974) (analyzing the removal of restrictions on the size and power of businesses).

[6] *See generally* A. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977) (discussing the increasingly active role of the professional manager during this century).

level, public utility commissions were created to regulate the rates and services of natural monopolies.[7] Congress passed the Interstate Commerce Act[8] to regulate the railroads, and the Sherman[9] and Clayton[10] Acts to preserve the benefits of competition.

Corporatism advanced to its second stage, the age of the professional business manager. As noted by Berle and Means in their seminal work, *The Modern Corporation and Private Property,*[11] the distinguishing feature of this stage was the growth in the size of businesses with a concomitant separation of ownership from control.[12] Berle and Means raised the specter of professional managers, unchecked by a now diffuse group of stockholders, acting for selfish rather than corporate motives.[13] The threatened social results were concentration of economic power, a decrease in economic efficiency, and a misallocation of resources.

The second stage of corporatism spawned regulation designed to promote corporate responsibility to investors and to society at large. Congress passed the federal securities laws in order to promote corporate responsibility to owners of the corporation.[14] Congress then ex-

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[7] *See generally* H. TRACHSEL, PUBLIC UTILITY REGULATION 110-123 (1947) (discussing the creation and development of public utility commissions).

[8] Ch. 104, 24 Stat. 379 (1887) (codified as amended at 49 U.S.C. §§ 501-07, 521-26, 10101-11917 (West Supp. 1987)).

[9] Ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1-7 (1982 & Supp. III 1985)).

[10] Pub. L. No. 63-212, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. §§ 12-27 (1982 & Supp. III 1985)).

[11] A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932 & photo. reprint 1982).

[12] *See id.* at 119-25.

[13] Among the selfish motives discussed by Berle and Means is the possibility that professional managers would act in order to increase managerial prerogatives, which would tend to increase the power of the manager. As a consequence of management's separation from ownership, it would not necessarily be the case that such power would be exercised to benefit the corporation. *See id.* at 121-24.

[14] The House of Representatives' debate leading to the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1982 & Supp. III 1985)), demonstrates this general concern with ensuring the responsibility of the professional manager to the owners of large corporations. *See* 77 CONG. REC. 2918 (1933) (statement of Rep. Rayburn). In discussing the objectives of his bill, Representative Rayburn stated:

> These hired officials of our great corporations . . . present a pitiable spectacle. Five years ago they arrogated to themselves the greatest privileges. They scorned the interference of the Government. They dealt with their stockholders in the most arbitrary fashion. . . . Safe from the pitiless publicity of Government supervision, unrestrained by Federal statute, free from any formal control, these few men, proud, arrogant, and blind, drove the country to financial ruin. . . .
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> . . . This bill undertakes to define the duty of officers of corporations issuing securities, of syndicates underwriting issues, the duties of these cor-

tended corporate responsibility by addressing the needs of labor,[15] consumers,[16] and communities,[17] through a variety of legislation. In addition, derivative and class actions provided private means for enforcing internal and external corporate duties.[18]

We have reached yet a third stage of corporatism, the age of finance corporatism, which is dominated by the institutional investor and the professional investment manager.[19] The existence of large pools of

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> porate officials to the investing public. It undertakes to fix responsibility for information.

*Id.*

Similar concerns prompted the passage of additional securities regulation in the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982 & Supp. III 1985 & West Supp. 1987)); the Public Utility Holding Company Act of 1935, Pub. L. No. 74-333, 49 Stat. 803 (codified at 15 U.S.C. §§ 79-79z-6) (1982)), *see* 79 CONG. REC. 9042 (1935) (statement of Sen. Wheeler) (addressing the purposes of the law); the Trust Indenture Act of 1939, Pub. L. No. 76-253, 53 Stat. 1149 (codified at 15 U.S.C. §§ 77aaa-77bbbb (1982)), *see* 84 CONG. REC. 5007 (1939) (statement of Sen. Barkley); the Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to a-52 (1982 & West Supp. 1987)); and the Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to -21 (1982 & West Supp. 1987)), *see* 86 CONG. REC. 9809 (1940) (statement of Rep. Cole).

15 *See* Labor Management Relations Act, 1947, Pub. L. No. 80-101, 61 Stat. 136 (codified as amended at 29 U.S.C. §§ 141-187 (1982 & Supp. III 1985)); National Labor Relations Act, Pub. L. No. 74-198, 49 Stat. 449 (1935) (codified as amended at 29 U.S.C. §§ 151-169 (1982 & Supp. III 1985)). As Senator Wagner observed in discussing the need to modify the National Labor Board, "the experience of everyone connected with the National Labor Board has shown that no board alone can promote cooperation and industrial peace." 78 CONG. REC. 3679 (1934), *reprinted in* NLRB, LEGISLATIVE HISTORY OF THE NATIONAL LABOR RELATIONS ACT, 1935, at 18-19 (1985).

16 *See* Consumer Product Safety Act, Pub. L. No. 92-573, 86 Stat. 1207 (1972) (codified as amended at 15 U.S.C. §§ 2051-2083 (1982 & Supp. III 1985)); HOUSE CONFERENCE REPORT TO ACCOMPANY S. 3419, THE CONSUMER PRODUCT SAFETY ACT, H.R. CONF. REPT. NO. 1593, 92d Cong., 2d Sess. 21-22, *reprinted in* 1972 U.S. CODE CONG. & ADMIN. NEWS 4596, 4615-16 (discussing civil and criminal penalties against management); SENATE COMM. ON LABOR AND PUBLIC WELFARE, CONSUMER PRODUCT SAFETY ACT, S. REP. NO. 835, 92d Cong., 2d Sess. 7, *reprinted in* 1972 U.S. CODE CONG. & ADMIN. NEWS 4573, 4579 (adding findings and declaration of policy to ensure the effectiveness of the protection of consumers from corporate activities).

17 *See* Environmental Quality Improvement Act of 1970, Pub. L. No. 91-224, tit. II, 84 Stat. 114 (codified as amended at 42 U.S.C. §§ 4371-4375 (1982 & Supp. III 1985)); H.R. CONF. REP. NO. 940, 91st Cong., 2d Sess. 62-64, *reprinted in* 1970 U.S. CODE CONG. & ADMIN. NEWS 2712, 2749-50 (discussing the importance of research and monitoring of the impact of manufacturing activities on the environment).

18 *See* FED. R. CIV. P. 23.1 (specifying the requirements for bringing a derivative action); FED. R. CIV. P. 23 (specifying the requirements for bringing a class action); *see also* Ross v. Bernhard, 396 U.S. 531, 534-35 (1970) (describing the historical development of the derivative action).

19 *See* Clark, *supra* note 1, at 564. The problems of this third stage and the tensions among institutional investors, corporate managers, and other corporate constituencies are now being recognized in the popular press and by academics. *See, e.g.,* Kelley,

capital managed to maximize short-term performance has fueled a wave of highly leveraged takeovers that threatens a variety of constituencies, including shareholders, employees, customers, suppliers, and communities, as well as the economy as a whole.[20] At the same time, the rise of the institutional investor also presents a unique opportunity to bridge the gap between ownership and control. If properly channeled, the institutional investor's power provides a means of making management responsive to the needs of shareholders and other corporate constituencies.

The age of finance corporatism, therefore, requires a fresh appraisal of the corporate governance issues first addressed by Berle and Means over fifty years ago. Part I of this Article examines the abusive takeover tactics that have become one of the hallmarks of finance corporatism. Part II reassesses the corporate governance debate in light of these tactics and analyzes which of the affected constituencies are entitled to managerial concern. Part III critiques certain suggested solutions to the corporate governance problems of this age. Part IV proposes a comprehensive legislative scheme to address these problems. Part V suggests a mechanism by which corporations can achieve many of the goals of the proposed legislative program through their own devices.

## I. The Takeover Boom

The dominance and short-term investment strategy of the institutional investor have dangerous implications for our economy. Takeovers in the 1980's are driven by speculative, financial considerations rather than by intrinsic business considerations. These takeovers have assumed

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*The New Dominant Investor,* 9 DIRECTORS & BOARDS 15, 15 (1985); Nussbaum & Dobrzynski, *The Battle for Corporate Control,* BUS. WK., May 18, 1987, at 102, 102; Heard, *Institutional Investors Are Flexing Their Muscles,* Legal Times, October 24, 1983, at 11, col. 1; *see also* Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty,* 60 N.Y.U. L. REV. 630, 639-45 (1985) (discussing the limits of fiduciary duty); Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance,* 84 COLUM. L. REV. 1145, 1162-75 (1984) (discussing the conflicts among corporate constituencies); Gavin and Neilson, *Individual v. Institutional Investors: Who Will Govern?,* N.Y.L.J., May 28, 1985, at 29, 29 (discussing difficulty of satisfying both institutional and individual investors).

[20] *See* Nussbaum & Dobrzynski, *supra* note 19, at 103 (discussing a hostile takeover's effect on the target company's employees, suppliers, customers, and community); Sheets, *People Pay the Highest Price in a Takeover,* U.S. NEWS & WORLD REP., July 22, 1985, at 51 (discussing the adverse impact of a takeover on employees and local community); Norris, *Not the Preferred Treatment: Proposed Uniroyal Buyout Hurts One Class of Securities,* Barron's, June 17, 1985, at 45, col. 1 (discussing negative impact of a takeover on preferred stockholders).

increasingly abusive forms, endangered a wide variety of constituencies, and generated a host of powerful defensive responses. Modern solutions to problems of corporate governance must address the rise of the institutional investor and its effect on the market for corporate control.

## A. *The Current Environment*

### 1. Institutional Investors

The age of finance corporatism is dominated by the institutional investor. "With $1.5 trillion—and soon to reach $2 trillion—in assets, pension funds now own a third of the equity of all publicly traded companies in the U.S., and 50% or more of the equity of the big ones."[21] To this must be added the holdings of mutual funds, banks, savings institutions, and insurance companies.[22]

The managers of these institutional shareholders compete for funds to manage, and are compensated on the basis of their investment performance; a manager with below-average performance suffers a loss of business and a decline in compensation.[23] Consequently, institutional investors are driven to maximize profits in the short term.[24] They have become enamored with options, futures, junk bonds, computer program trading, and a host of other speculative devices designed to enhance

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[21] Drucker, *A Crisis of Capitalism,* Wall St. J., Sept. 30, 1986, at 32, col. 1, 32, col. 3. Of the 1000 companies with the greatest market value, more than 75% have at least 35% of their shares held by institutions. *See The Top 1000 U.S. Companies Ranked by Stock Market Valuation,* BUS. WK., April 17, 1987, at 46 (listing the percentage of the nation's 1000 largest capitalized firms' shares held by institutions); *see also* MONEY MARKET DIRECTORIES, INC., 1986 DIRECTORY OF PENSION FUNDS xiv-xxii (1985) (providing statistics on the holdings of pension funds).

[22] Mutual funds at the end of 1986 controlled assets totalling about $710 billion, *see* INVESTMENT COMPANY INSTITUTE, 1987 MUTUAL FUND FACT BOOK 4 (1987), while FSLIC-insured savings and loan institutions at the end of 1985 held about $1.07 trillion in assets, *see* FEDERAL HOME LOAN BANK BOARD, COMBINED FINANCIAL STATEMENTS iv (1986), and property-casualty insurance companies at the end of 1985 held assets of approximately $311 billion, *see* BEST'S AGGREGATES & AVERAGES: PROPERTY-CASUALTY 1986, at 2 (47th ed. 1986).

[23] *See* Drucker, *supra* note 21, at 32, col. 1 ("And a[n investment]-fund manager has little choice but to focus on the very shortest term; his own job depends on showing immediate gains, with his performance in most cases judged quarter by quarter.").

[24] *See* Ellsworth, *Capital Markets and Competitive Decline,* HARV. BUS. REV., Sept.-Oct. 1985, at 171, 171 (managerial "sense of duty to maximize shareholder wealth" preoccupies American executives and "divert[s] attention from product-market needs . . . frustrat[ing] efforts to improve competitiveness"). Institutional investment managers in pursuit of short-term profits must also keep moving faster in order to stay where they are. *See* M. CARNOY & D. SHEARER, ECONOMIC DEMOCRACY 104-07 (1980); P. DRUCKER, THE UNSEEN REVOLUTION 70-74 (1976); P. HARBRECHT, PENSION FUNDS AND ECONOMIC POWER 107-19, 211 (1959).

short-term performance.[25] Their desire for quick profits has contributed to the current wave of highly leveraged takeovers to the detriment of both undervalued companies and individual shareholders with a long-term investment motive.[26]

Institutional investors have become increasingly active in recent years. "Institutional activism, especially among public pension funds, may in fact become the principal legacy of the 1984 annual meeting season. Institutional investors have been moving away for years from the traditional posture of supporting management on controversial issues at annual meetings."[27] They have channeled this activity into defending their right to receive short-term profits. The 1986 annual meeting season saw "continued growth in the activism of public pension funds on corporate governance questions," with "more and more public funds . . . voting against management proposals that they believe are contrary to their [economic] interests."[28]

The ascendancy, increased activism, and short-term focus of the institutional investor have significant implications for this age of corporatism.[29] Whatever the perceived vices of management control, manage-

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[25] *See* Saul, *Hostile Takeovers: What Should Be Done?*, HARV. BUS. REV., Sept.-Oct. 1985, at 18, 19. One commentator attributes the rise to prominence of junk-bond financing to the "willingness of institutional investors . . . to absorb such bonds in almost any quantity into their portfolios." J. BROOKS, THE TAKEOVER GAME 190-91 (1987).

[26] After learning that a takeover is being mounted, institutional investors and arbitrageurs often take substantial positions in the stock of a prospective target, place the target "in play," and then profit greatly when their stock is sold to an acquirer, or another party, at a premium that maximizes the short-term value of the target's stock. *See The Place of Arbitrageurs in Mergers and Acquisitions*, 21 MERGERS & ACQUISITIONS July-Aug. 1986, at 24; *see also* Warren, *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549 (1985) (emphasizing the special role of debt and tax advantages for both arbitrageurs and fellow investors). The effect of the arbitrage mechanism is substantially strengthened by the followers it creates. *See* Rudnitsky, Sloan & Stern, *The Wizard of Arb*, FORBES, Dec. 15, 1986, at 38, 39.

One commentator has noted that the " 'temporary owners' " that dominate the current age of corporatism "play a role that can lead to the acquisition of corporate assets through creative financing—for the purpose of reaping a forced assumption of major debt by the corporation under attack." Smale, *What About Shareowners' Responsibility?*, Wall St. J., Oct. 16, 1987, at 28, col. 3.

[27] Heard, *Voting by Institutional Investors on Corporate Governance Questions: 1984 Proxy Season*, 1984 CORP. GOVERNANCE SERVICE 1.

[28] Mathiasen & Rosenbaum, *Voting by Institutional Investors and 1986 Annual Meeting Results*, CORP. GOVERNANCE SERVICE, Oct. 1986, at 1, 33; *see* Nussbaum & Dobrzynski, *supra* note 19, at 102 (noting an example of a large institutional investor voting against management and predicting this is the wave of the future).

[29] One commentator has compared the current situation with the decline of Britain in the late nineteenth century: "The clear lesson for America is that an investment strategy that maximizes short-term profitability at the expense of long-term development is hazardous to economic health; . . . '[w]e have about twenty years to reverse this position before somebody else passes us'." *Lessons from the Rise and Fall of Na-*

ment historically pursued socially beneficial objectives such as expanding the enterprise, improving productivity, and cultivating planning, research, and development. In contrast, the new control persons—the institutional investors—share none of these social goals. Any corporate governance proposal in the age of finance corporatism must seek to channel the energy of institutional investors to recapture the vital economic objectives of increased productivity through investment in capital assets and research.[30]

### 2. Tax and Accounting

Tax rules have long provided an environment conducive to highly leveraged takeovers financed by low-quality debt. Tax rules encourage the financing of takeovers with debt because interest payments are deductible.[31] This preference is magnified when a profitable company is acquired in a leveraged transaction that substitutes debt for equity. By proceeding in this manner, the raider gets the United States government to finance part of the purchase.[32]

In addition, Section 338 of the Internal Revenue Code of 1954[33] permitted the purchaser of 80% of a corporation's stock to "step up" the basis of the target's assets, with exceptions for certain recapture items, thereby increasing the purchaser's ability to shelter income through increased depreciation.[34] Through the use of "mirror" subsidi-

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*tions,* WILSON CENTER REP., July/Aug. 1987, at 1 (quoting address by Professor Rosencrance, The Wilson Center (June 3, 1987)).

[30] One commentator has noted that with the concentration of ownership in the hands of institutional investors, "the separation of control from responsibility may become the key issue in the future." Margotta, *Institutional Ownership of Stock: Implications for Long-Term Corporate Stability,* 64 TAPPI 65, 69 (1981).

[31] *See generally* SOLOMON, STEVENSON & SCHWARTZ, CORPORATIONS: LAW AND POLICY 157 (1982) (discussing the tax aspects of the difference between debt and preferred stock). Interest paid on corporate debt is a deductible business expense under § 163 of the Internal Revenue Code, I.R.C. § 163 (1982 & West Supp. 1987), while dividends paid on common and preferred stock are not deductible.

[32] *See* Canellos, *The Over-Leveraged Acquisition,* 39 TAX LAW. 91, 100 (1985). The acquiring firm typically channels the target's cash flow to pay off the fixed obligations incurred to acquire the business. *See id.* Through tax deductions for interest, which is supplemented in some cases by enhanced depreciation resulting from a stepped-up basis on the assets purchased, the buying group uses pre-tax cash flow to the maximum extent. *See id.* The U.S. government in effect finances a large part of the purchase price because the forgone federal income tax revenue is essentially a government expenditure.

[33] Act of Aug. 16, 1954, ch. 736, 68A Stat. 107 (current version at I.R.C. § 338 (1982 & Supp. III 1985 & West Supp. 1987)). Under the Tax Reform Act of 1986, an acquirer wishing to step up the basis of the target's assets must be willing to absorb the tax on any gain. *See* I.R.C. §§ 336, 338 (1982 & Supp. III 1985 & West Supp. 1987).

[34] This ability was further enhanced by the use of "accelerated depreciation schedules that may bear little relation to the economic life of the assets." Saul, *supra*

aries an acquirer, unlike the target, could avoid tax on divestiture of unwanted assets.[35]

Accounting rules also favor the acquisition of existing assets over the internal development of new ones. While the costs of an acquisition are capitalized and amortized over an extended period,[36] a current charge against income must generally be taken for the costs of starting a new business,[37] research and development,[38] or introducing new products.[39] Tax and accounting considerations, therefore, provide an

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note 25, at 19.

[35] Prior to the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, an acquirer wishing to use the mirror technique would create as many subsidiaries as the target had subsidiaries or divisions that it wished to be able to sell without recognizing gain. The subsidiaries would be capitalized with the financing for the acquisition and would jointly own the acquisition vehicle, that is, the actual person making the tender offer. Once the acquisition vehicle acquired the target, it would be merged into the target, with the result that the acquirer's subsidiaries would jointly own the target. The target would then be liquidated, with its divisions and subsidiaries distributed to the acquirer's subsidiaries. Even if the target's assets had appreciated, this would be a tax-free distribution under § 332 of the 1954 Code, Act of Aug. 16, 1954, ch. 736, 68A Stat. 102 (current version at I.R.C. § 332 (1982 & West Supp. 1987)), because it would be viewed as the liquidation of a subsidiary (*i.e.*, the target) jointly owned by the acquirer's subsidiaries, who would be entitled to aggregate their interests for this purpose. *See* Treas. Reg. § 1.1502-34 (1966). The acquirer could then sell the stock of its mirror subsidiaries, and dispose of unwanted target assets, while recognizing little if any gain because the acquirer would likely have something approaching a fair market value basis in the stock of its subsidiaries. After the Tax Reform Act of 1986, there is some question as to whether aggregation of interests among the acquirer's subsidiaries, which is an integral part of the scheme, continues to survive. *See* I.R.C. § 337(c) (1982 & West Supp. 1987) (defining the distributee after liquidation as "the corporation"); 2 H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 202 n.9, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4290 n.9 (suggesting that the Treasury Department consider whether the aggregation rules should continue to apply).

[36] *See* BUSINESS COMBINATIONS, APB Opinion No. 16, ¶ 76 (Am. Inst. of Certified Pub. Accountants 1970); 2 APB ACCOUNTING PRINCIPLES, Accounting Interpretation No. 33 of APB Opinion No. 16 (Am. Inst. of Certified Pub. Accountants 1971) (noting, for example, that a finder's fee and fees paid to outside consultants for accounting, legal, or engineering investigations relating to an acquisition are capitalized).

[37] *See* ACCOUNTING AND REPORTING BY DEVELOPMENT STAGE ENTERPRISES, Statement of Financial Accounting Standards No. 7, ¶ 10 (Fin. Accounting Standards Bd. 1975) (treating development stage enterprises like any other enterprise and thereby increasing difficulty of capitalizing start-up costs); Kerley, *Intangible Assets*, in 1 ACCOUNTANTS' HANDBOOK 23.21 (1981) ("Deferral of start-up and preoperating costs is not routine because of the difficulty of assigning benefits to future periods and the possibility that costs will not be recovered from future operations.").

[38] *See* ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS, Statement of Financial Accounting Standards No. 2, ¶ 12 (Fin. Accounting Standards Bd. 1974) ("All research and development costs encompassed by this statement shall be charged to expense when incurred.").

[39] *See* INTANGIBLE ASSETS, APB Opinion No. 17 (Am. Inst. of Certified Pub. Accountants 1970) (setting standards for deferral of expenses connected to intangible assets); Charles, *Other Assets and Research and Development*, in HANDBOOK OF ACCOUNTING AND AUDITING 21-14 (1981) (noting that deferral of advertising and promotion expenditures "was and continues to be infrequent").

artificial impetus to highly leveraged acquisitions. Although a more thorough analysis of such concerns is beyond the scope of this Article, any reform of corporate governance must consider the consequences of the relevant tax and accounting rules.

### B. *Abusive Takeover Tactics*

#### 1. The Highly Leveraged Takeover

Most prominent among the speculative, abusive takeover tactics spawned by the age of finance corporatism is the "junk-bond, bust-up" takeover. In such a takeover, junk bonds (non-investment grade securities with high rates of return) allow a raider to make a 100% cash offer for a target of almost any size. If successful in obtaining a controlling interest, the raider merges the target into itself and sells assets of the target to help finance the acquisition.[40] The junk-bond, bust-up takeover was born in early 1984 when Drexel Burnham Lambert arranged junk financing for T. Boone Pickens' bid for Gulf Oil.[41] By mid-1985, the flow of junk-financed takeovers had become "an avalanche."[42]

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[40] A classic example of the junk-bond, bust-up takeover was Pantry Pride's acquisition of Revlon. Pantry Pride ultimately acquired Revlon by means of a $1.7 billion hostile tender offer, backed by $725 million in junk bonds. Within one year of the acquisition, Pantry Pride sold Revlon's Norcliff Thayer, Reheis, and Beecham subsidiaries for $395 million, Revlon's ethical pharmaceuticals business for $690 million, and Revlon's Technicon subsidiary for $300 million. *See Pantry Pride Takes an Ax to Revlon,* Bus. Wk., Dec. 9, 1985, at 46; Siconolfi, *Revlon Will Sell Technicon Unit for $300 Million,* Wall St. J., June 3, 1986, at 23, col. 3; *Pantry Pride to Sell Revlon Unit to Rorer,* L.A. Times, Nov. 30, 1985, pt. 4, at 2, col. 3. In sum, nearly $1.4 billion of Revlon's assets were sold to finance Pantry Pride's purchase.

[41] *See* K. Bialkin, A. Fleischer & E. Greene, New Techniques in Acquisitions & Takeovers 70-73 (1985).

[42] Brady, *Equity Is Lost in Junk-Bondage,* N.Y. Times, April 25, 1985, at A27, col. 1, A27, col. 3. Recent examples include the $5.4 billion in junk financing for Turner Broadcasting System Inc.'s bid for CBS Inc.; $3.9 billion in junk financing in Revlon Group Inc.'s bid for Gillette Co.; $3 billion in junk financing in Mesa Partners' bid for Unocal Corp.; $1.5 billion in junk financing in Icahn Group Inc.'s bid for Phillips Petroleum Co.; $725 million in junk financing in Pantry Pride Inc.'s bid for Revlon Inc.; $550 million in junk financing in Reliance Financial Services Corp.'s bid for Walt Disney Productions; $400 million in junk financing in Sir James Goldsmith's bid for Crown Zellerbach Corp.; and $365 million in junk financing in Triangle Industries Inc.'s bid for National Can Corp. *See* Scredon & Wilke, *Time Is Running Out on Ted Turner's Bid for CBS,* Bus. Wk., July 22, 1985, at 68 (Turner-CBS); Belkin, *Gillette Deal Ends Revlon Bid,* N.Y. Times, Nov. 25, 1986, at D1, col. 6, D9, col. 2 (Revlon-Gillette); Whitefield, *"Junk Bond" Financiers Back Pickens,* L.A. Times, April 18, 1985, pt. 4, at 1, col. 1 (Mesa-Unocal); Cole, *Icahn Gets Drexel Aid on Phillips,* N.Y. Times, Feb. 16, 1985, at 29, col. 6 (Icahn-Phillips); Cole, *Pantry Pride Revlon Bid Raised by $1.75 a Share,* N.Y. Times, Oct. 19, 1985, at 34, col. 1 (Pantry Pride-Revlon); Bleakley, *The Power and Perils of Junk Bonds,* N.Y. Times, April 14, 1985, § 3, at 1, col. 4 (Reliance-Disney); Sivy, *Separating Junk from Toxic Waste,* Money, June 1985, at 169, 169-70 (Goldsmith-Crown Zellerbach); Weiss, *Will Corporate*

Thus, while bond issues represented only 0.3% of tender offer financing for the years 1981 through 1984,[43] one study concluded that, in the first half of 1985, junk bonds accounted for 13.6% of all successful tender offer financing and 24.7% of hostile tender offer financing.[44] Another study concluded that debt financing accounted for 16% of all tender offer financing in 1985 and 29% of such financing for the first nine months of 1986.[45]

The dramatic increase in junk-bond takeovers caused concern in several quarters. In January of 1986, over the objections of other government agencies, the Federal Reserve Board interpreted existing margin regulations to cover the use of shell corporations to make junk-bond tender offers.[46] As a consequence, a raider seeking to collateralize its loans by using a shell subsidiary corporation to issue junk bonds may now leverage no more than 50% of a takeover transaction. There was speculation that the Federal Reserve Board's action would sound the death knell for the junk-financed takeover.[47] The Federal Reserve Board's margin regulations, however, do not affect junk financing if preferred stock is used rather than debt, or if a raider is willing to use its own assets as collateral.[48] In such cases, the raider may leverage as much of a takeover transaction as it likes.[49] As a consequence, the Federal Reserve Board's margin regulations have had little, if any, impact

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*Raiders Have to Kiss the Junk Bond Good-bye?*, BUS. WK., Dec. 16, 1985, at 74 (Triangle-National Can).

[43] *See* H. SHERMAN & R. SCHRAGER, JUNK BONDS AND TENDER OFFER FINANCING 16 (1987).

[44] *See* STAFF OF HOUSE SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 99TH CONG., 2D SESS., CORPORATE MERGERS AND HIGH YIELD [JUNK] BONDS: RECENT MARKET TRENDS AND REGULATORY DEVELOPMENTS 14 (Comm. Print 1986) [hereinafter CORPORATE MERGERS].

[45] *See* H. SHERMAN & R. SCHRAGER, *supra* note 43, at 16-17. *But see* CORPORATE MERGERS, *supra* note 44, at 51.

[46] *See* 51 Fed. Reg. 1771, 1775 (1986) (to be codified at 12 C.F.R. pt. 207). In such a takeover, the shell acquirer's prospective assets—for example, the stock of a target company—effectively are collateral for takeover loans.

[47] *See Shareholder Protection Act: Hearings on S-1539 Before the New Jersey Senate Comm. on Labor, Industry, and Professions, Testimony of Securities Industry Ass'n* 3 (Mar. 24, 1986) (statement of Stephen Blumenthal, vice president and director of Regulatory Relations for S.I.A.).

[48] *See* 51 Fed. Reg. 1771, 1771 (1986) (to be codified at 12 C.F.R. pt. 207) ("The presumption that the debt securities are indirectly secured by margin stock would not apply if there is specific evidence that lenders could in good faith rely on assets other than margin stock as collateral, such as a guaranty of the debt securities by the shell corporation's parent company or another company that has substantial non-margin stock assets or cash flow.").

[49] For example, the Federal Reserve Board's margin regulations did nothing to stop Revlon from financing $3.9 billion of a $4.1 billion bid for Gillette with junk bonds. *See* Belkin, *supra* note 42, at D1, col. 6.

on the use of junk bonds for takeover financing.[50]

### 2. Bridge Financing

Bridge financing, occasioned by the changing role of investment bankers in merger and acquisition activity, has also contributed to the recent wave of speculative, highly leveraged takeovers. Deregulation and increased competition among the investment houses have reduced their traditional sources of revenue, the commissions charged for trading stocks and underwriting securities offerings.[51] Investment banks have filled the gap with the higher profits of junk-bond offerings and the substantial fees charged for merger and acquisition services.[52] These institutions, moreover, have begun to protect their enormous stake in takeover deals by placing their own capital at risk and performing a "merchant banking" function.[53] A manifestation of this trend is the provision by investment banks of "bridge financing" for acquisitions.[54] In a typical transaction, the investment bank provides financing with the intention of refinancing and obtaining permanent capital through commercial bank loans, the sale of junk bonds, or the sale of target assets. In the words of Samuel L. Hayes III, a Harvard Business School professor of investment banking, the investment banking profession has experienced a "steady movement away from the traditional role as counselor toward activity initiated by the investment banker himself."[55]

A number of recent deals have contained bridge financing. For ex-

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[50] *See* J. BROOKS, *supra* note 25, at 277 (noting that the Federal Reserve's rule "had virtually no practical effect because it could be circumvented by the use of preferred stock . . . and because hostile takeovers were no longer being done by shell companies"); H. SHERMAN & R. SCHRAGER, *supra* note 43, at 15 ("Takeover professionals believe that the Fed ruling has had little or no impact on the role of junk bonds in takeover financing.")

[51] *See* J. BROOKS, *supra* note 25, at 8-12; Bianco, *American Business Has a New Kingpin: The Investment Banker,* BUS. WK., Nov. 24, 1986, at 77, 80.

[52] *See* J. BROOKS, *supra* note 25, at 103, 243-53; Bianco, *supra* note 51, at 80.

[53] *See* J. BROOKS, *supra* note 25, at 198-99; *Survey of Wall Street,* ECONOMIST, July 11, 1987, at Supp. 9-13.

[54] Another manifestation of the trend toward merchant banking involves participation by investment banks in leveraged buy outs. *See, e.g., infra* note 96.

[55] Bianco, *supra* note 51, at 80 (quoting Professor Hayes). An extreme example of this trend toward banker-initiated activity is charged by Staley Continental, Inc. in its recent complaint against Drexel Burnham Lambert, Inc. Staley charges Drexel with putting targets in play through stock accumulation and manipulation with the goal of creating a takeover bid by one of its clients or, in Staley's case, of forcing management to accept a Drexel-sponsored leveraged buy out. Drexel denies the charge. *See* Stewart & Hertzberg, *Expanding Inquiry: Drexel and Milken Are Focus of Federal Probe That Is Growing Wider,* Wall St. J., Sept. 11, 1987, at 1, col. 6; Welles & Frank, *Did Drexel Bully Takeover Candidates?,* BUS. WK., Mar. 9, 1987, at 43, 43.

ample, First Boston provided $865 million to help Campeau Corp. acquire Allied Stores Corp.[56] Shearson Lehman Brothers offered $1.6 billion to Campeau's rival, Edward DeBartolo.[57] Merrill Lynch offered $1.9 billion to Sir James Goldsmith to help him pursue his unsuccessful bid for the Goodyear Tire and Rubber Co.,[58] provided $650 million to sponsor a leveraged buy out of Borg-Warner to defeat a bid for that company by GAF corporation, and provided $725 million in bridge financing to sponsor a leveraged buy out of Supermarkets General Corporation in the face of a bid from the Dart Group.[59]

Bridge financing exacerbates the dangers of highly leveraged takeovers by making it easier for raiders to pose a credible threat and put targets "in play." Once a target is in play, risk arbitrageurs, including trading desks at investment banking firms, invest large amounts in takeover stocks.[60] After arbitrageurs take control of a large fraction of the target's stock, sale of the company, or a defensive maneuver to maximize short-term value, becomes almost a self-fulfilling prophecy.[61]

Just as investment banks are beginning to play a merchant banking role by providing bridge loans, commercial banks are beginning to play an investment banking role in order to cash in on the huge fees generated by the present environment. Erosion of the Glass-Steagall

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[56] *See* Welles & Farrell, *Now Drexel Burnham Is Fighting on Two Fronts,* BUS. WK., Feb. 16, 1987, at 90, 96.

[57] *See id.*

[58] *See id.*

[59] *See* Horowitz, *Merrill Lynch Downplays Bridge Loan Role,* AM. BANKER, April 27, 1987, at 3, 3.

[60] *See* Bianco, *supra* note 51, at 80 (Wall Street's block trading and risk-arbitrage desks make it possible to amass an enormous block of shares in almost any company on short notice). It is estimated that risk arbitrageurs have grown from a cadre of about a dozen firms and individuals investing a hundred million dollars or so in the mid-1970's to an army of more than 200 with aggregate capital of as much as $15 billion. *See* Metz, *Trading Abuses Run Deep on Wall Street,* Wall St. J., Feb. 17, 1987, at 31, col. 1.

[61] The takeover of Avco may be cited as a classic example:

> Leucadia National, a much smaller company, took a position in Avco and then announced a tender offer. It withdrew when Avco paid it off in what amounted to a greenmail transaction. The *Wall Street Journal* reported that the arbitrageurs were upset by this turn of events and some, expecting another tender offer, decided to hold their positions in Avco.
>
> In quick succession, the Irwin Jacobs group took a 12% position in Avco, Ivan Boesky, the arbitrageur, bought 8% of Avco's shares in the open market, and Textron announced a tender offer. Under its agreement with Avco, Leucadia received the benefits of Textron's premium price to Avco shareholders. Thus, three groups of takeover entrepreneurs and the arbitrageurs received millions in quick profits while Textron loaded itself with debt.

Saul, *supra* note 25, at 20.

Act, which prohibits commercial banks from underwriting securities,[62] has helped commercial banks play an expanded role in the financial arena.[63] For example, a recent court decision condoned a commercial bank's placement of commercial paper issued by third parties.[64] Major commercial banks, such as Citicorp and Morgan Guaranty, have expanded their role in the financial arena by providing both financing and merger and acquisition services.[65] The merging of the investment and commercial banking functions results in an artificial stimulation of deals, which are pursued to create fees rather than to increase intrinsic value.[66]

### 3. Partial Bids

The rise of takeover bids, mounted in order to garner speculative, short-term profits, has resulted in a number of abusive techniques based on the raider's purchase of less than 100% of the target's stock. Such techniques deny material information to the target's shareholders, pressure the target's shareholders into selling their stock, treat the target's shareholders unequally, and minimize the price that target shareholders receive for their stock. These techniques include creeping acquisitions, sweeping the street, partial tender offers, and two-tiered tender offers.

#### a. *Creeping Acquisitions*

Under current rules, a raider, sometimes acting through a group of persons, can quietly begin buying a target company's stock up to a level

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[62] *See* 12 U.S.C. § 24 (1982) (commercial banks "shall not underwrite any issue of securities or stock").

[63] *See* J. BROOKS, *supra* note 25, at 303 ("The inescapable truth is that . . . investment banking has changed so much that Glass-Steagall [is] left as a rule without a game."); Fidler, *Why Commercial Banks Look for Liberalisation,* Fin. Times, June 16, 1987, § 2, at VI, col. 1 (citing a "gradual erosion" of the Glass-Steagall Act, which has resulted in commercial banks now dealing in an estimated 80% of securities issues in the United States). *But see* Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, tit. II, § 201(b), 101 Stat. 552, 582 (placing temporary moratorium on increases in underwriting by commercial banks).

[64] *See* Securities Indus. Ass'n v. Board of Governors, 807 F.2d 1052, 1067-70 (D.C. Cir. 1986); *see also* Fidler, *supra* note 63, § 2, at VI, col. 1 ("Recent rulings [have allowed] banks to underwrite issues in the rapidly growing commercial paper market.").

[65] *See* J. BROOKS, *supra* note 25, at 302; Wayne, *Latest Corporate Takeovers Involve More Than Just Paper,* N.Y. Times, Mar. 15, 1987, § 4, at 26, col. 1.

[66] As James Walter, a finance professor at the Wharton School of the University of Pennsylvania, has stated: "There are too many middlemen just going for the fees when they should be looking at the quality of the loans [they extend]." Bianco & Farrell, *Power on Wall Street,* BUS. WK., July 7, 1986, at 56, 58.

just short of 5% of the target's outstanding shares, the point at which public disclosure is required.[67] The actual purchases are typically made through obscure corporations and partnerships in order to keep the identity of the raider secret.[68] Before crossing the Williams Act 5% threshold, at which point the raider has 10 days to make a public disclosure of its target company holdings,[69] the raider firms up its buying group and obtains the financing required for its planned stock purchases. The raider then crosses the 5% threshold and commences a vigorous, open market purchase program. Usually an acquirer will be able to accumulate up to 10% or even 20% of the target's shares in that 10-day period before disclosing such purchases or any aspect of its plans.[70]

Creeping acquisitions are problematic for several reasons. First, they enable raiders to profit solely by putting a target "in play," even if the raider has no intention of acquiring the target at a price that reflects the full value of the target's shares. Merely accumulating shares may identify a company as a "target," engender a tender offer at a premium by a third party, or force a sale of the target or restructuring to raise share values and avert a takeover.[71] Second, creeping acquisitions deny selling shareholders full and fair disclosure with respect to the raider's initial purchases. Had the raider's control intent been disclosed, target shareholders selling in the open market would have demanded a higher price for their shares.[72] Third, creeping acquisitions deny target shareholders an equal opportunity to share in the control premium resulting from the target's sale.[73] Finally, creeping acquisitions deprive the target's board of the opportunity to structure an alternative transaction that might have maximized share values for all target shareholders.[74]

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[67] *See* 15 U.S.C. § 78m(d)(1) (1982).

[68] *See* 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS § 2.02[2] (1986).

[69] *See* 17 C.F.R. § 240.13d-1(a) (1987).

[70] *See* J. BROOKS, *supra* note 25, at 259.

[71] *Id.* at 260.

[72] *See* Testimony of Martin Lipton Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 100th Cong., 1st Sess. 16 (July 9, 1987) [hereinafter Testimony of Martin Lipton] (author's transcript on file with the *University of Pennsylvania Law Review*). For a discussion of creeping acquisitions, see generally 1 M. LIPTON & E. STEINBERGER, *supra* note 68, at § 2.02[2], 2-26.

[73] Testimony of Martin Lipton, *supra* note 72, at 16.

[74] *Id.*

b. *Sweeping the Street*

"Sweeping the street" currently is a fashionable method of obtaining control of a target through large purchases on the open market. Such acquisitions have been made possible due to recent court holdings that such open market purchases are beyond the scope of the Williams Act.[75] In several cases, large accumulations of stock through open market purchases have been made by the raider following the termination of a previously announced tender offer. For example, Campeau Corporation dropped its takeover bid for Allied Stores and obtained control of Allied Stores after purchasing a block assembled by Jeffries & Co. from a small number of large holders.[76] Hanson utilized the same technique to acquire control of SCM.[77]

The chief disadvantages of sweeping the street are similar to those of creeping acquisitions. The raider's purchases are made without the benefit of Williams Act disclosures. Small, unsophisticated shareholders are denied an equal opportunity to sell their shares at a premium. In addition, the target's board is given no opportunity to structure an alternative transaction that maximizes the value of the target's shares.[78]

c. *Partial Tender Offers*

A partial tender offer is a bid to purchase a controlling but less than 100% interest in a target.[79] Such a tender offer is abusive because

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[75] *See, e.g.,* Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 57-58 (2d Cir. 1985) (Hanson's purchase of 25% of SCM stock was not a tender offer because a small number of sophisticated investors was involved, there was no pressure on stockholders to sell, no public solicitation was used, no premium was paid, no fixed term was set, and the purchase was not contingent on Hanson obtaining a fixed amount of stock.); SEC v. Carter Hawley Hale Stores, 760 F.2d 945, 953 (9th Cir. 1985) (Carter Hawley's repurchase of a large quantity of stock was not a tender offer because "[its] purchases were made in the open market, at market and not premium prices, without fixed terms and were not contingent upon the tender of a fixed minimum number of shares."); *see also* Ivanhoe Partners v. Newmont Mining Corp., Nos. 9281, 9221 (Del. Ch. Oct. 15, 1987) (upholding street sweep by target's largest shareholder under Delaware law). Such purchases do not of themselves constitute "tender offers" within the meaning of 15 U.S.C. § 78n(d)(1) (1982) and, as a consequence, do not fall within the ambit of the Williams Act.

[76] *See Toronto's Campeau Buys Allied on the Open Market,* DUN'S BUS. MONTH, Dec. 1986, at 22, 22.

[77] *See Hanson Trust PLC,* 774 F.2d at 51 (Hanson dropped its cash tender offer in favor of obtaining SCM stock through private purchases.). Hanson subsequently completed its acquisition of SCM. *See* Dodsworth, *Hanson Lifts SCM Stake to 66%,* Fin. Times, Jan. 8, 1986, § 1, at 19.

[78] *See* SEC, Commission to Consider Three Items at Open Meeting (Sept. 14, 1987) (SEC news release No. 87-62) (suggesting rules that would prevent market sweeps immediately following termination of a tender offer).

[79] *See* Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender*

it allows a raider to gain control of a target and hold a minority interest captive, with little protection for the stockholder against self-dealing or a squeeze-out merger.[80] Indeed, the threat to the shareholder of being locked into such a minority position provides a strong incentive for her to tender.[81]

### d. *Two-Tiered Tender Offers*

The two-tiered tender offer, by contrast, gives the raider a mechanism for forcing target shareholders to tender because the squeeze-out merger is an announced part of the deal.[82] In such an offer, the raider makes a cash tender offer for a controlling interest in the target and, upon obtaining control, merges the target into itself at a lower second-tier price and usually in exchange for securities.

State appraisal law provides the only protection against the two-tiered tender offer.[83] While most states guarantee "fair value" to shareholders who dissent from the merger,[84] appraisal laws are burdened with complicated procedural requirements,[85] and fair value normally

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*Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law,* 11 SEC. REG. L.J. 291, 291-93 (1984).

[80] *See* Beebe v. Pacific Realty Trust, 578 F. Supp. 1128, 1137 (D. Or. 1984) (noting that an acquisition of a 51% interest would "subject the remaining stockholders to a captive status").

[81] *See* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 631 (D. Md. 1982); Radol v. Thomas, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982); Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers,* 98 HARV. L. REV. 1695, 1710-13 (1985); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 HARV. L. REV. 297, 337 (1974); Finkelstein, *supra* note 79, at 293; Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation,* 83 COLUM. L. REV. 249, 307-08 (1983); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred,* 97 HARV. L. REV. 1964, 1966 (1984).

[82] In a classic example, U.S. Steel offered to purchase 51% of Marathon Oil Company's stock in 1981 for $125 per share in cash with the announced intention of acquiring the minority interest in Marathon in a second-step merger for securities worth approximately $86 per share. *See* Note, *Second Step Transactions in Two-Tiered Takeovers: The Case for State Regulation,* 19 GA. L. REV. 343, 348 (1985); *see also* SEC, ADVISORY COMMITTEE ON TENDER OFFERS: REPORT OF RECOMMENDATIONS 24-26 (1983) [hereinafter TENDER OFFER RECOMMENDATIONS] (recommending regulatory disincentive to two-tiered bids).

[83] *See* Note, *supra* note 82, at 366-67.

[84] *See id.* at 367; *see also, e.g.,* CONN. GEN. STAT. §§ 33-373 to -374 (1987) (Any dissenting shareholder is entitled to have the corporation "purchase his shares at fair value."); FLA. STAT. § 607.247(2) (1979 & Supp. 1987) (In the event of a merger, a dissenting shareholder may demand the corporation pay "fair value" for her shares.).

[85] *See* Note, *supra* note 82, at 367; *see also, e.g.,* CONN. GEN. STAT. § 33.374 (1986) (the shareholder has 15 days from the "date of mailing the plan of merger" to notify the corporation of her dissent; her stock must not be voted in favor of the merger; the corporation has 10 days from the receipt of the shareholder's demand or from the date of the merger (whichever is later) to offer the shareholder "fair value" for her

excludes any portion of the tender offer premium or any synergistic gains flowing from the merger.[86] As a consequence, state appraisal law allows a wide divergence between the first and second-tier prices,[87] thus leaving untouched the most coercive element of the two-tiered offer.

The difference in the prices of the tiers unfairly pressures the target shareholder. A shareholder who would prefer that the target remain independent will usually tender anyway out of fear that a majority of her fellow shareholders will tender, leaving her squeezed out of her investment at the lower second-tier price.[88] Moreover, because individuals do not possess the same access to information or investment skills as institutional investors, they are less likely to respond quickly and efficiently to takeover bids and are more likely to be saddled with the lower second-tier price.[89]

While the number of two-tiered tender offers has declined as the availability of junk-bond financing has increased, there is no guarantee that this technique will remain dormant. The takeover process is dynamic. To the extent that junk-bond financing declines—as a conse-

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shares; the shareholder shall deliver her certificates to the corporation within 20 days of "demanding the purchase of [her] shares;" the corporation or shareholder may petition the court to determine the "fair value" of the stock); FLA. STAT. § 607.247(6-10) (1979) (covering, among other items, the deadline for the corporation and shareholder to agree on the fair value of the stock; the procedure, in the event of non-agreement, for the corporation to petition the court to determine the fair value of the stock; the imposition of court costs on the corporation for such a proceeding (unless the court determines that the refusal of the shareholders to accept the fair value is "arbitrary or vexatious or not in good faith"); and the procedure for the dissenting stockholder to surrender her certificates to the corporation).

[86] *See* DEL. CODE ANN. tit. 8, § 262(h) (1983) (defining appraisal value as "fair value exclusive of any element of value arising from the accomplishment or expectation of the merger"). ***But see*** N.Y. BUS. CORP. LAW § 623(h)(4) (McKinney 1986) ("fair value" may include the effects of the merger on the corporation and its shareholders).

[87] *See* Note, *supra* note 82, at 368.

[88] The coercive nature of the two-tiered tender offer has been widely recognized. *See, e.g.,* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 630 (D. Md. 1982) ("If the [tender] offer is in fact 'coercive,' it would only be because its two-tier structure is revealed."); Radol v. Thomas, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982) (A two-tiered tender offer is inherently coercive.); Brudney & Chirelstein, *supra* note 81, at 337 ("[A]n announced disparity between the tender and the merger figures would deprive [the] stockholders of their ability to make an unforced, independent judgement."); Finkelstein, *supra* note 79, at 293 (Two-tier tender offers "put pressure on shareholders to tender their shares to avoid being frozen out for lesser consideration in the second-step transaction." (footnote omitted)); Lowenstein, *supra* note 81, at 308 ("The two-tier pricing structure was concededly intended . . . to coerce shareholders into tendering at the first."); Note, *supra* note 81, at 1966 (The two-tier tender offer "maximizes the coercion inherent in the tender offer process.").

[89] *See* Scriggins & Clarke, ***Takeovers and the 1983 Maryland Fair Price Legislation,*** 43 MD. L. REV. 266, 271 n.22 (1984); Note, *supra* note 82, at 352-54; Comment, ***Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique,*** 131 U. PA. L. REV. 389, 409 (1982).

quence, perhaps, of the recent Wall Street insider trading scandals, legislative reforms, economic or other reasons—the two-tiered tender offer may well experience a resurgence.[90]

### C. *The Effects of Abusive Takeovers*

#### 1. Debt Creation

Abusive takeovers have increased the amount of debt in our economy to extraordinary proportions. In addition to the debt assumed by raiders in order to mount takeover bids, target companies have also assumed huge amounts of debt as defensive measures.[91] Assumption of debt to allow stock repurchases has been employed to defeat hostile tender offers[92] and as a prophylactic measure to boost the stock prices

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[90] SEC Commissioner Joseph A. Grundfest has recently questioned the completeness and logic of legislation that restricts hostile two-tiered offers without restricting management-supported two-tiered offers and self-tenders. *See* Address by J. Grundfest, Two-Tier Tender Offers: A Mythectomy, United Shareholders Association Annual Meeting (June 5, 1987) and the National Association of Manufacturer's Congress of American Industry, Government Regulation and Competition Session (May 27, 1987) (on file with the *University of Pennsylvania Law Review*). However, in the absence of a comprehensive legislative program designed to remove all barriers to shareholder choice, the rationale for distinguishing between hostile and board-supported two-tiered offers is clear. The board is bound to act in a fiduciary capacity for the benefit of the company's shareholders, and its actions are closely scrutinized by the courts. *See, e.g.*, Edelman v. Fruehauf Corp., 798 F.2d 882, 885-86 (6th Cir. 1986) (directors breached fiduciary duty by "rubber stamping" a management buy out proposal that was less advantageous to shareholders than an outside bid); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274-77 (2d Cir. 1986) (directors' fiduciary duty to shareholders includes the duty to acquire and analyze material information about an offer and the duty to monitor outside advice regarding an offer); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (invalidating certain defensive tactics because, once a decision had been made to sell the target, "obtaining the highest price for the benefit of the target's stockholders should have been the central theme guiding director action"); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 113-15 (Del. Ch. 1986) (enjoining a target's self-tender because it was unnecessarily coercive and precluded the target's shareholders from choosing to tender into a pre-existing offer). A raider is bound by no such fiduciary duty and may act purely in its own self-interest.

[91] *See* J. BROOKS, *supra* note 25, at 192 (Phillips Petroleum, Unocal, and CBS had to assume large amounts of debt to defend against hostile takeovers.); Jonas & Berger, *Do All These Deals Help or Hurt the U.S. Economy?*, BUS. WK., Nov. 24, 1986, at 86, 86 ("[E]xecutives . . . are loading up their companies with high risk debt to stave off raiders."); Cowan, *The Allure of Stock Buybacks*, N.Y. Times, Mar. 5, 1987, at D1, col. 3 (noting that stock repurchases totalled $45 billion in 1986 and $8 billion for the first two months of 1987).

[92] For example, Union Carbide engaged in a stock repurchase program, backed by $2.5 billion in debt securities, to defeat GAF's junk-bond, bust-up bid. *See* UNION CARBIDE CORP., AMENDMENT NO. 4 TO RULE 13E-1 INFORMATION AND SCHEDULE 13E-4 ISSUER TENDER OFFER STATEMENT 3-5 (Jan. 3, 1986) (on file with *the University of Pennsylvania Law Review*); Wiener, *Deals of the Year*, FORTUNE, Feb. 2, 1987, at 68, 68.

of potential targets,[93] or to make a company's balance sheet less attractive to raiders.[94] Targets that have paid greenmail to defeat abusive, highly leveraged takeover bids often make a premium repurchase from other stockholders in order to increase leverage and discourage yet another greenmail attempt.[95] Targets and potential targets have also resorted to leveraged buy outs[96] and recapitalizations, which are, in effect, public leveraged buy outs.[97] Typically, the proportion of debt capital in a large deal is as high as 90%.[98]

The amount of debt produced by, and in reaction to, abusive takeovers is staggering. "Over the two years 1984 and 1985, the debt of nonfinancial corporations rose by $384 billion, while equity contracted by $99 billion. This contraction comprises the total of retained earnings, which were a positive $53 billion, and net new equity issuance,

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[93] *See, e.g.*, Nussbaum, *Deal Mania,* BUS. WK., Nov. 24, 1986, at 74, 75 (noting that Westinghouse Electric Corp.'s plan to repurchase 20% of its equity helped boost the price of its stock from $33 to $58, thereby increasing the company's capitalization and making it more expensive for raiders to be successful).

[94] *See* Levine & Lykos, *Recent Developments in Defensive Strategies,* 1 HOSTILE BATTLES FOR CORP. CONTROL 105, 108 (1985); Jonas & Berger, *supra* note 91, at 87.

[95] After purchasing Sir James Goldsmith's stock at a profit to Goldsmith of approximately $93 million, Goodyear assumed substantial debt to allow repurchase of 40 million of its remaining 109 million shares at a cost of $2.6 million. *See* Hicks, *Goodyear Buys Out Goldsmith,* N.Y. Times, Nov. 21, 1986, at D1, col. 6. CPC International, Inc. and Gillette both bought back Ronald Perelman's (Revlon Group's Chairman) stake in their companies, *see* Belkin, *Gillette Deal Ends Revlon Bid,* N.Y. Times, Nov. 25, 1986, at D1, col. 6; Cole, *Perelman Is Said to Sell CPC Stake,* N.Y. Times, Nov. 6, 1986, at D1, col. 3; Miller & Hall, *CPC to Buy Perelman Stake from Its Banker,* Wall St. J., Nov. 6, 1986, at 3, col. 1, and then announced substantial debt-financed repurchasing programs. *See* Miller & Watkins, *Gillette Blocks Takeover Move; Stock Slumps,* Wall St. J., Nov. 25, 1986, at 5, col. 1; Miller & Hall, *supra,* at 3, col. 2. Federated Department Stores paid $88.88 per share to buy back the Haft family's 4.5% stake in their company and announced a stock repurchase program. *See* Bianco, *A Flurry of Greenmailing Has Stockholders Cursing,* BUS. WK., Dec. 8, 1986, at 32, 32-33.

[96] For example, Merrill Lynch Capital Partners recently consummated a $4.23 billion leveraged buy-out of Borg-Warner to defeat a takeover bid by GAF Corporation. *See Borg-Warner Corp. Holders Approve Merger,* Dow Jones News Wire, July 30, 1987; Cole, *GAF Withdraws Its Bid for Borg,* N.Y. Times, April 28, 1987, at D1, col. 3; Cole, *Merrill Unit to Acquire Borg,* N.Y. Times, April 13, 1987, at D1, col. 6. In connection with the deal, Merrill Lynch received $31.5 million in investment banking fees. *See Borg-Warner Fees,* N.Y. Times, July 10, 1987, at D3, col 5. In 1986, Safeway Stores was acquired in a $4.1 billion leveraged buy out to repel a takeover, and Macy's, which was not faced with a takeover bid, went private in a $3.7 billion leveraged buy out. *See* Brooks, *Safeway Agrees to Sale Valued at $4.1 Billion,* L.A. Times, July 28, 1986, pt. 1, at 4, col. 2.

[97] Colt Industries recently recapitalized in a transaction that gave it total debt of $1.42 billion and shareholders' equity of negative $1.56 billion. *See* Selby, *Learning to Like Leverage,* INSTITUTIONAL INVESTOR, Dec. 1986, at 118, 125.

[98] *See id.* at 120.

which was a negative $152 billion."[99] As the corporate debt burden has increased, there has been a corresponding decline in the quality of outstanding debt.[100] Economist John Kenneth Galbraith draws a parallel to the crash of 1929:

> Leverage is again working its wonders. Not in utility pyramids: these in their full 1929 manifestation are forbidden by law. And the great investment houses, to be sure, still raise capital for new and expanding enterprises. But that is not where the present interest and excitement lie. These lie in the wave of corporate takeovers, mergers, and acquisitions, and the *leveraged* buy-outs. And in the bank loans and bond issues, not excluding the junk bonds, that are arranged to finance these operations.
>
> The common feature of all these activities is the creation of debt. In 1985 alone some $139 billion dollars' worth of mergers and acquisitions was financed, much of it with new borrowing. More, it would appear, was so financed last year. Some $100 billion in admittedly perilous junk bonds (rarely has a name been more of a warning) was issued to more than adequately trusting investors. This debt has a first claim on earnings; in its intractable way, it will absorb all earnings (and claim more) at some astringent time in the future.
>
> That time will come. Greatly admired for the energy and ingenuity it now and recently has displayed, this development (the mergers and their resulting debt), to be ade-

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[99] Kaufman, *Heavy Debt Poses Threat to Economic and Financial Stability*, AM. BANKER, Sept. 22, 1986, at 12, 12-13; *see also* Clark & Malabre, *Debt Keeps Growing, with the Major Risk in the Private Sector,* Wall St. J., Feb. 2, 1987, at 1, col. 1, 16, col. 1 (noting that "[i]n a recent three-year period, corporations raised $483.4 billion through various sorts of borrowing, but their equity financing fell $226.1 billion").

[100] *See* Kaufman, *supra* note 99, at 12 (comparing the decline in the AAA market with the increase in the junk-bond market); *see also* Worthy, *The Coming Defaults in Junk Bonds,* FORTUNE, Mar. 16, 1987, at 26, 34 (noting that defaults on the lowest grade junk bonds could have a domino effect (quoting Edward Yardeni, chief economist for Prudential-Bache Securities)); Buchan, *Junk Bonds: A Questionable Middle Age,* Fin. Times, June 16, 1987, § 2, at IX, col. 1 ("On a par value basis, the default rate for junk bonds last year was 3.4 per cent, against a negligible rate for investment grade bonds. This is the highest default rate since . . . 1970."); Lowenstein, *Three New Reasons to Fear Junk Bonds,* N.Y. Times, Aug. 24, 1986, § 3, at 3, col. 1 (identifying invention of zero-coupon junk bonds as evidence of declining quality). The decline in the quality of debt has raised concerns regarding the willingness of certain financial institutions with fiduciary obligations to policyholders, depositors, and retirees, such as insurance companies, savings and loans, commercial banks, and pension funds, to invest in high-yield, high-risk instruments. *See* Rohatyn, *The Blight on Wall Street,* N.Y. REV. BOOKS, Mar. 12, 1987, at 21, 22; Lowenstein, *supra,* § 3, at 3, col. 1.

> quately but not unduly blunt, will eventually be regarded as no less insane than the utility and railroad pyramiding and the investment-trust explosion of the 1920s.[101]

His concern is widely shared.[102]

### 2. Changing the Focus of Management

The advent of the highly leveraged takeover, and the defensive responses to it, have forced companies to focus on short-term profitability rather than on capital investment,[103] or long-term planning, research, and development.[104] Targets that have increased leverage to ward off

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[101] Galbraith, *The 1929 Parallel,* ATLANTIC MONTHLY, Jan. 1987, at 62, 64-65.

[102] *See Impact of Corporate Takeovers: Hearings on the Effect of Mergers on Management Practices, Cost, Availability of Credit, and the Long-Term Viability of American Industry Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs,* 99th Cong., 1st Sess. 448 (1985) [hereinafter *Impact Hearings*] (testimony of John Shad, SEC Chairman) ("[I]n a serious recession or a period of rapidly rising interest rates, the companies that are obligated under the junk bonds could get into financial difficulties."); *id.* at 577 (testimony of Preston Martin, Vice Chairman of Federal Reserve Board of Governors) ("Because many mergers and leveraged buyouts have involved heavy reliance on debt coupled with retirement of existing equity, the surviving firms are more vulnerable to downturns in earnings or sharp increases in interest rates."); *id.* at 18-19 (testimony of Martin Lipton) ("Leverage produces great results on the way up, but . . . high leverage inevitably produces a crash when the economy turns down."); J. BROOKS, *supra* note 25, at 228 (Given the perilously high levels of short-term debt and debt-to-equity ratios, companies are particularly vulnerable to an increase in interest rates.); *Debt Worries,* BANKER, Feb. 1986, at 65 (noting that Paul Volcker, Chairman of the Federal Reserve Board, expressed concern about debt-financed acquisitions); *Too Much Corporate Debt,* BANKER, Feb. 1986, at 3 (noting with disquiet that the current wave of mergers is accentuating corporate debt); Brady, *supra* note 42, at A27, col. 3 ("[J]unk takeover financing . . . dangerously threatens to destabilize America's national savings system.").

Others have taken issue with Galbraith's fear of leverage. *See* CORPORATE MERGERS, *supra* note 44, at 14 (" 'Overall, the data seem to suggest that [the changing role of junk bonds in tender offer activity has] been less dramatic than public perception suggests.' " (quoting SEC, OFFICE OF THE CHIEF ECONOMIST, NONINVESTMENT GRADE DEBT AS A SOURCE OF TENDER OFFER FINANCING 9-10 (June 20, 1986))); Jonas & Berger, *supra* note 91, at 86 (noting that there is no general consensus on the future economic effects of junk-bond financed takeovers); Selby, *supra* note 97, at 118 (discussing the beneficial consequences of debt on return on equity and corporate efficiency); Taggart, *Corporate Financing: Too Much Debt?,* FIN. ANALYSTS J., May-June 1986, 35, 35-36 (arguing that despite the fears raised by, among other trends, the growth of junk-bond financing, the degree of financial weakening due to growing corporate debt has been exaggerated).

[103] *See* Dobrzynski, *More Than Ever, It's Management for the Short Term,* BUS. WK., Nov. 24, 1986, at 92; *see also* Hayes & Abernathy, *Managing Our Way to Economic Decline,* HARV. BUS. REV., July-Aug. 1980, at 67, 68-70 (American corporations over the last 20 years have sacrificed long-term investments in R & D and new equipment for short-term, market-driven concentration on return on investment.).

[104] *See* Testimony of Robert E. Mercer Before Subcomm. on Monopolies and Commercial Law of House Comm. on the Judiciary, New Jersey, at 6 (Nov. 18, 1986)

raiders find that virtually all of their cash flow must be used to service debt.[105] Potential targets seek to maximize short-term performance in the hope of averting takeover bids.[106] And in the era of junk bonds, virtually every company is a potential target.[107]

In addition, the current wave of takeover activity has caused both raider and target to expend enormous resources on inherently nonproductive activity:

> We must not for a moment forget that there is nothing economically useful in this merger activity. It doesn't produce goods, or increased efficiency. It doesn't improve the system. If anything, it is damaging to the operation of the system because it diverts attention from the hard tasks of producing goods and services efficiently.[108]

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(describing the adverse consequences of the drastic restructuring of Goodyear Tire & Rubber Co. in response to the hostile takeover bid by Sir James Goldsmith) (author's transcript on file with the *University of Pennsylvania Law Review*); Drucker, *Taming the Corporate Takeover,* Wall St. J., Oct. 30, 1984, at 30, col. 3 (The wave of takeovers "contributes to the obsession with the short term and the slighting of tomorrow in research, product development, [and] market development.").

[105] For example, Owens-Corning Fiberglass Corp., which incurred $2 billion in debt to thwart a bid by Wickes Corp., was forced to slash its research budget in half, discharge 480 research employees, and moth-ball 14% of its productive capacity. *See* Willoughby, *What a Raider Hath Wrought,* FORBES, Mar. 23, 1987, at 56, 56; *see also* Selby, *supra* note 97, at 120 (In a typical deal, "*more* than 100 percent of the cash flow can be committed to debt payments.").

[106] *See* Ellsworth, *supra* note 24, at 172 (noting that "strategies designed to shore up short-term returns to shareholders erode the company's international competitiveness"); Williams, *It's Time for a Takeover Moratorium,* FORTUNE, July 22, 1985, at 133, 136 ("The fear of raiders also reinforces an already troublesome emphasis on short-term thinking in American business."); Drucker, *supra* note 21, at 32, col. 5 (noting the role of "the panicky fear of the raider" in pushing top management "toward decisions they know to be costly . . . mistakes").

[107] *See* J. BROOKS, *supra* note 25, at 192 ("For practical purposes, junk bonds all but eliminated corporate size as a takeover defense.").

[108] Crichton, *Galbraith on the Boesky Scandal,* N.Y. Times, Nov. 23, 1986, § 3, at 3, col. 1; *see also* R. REICH, THE NEXT AMERICAN FRONTIER 145 (1983) (noting that ploys such as threatened takeovers "do not enlarge the economic pie; they merely reassign the slices"); Coffee, *supra* note 19, at 1221-50 (examining three types of diseconomies that might result "from a policy aimed at maximizing the frequency of takeovers"); Fisher & Lande, *Efficiency Considerations in Merger Enforcement,* 71 CALIF. L. REV. 1582, 1586 (1983) (concluding that empirical studies are "inherently incapable of proving . . . that mergers on average yield efficiencies"); Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research,* 60 N.Y.U. L. REV. 761, 826 (1985) (stating that unanswered questions "undermine the evidence marshaled for the view that unfriendly tender offers, by displacing entrenched inefficient managements, increase shareholder welfare"); *The Odds Against the Casino Society,* BUS. WK., Sept. 16, 1985, at 144, 144 (stating that speculation channels "far too much talent and energy into financial shell games rather than into producing real goods and services"); Adams & Brock, *The Hidden Costs of Failed Mergers,* N.Y. Times, June 21, 1987, § 3, at 3, col. 1 (detailing the expenditures on mergers, which in 1985 exceeded combined expenditures for research and development and net new investment).

The huge amount of resources spent paying for the costs of merger activity has been diverted to service industries. As a consequence, "[e]mployment in many investment banking firms, law firms, arbitrage firms, investment advisers, etc., has grown tenfold over the last few years."[109] As noted by former SEC Chairman Harold Williams, this "loss in management effectiveness works against corporate and national productivity, the wages of employees, and returns to stockholders. It undermines our economy and our society."[110]

### 3. Effect on Corporate Constituencies

The current wave of highly leveraged takeovers has threatened or caused the flight of business operations upon which communities have come to rely and disrupted settled relationships between the target companies and employees, customers, and suppliers.[111] Justice Powell recently noted the effect of hostile takeovers on communities generally:

> The corporate headquarters of the great national and multinational corporations tend to be located in the large cities of a few States. When corporate headquarters are transferred out of a city and State into one of these metropolitan centers, the state and locality from which the transfer is made inevitably suffer significantly. Management personnel—many of whom have provided community leadership—may move to the new corporate headquarters. Contributions to cultural, charitable, and educational life—both in terms of leadership and financial support—also tend to diminish when there is a move of corporate headquarters.[112]

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*But see* ECONOMIC REPORT OF THE PRESIDENT 198 (1985) ("The evidence is strong that takeovers generate aggregate net benefits to the economy."); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 HARV. L. REV. 1161, 1168-74 (1981) (the prospect of a tender offer creates economic benefits by inducing more efficient management).

[109] Rohatyn, *supra* note 100, at 21.

[110] Williams, *supra* note 106, at 136.

[111] *See* Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REV. 1, 72 (1986); O'Boyle & Carey, *Gulf's Departing Pittsburgh Would Deal a Harsh Blow to City's Economy and Pride,* Wall St. J., Mar. 9, 1984, at 33, col. 3; Mintz, *Community Dislocations: A Painful Side Effect of Merger,* Wash. Post, Apr. 20, 1980, at A2, col. 1.

[112] Edgar v. MITE Corp., 457 U.S. 624, 646 n.* (1982) (Powell, J., concurring in part); *see also* J. BROOKS, *supra* note 25, at 234 (noting the potential of takeover bids for "disruption of communities that are built around a single company"); Sheets, *supra* note 20, at 51 (noting that Gulf Oil, prior to its exodus from Pittsburgh as a consequence of Mesa Petroleum's junk-bond, bust-up bid, contributed over $2 million in 1983 to more than 50 Pittsburgh organizations).

Hostile takeovers have been equally harmful to more concrete constituencies. As part of its restructuring to defeat a bid by Wickes Corporation in late 1986, Owens-Corning was forced to cut its pretakeover bid workforce of 28,000 by approximately 13,000.[113] Sir James Goldsmith's November 1986 bid for Goodyear affected a company that employed over 12,000 people, nearly one-eighth of Akron's workforce, generated $500 million in employee income and $300 million in supplier income, and supported three to four other local jobs for every Goodyear job in the community.[114] Hostile takeovers clearly have traumatic effects on the constituencies integral to corporate existence.

### 4. Effect on Security Holders

The effect of hostile takeovers on security holders, the corporate constituency most directly affected, is less clear. Although share price studies suggest that target stockholders gain as a result of takeover activity, there is evidence that shareholders of the raider experience a decline in share values.[115] There is also evidence that diversification by acquisition is often detrimental.[116] Moreover, the "gain" experienced

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[113] *See* O'Brien & Kline, *An Rx for Jobs Lost Through Mergers,* N.Y. Times, Feb. 22, 1987, § 4, at 23, col. 2.

[114] *See* Testimony of Thomas C. Sawyer Before Subcomm. on Monopolies and Commercial Law of House Comm. on the Judiciary, New Jersey, at 2 (Nov. 18, 1986) (author's transcript on file with the *University of Pennsylvania Law Review*); *see also* Prokesch, *People Trauma in Mergers,* N.Y. Times, Nov. 19, 1985, at D1, col. 3, D5, col. 1 ("In an effort to slash overhead by consolidating staffs and functions, . . . acquiring companies . . . have discharged or pushed into early retirement tens of thousands of people.") Similarly, Mobil Corporation's 1981 bid for Marathon Oil Company, had it been successful, "would have spelled economic doom for the town of Findlay, OH, population 38,000—2,500 of them employees of Marathon Oil . . . ." *Takeover Tactics and Public Policy: Hearings on H.R. 2371 et al. Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce,* 98th Cong., 2d Sess. 381 (1984) (statement of Rep. Oxley).

[115] *See* CHAIRMAN OF SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE OF HOUSE COMM. ON ENERGY AND COMMERCE, 99TH CONG., 2D SESS., CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS FOR THE ECONOMY AND CORPORATE GOVERNANCE 31-34 (Comm. Print 1987); Dent, *Unprofitable Mergers: Toward a Market-Based Legal Response,* 80 NW. U.L. REV. 777, 778-79 (1986) ("Some studies have found, on average, slight gains from acquisitions, but other studies have found that, on average, acquiring companies suffer losses, and even the more optimistic studies do not deny that many acquisitions depreciate the bidder's stock."); *see also* J. BROOKS, *supra* note 25, at 233 (noting that "in almost any heavily leveraged takeover or acquisition the target shareholders' short-term gain is, logically and inevitably, the acquirer and target bondholders' short-term loss").

[116] One study analyzed the acquisitions made by 33 major corporations and found that more than 50% of their acquisitions in new industries, more than 60% of their acquisitions in entirely new fields, and more than 70% of their acquisitions in unrelated industries were ultimately divested. *See* Porter, *From Competitive Advantage to Corporate Strategy,* 65 HARV. BUS. REV., May-June 1987, at 43, 44-46.

by target shareholders may be a short-term phenomenon. According to one study, despite the fact that the bids examined generally involved a substantial premium over the prevailing market, a majority of targets that defeated hostile tender offers ultimately saw their stock prices exceed the tender offer price in real terms.[117]

In contrast to stockholders, bondholders have been universally harmed by the increase in corporate leverage. Whether the growth in leverage results from a successful takeover or a successful defense, it makes outstanding bonds riskier and, as a consequence, less valuable.[118] The result is a transfer of wealth from bondholders to stockholders that has not been, and arguably cannot be, prevented by contract or other existing constraints.[119] Preferred stockholders are similarly disadvan-

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[117] *See* KIDDER, PEABODY & CO., SUMMARY OF DEFEATED HOSTILE TENDER OFFERS: 1973-1984 (1984); *see also* Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year,* 36 BUS. LAW. 1017, 1025-26 (1981); Lipton, *Takeover Bids in the Target's Boardroom,* 35 BUS. LAW. 101, 132-34 (1979) [hereinafter *Takeover Bids*]. A critique of the Kidder, Peabody study suggests that shareholders of targets that defeat tender offers do not recover the equivalent of the bid premium within two years. *See* Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?,* 59 N.Y.U. L. REV. 277, 287-91 (1984); *see also* Coffee, *supra* note 19, at 1171-72 n.69 (discussing a critique of the Kidder, Peabody & Co. study that adjusts the data for the time value of money and indicates that target shareholders would have done better to have accepted the tender offer premium). However, a critique of the Easterbrook & Jarrell study has in turn revealed that, if the time horizon is not artificially restricted to two years, the stock price performance of targets defeating tender offers exceeds that of the Standard & Poor's 500 index. *See* D. MARGOTTA & F. MARSTON, LONG-TERM RESULTS OF DEFEATED TENDER OFFERS (Northeastern University College of Business Administration Working Paper: 87-29, June 1987).

[118] *See* J. BROOKS, *supra* note 25, at 232-33; Farrell, *Takeovers and Buyouts Clobber Blue Chip Bondholders,* BUS. WK., Nov. 11, 1985, at 113, 113 (noting that 27% of Moody's downgrades of corporate bonds in 1985 resulted from takeover activity); Weberman, *Redmail,* FORBES, Oct. 7, 1985, at 173, 173 ("What's good for CBS' stockholders is bad for its bondholders."); Forsyth, *Bad Grades: Takeovers Teach a Costly Lesson to Bond Holders,* Barron's, Feb. 24, 1986, at 24, 25-26 ("[T]he bolts from the blue—mergers, stock buybacks and LBOs sprung on unsuspecting investors— . . . have dealt the biggest blow to prices of bonds of corporations involved in these deals."); Prokesch, *Merger Wave: How Stocks and Bonds Fare,* N.Y. Times, Jan. 7, 1986, at A1, col. 1 ("[S]hareholders of the surviving companies are no better off and . . . bondholders on both sides are often big losers.").

[119] *See* McDaniel, *Bondholders and Corporate Governance,* 41 BUS. LAW. 413, 455-56 (1986) ("Contrary to popular belief, indentures do not have numerous, detailed covenants that regulate the bondholder-stockholder conflict. . . . Such covenants are costly. Other constraints on stockholder gain at bondholder expense are ineffective." (footnote omitted)). One method of attempting to protect bondholders against leveraged takeovers and buy outs is to give bondholders the power to cash in or "put" their bonds in the event of a change in control. *See* Hertzberg, *"Poison-Put" Bonds Are Latest Weapon in Companies' Anti-Takeover Strategy,* Wall St. J., Feb. 13, 1986, at 5, col. 1; *see also* Clemens, *Poison Debt: The New Takeover Defense,* 42 BUS. LAW. 747, 749-54 (1987) (suggesting typical "poison debt" provisions that protect a company's bondholders against highly leveraged takeovers). A variant of this scheme was employed by Phillips Petroleum Co. in its 1985 battle with Carl Icahn. As part of its defense, Phillips assumed $4.5 billion in new debt, and its loan contracts prohibited future suitors from

taged by an increase in leverage.[120]

### D. *Defensive Tactics*

The current wave of hostile takeovers has generated a host of vigorous defensive tactics. These tactics, which restrict the choices of target shareholders and may be undesirable in the abstract, are currently legitimate responses to abusive takeover schemes, such as the highly leveraged, asset-stripping takeover. One such defensive tactic, increased leverage by the target, has already been discussed.[121] Other examples follow.

#### 1. Alteration of Voting Rights

Restricting the voting rights of large or short-term stockholders is one method of deterring the speculative takeover bidder. A number of companies have departed from the one-share, one-vote principle and have restricted the voting rights of those owning more than a specified percentage of shares.[122]

Other companies have created a new class of common stock with higher voting rights than ordinary common stock. A typical plan reclassifies the common stock into two categories, Series A and B. Series A possesses one vote per share and the right to dividends at least 10% higher than Series B. Series A is not convertible into Series B. Series B

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using Phillips' assets as security for loans without first paying off the $4.5 billion debt. *See* Whitefield, *Icahn Withdraws Bid for Phillips as Oil Firm Sweetens Its Own Offer,* L.A. Times, Mar. 5, 1985, pt. 4, at 1, col. 5. However, control clauses in loan agreements are problematic because they tend to jeopardize the lender's creditor status, expose the lender to shareholder suits, and impede management's ability to consummate friendly acquisitions. *See* 1 M. LIPTON & E. STEINBERGER, *supra* note 68, at § 6.03[4].

[120] *See e.g.,* Norris, *supra* note 20, at 45, col. 1.

[121] *See supra* notes 94-97 and accompanying text.

[122] For example, such plans have been enacted for a specified number of years by Allegheny Corporation, Lucky Stores, Multimedia, and Premark, and without time limitations by MCI, Figgie International, and Heights Finance. Voting restrictions of this sort arguably violate the principle that each share of a class of stock have the same incidents. Delaware has taken the position that discrimination among shareholders based on the number of shares owned does not constitute unlawful discrimination among shares. *See* Providence & Worcester Co. v. Baker, 378 A.2d 121, 122-24 (Del. 1977); *see also* Dynamics Corp. of America v. CTS Corp., 805 F.2d 705, 718 (7th Cir. 1986) (holding that Indiana would follow Delaware in allowing discrimination among shareholders), *rev'd on other grounds,* 107 S. Ct. 1637, 1653 (1987). In addition, a recent Delaware case upheld a recapitalization plan that provided for differential voting rights based on length of ownership. *See* Williams v. Geier, No. 8456, slip op. at 8-9 (Del. Ch. May 20, 1987). The law in other jurisdictions is unclear. *See, e.g.,* Asarco, Inc. v. M.R.H. Holmes A Court, 611 F. Supp. 468, 478 (D.N.J. 1985) (doubting that New Jersey would follow *Providence & Worcester*).

provides ten votes per share, can be converted into Series A, and is subject to severe restrictions on transferability.[123]

In addition, a number of states have passed "control share acquisition" statutes to deter the speculative takeover bidder.[124] The Indiana version was recently upheld by the Supreme Court in *CTS Corp. v. Dynamics Corp. of America.*[125] Under the Indiana statute, the acquisition of "control shares"[126] in an Indiana corporation does not include voting rights unless a majority of pre-existing disinterested shareholders of the target agree. The Supreme Court's decision in *CTS* could be an

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[123] *See* Baron v. Strawbridge & Clothier, 646 F. Supp. 690, 693, 696-99 (E.D. Pa. 1986) (refusing to enjoin preliminarily such a revised voting scheme). Twenty-six companies listed on the New York Stock Exchange ("NYSE") have issued or intend to issue classes of stock with unequal voting rights. *See* Ingersoll, *One-Share, One-Vote Controversy Comes to Head in SEC Hearings,* Wall St. J., Dec. 16, 1986, at 37, col. 4; *see also* Klott, *A Fight over Unequal Stock,* N.Y. Times, Oct. 22, 1985, at D1, col. 3 (noting that approximately 5% of the approximately 2,200 companies listed by the National Association of Securities Dealers have some form of high or low voting stock). To prevent loss of business to other markets, the NYSE recently applied to the SEC for permission to change its one-share, one-vote rule. After the major exchanges were unable to reach agreement, the SEC proposed a rule mandating a modified one-share, one-vote requirement for listing on a national exchange. The SEC would prohibit issuance of new classes of stock, on or after May 15, 1987, that "have the effect of nullifying, restricting, or disparately reducing the per share voting rights of holders of an outstanding class or classes of common stock of such issuer registered pursuant to section 12 of the [1934] Act." 52 Fed. Reg. 23,665, 23,677 (1987) (to be codified at 17 C.F.R. pt. 240) (proposed June 24, 1987). Thus, the SEC would allow disparate voting stock issued prior to May 15, 1987, issued when first going public, or issued as new stock with lower voting rights than outstanding stock. The SEC would also permit the exchanges to exempt types of corporate actions from the rule if consistent with the policy of the rule (for example, disparate voting stock issued as payment for an acquisition). *See id.* at 23,678; *see also* Statement of David S. Ruder, Chairman of the SEC, Before Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce Concerning Pending Legislation Regarding Contests for Corporate Control, 100th Cong., 1st Sess. 56 (September 17, 1987) ("proposed Rule 19c-4 . . . sets forth a standard that prohibits only transactions which have the effect of disenfranchising shareholders").

[124] *See, e.g.,* HAW. REV. STAT. §§ 416-171 to -172 (1986); IND. CODE ANN. §§ 23-1-42-1 to -11 (West Supp. 1987); MO. ANN. STAT. § 351.407 (Vernon Supp. 1987); OHIO REV. CODE ANN. § 1701.83.1 (Anderson 1985 & Page Supp. 1986); WIS. STAT. ANN. § 180.25(9) (West Supp. 1987); Act of July 22, 1987, ch. 3, § 2, 1987 Ariz. Legis. Serv. 32, 38-41 (West) (to be codified at ARIZ. REV. STAT. ANN. §§ 10-1211 to -1217); Act of July 21, 1987, ch. 272, 1987 Mass. Adv. Legis. Serv. 200 (Law. Co-op.) (to be codified at MASS. GEN. L. ch. 110D, §§ 1-8, ch. 110E §§ 1-7); Act of June 25, 1987, ch. 1, § 24, 1987 Minn. Sess. Law Serv. 911, 928-35 (West) (to be codified at MINN. STAT. ANN. § 302A.671 (West)).

[125] 107 S. Ct. 1637, 1653 (1987); *see also* Labaton, *Business and the Law: Preemption Cases Abound,* N.Y. Times, Sept. 14, 1987, at D2, col. 1 (noting that *CTS* is indicative of a trend by the Court permitting states to regulate in ways that do not directly conflict with federal goals).

[126] Under the Indiana Act, an entity acquires "control shares" whenever it acquires shares that, but for the Act, would bring its voting power to or above one of the following thresholds: 20%, 33 ⅓%, or 51%. IND. CODE ANN. § 23-1-42-1 (West 1987).

important step in discouraging the junk-bond, bust-up tender offer. In states with control share acquisition statutes, the bidder can no longer unilaterally obtain the voting power necessary to obtain control of the target, effect a second-step merger, and sell the target's assets as a financing mechanism. However, these statutes can be counterproductive in that a raider is permitted to buy up to 20% of the target and then demand a shareholder vote, on which a tender offer or other control transaction can be conditioned. As raiders become accustomed to dealing with these statutes, we may find that they promote rather than deter takeovers.

The obvious point of schemes to restrict voting rights, whether by charter amendment or statute, is that they help prevent raiders from achieving speculative takeover profits at the expense of long-term shareholders. The obvious detriment is that they increase insulation of management from shareholder discipline and run the risk of breeding a new generation of as yet unimagined problems.[127]

### 2. Poison Pills

The share purchase rights plan, dubbed the "poison pill," is a maneuver specifically aimed at curbing the junk-bond, bust-up tender offer.[128] A typical rights plan contains a "flip over" provision that enables rightsholders to purchase shares of an acquirer at half price in the event a target is merged into an acquiring person.[129] As a consequence, the rights plan impedes a second-step merger designed to give a raider control of the target's assets.[130] The rights plan has been upheld as a

[127] *See* Williams, *supra* note 106, at 136 (observing that such barriers "insulate managers against legitimate shareholder action to depose them").

[128] The author has been credited with inventing the poison pill. *See* J. BROOKS, *supra* note 25, at 194.

[129] *See* Moran v. Household Int'l Inc., 500 A.2d 1346, 1348-49 (Del. 1985) (upholding rights plan with such a flip over provision).

[130] A number of states have enacted statutes functionally similar to the rights plan in that they inhibit second-step mergers designed to give the raider control of the target's assets. These statutes prevent a 10% shareholder from effecting a business combination with a target for five years following the 10% acquisition unless the combination is approved by the target's board prior to acquisition of the 10% stake. *See* IND. CODE ANN. § 23-1-43-18 (West Supp. 1987); KY. REV. STAT. ANN. § 271A.397(3) (Michie/Bobbs-Merrill Supp. 1986); MO. ANN. STAT. § 351.459 (Vernon Supp. 1987); N.J. STAT. ANN. § 14A:10A-4 (West Supp. 1987); N.Y. BUS. CORP. LAW § 912(17)(b) (McKinney 1986); Act of Sept. 17, 1987, 1987 Wis. Act 45 (to be codified at WIS. STAT. §§ 180.725 to .726) (setting time limit at three years rather than five); Act of Aug. 10, 1987, ch. 4, § 4, 1987 Wash. Legis. Serv. 10, 19-20 (West); Act of July 22, 1987, ch. 3, § 2, 1987 Ariz Legis. Serv. 32, 41-44 (West) (to be codified at ARIZ. REV. STAT. ANN. § 10-1221 to -1223); Act of June 25, 1987, ch. 1, § 25, 1987 Minn. Sess. Law Serv. 911, 936-45 (West) (to be codified at MINN. STAT. § 302A.673).

reasonable, initial response to "a small highly leveraged company bent on a 'bust-up' takeover by using 'junk bond' financing to buy [the target] cheaply, sell the acquired assets to pay the debts incurred, and retain the profit for itself."[131]

The rights plan thus forces a raider to negotiate with the target's board to determine if it desires a second-step merger, and helps to ensure that the raider will not abuse the tender offer process. Thus, the rights plan is a very effective defensive mechanism in the age of abusive takeovers.[132]

### 3. Greenmail

Under current law, a raider may secretly accumulate up to 5% of a company and, after reaching the 5% threshold, may continue to buy stock for ten days before any disclosure is required.[133] The raider may then declare an intention to seek control, put the company in play, and set the stage for "greenmail."[134] The target may be willing to pay greenmail as part of an entrenching maneuver or to protect existing shareholders and other corporate constituencies from the consequences of an abusive bid. For example, the target may pay greenmail to prevent a raider from obtaining control of the target and arrogating to itself the inherent worth of an undervalued target through a bust-up takeover, a threat made real by the availability of junk-bond financing.[135]

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[131] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180-81 (Del. 1986).

[132] One study concluded that the rights plan has beneficial effects. The stock prices of 75% of the companies studied increased following the announcement of a rights plan, and the companies studied, taken as a whole, outperformed the Standard & Poor's 400 Index. *See* KIDDER, PEABODY & CO., IMPACT OF ADOPTION OF STOCKHOLDER RIGHTS PLANS ON STOCK PRICES 1 (1986). By contrast, based upon examination of the change in stock prices one day before and one day after announcement of the adoption of a rights plan, a recent SEC study concludes that "poison pills are harmful to target shareholders." OFFICE OF THE CHIEF ECONOMIST, SEC, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS 43 (1986). However, even this study found no statistically significant impact on stock prices from adoption of the "flip over" pill described above.

[133] *See* Securities and Exchange Act of 1934, § 13(d), 15 U.S.C. § 78m(d) (1982).

[134] Greenmail has been defined as "a targeted repurchase of securities at a premium price from an investor who holds more than 3% of the corporation's stock and has held the stock for less than two years." Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis,* 98 HARV. L. REV. 1045, 1045 n.3 (1985).

[135] *See supra* text accompanying notes 40-50; Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty,* 60 N.Y.U. L. REV. 630, 636, 662 (1985); *Flurry of Greenmail,* BUS. WK., Dec. 8, 1986, at 32-33.

Although greenmail may be a necessary evil in some cases, it raises a number of substantial concerns: the raider receives preferential treatment not afforded other shareholders, target companies are saddled with debt after borrowing to make the repurchase; and the possibility of greenmail itself attracts speculative bids in the first instance.[136]

The proliferation of junk bonds increases the danger of greenmail because easy access to financing allows almost any raider to mount a credible threat, and the use of junk takeover bonds threatens a bust-up of the target accompanied by a variety of negative consequences. The current trend of highly leveraged takeover bids has led to a wave of greenmail payments that has resulted in a public uproar.[137] Several bills have been introduced in Congress and state legislatures aimed at curbing the payment of greenmail.[138]

### 4. Self-Liquidation

One catalyst of the current takeover wave is the failure of the financial markets to place a value on the securities of companies that is commensurate with their underlying assets.[139] As a consequence, it can be enormously profitable to leverage a bid for an undervalued company, sell the target's assets to finance the acquisition, and pocket the

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[136] *See* 133 CONG. REC. S337 (daily ed. Jan. 6, 1987) (statement of Sen. Metzenbaum); *see also* J. BROOKS, *supra* note 25, at 231 (noting that greenmail payments often cause a target's stock to drop below the pre-bid market price).

[137] Heavily criticized have been Sir James Goldsmith's $93 million profit at the expense of Goodyear, *see* Hicks, *supra* note 95, at D1, col. 6, Revlon's $43 million profit at the expense of Gillette, *see* Belkin, *supra* note 95, at D1, col. 6, Revlon's $40-50 million profit at the expense of CPC, *see* Miller & Hall, *supra* note 95, at 3, col. 1, Irwin Jacobs' $20 million payment from Enron Corp., *see Enron Pays Jacobs Greenmail*, BUS. WK., Nov. 3, 1986, at 36, 36, the Belzberg family's $37 million profit at the expense of the USG Corporation, and the Haft family's undisclosed profit at the expense of Federated Department Stores, *see* Nash, *Wall Street Bemoans a New "Greenmail" Season*, N.Y. Times, Dec. 28, 1986, § 4, at 4, col. 3.

[138] *See, e.g.*, S. 78, 100th Cong., lst Sess. (1987) (preventing premium repurchases from a 3% shareholder who has held his stake less than two years, unless the repurchase is approved by a majority vote of the shareholders or the same offer is made to all shareholders). Several states are also considering similar or analogous legislation. *See, e.g.*, S. 542 § 1 (Cal. Feb. 24, 1987) (amending the Corporations Code to "prohibit a target corporation . . . from purchasing more than 3% of its equity securities for more than the *post-disclosure* market price . . . from a shareholder or beneficial owner unless approved by the board of directors and shareholders").

[139] *See* Jonas & Berger, *supra* note 91, at 87 (noting that because the Q ratio, the ratio of market value of assets to replacement value, is above .75 but less than 1, it continues to be cheaper to buy old assets than to build new ones). One commentator attributes the cause of the disparity between market and replacement costs to many years of inflation. *See* Drucker, *Corporate Takeovers—What Is To Be Done?*, 82 PUB. INTEREST, Winter 1986, at 3, 6 ("[T]he most predictable, indeed the most typical distortion of inflation is between the value of assets and their earning power.").

profits.[140] Targets have resorted to self-liquidation to raise share prices in the short-term and preserve the resulting gain from the asset sales for their own shareholders.[141] The leverage boom, therefore, has forced companies to sell assets in order to increase the paper value of their shares, rather than for intrinsic business reasons.[142]

### 5. Institutional Investor Activism

One manifestation of increased activism on the part of institutional investors has been the formation of institutional investor organizations to oppose takeover defenses. In 1985, at the initiative of the California State Treasurer, the Council of Institutional Investors was formed.[143] The Council adopted a "Shareholders Bill of Rights" in April 1986. The Bill demands that shareholder approval be required for a wide range of management actions, including issuing stock that would dilute the voting power of existing shares by 20% or more, selling 20% or more of corporate assets to a hostile bidder in exchange for a takeover ceasefire, paying greenmail, or adopting a poison pill.[144] Similarly, the California Public Employees' Retirement System has solicited proxies, albeit unsuccessfully, from shareholders of more than a dozen companies in opposition to management proposals that might inhibit takeovers, such as proposals to elect directors to staggered terms and proposals that authorize the issuance of large amounts of common stock for

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[140] As noted, Pantry Pride's acquisition and bust-up of Revlon, *see supra* note 40, remains the prototype. There has been recent speculation that the Haft family's attempt to buy Dayton Hudson Corp., "one of the best managed companies in retailing," springs in large part from the fact that Dayton "has been investing heavily in new stores that haven't yet boosted its earnings." Schwadel, *Haft's Bid for Dayton Apparently Aimed at Proving Family Can Run Big Retailer,* Wall St. J., Sept. 21, 1987, at 8, col. 1; *see also* J. BROOKS, *supra* note 25, at 227 (citing a study showing that "in a majority of cases, the acquirers themselves considered their targets already to be well managed: that is, their objective was not to discipline or replace poorly run companies but to own well-run ones").

[141] For example, Goodyear was forced to dismantle a number of units and plants to raise share prices in the wake of Sir James Goldsmith's bust-up bid, *see* Bianco, *supra* note 95, at 32, and Purolator announced a self-liquidation plan to save itself from Unicorp, *see Company News: Purolator Strategy,* N.Y. Times, Nov. 21, 1986, at D5, col.6.

[142] *See generally* SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE, 99TH CONG., 2D SESS., CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS FOR THE ECONOMY AND CORPORATE GOVERNANCE 13-18, 40-48, 57-63 (Comm. Print 1986) (noting the various non-production-based forces driving the sale and idling of assets); Rohatyn, *supra* note 100 (underscoring the generally non-productive nature of these transactions).

[143] *See* 1 ENCYCLOPEDIA OF ASSOCIATIONS 312 (K. Gruber 21st ed. 1987) (describing the organization and its goals).

[144] *See* Castro, *And Now Proxy Power: Calls for More Corporate Say,* TIME, April 21, 1986, at 62; Mathiasen & Rosenbaum, *supra* note 28, at 33.

unspecified purposes.[145]

The California Retirement System has been joined by, among other organizations, the College Retirement Equities Fund ("CREF"), which controls pension assets for a nationwide group of college and university employees, in opposing the poison pill. By early 1987, some thirty shareholder resolutions urging companies to either refrain from adopting any poison pill plan without shareholder approval or rescind any such existing plan unless it is approved by stockholders were voted on at annual shareholder meetings.[146] While these resolutions did not receive a majority vote at any meeting, they demonstrated significant institutional support.[147]

Two other organizations contributed to institutional investor activism in 1986. In March 1986, the State of Wisconsin Investment Board announced its intention to sponsor shareholder resolutions opposing such widely divergent measures as U.S. investment in South Africa and poison pills.[148] In August 1986, T. Boone Pickens formed the United Shareholders Association as a pro-takeover lobbying group. During its brief existence, Pickens' group has opposed greenmail, poison pills, management control of the proxy machinery, and variations on the one-share, one-vote scheme.[149]

Opposition to defensive tactics of these sorts might be welcome in the context of an overall regulatory scheme that also sought to curb abusive takeover tactics. In isolation, however, such opposition must be viewed as an attempt to maintain a high level of takeover activity in

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[145] *See* Mathiasen & Rosenbaum *supra* note 28, at 33.

[146] *See* Anders, *Institutional Holders Irked by "Poison Pill"*, Wall St. J., Mar. 10, 1987, § 1, at 6, col. 1; Lipton, *A Sensible Deterrent to Takeover Mania,* N.Y. Times, Dec. 14, 1986, § 3, at 2, col. 3; Hall, *U.S. Pension Fund Attacks Companies on Poison Pill,* Fin. Times, Nov. 4, 1986, § 1, at 34, col. 4.

[147] Based on the results of approximately 20 meetings, about 20% of the outstanding shares have been voted in favor of such resolutions, which have not attained a majority vote at any meeting. *See 1987 Poison Pill Rescission Proposals—What Did It All Mean?,* GEORGESON REP. 1, 2 (2d Qtr. 1987) (noting further that, "[i]n no case did a poison pill rescission proposal achieve a favorable vote in excess of 30% of the outstanding shares"). Institutional investors have reported the average favorable vote for the anti-pill resolutions as a percentage of votes cast (29.4%) rather than as a percentage of outstanding shares and have attempted to draw some solace from the fact that the anti-pill resolutions garnered more average support than the general shareholder-sponsored resolutions. *See Anti-Poison Pill Proposals Draw Strong Shareholder Vote,* CORP. GOVERNANCE BULL., May-June 1987, at 66-71.

[148] *See* Mathiasen & Rosenbaum, *supra* note 28, at 33-34 (noting that Wisconsin officials have said they are prepared to solicit proxies in support of their proposals if the companies do not voluntarily agree to take the actions requested).

[149] *See* Sarasohn, *Wall Street Amasses Huge Lobbying Forces,* Legal Times, Apr. 13, 1987, at 1; *Rep. Markey Urges Congress to Adopt Comprehensive Takeover Package,* DAILY REP. FOR EXECUTIVES, Apr. 2, 1987, at A-6.

order to create speculative profits for institutional investors.[150]

## II. THE SCOPE OF CORPORATE GOVERNANCE

In 1932, Professor E. Merrick Dodd broadened the corporate governance debate by asking which constituencies corporate managers could legitimately claim to represent.[151] Against a background of massive unemployment and social unrest, Dodd argued that corporate managers must serve as trustees for a wide variety of constituencies in addition to shareholders.[152] Professor Berle, who had previously expressed concern that management inadequately represented the interests of shareholders,[153] resisted Dodd's expansive concept of corporate responsibility: "[Y]ou can not abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else."[154]

The advent of junk-bond, bust-up takeovers, the defensive responses to such takeovers, and the dangers posed to a wide variety of constituencies has again focused debate on the issue that divided Berle and Dodd over fifty years ago. For whom are corporate managers trustees?

### A. *Shareholders*

It would seem beyond question that corporate managers must govern on behalf of shareholders by whom they are elected and to whom the fiduciary duties of care and loyalty are said to run. Even this notion, however, has elicited some debate. Professor Abram Chayes has suggested that shareholders may be the constituency least deserving of management's protection.[155] They are able to liquidate their invest-

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[150] *See* Lipton & Brownstein, *Takeover Responses and Director's Responsibilities—An Update,* 40 BUS. LAW. 1403, 1430 (1985) (describing the role of speculation).

[151] *See* Dodd, *For Whom Are Corporate Managers Trustees?,* 45 HARV. L. REV. 1145 (1932).

[152] *See id.* at 1162-63.

[153] *See* A. BERLE & G. MEANS, *supra* note 11, at 277.

[154] Berle, *For Whom Corporate Managers* Are *Trustees: A Note,* 45 HARV. L. REV. 1365, 1367 (1932). It is interesting to note that 22 years later Berle conceded that "[t]he argument has been settled . . . squarely in favor of Professor Dodd's contention." A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954). He later noted: "[M]odern directors are not limited to running business enterprise for maximum profit, but are in fact and recognized in law as administrators of a community system." Berle, *Foreword* to THE CORPORATION IN MODERN SOCIETY xii (1972) [hereinafter THE CORPORATION].

[155] *See* Chayes, *The Modern Corporation and the Rule of Law,* in THE CORPORATION, *supra* note 154, at 25, 40-41.

ments quickly and may be viewed as having less of a permanent stake in the enterprise than other constituencies.[156] Chayes argues that shareholders deserve "the voiceless position in which the modern development left them."[157]

As noted by Professor Williamson, however, such a view confuses shareholders of the moment with the firm's shareholders as a permanent constituency.[158] Professor Williamson has observed:

> Stockholders as a group bear a unique relation to the firm. They are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal. Labor, suppliers in the intermediate product market, debt-holders, and consumers all have opportunities to renegotiate terms when contracts are renewed. Stockholders, by contrast, invest for the life of the firm and their claims are located at the end of the queue should liquidation occur.[159]

Although shareholders may be able to liquidate their investments quickly, those who choose to invest for the long-term are surely deserving of management consideration.[160]

## B. *Legitimacy of Broader Concerns*

Management, many have argued, should be concerned solely with the maximization of shareholder wealth.[161] Proponents of this view as-

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[156] *See id.* at 40.

[157] *Id.* at 41 (footnote omitted).

[158] Williamson, *Corporate Governance,* 93 YALE L.J. 1197, 1210 (1984) (arguing instead that the board of directors is a governance structure "whose principal purpose is to safeguard those who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill-defined, and cannot be protected in a well-focused, transaction-specific way" and that, consequently, "the board of directors should be seen as a governance instrument of the stockholders").

[159] *Id.* at 1210.

[160] *See* Kissinger, *The Word for Takeovers: Pernicious,* N.Y. Times, Dec. 5, 1986, at A35, col. 2, A35, col. 4 ("[I]t is ludicrous that the speculator . . . should have the same moral claim and rights as an investor who has devoted his whole life to the building of a company and who carries within him a sense of obligation to the company's long-term stockholders, its employees and the community where the company may be the principal employer.").

[161] *See, e.g.,* Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986) (noting that the primary criterion for judging the legality of a poison pill plan is "the goal of stockholder wealth maximization"), *rev'd on other grounds,* 107 S. Ct. 1637 (1987); Dodge v. Ford Motor Co., 204 Mich. 459, 507, 170 N.W. 668, 684 (1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

In the takeover context, proponents of this view argue that management should do nothing to impede tender offers at premium prices. *See, e.g.,* Easterbrook & Fischel, *supra* note 108, at 1164 (arguing that "legal rules allowing the target's management to sert that broader management concerns would lead to inefficiency[162] and promote arbitrary management decision-making,[163] and that non-shareholder constituencies may adequately protect themselves through contract.[164]

However, the shareholders-only view ignores the reality that other constituencies both share the risk and are vital to the success of corporate activity. With respect to employees, Clyde Summers has noted:

> If the corporation is conceived . . . as an operating institution combining all factors of production to conduct an ongoing business, then the employees . . . are as much members of that enterprise as the shareholders who provide the capital. Indeed, the employees may have made a much greater investment in the enterprise by their years of service,

engage in defensive tactics in response to a tender offer decrease shareholders' welfare"); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers,* 33 STAN. L. REV. 819, 845 (1981) (stating that "the corporate structure requires that tender offerors have unrestricted access to target shareholders"). Professor Gilson argues that the role of arbitrageurs in the tender offer process demonstrates that in such context the distinction between short- and long-term shareholders is of no significance. *See id.* at 856 (arbitrageurs stand as "surrogates" for long-term investors, "who have *already demonstrated,* by selling their shares to the arbitrageurs, that they perceived their 'long-term' interests were outweighed by the size of the [tender offer] premium"). Gilson's analysis, however, confuses cause and effect. Merely because target shareholders do sell to arbitrageurs is not proof that they believe such action is desirable. Even target shareholders who would prefer that the target remain independent may sell to avoid the possibility of being left with devalued minority shares in the event the tender offer succeeds. *See* Bebchuk, *supra* note 81, at 1722 (noting that "as long as the bid has some chance of success, the prospect of a takeover will pressure the shareholder to tender his shares"). In addition, there is objective evidence for the proposition that recent tender offers at substantial premiums over the market did not capture the long-term value of the targets' stock. *See supra* note 117. Therefore, the distinction between short- and long-term value remains legitimate.

162 *See* E. EPSTEIN, WHO OWNS THE CORPORATION? 42 (1986) (noting that making managers the custodians of institutions would "create dislocation in supply and demand and stagnation"); M. FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962) (arguing that broadening the scope of management concerns is a "fundamentally subversive doctrine" that could "thoroughly undermine the very foundations of our free society"); Rostow, *To Whom and for What Ends is Corporate Management Responsible?,* in THE CORPORATION, *supra* note 154, at 64 ("The new corporate morality may result in prices and wages which sabotage the market mechanism and systematically distort the allocation of resources. Such pricing practices would make the task of monetary and fiscal authority in controlling general fluctuations of trade more expensive and more difficult, and could well make it impossible to sustain high levels of employment save at the cost of considerable price inflation.").

163 *See* Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility,* 21 STAN. L. REV. 248, 281 (1969).

164 *See* Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court,* 72 CORNELL L. REV. 117, 140 (1986) (arguing that creditors, for example, can sue on underlying debt contract); Williamson, *supra* note 158, at 1228 (arguing that labor, suppliers engaged in large, firm-specific projects, and some customers may influence the corporation through contract).

> may have much less ability to withdraw, and may have a greater stake in the future of the enterprise than many of the stockholders.[165]

Much the same can be said for other constituencies such as customers, suppliers, and host communities.[166] The integral role that these constituencies play requires that management be free to consider their interests.[167] Rational shareholders with an interest in the long-term prosperity of the corporation would also desire that management have this flexibility.[168]

The availability of the contracting process, moreover, is not sufficient cause to restrict the concerns of management. First, it is unclear, as a factual matter, whether non-shareholder constituencies can adequately protect themselves through contract.[169] Second, the contracting

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[165] Summers, *Codetermination in the United States: A Projection of Problems and Potentials,* 4 J. COMP. CORP. L. & SEC. REG. 155, 170 (1982); *see also* R. DAHL, AFTER THE REVOLUTION? 115-40 (1970) (arguing that corporate governance should not be exclusively a shareholder concern, and that other constituencies, such as employees, have a role to play).

[166] Harold Williams, a former SEC Chairman, has noted: "[A] corporation is more than the aggregate of its tangible assets—and more than the equity of its current shareholders—it is an institution with a complex of interpersonal and contractual relationships that create legitimate interests in the corporation among employees, suppliers, customers, communities, and the economy at large." Williams, Speech Before the Seventh Annual Securities Regulation Institute, *reprinted in* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445, 82,876 (Jan. 17, 1980); *see also* Brewster, *The Corporation and Economic Federalism,* in THE CORPORATION, *supra* note 154, at 72-73 (noting that the modern corporation "governs" a constituency whose interests are often distinguishable from those of ownership); Klein, *The Modern Business Organization: Bargaining Under Constraints,* 91 YALE L.J. 1521, 1563 (noting ownership of corporation is not as important as much of academia believes, and that a wide variety of actors must be considered "participants and not appendages"); Nussbaum & Dobrzynski, *supra* note 19, at 103 (quoting Hicks B. Waldron, chairman of Avon Products, Inc., who has recognized his duty to take a long-term perspective for the benefit of "40,000 employees and 1.3 million representatives around the world . . . [and for] suppliers, institutions, customers, [and] communities").

[167] *See* Williams, *supra* note 166, ¶ 82,881; Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests,* 11 SEC. REG. L.J. 44, 68 (1983).

[168] *See* Knauss, *Corporate Governance—A Moving Target,* 79 MICH L. REV. 478, 498 (1981) (arguing that the directors' obligation to act for the benefit of the corporation includes the obligation to ensure that the corporation does what society expects); Soderquist & Vecchio, *Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management,* 1978 DUKE L.J. 819, 840 (arguing that shareholders expect to be treated like investors as opposed to "owners," and expect management to consider a wide constituency when making corporate decisions); Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation,* 33 BUS. LAW. 2083, 2099 (1978) (stating that "share owners and directors alike have an interest in assuring that entities with which they are identified behave ethically and as good citizens").

[169] *See* Chayes, *supra* note 155, at 43 (suggesting that non-labor constituencies have not yet developed arrangements as effective as the collective bargaining process);

process is by its nature a prospective attempt to legislate relations between a corporation and a constituency. As such, it is best confined to the intrinsic elements of a given relationship.[170] Corporations and employees, for example, should be able to come to terms over wages, hours, and tasks, but will have difficulty agreeing on the manner in which a target's board should respond to a future takeover bid whose form is as yet unknown.[171] Some takeover bids will affect employee interests the most; others will have greater impact on different constituencies. Management must be free in each case to respond to the threats posed by particular bids. Finally, the possibility that management will seize on its greater flexibility to act in its self-interest is best addressed generally through mechanisms that impose discipline on management. Such mechanisms are discussed in Parts III and IV of this Article.

### C. *Legal Legitimacy*

Courts have recognized that constituencies other than shareholders are proper objects of management concern.[172] In *Herald Co. v. Seawell,*[173] the Tenth Circuit upheld the Denver Post's defensive maneuvers against a bid by a newspaper publisher with a history of labor difficulties. The court noted the legitimacy of the Post's concern for non-shareholder constituencies:

> A corporation publishing a newspaper . . . has other obligations besides the making of a profit. It has an obligation to the public, that is, the thousands of people who buy the paper, read it, and rely on its contents.

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McDaniel, *supra* note 119, at 455-56 (noting that bondholders have not been able to protect themselves by contract).

[170] *See* Cox, *Reflections upon Labor Arbitration,* 72 HARV. L. REV. 1482, 1499 (1959) (noting that it is not possible to reduce all rules necessary to govern a company down to a written contract); Easterbrook & Fischel, *Voting in Corporate Law,* 26 J. L. & ECON. 395, 401 (1983) (stating that it is inefficient to detail every element of a relationship by contract).

[171] *See* Summers, *supra* note 165, at 164-65 (commenting that collective bargaining typically covers wages, hours, and working conditions, but not corporate decisions such as whether to merge with another company); Comment, *Broadening the Board: Labor Participation in Corporate Governance,* 34 Sw. L.J. 963, 977 (1980) (noting that the bargaining process is "directed to the end of fixing the parties' rights and obligations" and as such "prevents adaptation to unforeseen problems").

[172] *See, e.g.,* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 266 (2d Cir. 1984) (stating that board must have wide latitude to protect the interests of shareholders, employees and management when considering a takeover bid); Enterra Corp. v. SGS Assoc., 600 F. Supp. 678, 687 (E.D. Pa. 1985) (noting management might properly consider the interests of suppliers, customers, lenders, and the stability of the company when considering a takeover bid).

[173] 472 F.2d 1081 (10th Cir. 1972).

> . . . Such a newspaper corporation, not unlike some other corporations, also has an obligation to those people who make its daily publication possible.[174]

Judge Pollack of the Southern District of New York recently upheld defensive measures taken to thwart GAF's junk bond, bust-up bid for Union Carbide:

> A corporation with a perceived threat of dismemberment of large divisions of the enterprise, employing thousands of employees, owes substantial regard for their pension benefits, and in the case of loyal management, severance benefits. These legitimate concerns for their past conduct of the enterprise and its requirements need not be left to the goodwill of an unfriendly acquiror of corporate control in the jungle warfare involving attempted takeovers. The exercise of independent, honest business judgment is the traditional and appropriate way to deal fairly and even-handedly with both the protection of investors, on the one hand, and the legitimate concerns and interests of employees and management of a corporation who service the interests of investors, on the other.[175]

Similarly, in *Unocal Corp. v. Mesa Petroleum Co.*,[176] the Delaware Supreme Court upheld a target's self-tender that excluded a raider from participation. The court noted that, in taking such action, the target's board was authorized to consider "the impact [of a takeover bid] on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[177]

There is, however, no consensus among the courts regarding the legitimacy of directors' concern for broader constituencies. Only one year after the *Unocal* decision, the Delaware Supreme Court held in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[178] that a target's board may not consider the interests of the corporation's noteholders once a decision has been made to sell the company.[179] At that point,

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[174] *Herald*, 472 F.2d at 1094-95; *see also Takeover Bids*, *supra* note 117, at 106 (supporting efforts to "further the interests of the community, employees, the environment, consumers, and perceived national policy at the expense of maximum profits and maximum benefits to shareholders").

[175] GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985).

[176] 493 A.2d 946 (Del. 1985).

[177] *Id.* at 955.

[178] 506 A.2d 173 (Del. 1986).

[179] *Id.* at 182 (noting that "concern for non-stockholder interests is inappropriate

the court stated, the target's board is restricted to conducting a fair and open auction for the exclusive benefit of the shareholders.[180] Although *Revlon* should not restrict the capacity of a target's board to act for broader constituencies when the target is not yet for sale, *Revlon* does make the scope of the *Unocal* concern for nonshareholder constituencies less certain.

In *Dynamics Corp. of America v. CTS Corp.*,[181] moreover, the Seventh Circuit refused to sanction a poison pill rights plan designed to protect the target and its several constituencies against a junk-bond, bust-up tender offer. The court's sole criterion for assessing director behavior in adopting the plan was whether the plan advanced "the goal of stockholder wealth maximization."[182]

State legislatures have responded to the uncertainty created by the courts by enacting statutes that designate the constituencies that directors may legitimately represent. Ohio,[183] Pennsylvania,[184] Maine,[185] and Minnesota[186] have codified management's right to consider generally the interests of employees, suppliers, customers, and other community interests. Missouri has passed legislation authorizing consideration of such interests in responding to a takeover bid.[187] In addition, several corporations have adopted charter provisions specifying management's right to consider the interests of nonshareholder constituencies.[188]

Conflicting case law and the scarcity of legislation in this area have clouded the legal status of nonshareholder constituencies with a stake in the enterprise and the rights and responsibilities of directors in addressing the interests of these constituencies. The judicial and legislative attempts to expand management responsibilities in the age of finance corporatism, however, have generally been ad hoc attempts to deal with symptoms of what is a much larger, more complex problem.

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when an auction among active bidders is in progress"); *accord* Edelman v. Fruehauf Corp., 798 F.2d 882, 886-87 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 278 (2d Cir. 1986).

[180] *Revlon,* 506 A.2d at 182.

[181] 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds,* 107 S. Ct. 1637 (1987).

[182] *Id.* at 256.

[183] *See* OHIO REV. CODE ANN. § 1701.59(E) (Anderson Supp. 1986).

[184] *See* 42 PA. CONS. STAT. ANN. § 8363(B) (Purdon Supp. 1987).

[185] *See* ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1986).

[186] *See* 1987 Minn. Sess. Law Serv. 190 (West) (to be codified at MINN. STAT. ANN. § 302A.251 (West)).

[187] *See* MO. ANN. STAT. § 351.347(4) (Vernon Supp. 1987).

[188] For example, Control Data Corp. and McDonald's have recently amended their charters in this fashion. *See* Form SE, Control Data Corp., Exhibit 3, Certificate of Incorporation (April 23, 1986); Form 10-K, McDonald's Corporation, Exhibit 3, Restated Certificate of Incorporation (June 16, 1986).

Not only must any attempt to reform contemporary corporate governance address the global problems created by institutional investor control, highly leveraged takeovers, and defensive responses to such takeovers; it must also clarify the expanded responsibility of management.

### D. *Social Concerns*

An attempt could be made to expand this Article's suggestion that corporate managers consider the welfare of certain nonshareholder constituencies. In support, one could cite the considerable literature that is devoted to the proposition that corporations have a duty to society to be "good citizens" and act "responsibly."[189] This view originated from a concern that corporations were taking such actions as polluting the environment, producing unsafe products, and resorting to bribery to maximize profit. The law has varied on whether general social, moral, and political questions are proper concerns of corporate governance.[190]

This approach, however, is fundamentally misconceived. Expanding corporate governance to encompass society as a whole benefits neither corporations nor society. Because management is ill-equipped to deal with questions of general public interest, that is, issues broader in scope than those issues directly affecting the corporation and its constituencies, the corporation would only be harmed by the inevitable ineffi-

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[189] *See, e.g.,* R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 125 (1976) [hereinafter TAMING THE GIANT] (identifying a corporate manager's duty to balance the overall health of the organization against the relevant social concerns when making corporate decisions); C. STONE, WHERE THE LAW ENDS 116 (1975) (advocating corporate "responsibility of a 'mature' sort, emphasizing cognitive processes rather than blind rule obedience"); D. VOGEL, LOBBYING THE CORPORATION 6 (1978) (noting that a corporation wields the power of the government and therefore must be treated like a government, and held accountable to society at large); Blumberg, *Corporate Responsibility and the Social Crises,* 50 B.U.L. REV. 157, 164 (1970) (claiming that a corporation derives its sustenance from the community and therefore has a moral obligation to that community); Schwartz, *Towards New Corporate Goals: Co-Existence with Society,* 60 GEO. L.J. 57, 104 (1971) (stating that a corporation must shape its conduct to be consistent with society's goals); Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse,* 28 UCLA L. REV. 343, 345 (1981) (noting a manager must find a reasonable balance between maximizing corporate profits and lessening undesirable social effects).

[190] *Compare* Medical Comm. for Human Rights v. SEC, 432 F.2d 659, 678-82 (D.C. Cir. 1970) (suggesting that anti-napalm resolution was a proper subject of proxy solicitation), *vacated as moot,* 404 U.S. 403 (1972) *with* State *ex rel.* Pillsbury v. Honeywell, Inc., 291 Minn. 322, 329, 191 N.W.2d 406, 411 (1971) (denying inspection of corporate records because desire to stop manufacture of arms for Vietnam war was not a proper corporate purpose). Subsequent to the *Medical Committee* case, the SEC amended Rule 14a-8, 17 C.F.R § 240.14a-8 (1986), to confirm a shareholder's right to address general social issues through the proxy mechanism. *See* Exchange Act Release No. 34-12,999, 41 Fed. Reg. 52,994 (1976).

ciency that such an expansion would engender.[191] Encouraging corporations, a powerful group not directly accountable to or representative of our society, to take positions on the controversial social, moral, and political issues of the day also has dangerous anti-democratic implications.[192] The proper forum for the consideration of such issues is the legislature. If society is concerned that corporations are misbehaving on general social matters, such as the environment, the correct response is regulation, not an expanded notion of corporate governance.

The proper scope of corporate governance, therefore, encompasses all constituencies that are integral to the conduct of the enterprise and no others. These are the groups that shareholders, qua shareholders, would also desire their managers to represent.[193] It remains to consider methods to ensure that corporate managers will act in this manner, rather than in their own self-interest or according to some misguided notion of corporate responsibility.

## III. Critique of Various Proposals

### A. *Interest Group Representation*

The most direct method of ensuring that corporate management adequately represents all its constituencies is to grant these constituen-

[191] By contrast, because employees and communities are integral to the conduct of the enterprise, making contributions and establishing programs for the benefit of employees and communities in which the corporation operates constitute legitimate corporate purposes. *See, e.g.,* American Rolling Mill Co. v. Commissioner, 41 F.2d 314, 315 (6th Cir. 1930) (finding that a corporate contribution to a civic fund was in pursuit of legitimate corporate interests); Armstrong Cork Co. v. H.A. Meldrum Co., 285 F. 58, 58 (W.D.N.Y. 1922) (holding that corporate contributions to educational institutions are legitimate corporate expenditures). *See generally* Blumberg, *supra* note 189, at 166-92 (presenting a number of legal justifications for an expanded notion of corporate responsibility to its employees and community).

[192] *See* M. Friedman, *supra* note 162, at 196-202 (concluding that if corporations attempt to make determinations by considering social factors, this will undermine the free market system and the democratic foundation of our society).

[193] Rational shareholders would view management's representation of broader constituencies as conducive to profit-maximization in the long-term. A corporation's relationships with its employees, customers, and suppliers, for example, are heavily dependent on its ability to foster good will with these groups. To the extent a corporation has the confidence of such groups, it will generate higher productivity from its employees, a steady stream of business from its customers, and a stable source of materials from its suppliers. Over the long-term, good will should translate into dollars. The courts have recognized the symbiotic relationship between shareholders and broader corporate constituencies in upholding measures designed to advance the interests of such constituencies. *See, e.g.,* GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1020 (S.D.N.Y. 1985) (noting that a corporation's board may respond to "the legitimate concerns and interests of employees and management . . . who service the interests of investors"). *See also supra* notes 165-68 and accompanying text.

cies seats on the board of directors.[194] The most developed argument along these lines calls for employee codetermination,[195] usually in accordance with the German model.[196]

Although this approach has the value of affirming that corporations have duties to nonshareholder constituencies, its drawbacks far outweigh its benefits. Interest group representation may not guarantee

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[194] One commentator suggests that the principal purpose of the board of directors is to "safeguard those who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill-defined, and cannot be protected in a well-focused, transaction-specific way." Williamson, *supra* note 158, at 1210. He states that those constituencies least able to protect themselves by contract should be represented on the board of directors. Shareholders are the least able to protect themselves in this manner, but other groups who have contacts with the corporation may occasionally qualify for such representation. *Id.* at 1210, 1228. For example, labor may qualify for board representation when give-backs are requested by management, and suppliers and large customers may deserve board seats when engaged in major firm-specific projects. *See id.* at 1228; *see also* Dahl, *Power to the Workers?*, N.Y. REV. BOOKS, Nov. 19, 1970, at 20, 23 ("[O]thers whose interests would be affected by the decisions of an enterprise might be given the right to participate in decisions . . . through representatives on the board of directors of the firm.").

[195] *See* Dahl, *supra* note 194, at 20; Summers, *supra* note 165, at 183-86. Moreover, as noted above, corporate governance is a dynamic process. In recent years, employee ownership has emerged as a significant and rapidly growing factor in corporate ownership. *See* Hoerr, *"We're Not Going to Sit Around and Allow Management to Louse Things Up,"* BUS. WK., May 18, 1987, at 107, 107 ("[E]mployees own at least 20% of nearly 30 publicly traded companies with more than 1,000 workers."). For example, in the wake of a hostile bid by its pilots association, Allegis Corp. offered employees of its United Airlines unit an ownership interest in the company to quell labor difficulties. *See* Valente, *Allegis Weighs Greater Role for Employees*, Wall St. J., May 1, 1987, at 6, col. 1. The pilots' union has continued to pursue its $4.5 billion cash and note offer for United. Allegis' board has opposed the pilots' initiative, fearing that it would lead to "a heavily indebted, financially weak airline with severely limited growth potential;" it has, however, expressed willingness to consider any offer that "was for all cash and left the company adequately financed." Dallos, *Airline's Parent Softens Stance: Allegis Sets Preconditions for Sale of United,* L.A. Times, Aug. 15, 1987, § 4, at 1, col. 2.; *see also* J. BROOKS, *supra* note 25, at 203 (noting "the sudden and dramatic appearance of labor as a player in the takeover game"). Also prevalent is the growing power of employee stock ownership plans. *See* Hoerr, *supra*, at 107 ("The growing number of companies wholly or partially owned by Employee Stock Ownership Plans (ESOPs) is also increasing the voice of labor—union and nonunion—at all levels of the corporation."). I believe that these trends will continue and that, in the twenty-first century, employee ownership will replace institutional ownership as the dominant concern of corporate governance. *Cf.* Clark, *supra* note 1, at 565-67 (heralding a fourth stage of capitalism based, in part, on the proliferation of employee benefit plans).

[196] *See* Bonanno, *Employee Co-Determination: Origins in Germany, Present Practice in Europe, and Applicability to the United States*, 14 HARV. J. ON LEGIS. 947, 949 (1977) ("Any discussion of employee participation in management at the board level must start with the German system of worker codetermination. . . ."). According to the German model, a supervisory board is elected by shareholders and employees. The supervisory board exercises a broad oversight function and elects the managing board, which supervises the corporation's daily operations. *See id.* at 952-58; Schoenbaum & Lieser, *Reform of the Structure of the American Corporation: The "Two-Tier" Board Model,* 62 KY. L.J. 91, 96-102 (1973).

influence to the affected groups. To the degree that policy-making is performed at the management rather than the board level, board representation can have only limited impact.[197] Given that interest groups would generally have a minority number of board seats, representation would serve more to achieve a complete airing of views than to redistribute influence.[198] Moreover, labor unions have generally opposed board representation, fearing the possibility of co-option.[199]

Interest group representation also raises troublesome questions concerning the structure and purpose of the board of directors. It would transform the board from a directory body concerned with the good of the whole to a quasi-legislature functioning in pluralist fashion.[200] Such a system would necessarily give interest groups sway over a wide variety of issues with at most marginal effect on these groups and which, as a consequence, cannot be proper objects of their concern. Finally, mirroring the unions' fear of co-option, such a system would result in conflicts of interest for board members, who would be required to strike a balance between their parochial interests and the good of the corporation.[201] Consequently, some other method must be found to ensure

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[197] *See* Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants,* 63 CALIF. L. REV. 375, 377 (1975) ("In the large, publicly-held corporation, policymaking, like management, is an executive function."); Mace, *Directors: Myth and Reality—Ten Years Later,* 32 RUTGERS L. REV. 293, 295 (1979) ("Boards of directors of most large- and medium-sized companies [do] not establish objectives, strategies, and policies." These "roles [are] performed by management."); Summers, *supra* note 165, at 173-74 .

[198] *See* Summers, *supra* note 165, at 183-84.

[199] *See generally* P. BRANNEN, E. BATSTONE, D. FATCHETT & P. WHITE, THE WORKER DIRECTORS: A SOCIOLOGY OF PARTICIPATION 241 (1976) (acknowledging that "the independence of the trade unions is a crucial condition for their oppositional role and that involvement with participative structures may compromise this"); M. POOLE, WORKERS' PARTICIPATION IN INDUSTRY 119 (1975) ("[O]nly a rather narrow band of participation or control programmes has attracted the unreserved enthusiasm of officers . . . largely on the grounds that these serve to duplicate channels of workers' representation and in consequence weaken workers' inclinations to join trade unions and to overcome problems by means of union procedural systems."); Ellenberger, *The Realities of Co-Determination,* AFL-CIO AM. FEDERATIONIST, Oct. 1977, at 10, 15 ("[The American worker] is smart enough to know, in his bones, that salvation lies —not in the reshuffling of chairs in the board room or in the executive suite—but in the growing strength and bargaining power of his own autonomous organizations." (quoting Lane Kirkland, AFL-CIO Secretary-Treasurer)).

[200] *Cf.* Dahl, *supra* note 194, at 23 ("[Interest group representation] would convert the firm into a system of rather remote delegated authority.").

[201] *See* TAMING THE GIANT, *supra* note 189, at 124 ("[T]here is the danger that consumer or community or minority or franchisee representatives would become only special pleaders for their constituents and otherwise lack the loyalty or interest to direct generally."). One commentator has stated:

> Such a system would harm many constituencies and only help a powerful few. For a management team to stay in place it must satisfy its board of directors, so instead of pursuing a neutral goal as under the present system

proper managerial conduct in light of the constituencies to which corporations have duties.

### B. *Federal Incorporation*

The federal chartering of major corporations has been suggested as a way of ensuring corporate responsiveness to all corporate constituencies.[202] However, this proposal raises substantial federalism concerns.[203] The Supreme Court has recently reaffirmed that regulation of internal corporate affairs is properly left to the states.[204]

In addition, allowing different state approaches creates a commerce in corporate charters. The states that provide a more efficient form of corporate governance will be more successful in attracting business.[205] Despite charges that such a system creates a "race to the bottom,"[206] one study concludes that multi-state incorporation has

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> of profit maximization, management would have to fulfill the objectives of those powerful interest groups with the most control over the board. Thus, instead of a large amorphous group of shareholders benefitting from a corporate decision only a particular powerful group of constituents would benefit.

R. WINTER, GOVERNMENT AND THE CORPORATION 50-51 (1978).

[202] *See, e.g.*, TAMING THE GIANT, *supra* note 189, at 62-71; Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L. J. 89 (1972); *see also* Cary, *supra* note 5 (advocating federal standards of corporate responsibility).

[203] *See* Burks v. Lasker, 441 U.S. 471, 478 (1979) ("[I]t is state law which is the font of corporate directors' powers."); Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977) ("Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."); Congregation of the Passion v. Kidder Peabody & Co., 800 F.2d 177, 181 (2d Cir. 1986) ("Such an extension of Federal regulation . . . 'would overlap and possibly interfere' with traditional state common law governance of such fiduciary relationships." (quoting *Santa Fe Indus.*, 430 U.S. at 479).

[204] *See* CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637 (1987).

[205] *See* R. WINTER, *supra* note 201, at 7-11; Baysinger & Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 456 (1985); Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 282 (1980); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 923 (1982). Fischel argued:

> If a particular form of firm organization were more efficient, or if the law of one state were more conducive to maximizing shareholders' welfare than the law of Delaware, founders of corporations would have every incentive to make the structural change or move the state of incorporation voluntarily. That these changes have not been made voluntarily is perhaps the most persuasive argument against federal regulation of corporations.

*Id.*

[206] *See, e.g.*, Louis K. Liggett Co. v. Lee, 288 U.S. 517, 558-59 (1933) (Brandeis, J., dissenting) ("Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in

achieved its goal of maximizing shareholder wealth.[207] Firms reincorporating in Delaware, the jurisdiction generally believed to allow management the greatest flexibility, were found to earn abnormal positive returns of 30.25% over the twenty-five month period preceding and including the month of the change.[208] The study found no evidence of any negative market reaction either before or after re-incorporation.[209]

This is not to suggest that the federal government has no role to play in improving corporate governance. As argued in Part IV, it is entirely proper for Congress to enact takeover, tax, and proxy legislation, areas generally reserved to the federal government, to improve corporate governance. It is equally proper for Congress to regulate in areas of general societal concern. The impropriety lies in arrogating to Congress control over all aspects of internal corporate life.

### C. *ALI's Corporate Governance Project*

In 1978, the American Law Institute ("ALI") embarked on a corporate governance project. Its seven tentative drafts to date have engendered much opposition.[210] Originally styled a "Restatement" of the law of corporate governance, the ALI's views now appear as "analyses and recommendations" to indicate that the ALI has done more than merely codify existing law.[211]

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advertising their wares. The race was one not of diligence but of laxity."). The current validity of the "race to the bottom" theory, which posits competition among states to decrease the restrictions on managerial behavior, is weakened in light of recent decisions based on state law invalidating defensive tactics that were not shown to be reasonably related to the best interests of the corporation and its shareholders. *See* Edelman v. Fruehauf Corp., 798 F.2d 882, 885 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 281-83 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986); AC Acquisition Corp. v. Anderson Clayton & Co., 519 A.2d 103, 114 (Del. Ch. 1986).

[207] *See* Dodd & Leftwich, *supra* note 205, at 259.

[208] *See id.* at 275.

[209] *See id.* at 281-82.

[210] *See, e.g.*, NATIONAL LEGAL CENTER FOR THE PUBLIC INTEREST, THE AMERICAN LAW INSTITUTE AND CORPORATE GOVERNANCE: AN ANALYSIS AND CRITIQUE (Mink ed. 1987) [hereinafter ANALYSIS] (compilation of essays criticizing the ALI's tentative drafts); THE BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" (Feb. 1983) [hereinafter STATEMENT OF THE BUSINESS ROUNDTABLE] (criticizing the ALI's Tentative Draft No. 1).

[211] *Compare* ALI, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS viii (Tent. Draft No. 1, 1982) [hereinafter TENT. DRAFT NO. 1] ("[A] restatement with recommendations regarding the legal duties incident to corporate management and control.") *with* ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS vii-viii (Tent. Draft No. 2, 1984) [hereinafter TENT. DRAFT NO. 2] ("The change was made to allay the fear that

Early drafts of the ALI's corporate governance project were criticized for taking a regulatory, interventionist approach to corporate governance.[212] To bridge the gap between ownership and control first identified by Berle and Means,[213] the ALI sought to increase the duties, and exposure to liability, of directors.[214] The ALI's approach threatened to decrease managerial flexibility, reduce corporate risk-taking, and increase the difficulty of recruiting talented directors.[215] As a consequence of such criticism, subsequent ALI drafts have reflected a more balanced position. An analysis of the ALI's current positions follows.

### 1. Corporate Goals

The ALI has chosen to codify the proper objects of corporate behavior: "A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain. . . ."[216] The ALI recognizes exceptions for conforming the corporation's conduct to the law, taking account of ethical considerations regarded as appropriate to the responsible conduct of business, and devoting resources to charitable or philanthropic purposes.[217]

The Business Roundtable has criticized this statement of goals as unnecessarily codifying the law at a time when the scope of a corpora-

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courts might be misled by the traditional word "Restatement" in the title to view the entire document as purporting to restate existing law.").

[212] *See, e.g.*, STATEMENT OF THE BUSINESS ROUNDTABLE, *supra* note 210, at 4.

[213] *See* Wolfson, *The Theoretical and Empirical Failings of the American Law Institute's Principles of Corporate Governance*, in ANALYSIS, *supra* note 210, at 69.

[214] *See id.* at 93; Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1286-87 (1982).

[215] *See* Phelan, *Concerns of the New York Stock Exchange*, in ANALYSIS, *supra* note 210, at 3 (quoting a letter from the New York Stock Exchange to the ALI expressing concerns about Tentative Draft No. 1); STATEMENT OF THE BUSINESS ROUNDTABLE, *supra* note 210, at 6.

[216] TENT. DRAFT NO. 2, *supra* note 211, § 2.01. The provision reads, in pertinent part:

> A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain, except that, whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business
> (a) is obliged, to the same extent as a natural person, to act within the boundaries set by law,
> (b) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and
> (c) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

*Id.*

[217] *See id.*

tion's duties is becoming increasingly uncertain.[218] However, the ALI's statement does not exclude entirely consideration of nonshareholder constituencies such as employees, customers, suppliers, and host communities. It merely requires that business be conducted "with a view" to enhancing shareholder profit, a worthwhile goal by any standard. Moreover, so long as the statement is not limited to short-term shareholder gain, an issue still being debated within the ALI, there would seem to be no restriction on consideration of constituencies who are integral to the conduct of the enterprise, and without whom no shareholder gain would be possible.[219]

### 2. The Accountability of Management

The ALI's approach continues to reflect some distrust of corporate managers.[220] The ALI seeks to fashion the board into a vehicle for ensuring the accountability of management by influencing the structure of the board. The ALI recommends, *inter alia*, that every large publicly held corporation[221] have a majority of outside directors[222] and an audit committee consisting entirely of outside directors.[223]

This recommendation may be unwarranted.[224] Although a majority of outside directors is often thought desirable to take advantage of certain enhanced presumptions of good faith in the conflict or takeover context,[225] and although the New York Stock Exchange requires listed

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[218] *See* Comments of the Business Roundtable Concerning the American Law Institute's Corporate Governance Project 14-15 (May 4, 1984) (unpublished memorandum) (on file with the *University of Pennsylvania Law Review*).

[219] *See* Perkins, *The ALI Corporate Governance Project in Midstream,* 41 BUS. LAW. 1195, 1200-01 (1986); Schwartz, *Objective and Conduct of the Corporation,* 52 GEO. WASH. L. REV. 511, 527 (1984).

[220] *See* Hoog, *Tinkering with Successive Drafts Will Not Change the Reporters' Philosophy,* in ANALYSIS, *supra* note 210, at 28 (ALI views management as running corporations in an "arbitrary and capricious" manner).

[221] A large publicly held corporation is defined to be a publicly held corporation with 2,000 or more shareholders and at least $100 million in total assets. *See* TENT. DRAFT NO. 2, *supra* note 211, § 1.16.

[222] *See id.* § 3.04.

[223] *See id.* § 3.03.

[224] Corporations currently have the autonomy to structure their own boards; board structure is not dictated by judicial decisions, state law, or federal law. *See* TENT. DRAFT NO. 1, *supra* note 211, § 3.03 comment a; Karmel, *The Independent Corporate Board: A Means to What End?,* 52 GEO. WASH. L.REV. 534, 548 (1984). However, some states require directors who have an interest in a transaction to abstain from being present or participating in the meeting of the board approving the transaction. *See, e.g.,* DEL. CODE ANN. tit. 8, § 144 (Supp. 1986); N.J. STAT. ANN. § 14A:6-8 (West 1969 & Supp. 1987); N.Y. BUS. CORP. LAW § 713 (McKinney 1986).

[225] *See, e.g.,* Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir.) ("The presumption of good faith the business judgment rule affords is heightened when the majority of the board consists of independent outside directors."), *cert. denied,* 454 U.S.

companies to have two outside directors on their boards and an audit committee consisting entirely of outside directors,[226] corporations are now free to structure their boards as they wish. Current law provides needed flexibility.[227] Rules of moral suasion may alter the judicial perspective on boards with a majority of management directors, and make it more difficult to gain judicial approval of actions taken by such boards, despite the ALI's explicit disclaimer that these principles are purely hortatory.[228]

### 3. Duty of Care

The ALI restates the director's duty of care in language that closely approximates the common law version of the standard: "A director . . . has a duty . . . to perform his functions . . . with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[229] Nevertheless, commentators have criticized the ALI for employing an ordinary negligence standard.[230] These commentators suggest that a review of the cases demonstrates that directors are never liable, absent special cir-

1092 (1981); Polk v. Good, 507 A.2d 531, 537 (Del. 1986) ("[T]he presence of 10 outside directors on the Texaco board, coupled with the advice rendered by the investment banker and legal counsel, constitute a *prima facie* showing of good faith and reasonable investigation."); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (proof of good faith is enhanced when a majority of the board favoring the proposal are outside directors).

[226] *See* New York Stock Exchange, New York Stock Exchange Listed Company Manual ¶ 303.00 (1986). The SEC has recently approved a proposal from the National Association of Securities Dealers ("NASD") to adopt rules for the NASDAQ listing, effective February 1, 1989, requiring two independent board members and a majority of independent audit committee members. *See* NASD, Notice to Members 87-46, 3 (1987).

[227] *See* Seibert, *The Dynamics of Corporate Governance,* in Analysis, *supra* note 210, at 19. The current flexibility may be used to advantage by a corporation with diverse divisions and subsidiaries that may prefer to expand the number of inside directors to allow the total board's in-depth experience to match the company's diverse business. *See id.*

[228] *See* Tent. Draft No. 2, *supra* note 211, at pt. III (introductory note).

[229] ALI, Principles of Corporate Governance: Analysis and Recommendations § 4.01(a) (Tent. Draft No. 4, 1985) [hereinafter Tent. Draft No. 4]. Indeed, the ALI consciously chose to employ the "under similar circumstances test" rather than the somewhat stricter "personal business affairs" test. *See* Selheimer v. Manganese Corp., 423 Pa. 563, 573-76, 224 A.2d 634, 640-42 (1966) (statutory requirement to exhibit care "which ordinarily prudent men would exercise under similar circumstances in their personal business affairs" imposes a higher duty of care than the "similar circumstances" standard).

[230] *See e.g.,* Carney, *The Monitoring Board, Duties of Care, and the Business Judgement Rule,* in Analysis, *supra* note 210, at 120-24 (articulating a series of cases where courts have applied an ordinary negligence standard only in the special case of banks and financial institutions).

cumstances, unless they exhibit gross negligence and that recent cases now have explicitly recognized this gross negligence standard.[231]

Regrettably, it appears that the ALI has correctly stated the law and that the converse is in fact true: cases purporting to apply a gross negligence standard apply, at most, an ordinary negligence standard. For example, in *Smith v. Van Gorkom*,[232] the Delaware Supreme Court purported to apply a gross negligence test.[233] Nevertheless, the court held the directors of Trans Union liable for approving a cash-out merger despite the following facts: the merger price represented a $17 premium over the previously prevailing market price; no superior offer was made; the company's chief financial officer opined that the merger price was fair; and the company's outside counsel recommended the merger.[234]

As a consequence, as Part IV will argue, the difficulty with the ALI's approach to the duty of care lies precisely in continued recognition of the common law action for ordinary negligence rather than in any distortion of the law.

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[231] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (under the business judgement rule director liability is predicated upon concepts of gross negligence); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1101 (1968) (directors of industrial corporations do not run a substantial risk of liability for ordinary negligence); Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 613-15 (1984) (courts have applied the duty of care to the oversight function only where liability rested on neglect "that bordered on abdication"); Pease, Aronson v. Lewis: *When Demand Is Excused and Delaware's Business Judgment Rule*, 9 DEL. J. CORP. LAW 39, 74-76 (1984) (under Delaware law, director liability is predicated on "gross negligence"); Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 662-64 (1984) (directors or officers found to violate duty of care only when "egregious facts" were present); *see also* Joy v. North, 692 F.2d 880, 891 (2d Cir. 1982) (director's decision will stand absent a demonstration of self-interest or bad faith), *cert. denied*, 460 U.S. 1051 (1983); DePinto v. Provident Life Ins. Co., 374 F.2d 37, 43-44 (9th Cir.) (court applied simple negligence phraseology to describe director conduct that included disregard of substantial complaints about management, total unawareness about financial affairs, and failure to advocate the best interests of the company), *cert. denied*, 389 U.S. 822 (1967).

[232] 488 A.2d 858 (Del. 1985).

[233] *See id.* at 873. Indeed, it has been suggested that *Van Gorkom* might well have a different result under the ALI's approach to the duty of care. *See* Perkins, *supra* note 219, at 1215-17. It also has been suggested that *Van Gorkom* began a trend away from the traditional strict standard for director liability and toward an ordinary negligence standard. *See* King, *Director Protection Under Virginia Law*, 20 REV. SEC. & COMMODITIES REG. 129, 130 (1987).

[234] *See* 488 A.2d at 865-70. Although *Van Gorkom* can be explained in part by the board's failure to obtain an investment banker's opinion on the fairness of the merger, in Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986), the Second Circuit found a breach of the duty of care for granting an asset lock-up option despite the fact that the directors relied on the advice of their outside counsel and financial advisor. *Id.* at 275.

### 4. Duty of Loyalty

The ALI has overstated somewhat the duty of loyalty element of the business judgment rule:

> A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:
>
> (1) he is not interested . . . in the subject of his business judgment;
>
> . . . .
>
> (3) he rationally believes that his business judgment is in the best interests of the corporation.[235]

Although the ALI purports to be codifying existing law, its test may alter the traditional business judgment rule. According to the rule, directors' decisions are presumed to be based on sound business judgment, a presumption that can be rebutted only by a showing of fraud, bad faith, or gross overreaching.[236] The ALI would eliminate this element of presumption.[237]

### 5. Derivative Actions

In addition, the ALI would, as a general matter, liberalize the procedures and remedies available to shareholders seeking to challenge board conduct through derivative actions. Although the common law provided no means of calling corporate managers to account, the derivative action was born in the nineteenth century as an equitable remedy for this purpose.[238] It is well established that the derivative action presents great potential for abuse.[239] In such an action, a plaintiff

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[235] TENT. DRAFT NO. 4, *supra* note 229, § 4.01(c).

[236] *See, e.g.,* Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir.), *cert. denied,* 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 381 (2d Cir. 1980); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied,* 450 U.S. 999 (1981); Warshaw v. Calhown, 43 Del. Ch. 148, 157, 221 A.2d 487, 492-93 (Del. 1966); Gimbel v. Signel Co., 316 A.2d 599, 608-09 (Del. Ch.) *aff'd,* 316 A.2d 619 (Del. 1974).

[237] *See* TENT DRAFT NO. 4, *supra* note 229, § 4.01(a) comment (d). Indeed, a motion to add express language of presumption was debated by the ALI and rejected by a wide margin. *See* Perkins, *supra* note 219, at 1214.

[238] Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation,* 32 N.Y.U. L. REV. 980, 980-82 (1957).

[239] *See, e.g.,* Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform,* 81 COLUM. L. REV. 261, 261-62 (1981) (state legislatures adapted statutes as early as the 1940s to curb abuses from frivolous strike suit litigation; more recently judicial activity has been directed at curbing abuses, where legislative action has failed).

shareholder, with usually a nominal ownership interest, purports to act for the corporation, a function generally reserved to the board of directors. The real party in interest tends to be the plaintiff's attorney, rather than shareholders or the corporation.[240] In such circumstances, it is hardly surprising that "strike suits"—meritless actions brought for their nuisance or settlement value—are not uncommon. An early study confirmed that the costs of derivative claims far outweighed the benefits.[241]

As a result of the dangers posed by derivative actions, substantial procedural barriers have been erected. The complaint must be verified.[242] The plaintiff must be a shareholder at the time of the wrong complained of,[243] and must continue to be a shareholder through termination of the action.[244] The plaintiff first must demand that the board bring the suit on behalf of the corporation, unless such a demand would be futile,[245] and, in some states, a demand on the shareholders is required.[246] The plaintiff must adequately represent other sharehold-

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[240] It was recently reported that the noted plaintiff's attorney, Richard Greenfield, sees no difficulty in rushing to the courthouse to file shareholder litigation because "it's not uncommon for several shareholder suits to be filed almost simultaneously, and judges usually name the first attorney to file as the lead counsel for the plaintiffs." Amparano, *Holders' Advocate: A Lawyer Flourishes by Suing Corporations for Their Shareholders,* Wall St. J., April 28, 1987, at 1, col. 1, 29, col. 2. It was also reported that Greenfield's firm "maintains a list of clients and their stockholdings in order to be able to file quickly when the occasion arises." *Id.* at 29, col. 3.

[241] *See* F. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS 8-9 (1944). Although a subsequent study casts some doubt on Wood's conclusion, *see* Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits,* 60 B.U.L. REV. 542, 567-69 (1980), this study has itself been questioned, *see* Garth, Nagel & Plager, *Empirical Research and the Shareholders' Derivative Suit: Toward a Better-Informed Debate,* 48 LAW & CONTEMP. PROBS., Summer 1985, at 137, 146-47.

[242] *See, e.g.,* FED. R. CIV. P. 23.1; Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 365-66 (1966).

[243] *See* Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703, 708 (1974); FED. R. CIV. P. 23.1; DEL. CODE ANN. tit. 8, § 327 (1983); N.J. STAT. ANN. § 14A:3-6(1) (West 1969 & Supp. 1987); N.Y. BUS. CORP. LAW § 626(b) (McKinney 1986).

[244] *See* Schilling v. Belcher, 582 F.2d 995, 1002 (5th Cir. 1978); Tryforos v. Icarian Dev. Co., 518 F.2d 1258, 1263 (7th Cir. 1975), *cert. denied,* 423 U.S. 1091 (1976); Lewis v. Anderson, 477 A.2d 1040, 1049 (Del. 1984); Harff v. Kerkorian, 324 A.2d 215, 219 (Del. Ch. 1974), *modified on other grounds,* 347 A.2d 133 (Del. 1975).

[245] *See* Galfand v. Chestnutt, 402 F. Supp. 1318, 1331 (S.D.N.Y. 1975); Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984); Barr v. Wackman, 36 N.Y.2d 371, 378-79, 329 N.E.2d 180, 185-86, 368 N.Y.S.2d 497, 504-05 (1975) *aff'd in part and remanded on other grounds,* 545 F.2d 807 (2d Cir. 1976); FED. R. CIV. P. 23.1; N.Y. BUS. CORP. LAW § 626(c) (McKinney 1986); Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. CHI. L. REV. 168, 168-70 (1976).

[246] *See, e.g.,* Bell v. Arnold, 175 Colo. 277, 280, 487 P.2d 545, 547 (1971); Claman v. Robertson, 164 Ohio St. 61, 73, 128 N.E.2d 429, 436 (1955); ARIZ. R. CIV. P.

ers.[247] In many states, the plaintiff must post security for expenses to commence the action.[248] Once begun, the derivative action may not be discontinued or settled without court approval.[249]

The ALI essentially takes the traditional approach to commencement of derivative actions. It allows them subject to the usual procedural restrictions,[250] with minor deviations intended to facilitate the bringing of such actions.[251] The difficulty with traditional law and with the ALI's approach, however, is that the procedural requirements for commencing a derivative suit have not served to deter frivolous or strike suits.[252] As late as 1975, the Supreme Court continued to warn that:

> [I]n this type of litigation . . . the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate component of settlement value, but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial . . . .[253]

As Part IV of this Article will argue, the proper approach does not involve tinkering with the procedural elements of a derivative action, but instead focuses on the substantive scope of the action.

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23.1; MINN. R. CIV. P. 23.06; Comment, *supra* note 245, at 182-84.

[247] *See, e.g.*, Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549-50 (1949); Davis v. Comed, Inc., 619 F.2d 588, 592 (6th Cir. 1980); Youngman v. Tahmoush, 457 A.2d 376, 379 (Del. Ch. 1983); FED. R. CIV. P. 23.1.

[248] *See, e.g., Cohen*, 337 U.S. at 552-53; Haberman v. Tobin, 626 F.2d 1101, 1104 (2d Cir. 1980); Suburban Water Sys. v. Superior Court, 264 Cal. App. 2d 956, 958, 71 Cal. Rptr. 45, 46 (1968); CAL. CORP. CODE § 800(e) (West 1977 & Supp. 1986); N.Y. BUS. CORP. LAW § 627 (McKinney 1986).

[249] *See, e.g.*, Mokhiber *ex rel* Ford Motor Co. v. Cohn, 608 F. Supp. 616, 623-26 (S.D.N.Y. 1985), *aff'd* 783 F.2d 26 (2d Cir. 1986); Lewis v. Newman, 59 F.R.D. 525, 527-28 (S.D.N.Y. 1973); Prince v. Bensinger, 244 A.2d 89, 93 (Del. Ch. 1968); FED. R. CIV. P. 23.1; N.Y. BUS. CORP. LAW § 626(d) (McKinney 1986).

[250] *See* ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.02 (Tent. Draft No. 6, 1986) [hereinafter TENT. DRAFT NO. 6]; *supra* notes 242-49 and accompanying text.

[251] The ALI eliminates the verification and security for expenses, *see id.* § 7.04(c), and shareholder demand requirements, *see id.* § 7.03(c). For verification, the ALI substitutes an attorney signature requirement similar to FED. R. CIV. P. 11, *see id.* § 7.04(a), and, in place of security, the ALI relies on a potential award of costs and attorney's fees to deter bad faith actions, *see id.* § 7.05(a). Although the ALI does not dispense with the contemporaneous ownership rule, it would use the date of disclosure, rather than of actual consummation of the wrong, to determine standing. *See id.* § 7.02(a)(1).

[252] *See* Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures,* 52 GEO. WASH. L. REV. 745, 777-83 (1984).

[253] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742-43 (1975).

The ALI's position on termination of derivative actions is also problematic from a procedural perspective. Under current law, the board has unquestioned authority, within the confines of the business judgment rule, to terminate a derivative action if members of the board are not implicated and recovery is sought from a third party.[254] If directors are implicated, the board possesses the power of termination if the board is sufficiently disinterested to require that demand be made on the board prior to bringing the action and to require application of the business judgment rule.[255]

Current law reflects three separate positions on the capacity of special litigation committees to terminate derivative actions. The strictest view allows the committee to terminate a derivative action as long as its members are independent, act in good faith, and have made a proper investigation.[256] A middle view requires judicial review of the merits of the committee's decision to terminate in cases where demand on the board is excused.[257] The most liberal view generally requires judicial review of the merits of the termination decision and gives no recognition to the committee's action.[258]

The ALI would limit the board's power to terminate derivative actions to cases where no member of the board, or other inside party, is implicated.[259] In any other context, the court would consider the recommendation of a board or special litigation committee on the merits, taking into account such factors as the discounted value of the litigation to the corporation and non-litigation related effects on the corporation's

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[254] *See* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264-65 (1917); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903). *But see* Ashwander v. Tennessee Valley Auth., 297 U.S. 288, 319 (1936) (suggesting that a derivative action against a third party may not be dismissed if the corporation is yielding under duress to the "injurious and illegal action" of the third party). *Ashwander's* unique facts, however, cause it to be distinguished in later cases terminating derivative actions against other public authorities. *See, e.g.,* Klotz v. Consolidated Edison Co., 386 F. Supp. 577, 583 (S.D.N.Y. 1974).

[255] *See* Abramowitz v. Posner, 672 F.2d 1025, 1032-34 (2d Cir. 1982); Allison *ex rel.* General Motors Corp. v. General Motors Corp., 604 F. Supp. 1106, 1121 (D. Del.) *aff'd,* 782 F.2d 1026 (3d Cir. 1985); Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

[256] *See* Auerbach v. Bennett, 47 N.Y.2d 619, 623-24, 629, 393 N.E.2d 994, 996, 1000, 419 N.Y.S.2d 920, 922, 926 (1979); *accord* Roberts v. Alabama Power Co., 404 So.2d 629, 632 (Ala. 1981).

[257] *See, e.g.,* Zapata Corp. v. Maldonado, 430 A.2d 779, 788-89 (Del. 1981); Joy v. North, 692 F.2d 880, 891 (2d Cir. 1982) *cert. denied,* 460 U.S. 1051 (1983); *see also* Alford v. Shaw, 358 S.E.2d 323, 327 (N.C. 1987) (requiring judicial review on merits whether or not demand is excused).

[258] *See* Miller v. Register & Tribune Syndicate, 336 N.W.2d 709 (Iowa 1983).

[259] *See* TENT. DRAFT NO. 6, *supra* note 250, § 7.07(b) (requiring review on merits of board's decision to dismiss a derivative action "[i]n the case of an action against *a* director" (emphasis added)).

business.[260]

The ALI's proposal overly restricts the power of the board. The board's right and duty to manage the business affairs of the corporation, include the duty to manage affairs pertaining to litigation.[261] The implication of a single member of the board is not thought to disempower the board in other contexts,[262] and should not do so in the context of a derivative action. There is no justification for altering current law and denying a disinterested majority of the board the capacity to direct the corporation's litigation affairs.

In addition, with regard to the power of special litigation committees, the strict view appears to be the proper one.[263] If a disinterested majority of the board may terminate a derivative action, there seems to be no reason why a disinterested litigation committee should not have the same power.[264] Presumably, the members of such a committee will generally be more distant from and, therefore, less likely to appease interested directors than "disinterested" members of the board. At the very least, if the board is sufficiently disinterested to require demand, any special litigation committee should inherit the board's power under current law to terminate a derivative action in accordance with the business judgment rule.[265] A contrary result would create a peculiar penalty for an action taken beyond the law's requirements to eliminate any vestige of conflict of interest.

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[260] *See id.* § 7.08.

[261] *See* Allison v. General Motors Corp., 604 F. Supp. 1106, 1117 (D. Del. 1985) ("Demand is required in order to assure compliance with the most fundamental principle of corporate governance—directors are answerable to the shareholders and are charged with the duty and responsibility to manage all aspects of corporate affairs."); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation. . . . By its very nature the derivative action impinges on the managerial freedom of directors." (footnote omitted)).

[262] For example, a disinterested majority of the board retains an enhanced presumption of good faith in the takeover context, *see supra* text accompanying notes 225, and typically is empowered to authorize or ratify contracts between an interested director and the company, assuming the board has knowledge of the material facts pertaining to the interested director's situation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a)(1) (1983).

[263] *See, e.g.*, Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits*, 35 U. MIAMI L. REV. 1, 28 (1980) ("[T]he . . . committee should conduct itself so as to withstand strict judicial scrutiny.").

[264] *Id.* at 28 ("[T]he wisest course of action would be to name only nondefendant, disinterested, and independent persons to the special litigation committee. . . . [T]he board should delegate binding, nonreviewable authority to the committee to investigate and determine whether the suit is in the corporation's best interests." (footnote omitted)).

[265] *See id.* at 4-6.

### 6. Scope of Liability

The ALI's approach to corporate governance, which increases the likelihood that directors will be held personally liable for actions taken in good faith, would make it more difficult to recruit talented directors.[266] Perhaps cognizant of this criticism, the ALI recommends that a director's liability for breach of the duty of care be proportionate to the director's compensation during the year of the violation.[267] This limitation is significantly less generous than state statutes that have addressed the problem.[268] By merely limiting rather than disposing of director liability except in special instances, the possibility that directors will be risk-averse remains.[269] In addition, mere limitation of liability is an inadequate cure for the concerns underlying duty of care liability.

### 7. Corporate Control Transactions

In Part VI of its corporate governance project, the ALI plans to address corporate control transactions, which are crucial to corporate governance in the age of finance corporatism. The ALI's proposal is still in a formative stage.

The ALI's approach to regulating the capacity of a target's board to defend against unsolicited acquisition proposals generally tracks cur-

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[266] *See, e.g.,* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (noting that the threat of liability for ordinary negligence might create "incentives for overly cautious corporate decisions"); Smith v. Brown-Borhek Co., 414 Pa. 325, 333, 200 A.2d 398, 401 (1964) (noting that if ordinary negligence were employed "it would *realistically* be very difficult if not almost impossible to secure the services of *able and experienced* corporate directors"). Fear of liability resulting from the increase in shareholder litigation has caused many directors to resign. *See also* Baum & Byrne, *The Job Nobody Wants,* BUS. WK., Sept. 8, 1986, at 56, 56-57 (reporting mass resignations of outside directors from corporate boards since 1984 when a company is unable to secure liability insurance); ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 comment c (Tent. Draft No. 7, 1987) ("liability may chill the willingness of independent directors to serve") [hereinafter TENT. DRAFT NO. 7].

[267] *See* TENT. DRAFT NO. 7, *supra* note 266, § 7.17(a). The ALI would allow implementation by an enabling statute "that authorizes the inclusion of a limitation on damages in a corporation's certificate of incorporation," *id.* § 7.17(b)(1), or "a provision in a certificate of incorporation that is adopted by a vote of disinterested shareholders [§1.11] after appropriate disclosure concerning the provision," *id.* § 7.17(b)(2).

[268] For example, Indiana, Ohio, Pennsylvania, and Virginia have eliminated the director's liability for damages based on an objective, negligence standard. Each state requires at least recklessness. *See* IND. CODE ANN. § 23-1-35-1(e)(2) (West Supp. 1987); OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1987); PA. STAT. ANN. tit. 42, § 8364 (Purdon 1987); VA. CODE ANN. § 13.1-692.1(B) (1987); *see also* King, *supra* note 233, at 129-32 (discussing statutes limiting director liability in Delaware, Indiana, Ohio, Pennsylvania, and Virginia).

[269] The ALI itself noted that if the threat of liability causes directors to be excessively risk averse when making decisions, shareholders will be injured and the corporation will be less efficient. *See* TENT. DRAFT NO. 7, *supra* note 266, § 7.17 comment c.

rent law. Under the ALI's scheme, a target's board is at liberty to reject an acquisition proposal as long as the dictates of the business judgment rule are satisfied.[270] If an acquisition proposal is made directly to a target's shareholders, as in the case of a hostile takeover bid, the board may defend against the offer without soliciting a shareholder vote as long as its members "rational[ly] belie[ve] that their action is in the best interests of the corporation's shareholders, considered as a group."[271] The only difficulty with the ALI's formulation would seem to be the ALI's discounting of the interests of all corporate constituencies, other than those of common stockholders.

The ALI also has recommendations with respect to various defensive tactics. The ALI would allow a premium repurchase of shares on a non-pro-rata basis only if: 1) the seller has "held the shares for a significant period of time," or 2) the repurchase is approved by a disinterested majority of shareholders, or 3) the repurchase is "necessary to prevent immediate and substantial injury to the corporation," or 4) "the repurchase is pursuant to a contract entered into at or prior to the time the seller acquired the shares to be repurchased," or 5) the repurchase is "pursuant to a general repurchasing program that does not result in a disproportionate amount of the shares being repurchased from a single person or small group."[272] The ALI's recommendation sensibly helps to guard against greenmail, but allows for premium repurchases when they are necessary to defend a target against even greater evils.

The ALI proposes regulating the issuance of lock-up options,[273] and would require a shareholder vote to grant such options.[274] Current law allows a target's board to grant lock-up options without shareholder consent, subject to the restrictions of the business judgment rule.[275] The ALI's approach represents a slight and perhaps unneces-

[270] *See* ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 6.01 (Advisory Group Draft No. 9, 1987) [hereinafter DRAFT NO. 9] ("The board of directors, in the exercise of its business judgment . . . may approve, reject, or decline to consider a proposal . . . to engage in a transaction in control." (citations omitted)).

[271] *Id.* § 6.01 comment d(3).

[272] *See id.* § 6.04.

[273] *See id.* § 6.05(b). A lock-up option is an option granted by a target to a prospective purchaser to buy assets or stock of the target at a negotiated price. *See, e.g.*, Mobil v. Marathon Oil Co., 669 F.2d 366, 367 (6th Cir. 1981) (describing the lock-up option granted by Marathon to U.S. Steel).

[274] *See* DRAFT NO. 9, *supra* note 270, § 6.04 comment c(2).

[275] *Compare* Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 759-60 (2d Cir.), *cert. denied,* 464 U.S. 1018 (1983) (validating lock-up option) *and* Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 703-04 (2d Cir. 1980) (same) *with* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986) (invalidating

sary extension of the restrictions imposed by current law but allows, without requiring a shareholder vote, the granting of no-shop clauses[276] and break-up fees,[277] which similarly advantage one bidder at the expense of others.[278]

The most significant weakness in the ALI's approach to corporate control transactions appears to be that the ALI completely ignores the abusive takeover tactics that plague this age of corporatism. That is precisely why the ALI is unable to recommend severe restrictions on a target's defensive tactics. Although it might be inappropriate for an organization such as the ALI to propose a comprehensive solution to problems in the takeover context, Part IV of this Article will attempt to articulate such a solution.

## IV. A Proposal for Legislation

The problems of corporate governance in the age of finance corporatism will not be solved through tinkering with existing mechanisms, as the ALI and others propose. These problems require a balanced, comprehensive legislative solution. Any such scheme must protect shareholders and other constituencies from the junk-bond, bust-up tender offer and other equally abusive takeover tactics, eliminate the restrictions on shareholder choice inherent in certain defensive takeover tactics, and revive shareholder democracy as a check on arbitrary or inefficient management.[279] Only then can we be assured that corpora-

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lock-up option). *See generally* Note, *Lock-Up Options: Toward a State Law Standard,* 96 Harv. L. Rev. 1068, 1076-77 (1983) (discussing application of business judgment rule to lock-up options).

[276] A no-shop clause is an agreement by a target not to seek to solicit or to negotiate with competing bidders. The validity of such agreements has been questioned. *See, e.g., Revlon,* 506 A.2d at 184 (invalidating no-shop clause). *But see* Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555, 1562 (9th Cir. 1984) (upholding no-shop clause).

[277] A break-up fee is a fee paid to a disappointed bidder. Such a fee will be upheld, like a lock-up option, only if it stimulates rather than retards a bidding contest. *Compare* Beebe v. Pacific Realty Trust, 578 F. Supp. 1128, 1150-51 (D. Or. 1984) (upholding break-up fee) *with Revlon,* 506 A.2d at 184 (invalidating break-up fee).

[278] *See* Draft No. 9, *supra* note 270, §§ 6.05(b) comment a(2).

[279] "What is . . . in order . . . is a legislative package carefully balanced between restraints on raiders and restraints on targets, aimed at fairness to stockholders . . . ." J. Brooks, *supra* note 25, at 350. Moreover, even as ardent a proponent of the hostile takeover as SEC Commissioner Joseph Grundfest, *see, e.g.,* J. Grundfest & B. Block, Stock Market Profits from Takeover Activity Between 1981 and 1986: $167 Billion Is a Lot of Money (Sept. 28, 1987) (research paper in SEC news release), acknowledges that " 'the current system is not the best way' " and " '[w]e need a way to make changes [in the structure and control of corporations] more civilly'." *Grundfest Says Study Shows Takeovers Sharply Increase Shareholder Wealth,* 19 Sec. Reg. & L. Rep. (BNA) 1487, 1488 (1987).

tions will be run for the long-term benefit of their shareholders and other corporate constituencies, rather than for the corporate raider or entrenched management.[280]

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[280] The proposals that follow are in large measure based on The Shareholder Protection and Elimination of Takeover Abuses Act of 1985, which the author proposed in testimony before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs. *See Impact Hearings*, *supra* note 102, at 35-44 (testimony of Martin Lipton). In that testimony, the author said that the proposed legislation should be designed so that it:

> [(1)] Does not add new regulation, but primarily accomplishes its objectives through deregulation.
>
> [(2)] Protects shareholders from takeover abuses by both takeover entrepreneurs and entrenched managements.
>
> [(3)] Assures all shareholders of fair and equal treatment and ample time to make reasonable decisions as to their best alternatives in takeover situations.
>
> [(4)] Eliminates the universally condemned practice of greenmail.
>
> [(5)] Preserves shareholder democracy and gives the holders of common stock a meaningful opportunity to use the corporate proxy machinery to prevent management entrenchment. A substantial shareholder will have the same right as, and equal opportunity with, management to urge the shareholders to change corporate policy or management.
>
> [(6)] Does not deter or handicap takeover bids by companies that are prepared to make fair and equal offers to all shareholders and permits cash and securities tender offers to be made on an equal basis.
>
> [(7)] Protects employees, customers, suppliers, pensioners and communities against the disasterous [sic] effects of bust-up takeovers.
>
> [(8)] Does not in any way interfere with the traditional role of the states in corporate governance and leaves the business judgment rule to evolution in the state courts.
>
> [(9)] Eliminates abusive front-end loaded two-tier tender offers and creeping open-market takeovers that were developed to give takeover entrepreneurs the upper hand, and thereby eliminates the need for takeover targets to resort to shark repellents, crown jewel options, pac-man defenses, issuance of blocking preferreds, poison pills, greenmail and other pejoratively named defenses developed to try to counterbalance such takeover tactics.
>
> [(10)] Preserves the ability of corporations to raise venture capital, use innovative financing techniques, negotiate desirable mergers and acquisitions and have all the free market acquisition and financing flexibility they presently enjoy.
>
> [(11)] Enables corporations to reduce their concern with abusive bust-up takeovers and devote greater time and resources to the long-term planning that is essential to the preservation of the preeminent position of American industry in a worldwide economy.
>
> [(12)] Creates an even playing field on which free market forces and the competitive skills of corporate managements can assure that our public corporations and national assets are managed by the best people and are devoted to the uses that are most favored by free market forces.

*Id.* at 11-13.

### A. *Restricting Abusive Takeover Tactics*

#### 1. Partial Bids

Anyone wishing to effect a takeover should be required to declare her intentions in a timely fashion and to purchase 100% of the target at a uniform price. To accomplish this, securities laws should be amended to require that no more than 5% of a company's common stock be purchased except by tender offer for all of the company's common stock. In addition, the Section 13D disclosure threshold should be lowered to 2%,[281] with the proviso that no more than 2% of a company's stock can be purchased until after a 13D statement is filed.[282] Purely passive institutional investors would be allowed to purchase up to 10%, but would thereafter be prohibited from changing their intent and making a tender offer. This proposal would prevent creeping acquisitions, "sweeping the street,"[283] partial bids, and two-tiered tender offers.

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[281] Currently, any person acquiring over 5% of a company's stock must file a 13D disclosure document with the Securities and Exchange Commission within 10 days. *See* 15 U.S.C. § 78m(d)(1) (1982).

[282] Representatives Dingell (D-Mich.) and Markey (D-Mass.) have introduced legislation with many provisions that parallel the author's proposals for legislation. *See* H.R. 2172, 100th Cong., 1st Sess., 133 CONG. REC. H2540 (daily ed. Apr. 27, 1987) (Tender Offer Reform Act of 1987). The Dingell-Markey bill would prohibit accumulations over 10% except by tender offer but would not require that the tender offer be for 100% of the target. *See id.* at § 13. It would require the filing of a 13D Statement within 24 hours of crossing the 5% threshold, with a 2-day prohibition on purchasing after crossing the threshold. *See id.* at § 4. The Dingell-Markey bill would also prohibit purchases for 30 days following the termination of a tender offer, *see id.* at § 11, and would thus discourage "sweeping the street." Other takeover reform proposals have been sponsored by Representatives Lent (R-N.Y.) and Rinaldo (R-N.J.), *see* H.R. 2668, 100th Cong., 1st Sess., 133 CONG. REC. H4558 (daily ed. June 11, 1987) (Securities Trading Reform Act of 1987), and Senator Proxmire (D-Wis.), *see* S. 1323, 100th Cong., 1st Sess., 133 CONG. REC. S7601 (daily ed. June 4, 1987) (Tender Offer Disclosure and Finance Act of 1987). While expressing certain reservations, the author has taken the position that the Dingell-Markey, Lent-Rinaldo, and Proxmire bills "provide[] a sound basis on which to build a new takeover law." Testimony of Martin Lipton, *supra* note 72, at 2.

[283] Representative Dingell noted that "shareholders have insufficient time and information in the face of unregulated acquisition programs, and that some groups of shareholders are unfairly disadvantaged, because of the speed within which the transactions occur or the ability to participate on the same basis as other shareholders." 133 CONG. REC. E1564 (daily ed. Apr. 27, 1987). Dingell specifically criticized these conditions as arising from the "sweeping the street" transactions that were the subjects of Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985) and SEC v. Carter Hawley Hale Stores, 760 F.2d 945 (9th Cir. 1985). *See id.* Section 11 of the Dingell-Markey bill, *see supra* note 282, would prohibit sweeping the street after termination of a tender offer, as in *Hanson*, by interposing a 30-day cooling-off period after termination of a tender offer.

### 2. Timing

As currently structured, the tender offer process gives a target's management a minimum of only twenty business days to evaluate a bid and to consider alternatives.[284] This time frame should be extended to 120 calender days.[285] Such an extension would give the board a realistic opportunity to determine whether the target is best served by remaining independent or, if a sale is desired, whether the first offeror has made the most advantageous bid and would give the board sufficient time to solicit proxies making complete disclosure of the available alternatives.

In addition, no tender offer should be allowed to commence unless the bidder has actual commitments for all the financing needed to consummate the purchase.[286] Tender offers conditional on financing or founded on "highly confident" letters are transparent ploys that allow putting the target "in play" even if the bidder has no intention of consummating the purchase.[287] Such maneuvers contribute nothing to the long-term well-being of corporate America, and simply cater to the desire for immediate, speculative profit.[288]

### 3. Voting

Currently, target shareholders feel compelled to tender to avoid the risk of being left with minority shares after the takeover. Although partial and two-tiered bids are egregiously coercive in this respect, there is an element of coercion in every tender offer.[289] Therefore, within the 120-day tender offer period, the target's shareholders should have the opportunity to vote on the proposed tender offer. Only shareholders who were such at least 60 days prior to the announcement of the tender offer should be allowed to vote. If the bidder does not receive a majority

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[284] *See* 17 C.F.R. § 240.14e-1(a) (1987).

[285] Section 9 of the Dingell-Markey bill, *see supra* note 282 would lengthen the tender offer period to 60 days. Another study recommended a 44-day period to consider a partial bid. *See* TENDER OFFERS RECOMMENDATIONS, *supra* note 82, at 24-26 (LeBaron Commission findings).

[286] *See Impact Hearings, supra* note 102, at 673-74 (statement of Felix Rohatyn).

[287] *See Impact Hearings, supra* note 102, at 123-24 (statement of Louis Lowenstein); Bianco, *How Drexel's Wunderkind Bankrolls the Raider,* BUS. WK., Mar. 4, 1985, at 90, 91 (noting that purported junk financing arrangements are often a prelude to greenmail).

[288] *See* Coffee, *supra* note 111, at 106 n.297 (Many parties have enormous incentives to participate in a tender offer, even if there is no intention of actually consummating the deal. For example, in Pantry Pride's $1.7 billion acquisition of Revlon, over $200 million was charged merely for transaction costs.).

[289] *See* Bebchuk, *supra* note 81, at 1717-33; Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions,* 132 U. PA. L. REV. 647, 679-80 (1984); *Takeover Bids, supra* note 116, at 113-14.

of the shares voted, the bidder should be required to withdraw the tender offer.[290] If a majority of pre-existing shareholders desire to remain independent, the offer will be defeated. If a majority votes for the tender offer, dissenters can simply tender after the will of the majority has become known.[291]

This approach allows the target's shareholders, rather than the takeover bidder, to determine the target's fate. As a consequence, a bidder will no longer be able to make a highly leveraged offer, "force" the target's shareholders to tender, and then treat the target's remaining shareholders, assets, and employees as it wishes.

#### 4. Junk Bonds

Any proposal for reform in the takeover arena must address the threat that junk-bond financing poses not only to the vitality of individual corporations, but also to the national economy.[292] To discourage junk-bond, bust-up takeovers and other junk-financed leveraging, the tax code should be amended to eliminate the deductibility of interest on junk bonds issued to finance hostile takeovers or issued by a company in exchange for its own equity.[293] In addition, in order to strengthen the national savings system, federally regulated or insured institutions should be barred from holding more than 10% of their capital in junk bonds.[294]

#### 5. Institutional Shareholders

Institutional investors, arbitrageurs, and other market professionals are the crucial de facto control persons in the age of finance corpo-

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[290] For an alternative scheme that also seeks to reduce coercion, but emphasizes voluntary private sector reform, see Fogg, *Takeovers: Last Chance for Self-Restraint*, HARV. BUS. REV., Nov.-Dec. 1985, at 30, 38, 40.

[291] Eliminating coercion of target shareholders through a voting scheme was suggested in Bebchuk, *supra* note 81, at 1752-64.

[292] *See supra* text accompanying notes 91-102; *see also Impact Hearings*, *supra* note 102, at 685 (statement of Felix Rohatyn) (noting that much of this paper, which has been accumulated by some of the weaker financial sectors, has never been tested in a period of economic downturn). In 1986, 3% of below-investment-grade debt issues defaulted, an increase from 1.5% over previous years. At present, over $4 billion in junk bonds from 36 companies may be vulnerable to default. *See* Sheppard, *Should Junk Bond Interest Deductions Be Disallowed?*, 34 TAX NOTES 1142, 1142-46 (1987).

[293] Several similar proposals have been discussed in Congress. For example, Congressman Pickle (D-Tex.) at one time opposed deductions on certain issues of junk bonds whether used offensively or defensively. *See* Sheppard, *Jake Pickle's Junk Bond Proposal*, 27 TAX NOTES 864, 864 (1985).

[294] As an example of overexposure, Columbia Savings and Loan, as of June 30, 1986, owned $2.33 billion in junk bonds, representing 28% of its total portfolio. *See* Coffee, *supra* note 111, at 45 n.120.

ratism.[295] The record suggests that their energies have heretofore been focused on securing short-term gain at the expense of long-term considerations.[296] To reverse this trend, the tax code should again be amended to impose a graduated tax, based on length of holding, on profits from a security position of $5 million or more held less than five years. Specifically, short-term profits of such large holders should be taxed at the following rates: 60% on positions held for not more than one year; 50% on positions held for not more than two years; 45% on positions held for not more than three years; 40% on positions held for not more than four years; and 35% on positions held for not more than five years.[297]

The graduated tax would help shift the focus of institutional investors from the short to the long term, thereby harnessing the energy of a powerful group of professionals for improved corporate governance. A longer-term perspective will encourage institutional investors to bridge the gap between ownership and control by monitoring the ability of management to achieve the valuable long-term goals of expanding the enterprise and improving productivity. This focus, in turn, will increase the long-term value of corporate equity.

### B. *Defensive Tactics*

If the foregoing proposals are enacted to eliminate takeover abuses and impose needed long-term investment objectives on institutional investors, then the takeover defenses currently used to combat such abuses will no longer be justified. Standing alone, defensive maneuvers deprive target shareholders of an effective voice in corporate governance and should be eliminated. Such mechanisms, moreover, may insulate management from shareholder discipline and should be prohibited. This Article, therefore, proposes that a number of limitations on defensive tactics accompany the prohibitions on abusive takeover tactics already suggested.

Reform in this area should begin with the shareholder voting process. National stock exchanges and other organized trading markets should enact the following as prerequisites to listing. First, a listed company should adhere to the one-share, one-vote concept by disallow-

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[295] *See* Fogg, *supra* note 290, at 31.

[296] *See supra* text accompanying notes 23-26.

[297] Warren Buffett has proposed a 100% tax on profits from stock positions held less than one year. *See* Buffett, *How to Tame the Casino Society,* Wash. Post, Dec. 4, 1986, at A23, col. 3; *cf.* Fogg, *supra* note 290, at 38 (focusing on a 5% stock threshold limit instead of a tax scheme); *Impact Hearings, supra* note 102, at 124, 673 (statement of Louis Lowenstein) (supporting a 5% voting share threshold as not restrictive on traditional investors).

ing non-voting or low-voting common stock.[298] Second, a listed company's directors should be elected annually, thereby disallowing staggered boards. Finally, shark-repellent provisions in corporate charters that require supermajority shareholder votes to approve mergers should be proscribed.

With limitations on abusive takeovers in place, there no longer will be a justification for structural defenses that treat common stockholders unequally or are triggered by a change of control, such as poison pills, lock-up options, and fair-price provisions.[299] Such defensive tactics should be eliminated, giving target shareholders the opportunity to determine the fate of takeover bids.

Once the detrimental effects of takeovers are mitigated, the continued use of greenmail, a defensive tactic that absorbs enormous amounts of the target's resources, has no justification.[300] Legislative reform must include proscription of selective repurchases by a company of its own shares.[301]

### C. *Directors' Liability*

A remaining area requiring reform involves the liability of the director under state law. With the proposed legislative program in place, directors will be free to act in the best interests of the corporation and all its constituencies, and it should be presumed that shareholders concur in their decisions. Therefore, this Article proposes that directors be protected by state law from monetary liability arising from breach of

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[298] Section 3 of the Dingell-Markey bill, *see supra* note 282, would also require one-share, one-vote for trading on a national securities exchange or through a national securities association. For a different view suggesting a middle course between banning dual-class capitalization and unrestricted capital structuring, see Dent, *Dual Class Capitalization: A Reply to Professor Seligman,* 54 GEO. WASH. L. REV. 725, 736, 746-52 (1986) (arguing that the SEC may not have the power to forbid dual-class capitalization, and that there are efficiency arguments that favor such a structure).

[299] Sections 12 and 14 of the Dingell-Markey bill, *supra* note 282, would also prohibit such tactics as poison pills and lock-up options.

[300] *See supra* text accompanying notes 133-38 (discussing greenmail). As an example of the enormous sums involved, between 1979 and 1984 target firms spent $5.5 billion in share repurchase transactions, with an aggregate premium over market price of more than $1 billion. *See* Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?,* 19 GA. L. REV. 281, 282 (1985).

[301] Section 5 of the Dingell-Markey bill, *supra* note 282, would also prohibit greenmail, defined as a repurchase from a 3% holder of less than two years at a price exceeding the average market price during the 30 days preceding the repurchase, unless a majority of the company's shareholders approve or the same offer is extended to all shareholders. *See also* Gordon & Kornhauser, *Takeover Defense Tactics: A Comment on Two Models,* 96 YALE L.J. 295, 297 (1986) ("[T]arget stock buybacks are unlikely to increase shareholder wealth as a general matter and, on a shareholder wealth criterion, should not be permitted as a defensive tactic.").

fiduciary duty unless it can be proven that the director's actions were taken in bad faith or provided an improper personal benefit.[302] Derivative suits, moreover, should be permitted only if directors have profited personally at the corporation's expense.[303] Bad faith should be construed as intentional or reckless disregard of duty rather than as "gross negligence."

This proposal would relieve a number of problems that plague corporate governance, such as the current director-officer insurance crisis, the difficulty in recruiting talented directors, and the trend toward risk-aversion that some commentators fear in the wake of recent decisions and proposals for expanding the director's duty of care.[304] It will also mitigate the judiciary's role of second-guessing directors' judgments. Consequently, a management that is truly accountable to shareholders will be able to concentrate on running the enterprise rather than devoting time and energy to avoiding liability.

### D. *The Accountability of Managers*

After the distorting effects of takeover tactics and defenses are removed, corporations will be able to concentrate on operating their businesses. A broad legislative program must still address the issue posed at the outset of this Article: given the contemporary nature of corporatism, what is the best method of ensuring proper corporate governance? In the age of finance corporatism, the answer lies in promoting management accountability through a renewal of shareholder democracy.

Commentators have suggested that shareholder democracy in corporate governance is inherently unworkable because shareholders generally lack the interest to become involved in corporate governance.[305]

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[302] Several states have enacted statutes to reduce director exposure to liability. In Indiana, for example, there is no liability for breach of the duty of care absent "willful misconduct or recklessness." *See* Special Project Note, *Protecting Corporate Directors and Officers: Insurance and Other Alternatives,* 40 VAND. L. REV. 775, 803 (1987) (citing IND. CODE ANN. § 23-1-35-1(e)(2) (Burns Supp. 1986)). Delaware has amended its corporate code to permit shareholder adoption of provisions limiting directors' liability for damages for breach of duty of care. *See id.* at 803-04.

[303] The Delaware statute still imposes liability "for any transaction from which the director derived an improper personal benefit" as well as for the making of unlawful dividend payments or unlawful stock purchases or redemptions. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986). Discussion of technical violations related to the impairment of a corporation's capital is beyond the scope of this Article.

[304] *See, e.g.,* Wriston, *"Risk," the American Law Institute, and the Corporate Director,* in ANALYSIS, *supra* note 210, at 7, 14 ("if directors are penalized for taking business risks, our system is in jeopardy").

[305] *See* Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract,* 85 COLUM. L. REV. 1403, 1405-08 (1985) (expressing concern that the average stockholder lacks the requisite information and mechanisms to monitor and control

Such apathy has been viewed as rational.[306] Corporate elections have been parodied as "procedurally much more akin to the elections held by the Communist party of North Korea" than real democratic elections because "they normally provide only one slate of candidates."[307] The institutional investor's rise to prominence in the age of finance corporatism calls into question the conventional wisdom. Once institutional investors adopt a more long-term profit perspective, these investors will possess a significant stake in corporate governance and will have greater incentive to become involved in corporate decision-making. Such investors, moreover, possess the skills necessary to assert their influence.[308] Thus, strengthening shareholder democracy remains the most promising method of promoting management accountability and improving corporate governance in the current age.

To promote the accountability of management, this Article proposes that the federal securities laws be amended to allow any shareholder, or group of shareholders, with more than $5 million in market value of the corporation's shares free and equal access[309] to the corporation's proxy machinery at the corporation's expense.[310] Shareholders

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management); Hetherington, *supra* note 163, at 253 ("The overwhelming majority of the shareholding public probably prefers reading ball scores to proxy statements . . . . If [small corporate shareholders] become dissatisfied with the performance of management the best thing for them to do is sell.").

[306] *See, e.g.,* Easterbrook & Fischel, *supra* note 108, at 1171 (stating that free-rider problems render investor passivity to be in her self-interest); *see also* Kripke, *The SEC, Corporate Governance, and the Real Issues,* 36 BUS. LAW. 173, 175-78 (1981) (noting that typical stockholder views herself as investor with power to sell rather than as owner).

[307] E. EPSTEIN, *supra* note 162, at 13.

[308] Louis Lowenstein has suggested that shareholders be allowed to nominate and elect 20% of the board in addition to the management slate. His avowed aim is to "[e]ncourage [institutional investors] to participate in corporate governance before the event, rather than voting with their feet after." L. Lowenstein, Beating the Wall Street Rule with a Stick and a Carrot, Comments at Conference at Boston University 11 (May 1, 1987) (on file with the *University of Pennsylvania Law Review*) (drawn from forthcoming book). The only difficulty with Lowenstein's solution is that it does not go far enough. The institutions must be able to challenge management control, not merely possess minority representation on the board.

[309] Section 6 of the Dingell-Markey bill, *see supra* note 282, would provide free access to the corporate proxy machinery to a holder of 3% of the voting power or of $500,000 worth of shares, whichever is greater. *See also* Fogg, *supra* note 290, at 38 (suggesting that subjecting the takeover process to corporate proxy mechanisms would further accountability).

[310] When a policy issue is involved, a management group is entitled to charge to the corporation reasonable expenses it incurred in soliciting proxies. This general rule has been extended to expenses incurred by an insurgent group if it is successful in obtaining control and the charge is approved by a majority of shareholders. *See* Steinberg v. Adams, 90 F. Supp. 604, 607-08 (S.D.N.Y. 1950) (in contest over policy, successful insurgents may be reimbursed if both the board of directors and a majority of stockholders approve); Johnson v. Tago, Inc., 188 Cal. App. 3d 507, 516-17, 233 Cal.

with less than a $5 million stake would remain free to pursue independent proxy solicitations. Because broad social issues are beyond the proper scope of corporate governance,[311] such proposals would not be allowed at corporate expense.

Providing large shareholders, who have a substantial stake in corporate governance, with access to the proxy machinery will ensure the accountability of management far better than the current tender offer process,[312] which requires decision-making under conditions of extreme time pressure—within twenty days. As a practical matter, this requires target management to maximize the short-term value of the target's shares in response to a hostile bid. The only real alternatives to a hostile bid are a sale to a third party at a higher price or an internal restructuring that raises the trading price of the target's shares. There is little opportunity to explore whether the target would benefit over the long-term by remaining independent and unrestructured. It is little wonder that, in this pressurized environment, institutional shareholders have historically sought the highest short-term profit and have even considered it their duty to follow this course.[313]

Substituting real shareholder democracy for the hostile tender offer as a device for disciplining management has a number of advantages. It allows corporate decision-making to proceed under conditions of normalcy, rather than under the extraordinary pressures of the tender offer process. Under the suggested program, a company can safely remain independent and unrestructured if its shareholders believe this to be in the company's long-term interest. A raider seeking speculative gain will

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Rptr. 503, 507-08 (1986) (overturning lower court order that corporation pay expenses of shareholders in midst of proxy contest on grounds that court may determine only whether such a payment, after approval by shareholder majority, is reasonable, noting that "[r]epayment is generally given only to the winners, be they management incumbents or successful insurgents"); Rosenfeld v. Fairchild Engine and Airplane Corp., 309 N.Y. 168, 173, 128 N.E.2d 291, 293 (1955) (in a proxy contest over policy, "[t]he stockholders . . . have the right to reimburse successful contestants"); Annotation, *Expenses Incurred by Competing Factions Within Corporation in Soliciting Proxies as Charge Against Corporation,* 51 A.L.R.2d 873, 877 (1957).

[311] Lack of expertise on the part of management and the anti-democratic tendencies of corporate involvement in this area make it an inappropriate issue for corporate governance. *See supra* text accompanying note 192.

[312] *See* D. Walker, Some Perspectives for Pension Fund Managers (delivered at NAPF Investment Convention, Eastbourne, England) (Feb. 27, 1987), at 8-10.

[313] To counter this view, § 10 of the Proxmire bill, *see supra* note 282, would amend ERISA to provide that pension fund managers will not be liable for refusing to accept a tender offer in the absence of gross negligence or willful malfeasance. *Cf.* D. Walker, *supra* note 312, at 5 ("trustees, in proper exercise of their responsibilities, should take into account in determining the appropriate acceptance of risk not only the interests of current and future pensioners but also the implications for the company that has to pick up the tab if things go wrong").

no longer be able to impose a sale or restructuring on a target. If a sale or restructuring is desired by a company's shareholders, the company can proceed to explore carefully all alternatives to its current organization and select the one that is most advantageous.

Most importantly, a renewal of shareholder democracy and a deemphasis of the hostile takeover bid will free institutional shareholders, the actual control persons in this stage of corporatism, from the imperative of speculative short-term profits. Institutional shareholders will be able to guide corporate management in the long-term interest of the corporation and all its constituencies. To the corporation's benefit, its shareholder constituency will remain relatively stable. The diversity of its institutional owners, moreover, will ensure that a variety of views is expressed over time, with the attendant benefits of pluralist corporate democracy. The proposed reforms require that management run the corporation for the long-term benefit of the enterprise, rather than for the short-term creation of paper profits.

## V. THE SECOND GENERATION PILL

The legislative program outlined in Part IV allows shareholders to determine the fate of companies in today's overheated takeover environment. If a target's best long-term interests so dictate, the program frees the target's board from having to choose among allowing a hostile tender offer to succeed, selling the company to a white knight, or restructuring the company to increase short-term share values. Under the program, shareholders can dictate that a target remain independent and unrestructured.

Should corporations wish to take action on their own rather than await enactment of such a legislative program, many of the same goals can be accomplished directly through adoption of the second generation share purchase rights plan, which like its predecessor will undoubtedly be labeled a "poison pill."[314] Similar to its precursor, the second generation pill also contains a flip-over provision designed to guard against second-step, squeeze-out mergers and bust-up takeovers.[315] The flip-over, however, does nothing to deter raiders able to acquire majority control and willing to forego a second-step merger. The second generation pill adds a status "flip-in" provision to protect against abusive partial acquisitions. In the event a raider acquires 20% of a target, the new

[314] The second generation pill was recently adopted by MCA, Inc., and Foster Wheeler Corp. *See New Pills Find Few Takers,* CORP. CONTROL ALERT, October 1987, at 1, 5.

[315] *See supra* text accompanying note 129.

pill gives the target's shareholders, other than the raider, the right to acquire common stock of the target at half-price.[316] Thus, the flip-in gives shareholders of the target, other than the raider, the right to cause unacceptable dilution of the raider's holdings in the target.

The new pill may be redeemed by the company's board at a nominal price at any time prior to acquisition of a 20% stake by an acquiring person. To prevent the second generation pill from hindering advantageous offers, and to decrease concerns regarding judicial acceptance, the new pill provides that, under certain circumstances, a special shareholders meeting will be held to determine whether the pill should be redeemed. A bidder can avail itself of such a special shareholders meeting if it: (a) makes a cash offer for all the target's shares; (b) owns no more than 1% of the target's shares and owned no more than 1% at the time it disclosed its intention to control or acquire control of the target; (c) has financing or financing commitments; (d) furnishes an opinion, addressed to the target's shareholders, from a nationally recognized investment banking firm that the price of its offer is fair; and (e) agrees to bear half the costs of the special meeting.

In order to allow sufficient time to consider the bidder's proposal, to seek and evaluate alternative proposals, to prepare proxy materials, but also to avoid undue delay, the special shareholders meeting is required to be held not fewer than 90 days but not more than 120 days after the bidder's request. The record date for the meeting would be set in accordance with applicable by-law and charter provisions.[317] The bidder may submit any information it desires in the company's proxy

[316] Some early cases held that exclusion of the raider from the benefits of the flip-in violated statutory proscriptions against discrimination among shares of the same class. *See* Spinner Corp. v. Princeville Dev. Corp., No. 86-0701, slip op. at 6-7 (D. Haw. Oct. 31, 1986), *vacated,* [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,157 (D. Haw. Jan 30, 1987) (vacating prior proceedings as a consequence of settlement); Amalgamated Sugar Co. v. N.L. Industries, Inc., 644 F. Supp. 1229, 1234 (S.D.N.Y. 1986); R.D. Smith & Co. v. Preway, Inc., 644 F. Supp. 868, 873-75 (W.D. Wis. 1986) (denying preliminary injunction because shareholders failed to prove likelihood of irreparable injury). More recent cases, however, have held that the flip-in provision is lawful because it constitutes discrimination among shareholders, which is not prohibited by statute, rather than among shares. *See* Dynamics Corp. of America v. CTS Corp., 805 F.2d 705, 718 (7th Cir. 1986), *rev'd on other grounds,* 107 S. Ct. 1637, 1653 (1987); Harvard Indus. v. Tyson, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,064, 95,294 (E.D. Mich. Nov. 25, 1986); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 847-48 (D. Minn. 1986) (finding flip-in lawful in accordance with Minnesota statute that allows discrimination against shareholders within same class), *aff'd in part and vacated in part on other grounds,* 811 F.2d 414 (8th Cir. 1987).

[317] Absent statutory change, there is no method to prevent bidders and arbitrageurs from voting shares acquired after the bidder's request for a meeting. *See, e.g.,* DEL. CODE ANN. tit. 8, § 213(a) (1983) (record date must be not more than 60 days nor fewer than 10 days prior to date of meeting).

materials or mail its own proxy materials. The target's board may also solicit proxies and may give its opinion relating to such matters as the fairness of the offer, the advisability of alternative transactions, and the advisability of remaining independent and unrestructured. If a majority of the company's outstanding shares are voted in favor of the bidder's resolution, the new pill is redeemed, and the bidder may proceed with its offer—at a cash price not less than the price voted on by the shareholders—unaffected by the pill's provisions. Thus, under conditions that ensure that a bidder is not abusing the tender offer process, the second generation pill allows the target's shareholders to determine the fate of the company after disclosure of all relevant information and with sufficient time to consider and act on such information.

## CONCLUSION

The contemporary stage of corporatism, that of finance corporatism, poses both a great danger and a great opportunity for American economic prosperity. The danger is clearly evident in the current wave of abusive acquisitions, a trend that is a function of the financing mechanisms and market professionals that mark this phase of corporatism. The opportunity presented is a chance to ensure our future economic and social well-being by channelling economic energy from speculative endeavors into productive ones.

This Article has described the complex problems that currently threaten corporate America, such as the highly leveraged takeover and other abusive offensive techniques, the concomitant difficulties created for various corporate constituencies, the use of defensive tactics as a response to offensive abuses, and the resulting disempowerment of shareholders to make decisions that vitally affect their future. The Article has also provided a survey of various proposals to reform corporate governance. While each has ideas to contribute, they do not address the far-reaching and long-term impact that the age of finance corporatism has on our economy and society. The broad proposal for the reform of corporate governance provided herein, however, incorporates these realities. The suggestions address the financing mechanisms and market professionals that currently dominate economic activity, as must any successful proposal of reform. America must move to meet the challenge posed by the age of finance corporatism, or lose a unique opportunity to shape the attributes of the next stage of corporatism.

## POSTSCRIPT

The historic market crash of mid-October 1987 took place after this Article was set in type. The overleveraged takeover and the short-term oriented speculative activity associated with the takeover frenzy of the eighties were, predictably, significant factors leading to the crash.[318] As stated by Edward Yardeni, director of economics at Prudential-Bache Securities: "[T]he bull market was largely fueled by mergers, acquisitions and buy-backs. Stock values were driven up by corporate entrepreneurs willing to pay above-market prices to control other corporations."[319] Hopefully, the political and legislative reaction to the crash will result in takeover reforms of the type urged in this Article.

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[318] In 1985 testimony before Congress, the author stated: "[F]undamentally we are creating a system which historically has resulted in crashes, panics, and depressions. We can go back to the 17th century to the tulip bubble; to the 18th century, to the South Sea bubble; to the 19th century, with the money panics; and the 20th century, to 1929. I think we are again approaching a situation which gave rise to that kind of problem." *Impact Hearings, supra* note 102, at 132.

[319] Yardeni, *The M & A Tax Scare Rattling the Markets,* Wall St. J., Oct. 28, 1987, at 32, col.3, 32, cols. 4-5.