
MARTIN LIPTON MEMOS

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August 23, 1976

To Our Clients:Conflicts of Interest - Use of Special
Committees of Disinterested Directors

The utility of the special committee of disinterested directors to decide how a corporation should act in a situation where a majority of the directors have a conflict of interest was recently reaffirmed in Gall v. Exxon Corp., CCH Fed. Sec. L. Rep. ¶ 95,675 (S.D.N.Y. Aug. 2, 1976). Exxon had made what were alleged to be illegal foreign political contributions of about \$59 million. After a shareholder demand that Exxon bring suit against the officers and directors involved in the contributions to recover the damage to Exxon, the Exxon Board of Directors appointed a special committee of directors to consider the question. The special committee decided not to bring suit. The court held that under the usual business judgment rule applicable to corporate decisions, the determination of the special committee would not be subject to review by the court in a shareholder derivative suit and such suit would be dismissed. In order for the business judgment rule to be applicable to such special committee determinations, the special committee must have actual decision making authority and the members of the committee must be truly disinterested.

Other recent examples of the efficacy of the special committee approach are Lasker v. Burks, CCH Fed. Sec. L. Rep. ¶ 95,297 (S.D.N.Y. 1975) (determination not to sue mutual fund adviser with respect to a bad investment); Schulwolf v. Cerro Corp., N.Y.L.J. Feb. 15, 1976 p. 6, col. 5 (Sup. Ct., N.Y. Co. Feb. 13, 1976) (parent-subsidary freeze-out merger) and Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971) (purchase of assets from controlling shareholder).

The special committee of disinterested directors, advised by special outside counsel, investment bankers or other independent experts, depending upon the issue to be decided, has proved to be an effective means of meeting the strike suit attack on corporate conflict transactions. It warrants wider use.

Martin Lipton

February 4, 1977

Investment Bankers' Fairness Opinions

The increasing and expanding use of investment bankers' fairness opinions warrants reexamination of the premises on which they are based. The traditional fairness opinion evolved primarily from arms-length merger transactions in which the investment banker acted for the "deal". Recently, fairness opinions have become significant in a wide range of transactions:

1. Minority shareholder freezeouts;
2. Repurchases from insiders;
3. Second step acquisitions following tender offers;
4. Conflict mergers; and
5. Arms-length mergers.

Lawyers and management of corporations recognize that an investment banker's opinion can be a major factor in sustaining a corporate transaction against attack. Indeed, in Harriman v. E.I. duPont de Nemours & Co., CCH Fed. Sec. L. Rep. ¶ 95,386 (D.Del. 1975) it was argued that it would be a violation of Rule 10b-5 for the controlled party in a conflict merger to negotiate the terms without the assistance of an investment banker, and, although the court rejected the argument, it is clear that the court reached its conclusion, sustaining the

duPont-Christiana merger there in issue, primarily on the basis that the parties did in fact obtain investment bankers' fairness opinions.

Where a fairness opinion is used in a proxy statement for a business combination governed by Rule 145, the investment banker probably has the status of an expert within Section 11(a)(4) of the 1933 Act.* As such the investment banker will be held liable for any misleading statement, opinion or valuation made by it unless it can show that (except for statements made on the basis of other experts) it conducted a reasonable investigation and had reasonable grounds to believe that its statements were true and not misleading.

Where a fairness opinion is used in a proxy or information statement not governed by Rule 145 or where a fairness opinion is not communicated to shareholders, the liability standards may differ somewhat from the expert's liability under the 1933 Act. However, as Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1975), vacated

* From time to time a theory has been advanced that an investment banker's fairness opinion in a business combination proxy statement may make the investment banker a participant in the distribution and therefore an underwriter with full due diligence responsibility for the proxy statement. While we think that this theory is not well grounded, it must be recognized as a potential liability and taken into account in determining the form of the fairness opinion and the review procedures used in connection with the fairness opinion.

and remanded, 96 S. Ct. 1659 (1976) and Chris-Craft Industries, Inc. v. Bangor Punta Corp., 480 F.2d 341 (2d Cir. 1975), cert. granted, 96 S. Ct. 1505 (1976) demonstrate, the possibility that the courts may impose 1933 Act type due diligence standards in other contexts must be kept in mind.

Accordingly, a specific due diligence program should be developed for each fairness opinion. In this connection counsel should be consulted in each case for advice as to whether the usual procedures should be changed. Recent cases have changed substantially the standards which may apply in reaching fairness opinions and this is an evolving area of the law. See, e.g., Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585 (1975) and Del Noce v. Delyar Corp., CCH Fed. Sec. L. Rep. ¶ 95,670 (S.D.N.Y. 1976).

For many years it has been assumed that if a fairness opinion was qualified by use of "from a financial standpoint" or similar words, the investment banker limited its liability and had no duty to inquire into any aspect of the transaction other than the traditional economic matters taken into account in valuing a security or a business. Whether or not this assumption would stand up

in actual litigation has not been tested.* However, we believe that it would not be effective in cases where the investment banker has an advisory role or otherwise assists in the transaction beyond merely providing an opinion. To the extent that such assumption limits due diligence or limits the factors taken into account in reaching the opinion, it may be counterproductive and subject both the investment

* In Green v. Santa Fe Industries, Inc., 533 F.2d 1283 (2d Cir. 1976) cert. granted, 95 S.Ct. 54 (1976) a short-form cash merger freezeout transaction was found to violate Rule 10b-5 on the basis of substantial undervaluation, lack of corporate purpose and failure of Delaware law to provide prior notice to minority shareholders. The statutory notice of the effectuation of the short-form merger had appended to it an investment banker's opinion as to "the price at which [the stock of the merged subsidiary] would trade under current market conditions." The investment banker was alleged to have participated in the parent's Rule 10b-5 violation. On the basis that the investment banker's engagement was limited to valuation of the stock and compilation of a report on the subsidiary's financial status and on the basis that the investment banker was not involved in the planning or the effectuation of the short-form merger and had no knowledge of lack of corporate purpose, the court held that the investment banker was not a participant in the parent's Rule 10b-5 violation. However, the case arose on a motion to dismiss the complaint and the decision was premised on the absence of allegations as to the investment banker's participation. As a practical matter the investment banker does and should participate in the decision making with respect to this type of transaction and it is rarely possible to remain so removed from the transaction as to meet the criteria on which the court relied. Therefore it is better for the investment banker to participate, use due diligence and insist that the client obtain and follow well founded legal advice, than to rely on having expressed only a "financial" opinion. If the investment banker had indeed concerned itself with both substantive and procedural fairness for a freezeout transaction, in all probability its client as well as it would have escaped liability.

banker and its client to needless liability exposure. For example, in certain states such as New Jersey there is a substantial question whether a minority shareholder freezeout may be effected no matter what the financial terms.* Fairness from a financial standpoint may be only one element necessary to sustain such a transaction and the investment banker should take that into account. There are cases where the investment banker has no connection with the transaction other than responding to a request for an economic or market valuation. In such cases the investment banker may properly limit its function, but it should be specially careful to describe its limited role and to guard against its opinion being misused.

The broad spectrum of types of transactions in which fairness opinions may be used makes it not feasible to provide useful general guidelines. Each fairness opinion should be designed specially for the specific transaction. The client requesting the opinion should be asked to present an engagement letter which defines precisely the purpose of the opinion and the legal standards that govern the transaction. The engagement letter should be reviewed by counsel for the investment banker. The engagement should not be accepted unless there is agreement as to the scope of the work and the

* See Berkowitz v. Power/Mate Corp., 137 N.J. Super. 36 (Sup. Ct. Ch. Div. 1975).

applicable standards. Indemnification, including legal expenses, should be obtained for each engagement. The engagement letter should reserve the investment banker's control over the use of the opinion and any summary or description of the opinion.

The following additional procedures should be followed:

1. The opinion should describe the matters considered, those statements relied upon without investigation, those statements or matters that have been independently verified, and the inherent limitations, if any, of any procedures or standards that have been used.

2. The opinion should set forth any conflicts of interest and the fee and describe all relations with the client. If the investment banker participated in the negotiation of the transaction this should be noted in the opinion.

3. The opinion should be updated to the latest possible date and if that date is prior to the date of the transaction the opinion should set forth that it is as of a specific date and does not reflect matters thereafter.

4. Counsel for the investment banker should assist in the due diligence review and advise as to the kind of back-up material which should be prepared.

5. Independent verification of the key issue (e.g., limitation on future growth of the business in a repurchase; liquidation value in a minority shareholder freezeout) should be made.

6. Where a key issue is legal, the opinion should state that the investment banker has consulted counsel and relied on counsel with respect to such issue.

7. Where the opinion is to be used in a conflict transaction, the investment banker should be satisfied as to all the procedures to be used by the client, such as committee of independent directors, vote of minority shareholders, use of appraisers and other experts, etc.

8. The investment banker should not accept contingent compensation or any other arrangement that would impeach its independence in rendering a fairness opinion.

If properly structured and supported by a fairness opinion from an independent investment banker, there is virtually no corporate transaction, no matter how many or strong the conflicts of interest, that cannot be accomplished.

The foregoing provides a basis for tailoring a fairness opinion for any situation. The cardinal point is that the fairness opinion must be tailored to each situation -- standard forms will not work.

Martin Lipton

May 24, 1977

To Our Clients

Audit Committees

The increasing attention being focused on audit committees occasions note of an SEC consent order in SEC v. Killearn Properties, Inc. (N.D. Fla. Civ. No. TCA-75-67) entered earlier this month which sets forth the SEC conception of the functions of an audit committee. The order provides for an audit committee of three outside directors having the following duties:

1. It should review the engagement of the independent accountants, including the scope and general extent of their review, the audit procedures which will be utilized, and the compensation to be paid.

2. It should review with the independent accountants, and with the company's chief financial officer (as well as with other appropriate company personnel) the general policies and procedures utilized by the company with respect to internal auditing, accounting and financial controls. The members of the committee should have at least a general familiarity with the accounting and reporting principles and practices applied by the company in preparing its financial statements.

3. It should review with the independent accountants, upon completion of their audit, (a) any report or opinion proposed to be rendered in connection therewith; (b) the independent accountants' perceptions of the company's financial and accounting personnel; (c) the cooperation which the independent accountants received during the course of their review; (d) the extent to which the resources of the company were and should be utilized to minimize time spent by the outside auditors; (e) any significant transactions which are not a normal part of the company's business; (f) any change in accounting principles; (g) all significant adjustments proposed by the auditor; (h) any recommendations which the independent accountants may have with respect to improving internal financial controls, choice of accounting principles, or management reporting systems.

4. It should inquire of the appropriate company personnel and the independent auditors as to any instances of deviations from established codes of conduct of the company and periodically review such policies.

May 24, 1977

5. It should meet with the company's financial staff at least twice a year to review and discuss with them the scope of internal accounting and auditing procedures then in effect; and the extent to which recommendations made by the internal staff or by the independent accountants have been implemented.

6. It should prepare and present to the company's board of directors a report summarizing its recommendation with respect to the retention (or discharge) of the independent accountants for the ensuing year.

7. It should have the power to direct and supervise an investigation into any matter brought to its attention within the scope of its duties (including the power to retain outside counsel in connection with any such investigation).

M. Lipton

May 24, 1977

To Our Clients

Tender Offers; Acquisitions
to Block a Takeover

The Anaconda acquisition of Walworth which created an antitrust block to Crane's tender offer for Anaconda provoked a shareholder derivative action against the management of Anaconda under the federal securities laws on Rule 10b-5 and § 14(e) theories. Holding that even if the Walworth acquisition had no valid corporate purpose and was in fact for the sole purpose of blocking the Crane tender offer, the management of Anaconda had only committed corporate waste and breached its fiduciary duties which post Santa Fe are matters left to state law and do not give rise to federal securities law causes of action, the court dismissed the complaint. Altman v. Knight, CCH ¶ 96,040 (S.D.N.Y. 1977). After Royal Industries and Milgo, it was assumed that an acquisition or the issuance of shares by a target company to block a tender offer would be enjoined in a federal court action. If Altman holds up, targets may again gamble that state courts will not enjoin defensive acquisitions or issuances of shares and there could be a resurgence of these defensive techniques. It continues to be our opinion that unless there is a reason for the takeover block acquisition -- including blocking the takeover where that in itself is a reasonable business decision under the circumstances -- it should not be attempted.

M. Lipton

September 28, 1977

To Our Clients:

Going Private; Long-Form Freezeout Mergers; Delaware
Abandons Position that Appraisal is Exclusive Remedy

Despite recent cases in other jurisdictions to the contrary, until September 23, 1977, it was generally assumed that Delaware law was that absent fraud or blatant overreaching a long-form cash merger could be used to freezeout the minority shareholders of a subsidiary even though the freezeout does not serve any corporate or business purpose of the subsidiary and the minority has no voice in determining whether the merger will be effected and the sole remedy of the minority is an appraisal proceeding. This was the direct holding of the Delaware Court of Chancery in Singer v. Magnavox Co., 367 A.2d 1349 (Del. Ch. 1976). However, this decision was reversed by the Delaware Supreme Court which held that a long-form merger, "made for the sole purpose of freezing out minority stockholders is an abuse of the corporate process." Civ. No. 289 (Del. Sup. Ct., Sept. 23, 1977).

The facts of the Magnavox case are important for a full understanding of the decision. The case arose out of a hostile cash tender offer by North American Philips Corp. (NAPC) for all the shares of Magnavox at \$8 per share at a time when the market price was substantially less than \$8. Magnavox opposed the NAPC tender on the ground that the price was inadequate in light of the \$11 per share book value of Magnavox. After the usual skirmishing, management of Magnavox reached an accommodation (two-year employment contracts at their then salaries) with NAPC which resulted in an increase in the tender price to \$9 per share and withdrawal of opposition to the tender offer. The tender offer stated NAPC's purpose to acquire the entire equity of Magnavox and intent to acquire any shares outstanding after the tender by merger or other means. The tender offer drew 84% of the Magnavox shares and NAPC took full control of Magnavox. A few months later NAPC caused Magnavox to enter into a long-form cash merger agreement at \$9 per share. The corporate action by Magnavox on the merger was taken without the use of a committee of independent directors and without an in-

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dependent investment banker's opinion as to fair value. No corporate or business reason for the merger was advanced other than the desire of NAPC to eliminate the minority and to achieve full ownership of Magnavox. The merger was submitted to a vote of the Magnavox shareholders at a special meeting. Since NAPC owned 84% of the shares and did not agree to vote in accordance with the vote of the minority, the minority vote was meaningless and, as a practical matter, the merger was effected by the sole action of NAPC.

The Chancery Court in Magnavox summarized the Delaware law with respect to freezeout mergers as "(1) unless a minority shareholder could show fraud or blatant overreaching on the part of the majority in eliminating his stock interest through merger, the merger itself, and the reasons for it, were not subject to attack, and (2) a merger designed primarily to eliminate minority shareholders was not an improper use of either [the long-form or short-form merger provisions of the Delaware Corporation Law]." The Chancery Court rejected the recent federal and state cases (e.g., Green v. Santa Fe Ind. Inc., 533 F.2d 1283, (2d Cir. 1976), reversed 97 S. Ct. 1292 (1977); Berkowitz v. Power/Mate Corp., 342 A.2d 567 (N.J. Super. 1975); Jutkowitz v. Bourns, Civ. No. 000268 (Cal. Super. Nov. 19, 1975)) that invalidated freezeouts that were not justified by a business or corporate purpose of the subsidiary. The primary basis for rejection was the basic Delaware doctrine that a corporate transaction that is authorized by the Delaware Corporation Law is viewed as an independent transaction that does not need any extra-statutory justification -- motive is not significant if the transaction is specifically authorized by statute. In addition, the court noted that Power/Mate and Bourns involved going public high and going private low and said:

"Admittedly there seems something fundamentally inequitable about such a stark progression of events and perhaps a use of the Delaware statutes should not be permitted which would allow those with controlling interests who originally sought public participation to later kick out public investors for the sole reason that they have outlived their

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utility to those in control and are made easy pickings by existing market conditions. However, if such an exception is to be made it must wait for another day because, according to the complaint, such a situation does not exist here." 367 A.2d at 1358.

The rationale of the Delaware Supreme Court in Magnavox was almost directly opposite to that of the Chancery Court. First the Supreme Court held that the parent in a parent-subsidary merger has a fiduciary duty to the minority shareholders of the subsidiary and that this fiduciary duty cannot be met "simply by relegating [the minority shareholders] to a statutory appraisal proceeding." In so holding the Delaware Supreme Court accepted the reasoning of the Bourns and Power/Mate cases that a shareholder's rights are more than the mere assurance of fair value when the majority shareholder decides to eliminate the minority interest. This reasoning constitutes a clear retreat from the modern investment concept of share ownership in public corporations back to a property right concept.

The essence of the Delaware Supreme Court decision is contained in these paragraphs:

"We hold the law to be that a Delaware Court will not be indifferent to the purpose of a merger when a freezeout of minority stockholders on a cash-out basis is alleged to be its sole purpose. In such a situation, if it is alleged that the purpose is improper because of the fiduciary obligation owed to the minority, the Court is duty-bound to closely examine that allegation even when all of the relevant statutory formalities have been satisfied.

* * *

First, it is within the responsibility of an equity court to scrutinize a corporate act when it is alleged that its purpose violates the fiduciary duty owed to minority stockholders; and second, those who control the

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corporate machinery owe a fiduciary duty to the minority in the exercise thereof over corporate powers and property, and the use of such power to perpetuate control is a violation of that duty.

By analogy, if not a fortiori, use of corporate power to eliminate the minority is a violation of that duty, if done without a valid business purpose. Accordingly, while we agree with the conclusion of the Court of Chancery that this merger was not fraudulent merely because it was accomplished without any purpose other than elimination of the minority stockholders, we conclude that, for that reason, it was violative of the fiduciary duty owed by the majority to the minority stockholder.

We hold, therefore, that a [long-form] merger, made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process; and the complaint, which so alleges in this suit, states a cause of action for violation of a fiduciary duty for which the Court may grant such relief as it deems appropriate under the circumstances."

What is left of going private after Magnavox?

1. Magnavox involved a long-form merger. The long-form was necessary because the parent did not own 90% or more of the subsidiary. The opinion is expressly limited to long-form mergers and clearly does not affect short-form mergers. Therefore, Delaware law continues to be that short-form mergers may be accomplished without a business purpose of the subsidiary and absent fraud or blatant overreaching, appraisal is the exclusive remedy of the minority shareholders. Accordingly, successive tender offers or other voluntary acquisitions of shares followed by a short-form merger may continue to be used to eliminate minority ownership.

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2. Magnavox involved a cash freezeout, not an equity security merger. While the opinion is not clear, based on the repeated use of "cash-out" by the Court, it appears that this is a distinction that the Delaware Supreme Court may accept. It is, of course, much easier to find (or construct) business purposes when the minority shareholders continue to have an equity interest in the combined enterprise.

3. Despite a dissent which criticized the failure, the Delaware Supreme Court in Magnavox refused to deal with the question whether the requisite business purpose is that of the parent or the subsidiary and instead rendered a very narrow opinion on the conceded fact of no business purpose. This at least leaves open the possibility that Delaware would accept the elimination of conflicts and benefits of centralization business purposes accepted in New York in Tanzer Economic Associates, Inc. v. Universal Food Specialties, Inc., 383 N.Y.S.2d 472 (Sup. Ct., N.Y.Co. 1976).

4. The absence of the now customary procedures for assuring fulfillment of fiduciary duties in conflict situations, while not specifically mentioned, clearly was the underlying rationale of the Magnavox decision. We believe that the result would have been different if the merger had been approved by a committee of independent directors upon the advice of an independent investment banker that the terms were fair from a financial standpoint to the minority shareholders and if the merger was structured so that it would have been approved only if a majority of the minority shareholders voted in favor.

While Magnavox makes going private more difficult, in our opinion going private is not dead. We think the courts will continue to recognize the practical business, financial and economic advantages of going private and will continue to permit going private transactions which are accomplished with the appropriate safeguards of the rights of the minority shareholders noted above.

Magnavox emphasizes that the minority shareholder freezeout is the most sensitive of corporate transactions and should only be undertaken in compliance with procedures designed to assure the establishment of complete discharge of the parent's fiduciary duty to the minority shareholders of the subsidiary.

M. Lipton

August 5, 1976

7. Filing of Schedule 14D-1. In addition to the SEC and the target, a Schedule 14D-1 would have to be filed with the appropriate exchange for a listed target or the NASD for an OTC target.
8. Post-offer purchases. Purchases during the 40 days after the end of a tender offer would in effect be prohibited except for a second tender offer at no less than the original tender price.
9. Creeping tender offers. The SEC has invited comment on whether there should be a 40 day rule for pretender offer purchases.
10. Preemption of state statutes. The SEC has not done anything affirmatively to preempt the state takeover statutes. However, philosophically and literally the new rules are antithetical to the state statutes and bolster the argument that the Williams Act preempts the state statutes.

M. Lipton

August 14, 1978

To Our Clients:

Tender Offers; Fiduciary Duties of the Target's
Board of Directors

The Gerber directors have been exonerated from liability for their successful defense against the Anderson, Clayton tender offer. Berman v. Gerber Products Co., CCH Fed. Sec. L. Rep. ¶ 96,506 (W.D. Mich. July 19, 1978) is the first direct holding on the issue of the liability of a target's board if it successfully resists a tender offer. The court held that even where the tender offer price is substantial and there has been no determination that it is unfair or inadequate, the directors of the target may defend on the ground that the offer violates the securities laws or the antitrust laws and that such defense does not breach their fiduciary duty to the shareholders. The court said: "Far from violating the fiduciary duty imposed on them, Gerber's directors were seeking protection of a statutorily established right. It has been noted, moreover, that corporate management has an affirmative duty not to refrain from bringing actions under circumstances like those present here, but to 'oppose offers which, in its best judgment, are detrimental to the company or its stockholders.'"

The basic holding of the Gerber case can be summarized as: Where directors of a target act in good faith and exercise reasonable business judgment they are free to reject a tender offer and bring litigation to enjoin it even though the price is not inadequate or unfair.

The Gerber case also held that failure of the directors of a target to entertain proposals for White Knight deals was not action "in connection with any tender offer" and therefore not within Section 14(e) of the Williams Act; that Section 14(e) is limited to deception and disclosure and does not determine the fiduciary duties of the directors of a target; that integrity of management of a raider is a material disclosure item in a tender offer and sensitive payments are discoverable in detail and must be disclosed with particularity;

that where a tender offer is resisted on the ground of illegality and no statement is made as to the adequacy or fairness of the price, the failure to disclose the opinion of the target's investment banker that the price is "substantial" and market and earnings information was not a material omission; and that the Williams Act does not impose an affirmative duty on the directors of a target to respond to a tender offer.

M. Lipton

Takeover Bids in the Target's Boardroom

By MARTIN LIPTON*

The heightened level of takeover activity during the past five years¹ has focused attention on the legal, moral and practical questions faced by the directors of a company that becomes the target of an unsolicited takeover bid.² While as far as is known no director has ever been held liable for the rejection of a takeover bid, almost every successful takeover defense results in shareholder lawsuits against the directors of the target.³ Such decided cases as there

*Member, New York Bar. Mr. Lipton's associates, Meyer Koplow and Bruce Rosenblum assisted in the preparation of this article. Much of what is said in this article is based on Lipton & Steinberger, *Takeovers & Freezeouts* (1978) (reviewed in 34 Bus. Law. 2021), of which Mr. Lipton is coauthor.

The terms "takeover bid," "target" and "raider" are used in this article for clarity; there is no pejorative intent.

1. According to the W.T. Grimm Co. 1978 Merger Summary there were 325 acquisition proposals for public companies announced in 1978, an increase of 22% over 1977. Where the price was disclosed 24% were \$100 million or larger.

2. One commentator has described the director's dilemma as follows:

Attempts by the manager to reconcile the many conflicting interests is impossible. Among the goals the executive may pursue are 1) the shareholders' receiving a fair price for their shares, 2) the corporation's obtaining or maintaining good management, 3) the economy's producing goods and services more efficiently, 4) the general public's becoming better able to interact with powerful corporate institutions, and 5) his keeping his job. Suggestions that a corporate executive can always resolve this great dilemma ignore reality. A takeover creating a large, powerful corporation may give advantage to shareholders and improve economic efficiency, yet threaten further the ability of the individual to survive in our increasingly institutionalized society. Stopping a takeover may save the executive's job, maintain good management, and save individualism, yet cause the corporation to shrivel in the shadow of its larger competitors and thereby harm the shareholders.

There are no easy answers for management here, no suggested ranking of the relative importance of the conflicting goals of management, shareholders, and society.

Bowers, *It's A Raid! Strategies for Avoiding Takeovers*, 3 Wharton Magazine 22, 28 (Summer 1979).

Shareholders of companies that have rejected takeover bids sometimes charge "that most board members, particularly those from the management side, are only concerned with keeping their jobs, and will set up any kind of roadblock to keep tender offers from reaching shareholders directly, regardless of the financial benefits." Feinberg, *The Directors' New Dilemma*, in *The Takeover Crisis: A Special Report*, Institutional Investor, 32, 45 (June 1979). Faced with such charges, "directors from target companies often say that they're caught in the middle between their primary duty to shareholders and their ancillary responsibility—though one they believe to be almost equally important—to the corporation as a whole and its future as a business enterprise." *Id.* at 46. See also, *Heat on Directors*, Barron's, July 30, 1979, at 4, col. 1 ("it's still difficult to tell precisely what's expected of a director . . . in the event of a tender offer").

3. See e.g., *Labaton v. Universal Leaf Tobacco Co.*, 77 Civ. 119 (CMM) (S.D.N.Y. Aug. 2, 1979); *Panther v. Marshall Field & Co.*, 80 F.R.D. 718 (1978); *Berman v. Gerber Products Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978); *Grossman, Faber & Miller, P.A. v. Cable Funding Corp.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,913 (D. Del. 1974). See also, *In re Sunshine Mining Co. Securities Litigation*, 77 Civ. 4020 (S.D.N.Y. May 25, 1979) summarized

are sustain the right of the directors of a target to reject a takeover on the grounds of inadequacy of price,⁴ illegality of the offer,⁵ illegality of the acquisition of control of the target by that raider,⁶ and concern with the impact of the takeover on the employees of the target and the community in which it operates.⁷ However, the debate continues to rage.⁸ The following are the principal questions:

- 1) Must the directors accept any takeover bid that represents a substantial premium over the current market?
- 2) When faced with a takeover bid should the directors declare an open auction and seek to sell the company to the highest bidder?

in 509 Sec. Reg. & L. Rep. (BNA) A-9, which held that even if it were assumed that the directors of a target were selfishly motivated in rejecting a takeover, there is no shareholder cause of action under the federal securities laws against the directors; the shareholders' rights are governed by the applicable state corporation law.

4. See *Anaconda Co. v. Crane Co.*, 411 F. Supp. 1210, 1215 (S.D.N.Y. 1975) ("[I]t is clear . . . that a businessman could make a proper business judgment [on the basis of an investment banker's report] to recommend rejection of the Crane [tender] offer."); *Northwest Industries, Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969) ("[M]anagement has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or its shareholders."). Cf. *Kaplan v. Goldsamt*, 380 A.2d 556, 568 (Del. Ch. 1977); *Danziger v. Kennecott Copper Corp.*, N.Y.L.J., Dec. 7, 1977 at 7, col. 1, *aff'd on the opinion below*, 400 N.Y.S.2d 724 (1st Dept. 1977) (both cases holding that directors may rely on investment banker's reports in determining whether to make an offer to purchase stock at a certain price).

5. E.g., *Berman v. Gerber Products Co.*, *supra* n. 3, at 1318-23 (target with "legitimate concerns" about raider's possible violations of securities laws in making offer did not violate fiduciary duty in bringing action against raider to halt tender offer); *Consolidated Amusement Co. v. Rugoff*, [1978 Transfer Binder] CCH Fed. Sec. L. Rep. (CCH) ¶ 96,584, at 94,475, 94,478 (S.D.N.Y. 1978); *Copperweld Corp. v. Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975).

6. E.g., *Berman v. Gerber Products Co.*, *supra* n. 3; *Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co.*, 356 F. Supp. 1066 (S.D.N.Y.), *aff'd*, 476 F.2d 687 (2d Cir. 1973); *Allis-Chalmers Manufacturing Co. v. White Consolidated Industries, Inc.*, 414 F.2d 506 (3d Cir. 1969), *cert. denied*, 396 U.S. 1009 (1970); *Humana, Inc. v. American Mediacorp, Inc.*, [1977-1978 Transfer Binder] CCH Fed. Sec. L. Rep. (CCH) ¶ 96,286, at 92,823, 92,833 (S.D.N.Y. 1978).

7. See e.g., *Herald Co. v. Seawell*, 472 F.2d 1081 (10th Cir. 1972). In *Herald*, the court expressly held that directors—at least directors of certain kinds of corporations such as newspapers—have an obligation to "employees, and to the public," in addition to their duty to stockholders. Thus the directors in that case were justified in averting a takeover which they believed would have "an adverse impact on the character and quality" of the newspaper, and would lead to "poor relations with employees. . . ." *Id.* at 1092. See also *American Rolling Mill Co. v. Commissioner*, 41 F.2d 314 (6th Cir. 1930); *Armstrong Cork Co. v. H.A. Meldrum Co.*, 285 F. 58 (W.D.N.Y. 1922) (both cases holding that it is within legitimate business purpose of corporations to make contributions and establish programs for the benefit of employees and the community in which the corporation operates); *Dodd, For Whom Are Corporate Managers Trustees?* 45 Harv. L. Rev. 1145 (1932) ("those who manage our business corporations should concern themselves with the interests of employees, consumers, and the general public, as well as of the stockholders"); *Blumberg, Corporate Responsibility and the Social Crisis*, 50 Boston U. L. Rev. 157 (1970).

8. See e.g., *The Takeover Crisis: Special Report*, Institutional Investor, June 1979, at 32; *Wyser-Pratte, Takeover Panel Needed to Protect Shareholders*, N.Y.L.J., June 4, 1979, at 25, col. 5; *Fortune*, March 12, 1979 at 159 (interview with William Klein II).

- 3) Should the directors consider the impact of the takeover on employees, customers, suppliers, the community; indeed is national policy a proper consideration?
- 4) Do the shareholders of the target have a right to decide for themselves no matter what the directors believe to be the best interests of the target as a business enterprise?
- 5) May the directors ignore a clear antitrust issue or litigate a minor antitrust issue; may the directors litigate other issues such as failure to comply with the disclosure requirements of the federal securities laws?
- 6) May the directors adopt a policy that the company will remain an independent business entity and authorize management to reject any overtures or feelers?
- 7) May the directors build an antitakeover fence picketed with shark-repellent charter amendments and specially lobbied local takeover laws?
- 8) May the directors authorize a standstill arrangement with a big brother who buys 20 percent of the target in order to block a takeover or authorize a premium purchase of shares of the target from a potential raider who has accumulated them in the market?
- 9) Are the management directors of the target so infected with self-interest that they are disqualified from participating in the ultimate decision to accept or reject a takeover bid?
- 10) Must an investment banker opine that a takeover bid is inadequate to justify rejection by the directors of the target?
- 11) Should a company and its directors prepare to deal with a takeover bid, if one were in the future to be made, by consulting in advance with experienced investment bankers and legal counsel?
- 12) Is a takeover bid so significantly different from other major business questions that the usual rules governing directors must be displaced by rules unique to takeovers?

It is believed that experience and common sense prove that:

- 1) Directors should not be forced to accept any takeover bid that is at a substantial premium and the usual rule that directors may accept or

reject a takeover bid if they act on a reasonable basis and in good faith should continue.⁹

- 2) Takeover bids are not so different from other major business decisions as to warrant a unique sterilization of the directors in favor of direct action by the shareholders.¹⁰

Many of the lawsuits and much of the agitation for changes in the existing rules come from certain arbitrageurs and professional investors whose short-term perspectives are not in accordance with the long-term interests of other shareholders and other constituencies of corporations and who do not share the concern of corporate management with the need for long-term planning in a high technology economy.¹¹ It would not be unfair to pose the policy issue as: *Whether the long-term interests of the nation's corporate system and economy should be jeopardized in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares?* The overall health of the economy should not in the slightest degree be made subservient to the interests of certain shareholders in realizing a profit on a takeover. Even if there were no empirical evidence that refuted the argument that shareholders almost always benefit from a takeover (as noted below, the empirical evidence is to the contrary) and even if there were no real evidence,

9. *E.g.*, *Panther v. Marshall Field & Co.*, *supra* n. 3; *Berman v. Gerber Products Co.*, *supra* n. 3; *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 233-34 (9th Cir. 1975); *Heine v. Signal Cos.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,898, at 91,311, 91,322 (S.D.N.Y. 1977); *Northwest Industries, Inc. v. B.F. Goodrich Co.*, *supra* n. 4, at 711-12; *Cheff v. Mathes*, 199 A.2d 548, 554-56 (Del. 1964); *Scott v. Stanton Heights Corp.*, 131 A.2d 113, 116 (Pa. 1957) ("other considerations . . . may weigh in the appraisal of the offer which the ordinarily prudent businessman would accept than money price alone"). See generally, E. Folk, *The Delaware General Corporation Law*, 75-76 (1972).

10. Most modern corporation statutes provide that "the business and affairs of a corporation shall be managed by the board of directors." N.Y. Bus. Corp. Law § 701. See also, Model Bus. Corp. Act. § 35; Del. Corp. Law § 141(a); Ill. Bus. Corp. Act § 33. Directors routinely make the decision whether or not to enter into contracts or embark on new business ventures. In general, questions of policy and management are left to the decision of the directors. See generally, *Abbey v. Control Data Corp.*, (Current) Fed. Sec. L. Rep. (CCH) ¶ 96,721 (D. Minn. 1978); 2 W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 505. In particular, directors may borrow money, *id.* § 515; mortgage and lease property, *id.* §§ 516, 521; make purchases and sales, *id.* §§ 517, 518; issue stock and determine dividends, *id.* §§ 523, 526; file voluntary proceedings in bankruptcy, *id.* § 532; and institute suits, *id.* § 535. Such decisions may have as great an impact on the corporation as the decision to oppose a tender offer. See text accompanying nn. 59-60, *infra*.

11. Arbitrageurs such as Bache Halsey Stuart Shields' Guy Wyser-Pratte have been in the forefront of those suggesting, for example, that shareholders vote on proposed tender offers and that an independent "takeover panel" oversee offers. See Wyser-Pratte, N.Y.L.J., June 4, 1979, at 25, col. 5; Feinberg, *The Directors' New Dilemma in The Takeover Crisis*, *supra* n. 8, at 45-46. Takeover battles, particularly those that escalate into "bidding wars," have been a "bonanza" for arbitrageurs and similar short-term speculators. See, *Carborundum Stake May Be Bonanza For Broker Who Foresaw Bidding War*, Wall St. J., Nov. 28, 1977, at 4, col. 1; *Arbitrage: It's the Hottest Game in Town*, Bus. Week, Jan. 17, 1977, at 71.

but only suspicion, that proscribing the ability of companies to defend against takeovers would adversely affect long-term planning and thereby jeopardize the economy, the policy considerations in favor of not jeopardizing the economy are so strong that not even a remote risk is acceptable.

Role of Directors

Before turning to an analysis of the specific questions, it is helpful to review briefly the role played by directors in the corporate governance system as it exists today. Our corporate governance system is structured similarly to our national government. Ultimate power rests with the shareholders who cannot act directly but only through their elected representatives—the directors. The directors are elected annually and both state and federal law provide mechanisms which enable the shareholders either to change the composition of the board of directors or to instruct the directors to take action desired by the shareholders.¹² Directors are considered to owe a fiduciary duty to the shareholders—that is, they are supposed to act as prudent businessmen, in good faith and on a reasonable basis to assure that the business of the corporation is operated for the benefit of its shareholders.¹³ Corporation laws generally permit directors to rely on reports prepared by management and by outside experts such as lawyers, accountants and investment bankers, in discharging the directors' duties.¹⁴

In the early years of this century almost the sole focus of the directors of a corporation was its shareholders. Efforts to broaden the concerns of directors to include employees, consumers, the community, the environment and the national welfare have reached full fruition only during the last 20 years. It is now well settled through legislation and court decisions that corporations:

- a) must protect the environment,¹⁵
- b) must protect the health and safety of employees,¹⁶
- c) must protect the pensions of employees,¹⁷
- d) must produce safe products and replace products found to have defects,¹⁸

12. *E.g.*, Model Bus. Corp. Act § 28; N.Y. Bus. Corp. Law § 602; Del. Corp. Law § 211(d) (provisions for special meetings of stockholders). SEC rule 14a-8 requires management to include in its proxy statements certain kinds of proposals submitted by shareholders.

13. *E.g.*, *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Cheff v. Mathes*, *supra* n. 9; Model Bus. Corp. Act § 35; N.Y. Bus. Corp. Law § 717; Cal. Corp. Code § 309.

14. *E.g.*, Model Bus. Corp. Act. §§ 35, 48; N.Y. Bus. Corp. Law § 717; Del. Corp. Law § 141(e).

15. *See* 42 U.S.C.A. §§ 7401–7642 (1978 Pamphlet) (Environmental Protection Act).

16. *See* 29 U.S.C. §§ 651–678 (1976) (Occupational Safety and Health Act).

17. *See* 29 U.S.C. §§ 1001–1381 (1976) (Employee Retirement Income Security Act).

18. *See* 15 U.S.C. §§ 2051–2081 (1976) (Consumer Product Safety Act).

- e) may make charitable contributions from corporate funds,¹⁹
- f) may spend corporate funds, or assign employees to engage in activities, for the betterment of communities in which the corporation operates,²⁰
- g) may organize political action committees.²¹

The movement to further the interests of the community, employees, the environment, consumers and perceived national policy at the expense of maximum profits and maximum benefit to shareholders has not abated. In addition to the specific legislation and court decisions reflected above, the concept of federal chartering of major corporations for the purpose of assuring their adherence to national policy continues to be advanced.²² Our present system of corporate governance places the directors at the center of corporate decisionmaking and has expanded the corporation's responsibilities to safeguard interests broader than those of shareholders alone.

Contrary to Popular Belief Shareholders Usually Win When a Takeover Is Rejected

Central to an analysis of the questions posed at the outset is an examination of the ultimate effect on shareholders when a corporation rejects a takeover. Contrary to popular belief on Wall Street, the decision to accept or reject a takeover is not so heavily weighted in favor of acceptance that as a matter of experience it can be said that the shareholders are always disadvantaged by rejection. The 36 unsolicited tender offers that were rejected and defeated by the target between the end of 1973 and June 1979 (believed to be all such tender offers filed with the SEC during this period) show that the shares of more than 50 percent of the targets are either today at a higher market price than the rejected offer price or were acquired after the tender offer was defeated by another company at a price higher than the offer price. This is particularly true with respect to those tender offers that were defeated prior to 1978.²³ Eight of the 36—four where on the basis of market price as opposed to rejected offer price the shareholders of the target won as a result of the successful defense; and four where on the same basis the shareholders lost—have been selected as illustrations. While neither these illustrations nor

19. *E.g.*, *A. P. Smith Manufacturing Co. v. Barlow*, 98 A.2d 581 (N.J. 1953), *appeal dismissed*, 346 U.S. 861; *Theodora Holding Corp. v. Hendersen*, 257 A.2d 398 (Del. 1969); Cal. Corp. Code § 802(g); Del. Corp. Law § 122(9), (12); N.Y. Bus. Corp. Law § 202(a)(12). Virtually all states have similar provisions. See *Blumberg, supra* n. 7, at 167, 192-202, 208-10.

20. *E.g.*, *American Rolling Mill Co. v. Commissioner*, *supra* n. 7; *Huntington Brewing Co. v. McGrew*, 112 N.E. 534 (Ind. App. 1916). See generally, *Blumberg, supra* note 7.

21. See 2 U.S.C. § 441b (1976).

22. See *Nader, Green & Seligman, Constitutionalizing the Corporation: The Case for the Federal Chartering of Giant Corporations* (1976).

23. See Exhibit A.

Exhibit A distinguishes between cash tender offers and exchange offers and while the amounts and securities values have not been adjusted to present values or for interim dividends, it is apparent that the basic point is clearly established: the shareholders of more than 50 percent of the targets are better off today than if the defeated tender offer had succeeded. The following table shows the target, the raider, the date the offer was announced, the market price of the target one month and one week before the announcement, the price offered and the price at August 10, 1979 for the eight tender offers chosen as illustrations:

Target	Raider	Date	Market 1 Month Prior	Market 1 Week Prior	Offer Price	Price August 10, 1979
Dictaphone	Northern Electric	9/24/74	\$ 7.12	\$ 8.37	\$12.00	\$28.00 ²⁴
Foremost McKesson	Sharon Steel	5/17/76	15.50	16.62	27.00	24.00
Gerber Products	Anderson, Clayton	8/1/77	29.75	32.62	37.00	28.12
Marshall Field	Carter Hawley Hale	2/1/78	32.75 ²⁵	29.62	42.00	17.87
Mead	Occidental Petroleum	8/11/78	21.50	23.25	35.00	26.75
Sabine	Hamilton Brothers	9/22/76	21.50	22.19	30.00	40.12
Sterndent	Cable Funding	2/13/75	8.75	9.25	14.00	21.62
Universal Leaf Tobacco	Congoleum	10/8/76	12.13	11.94	16.25	23.25

There are no readily available studies which show the results of rejected takeover bids which did not reach the actual tender offer stage. Personal experience leads to the belief that the Viacom International illustration is not atypical. In January, 1977 when Viacom was selling for \$10 per share, Storer Broadcasting offered \$20 per share for a "friendly" takeover. Viacom rejected the offer. In August, 1979 the market price of Viacom was more than \$30 per share.²⁶

24. Acquired by Pitney-Bowes for \$28.00 per share in 1979.

25. Prior to a previous offer by Carter Hawley Hale, the market for Marshall Field was \$22 per share.

26. Another illustration of the win-some, lose-some nature of takeovers is a comparison of the offer by United Technologies in 1977 for Babcock & Wilcox with the offer by United Technologies in 1978 for Carrier. See, *United Technologies Makes a Bid For All Babcock & Wilcox Stock*, Wall St. J., March 30, 1977, at 3, col. 1; *United Technologies Will Bid \$510 Million for Babcock's Stock*, N.Y. Times, March 30, 1977, at § IV, p. 1, col. 6; Wall St. J., Nov. 13, 1968, at 30-31 (tombstone announcement of United Technologies' *Offer to Purchase*; Carrier offer). The Babcock offer was \$42.00 per share as compared to an average 30-day preoffer market of \$32.65. The Carrier offer was \$28 as compared to an average 30-day preoffer market of \$24.30. In each case the target was advised by Morgan Stanley that the offer was inadequate. In each case the target raised an antitrust defense (in each case the Government also brought an antitrust case) and after several months of legal proceedings, including trial of the antitrust proceedings, the offer was allowed to be made. See *Babcock & Wilcox Co. v. United Technologies Corp.*, 435 F. Supp. 1249 (N.D. Ohio 1977); *Carrier Corp. v. United Technologies Corp.*, [1978-2 Transfer Binder] Trade Cas. (CCH) ¶ 62,393 (N.D.N.Y. Dec. 6, 1978), *aff'd*, [1978-2 Transfer Binder] Trade Cas. (CCH) ¶ 62,405 (2d Cir. Dec. 18, 1978). In the Babcock situation a white knight, J. Ray McDermott, acquired the target for the equivalent of \$65 per share. In the Carrier situation United acquired Carrier at the original \$28 offer price. Babcock built the reactor involved in the Three Mile Island incident and the McDermott stock issued to Babcock shareholders at a value of \$65 at the end of June 1979 had a market value of \$53.25.

Two further points should be noted in determining the impact of rejection of a takeover bid on the shareholders of the target. First, the experience of the past five years shows that the stock market has been valuing most companies at between 50 percent and 66⅔ percent of what they are worth to someone acquiring control and also that the premiums that acquirors are willing to pay for companies have been increasing continuously during this period.²⁷ Therefore unless there has been a material downturn in the business of a target that has rejected a takeover, even if the market price of its stock has not caught up with the offer price, there has been no change in the fundamental value of the target and it could today be sold for more than the rejected offer price.²⁸ The proper comparison is not between the price of the stock in the market and the rejected offer price, but between the rejected offer price and the amount that could be obtained otherwise upon the sale of the entire company. While the damage suits that have been brought against directors of targets that have rejected takeovers are premised on the supposed loss to shareholders resulting from the difference between the offer price and the market price, if the directors were to be found to have acted wrongly, the proper measure of damages should not be the difference between the market price and what was offered, but between what was offered and the true value at that time.²⁹ Only if it were assumed that the raider was acting contrary to its self-interest and proposing to pay more than true value, would there have been any damage to the shareholders of the target that could be recoverable in such a lawsuit. Second, in about 95 percent of the cases where a company has been acquired after initially having resisted an unsolicited takeover bid, the shareholders have ended up with a higher price than the original offer.³⁰ One court has expressly held that it is appropriate for the target to resist a tender offer by litigation for the purpose of gaining time to get the best deal possible for the shareholders.³¹

Experience does not prove that the shareholders of the target are better off if the target accepts a takeover bid. Experience shows that from the standpoint of whether the shareholders win or lose, the decision to accept or reject is about 50/50 on market price alone and, if sale value today as opposed to yesterday's rejected offer price is used as the basis of comparison, the

See also, Shareholder Beware! Takeovers Don't Pay, The (London) Sunday Times, Oct. 1, 1978, at 61, col. 1.

27. *See Ehrbar, Corporate Takeovers Are Here to Stay*, Fortune, May 8, 1979, at 91.

28. *See* Dictaphone and Sterndent in chart at pp. 132-33, *supra*. Typically those companies which become the subject of unsolicited takeover bids are just those which are perceived by the raider as having bright prospects which are not adequately reflected in the market's current valuation of the target's shares.

29. *Cf. Labaton v. Universal Leaf Tobacco Co.*, *supra* n. 3.

30. Unpublished study by Goldman, Sachs & Co. of 85 takeover bids during the period January 1, 1976 to June 8, 1979.

31. *See Commonwealth Oil Refining Co. v. Tesoro Petroleum Corp.*, 394 F. Supp. 267, 274-75 n. 1 (S.D.N.Y. 1975).

shareholders have profited in the overwhelming majority of defeated takeovers. There is no empirical evidence to support an absolute requirement that the directors of a target accept any takeover bid. The fact that a raider chooses for *its* economic purposes to make a takeover bid does not mean that the directors of the target have a fiduciary obligation to cause a sale of the company either to the raider or a white knight which outbids the raider.

Requiring Acceptance of Any Takeover Bid is the Equivalent of Mandating a Periodic Decision to Sell or Liquidate

There is no logical distinction between a requirement that directors accept any takeover bid that represents a substantial premium over market and a requirement that the directors determine annually whether it would be possible to sell or liquidate the company at a substantial premium over market and that, if possible, the directors do so. The fact that a raider has taken the initiative is no basis for distinction. If the directors have an obligation to sell whenever a substantial premium is available, it should make no difference who initiates the activity. Indeed, if that is the rule, the directors should not await a raider's initiative, but are required to take the initiative themselves. Nor is the greater certainty created by a takeover bid as compared to the directors' assessment of what might be realized on sale or liquidation a basis for distinction. The skill and sophistication demonstrated by the major investment bankers in finding white knights or auctioning major companies like Carborundum³² and General Crude³³ prove that the advice of such a banker as to saleability and price is, for the purpose of this type of assessment by the directors, as certain as an unsolicited takeover bid made by a third party.

What, then, would be wrong with a requirement for annual assessment by the directors as to whether the company should be sold or liquidated? First, it shortens the directors' perspective to the present and forces them to ignore the long term. It defies common sense and ordinary business practices to mandate that a company be sold today for a substantial premium even though the directors believe it could be sold in the future for a larger premium, or that future market value plus interim dividends have a greater present value than the premium price now available. Second, a requirement for an annual life or

32. See, *Carborundum Stake May Be Bonanza for Broker Who Foresaw Bidding War*, Wall St. J., Nov. 28, 1977, at 4, col. 1; *Carborundum Deal Created Suspense*, N.Y. Times, Nov. 21, 1977, at 60, col. 1. For an account of the Carborundum bidding war see, *Control Battle for Carborundum Emerges as Eaton Enters Picture*, N.Y. Times, Nov. 3, 1977, at § IV, p. 1, col. 5; *Eaton Officially Offers \$47 a Share for Carborundum*, N.Y. Times, Nov. 10, 1977, at § IV, p. 1, col. 2; *Kennecott Offers \$66 a Share in Bid for Carborundum*, N.Y. Times, Nov. 16, 1977, at § IV, p. 1, col. 6; *Directors Approve Kennecott's Offer for Carborundum*, N.Y. Times, Nov. 17, 1977, at § IV, p. 1, col. 4.

33. See, *Mobil Oil Said to Prepare Offer for General Crude*, N.Y. Times, Mar. 15, 1979, at § IV, p. 1, col. 1; *Would-Be Acquirers Line Up for Change at General Crude*, N.Y. Times, Mar. 18, 1979, at § III, p. 15, col. 2; *Mobil Bids \$765 Million For General Crude Oil*, N.Y. Times, Mar. 23, 1979, at § IV, p. 1, col. 4.

death assessment would have a fundamental impact on the way in which corporations operate. Executives, employees, customers, suppliers and others dependent on doing business with the company would have no assurance of continuity. The scramble by each of these constituencies to protect against sale or liquidation would cause major disruptions in the manner in which business is now conducted. These disruptions would favor the short term at the expense of the long-term planning that is essential in a high technology economy. Third, there is no reason to believe that the experience with mandated annual life or death assessments would be any different than the experience with rejection of unsolicited tender offers. In sum, there is no empirical evidence or logic to support a requirement that sale or liquidation of the company be treated any differently from any other major business decision.

In this era of takeovers the directors of a company may find that it is good business management to take steps to assure employees, suppliers, customers and communities in which the company operates that the company intends to continue its current business policies and to that end intends to remain an independent entity and not be taken over. The adverse reaction of authors and editors to the Houghton Mifflin³⁴ and McGraw-Hill³⁵ takeover attempts illustrates that this may be particularly appropriate where a company is heavily dependent on highly paid and mobile employees. These assurances may take the form of a company policy not to engage in merger discussions;³⁶ a charter amendment requiring the directors to consider the interests of employees, customers, suppliers and others when considering a merger or takeover bid;³⁷ charter amendments designed to deter unsolicited takeover bids;³⁸ and

34. See, *Authors Protest Conglomerate Deal*, N.Y. Times, Apr. 20, 1978, at § III, p. 17, col. 5. The authors' protest was instrumental in thwarting Western Pacific's takeover attempt. After receiving numerous letters from authors, Western Pacific chairman Howard (Mickey) Newman came to the conclusion that "I'm going to buy this company and I ain't going to have nothing." See, *The Takeover Crisis*, *supra* n. 8, at 40.

35. See, *McGraw-Hill Bid Stirs Editorial Fears*, N.Y. Times, Jan. 14, 1979, at 51, col. 3; Friendly, *McGraw-Hill and a Free Press*, Wall St. J., Jan. 16, 1979, at 14, col. 4. As was the case with Western Pacific, American Express was eventually persuaded that McGraw-Hill was a "people company," and that, given the reaction of authors and editors, "there wasn't going to be anything left when they took over." See *The Takeover Crisis*, *supra* n. 8, at 35.

36. See 1 Lipton & Steinberger, *Takeovers & Freezeouts* 69, 290 (1978).

37. McDonald's Corporation recently added charter amendments charging directors with considering "the social, legal and economic effects on franchises, employees, suppliers, customers and business" when confronted with a takeover bid. See, *McDonald's Proposes Increased Protection Against Takeover Bids*, Wall St. J., Mar. 30, 1979, at 10, col. 2. Control Data Corporation had previously adopted a similar charter amendment. See, *Control Data Asks Holders to Approve Anti takeover Step*, Wall St. J., at 17, col. 2; Cuniff, *Supplementary Material* from New York Times News Service and the Associated Press, October 12, 1978. The Control Data charter provision reads as follows:

The Board of Directors of the Corporation, when evaluating any offer of another party to (a) make a tender or exchange offer for any equity security of the Corporation, (b) merge or consolidate the Corporation with another corporation, or (c) purchase or otherwise acquire all or substantially all of the properties and assets of the Corporation, shall, in connection

migration to a state with laws that inhibit unsolicited takeovers.³⁹ In addition, a company may make special provisions in employment contracts, employee

with the exercise of its judgment in determining what is in the best interests of the Corporation and its stockholders, give due consideration to all relevant factors, including without limitation the social and economic effects on the employees, customers, suppliers and other constituents of the Corporation and its subsidiaries and on the communities in which the Corporation and its subsidiaries operate or are located.

See Lipton & Steinberger, *supra* n. 36, at 65–66.

38. One such amendment is a provision requiring a supermajority vote to approve any business combination with a person owning a specified percentage of the company's shares. See Lipton & Steinberger, *supra* n. 36, at 266–71 (1978). The efficacy of such provisions is the subject of debate. See *id.* at 266; Securities Week, June 26, 1978, at 9.

Rubbermaid, Inc. coupled a supermajority provision with an amendment giving shareholders who do not tender shares during an offer the right to submit them for redemption—at the offer price or the highest market price during the previous 18 months, whichever is higher—should the raider obtain more than 50% of the company's stock. See, *Rubbermaid Seeks Nod From Holders on Plan to Deter Tender Bids*, Wall St. J., Apr. 18, 1978, at 17, col. 2.

See also, *Jewelcor Inc. v. Perlman*, 397 F. Supp. 221, 231 (S.D.N.Y. 1975) (company's "defensive strategy in the event of a tender offer" included charter amendments increasing the number of directors, creating three classes of directors with staggered terms, and requiring a two-thirds vote for repeal of the above provisions).

39. Three companies responding to a National Association of Accountant's survey stated that they had made this complicated change. See National Association of Accountants, *Takeovers: The State of the Corporate Defense Art Q8* (1978).

Shark-repellent charter amendments, migration to a state with a strong takeover law and similar actions, while legal and proper under the circumstances described in the text, may not be desirable. There is great doubt as to the constitutionality of the state takeover laws. See *Great Western United Corp. v. Kidwell*, 439 F. Supp. 420 (N.D. Tex. 1977), *aff'd*, 577 F.2d 1256 (5th Cir. 1978), *rev'd on other grounds*, (Current) Fed. Sec. L. Rep. (CCH) ¶ 96,900 (U.S. Sup. Ct. June 26, 1979). In addition, the SEC requires extensive disclosures with respect to shark-repellent provisions; its views are set forth in Securities Exchange Act Release No. 15230 (October 13, 1978), *reprinted in* [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,748. In general, the SEC requires explicit statements with respect to the negative impact on the shareholders and the benefits to management. The release details the nature of the disclosures the SEC will demand with respect to supermajority voting provisions, staggered boards, special classes of voting stock, and other shark-repellent provisions.

While the SEC release does not establish new disclosure requirements, it does serve to emphasize the negative aspects of shark-repellent provisions. *First*, except in rare situations of companies that would be attractive to bootstrappers, they are not a real practical deterrent to a takeover attempt. *Second*, they cast doubt on the legitimacy of rejection of takeover proposals that might be received in the future. *Third*, they advertise that the company fears that it is a takeover candidate. *Fourth*, they may create a false sense of security. *Fifth*, there is danger (particularly where there are large institutional holdings) that they will not receive the requisite vote and thereby advertise that the shareholders are receptive to a takeover. See, *PSA Inc. Is Winner In Proxy Fight Tied to Curbing Takeovers*, Wall St. J., Dec. 15, 1978, at 31, col. 3:

PSA Inc. won a hotly contested proxy fight over management's proposals to discourage takeovers by 32,455 votes, or fewer than 1% of the 3,339,498 shares eligible to vote on the issue.

The company, parent of Pacific Southwest Airlines, said it received 1,702,205 affirmative votes, with 1,148,136 votes cast against. It needed a majority of shares outstanding to make the changes in its certificate of incorporation. The changes will eliminate cumulative voting for directors, institute staggered board terms and require an 80% shareholder vote for some types of mergers involving holders of at least 20% of PSA stock. Under cumulative voting, each holder has as many votes as the number of his shares multiplied by the number of directors up for election. He may concentrate, or distribute, these votes and thus can gain board representation even with a relatively small minority interest.

benefit plans and material agreements with customers and suppliers to assure against abrogation or change in the event of a takeover.⁴⁰ In connection with the question whether the directors of a target may consider constituencies other than the shareholders in passing on a takeover bid, it should be noted that the Carter Administration in connection with proposed legislation designed to *rescue* Chrysler Corp. insisted that Chrysler show that its shareholders, employees, suppliers and others are making *maximum sacrifices*.⁴¹ If employees, suppliers and others must participate in rescuing a company from bankruptcy, it is hard to argue that they should be *ignored* when the question is a takeover that will benefit the shareholders.

There Is No Requirement to Negotiate or Sell

If we accept the premise that directors should not be compelled either to assess annually the continuance of the company as an independent entity or accept any substantial premium opportunity to sell or liquidate, and that it may be important to the good management of the business of the company to provide assurances against a takeover, we answer some of the questions with which we started. It follows that:

- 1) A company need not have a perpetual "for sale" sign on its front lawn, *i.e.*, there is no requirement that the management or the directors engage in acquisition discussions at another person's initiative;⁴² on the contrary, a company may have an express policy of continuing as an independent business enterprise.
- 2) The directors are not required when faced with a takeover bid to declare an auction and seek to sell the company to the highest bidder.

PSA also denied a request by the leading opponent of its proposals to review the balloting, and said it would file the new certificate immediately.

Harold Simmons, who owns about 20% of PSA's stock and led the fight to block the antitakeover measures, said in a telephone interview from Dallas, "We're definitely going to challenge; we demand the right to inspect the ballots." He said that "it's unusual" for a certificate to be filed immediately after such a close vote, and "I'm told by my attorneys that 1% of the votes normally are challengeable," he said.

40. See *Freedman v. Barrow*, 427 F. Supp. 1129, 1154 (S.D.N.Y. 1976). Placement of reasonable provisions in such plans and contracts is fully consistent with the directors' fiduciary duties. Assurance of fair and adequate treatment of officers, employees, customers and suppliers in the event of a takeover is a major factor in the consideration of any takeover proposal. Such provisions are not in the category of shark repellents designed to entrench management but are just the opposite—reasonable provisions designed to protect important constituents of the company and assure full and fair consideration of the takeover proposal.

41. *Financing Unit of Chrysler Sets Receivables Sales*, Wall St. J., Aug. 13, 1979 at 3, Col. 1: "Treasury Secretary G. William Miller made clear last week that the burden is on the company to produce a workable plan, including the 'substantive contributions or concessions' that are to be made by the auto-maker's management, employees, bankers, stockholders and others."

42. Such discussions are often misperceived by the potential acquiror and result in unwanted takeover offers. Disclosure of such discussions (usually "leaks") may have the same type of unsettling effect on employees, customers, suppliers and communities as an unsolicited takeover bid.

- 3) A company may make special provisions, such as full vesting and immediate cash-out in the event of a change of control, in its employee stock option and other benefit plans to protect the beneficiaries in the event of a takeover.
- 4) A company may attempt to discourage takeovers through such tactics as shark-repellent charter amendments and lobbies for takeover laws that have the same effect.

A Shareholder Referendum Is Not the Answer

Assuming that a raider makes a firm takeover offer at a substantial premium, must the directors ignore questions as to the adequacy of the price, the legality of the acquisition, the impact on employees, customers, suppliers, communities and national policy and let the shareholders decide for themselves?

In pursuing this discussion it will be assumed that the holders of a majority of the shares of the target would accept the offer. This has been the experience in almost every tender offer during the past five years. One prominent exception was the 1976 tender offer by Airco for Unitek at a 30 percent premium which resulted in Airco acquiring less than 22 percent of the Unitek shares.⁴³ Only a few substantial companies in addition to Unitek have been successful in convincing their shareholders not to accept a tender offer. The failure of management to convince shareholders not to accept a tender offer is the result of several factors. First, the special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion—they will tender, therefore, it is misleading to speak of a free shareholder choice at all. The existence of an offer to acquire a controlling interest in a company makes it almost impossible for a shareholder in the target to prudently retain his shares unless he does so for the purpose of exchanging them in a promised subsequent tax-free exchange. Once a raider has acquired control—and target shareholders must assume that the raider will acquire control—it is highly unlikely that shareholders will receive a higher price than that initially offered: since there is no possibility of a competing offer at a higher price, the public trading market (if one still exists) will have been capped at the price offered in the tender offer and the raider is not likely to offer more for the target's shares once it has achieved control. Retaining the target's shares in the face of a tender offer will bring the shareholder no benefit. He is likely to be forced out through a merger at a later date for the

43. See Wall St. J., May 10, 1976, at 16 (tombstone announcement of Airco *Offer to Purchase* at \$30 per share). Airco received only 15% of Unitek's shares in response to the tender offer. See, *Airco Acknowledges It Failed in Attempt to Acquire Unitek*, Wall St. J., June 8, 1976, at 42, col. 2. Through subsequent purchases, Airco increased its holdings to 21.7%. See Wall St. J., March 22, 1977, at 21, col. 1. More than a year after the Airco offer at \$30 per share Unitek was acquired by Bristol-Myers for \$59.14 per share in a negotiated merger; another example of the shareholders winning by the rejection and defeat of a takeover.

same price he could have realized upon the initial offer.⁴⁴ The outcome of a shareholder referendum conducted in the form of a tender offer cannot realistically be said to reflect a careful appraisal of the merits or demerits of the offer. Each individual shareholder must look to his own interest and must pragmatically assume that most other shareholders will tender with the result that the nontendering shareholder will be left in a minority, illiquid investment position. Thus, any uncoerced decision *against* acceptance of a tender offer can *only* be made at the board of directors level.

The second factor which accounts for acceptance of tender offers by shareholders is the shift of equities from individuals to professional investment managers during the last 30 years; a shift that has closely paralleled the growth of institutions such as pension funds, private foundations and mutual funds. Today, practical control, *i.e.*, 20 percent to 50 percent of the stock of a large number of major corporations is held by professional investors. As predicted by A.A. Berle, we have now reached the tertiary stage of capitalism. Control of American business passed from the founder-shareholders to the professional managers who held sway until the 1970s and now, at least in the sense of ability to control in the event of a tender offer or proxy contest, to the professional managers of pension funds, foundations and mutual funds.⁴⁵ In addition to the holdings of the institutional investors, professional and amateur arbitrageurs will frequently purchase 10 percent to 50 percent of the shares of a target. While some of the arbitrage stock comes from the institutions, it is not infrequent that the institutions and arbitrageurs together quickly end up with a greater than 50 percent interest in a target and thus have the ability to determine its destiny. It is rare for a target to survive as an independent company after such a situation develops.

The only interest of the arbitrageur is in a quick sale at a profit. Some of the institutions may have a longer investment perspective, but in the competition to demonstrate performance among professional investment managers, the lure of improving performance and the ability of tax-exempt funds to realize gains without incurring any tax almost always results in a decision to sell even when there is no more attractive long-term investment available. Frequently this decision to sell is motivated in part by a desire to avoid becoming a minority holder—often with a loss of market liquidity—in a target that will be controlled by the raider. This is so even where the control is less than 50%.

44. See e.g., *Singer v. Magnavox Co.*, *supra* n. 13. See also Borden & Weiner, *An Investment Decision Analysis of Cash Tender Offer Disclosure*, 23 N.Y.L. Sch. L. Rev. 553 (1978); Schwartz, *Response: Some Thoughts on the Directors' Evolving Role*, 30 *Hast. L. Rev.* 1405, 1406 n. 1 (1979).

45. See generally Berle, *The Modern Corporation Revisited*, 64 *Colum. L. Rev.* 1410 (1964); Berle & Means, *The Modern Corporation and Private Property* (1932); W. Cary, *Corporations* 229-37 (4th ed. unabridged 1969). See also *Wellman v. Dickinson*, [Current] *Fed. Sec. L. Rep. (CCH)* ¶ 96,918 (S.D.N.Y. July 9, 1979).

In sum, an unsolicited tender offer is often successful not because a majority of the shareholders of the target determine that it is a good acquisition, but because the dynamics of a tender offer trigger motivations by different minority segments of the shareholder body, such as those who:

- a) believe that once the raider gets control it will probably move to obtain 100% ownership and it is unlikely that they will be able to realize any more for their shares than the takeover price;
- b) need to show performance;
- c) desire to avoid a loss of market liquidity;
- d) believe that the raider is not a good manager;
- e) desire not to be a minority shareholder in a controlled company;
- f) have a tax incentive to sell;
- g) fear poor treatment on a second step freezeout by the raider;

that in aggregate creates an *ad hoc* consortium of sellers of a majority of the shares of the target. The United Technologies Corporation tender offer for Carrier illustrates this point.⁴⁶ The tender offer, which was vigorously opposed and litigated by Carrier, was oversubscribed even though United Technologies had initially announced its willingness to negotiate a merger at a higher price than the tender offer price.

Even in the face of such an *ad hoc* consortium, the necessity from technological, social and economic standpoints for long-term planning by business requires a policy decision in favor of not mandating decisions that ignore or penalize long-term planning. Rather than forcing directors to consider only the short-term interests of certain shareholders, national policy requires that directors also consider the long-term interests of the shareholders and the company as a business enterprise with all of its constituencies in addition to the short-term and institutional shareholders. There would be a compelling argument for this result even if experience had proven that all takeovers turned out better for the shareholders of the target if they sold at the takeover price. Since experience proves that the decision to sell or remain independent is not clear, and that even when measured by comparing the rejected offer price with the market price, in more than 50 percent of the rejected takeovers the shareholders did better by the target remaining independent. There is no reason to remove the decision on a takeover from the reasonable business judgment of the directors. On the contrary, the policy considerations are overwhelmingly in favor of specific recognition that the directors not only have the right to make takeover decisions based on their

46. See discussion in n. 26, *supra*.

reasonable business judgment, but that macrosocioeconomic issues must be considered along with the long-term interests of the shareholders and the company as a business enterprise.

If the shareholders are dissatisfied with the directors' rejection of a takeover bid, they have the right, through the normal proxy machinery, to replace the directors or to instruct the directors to accept a takeover bid. This right, however, should not be translated into an absolute requirement that the directors pass to the shareholders the direct right to accept or reject any takeover bid. To do so would be the equivalent of mandating sale whenever an unsolicited takeover bid is made.

The proponents of direct reference to the shareholders point out that the usual procedure on a merger is for the directors to approve the merger agreement and refer the matter to a shareholder vote.⁴⁷ The proponents argue by analogy that substantially the same procedure should be followed with respect to unsolicited takeover bids and the directors should have the right, if they are so minded, to issue strong advice to reject the takeover. In the case of a merger, however, nonapproval by the directors means that it is not submitted to the shareholders. There is not, and there should not be, any requirement that, just because a raider requests approval or nonopposition by the directors of the target, they accede to the request without making the same study and determination they would make in the case of a negotiated merger.

Where the only issue in a tender offer is price, our present legal structure permits a raider, after compliance with the applicable federal and state laws, to short-circuit acceptance by the directors of the target and to make its offer directly to the shareholders of the target. The shareholders then have the power, independent of the directors, to determine whether or not to accept the offer. Even under the most far-reaching of the state takeover statutes, no tender offer has been blocked on the question of price.⁴⁸ The decisions are uniform that where there is a cash tender offer, the state will not determine what is a fair premium but will leave that determination to the shareholders.⁴⁹

47. *E.g.*, Model Bus. Corp. Act § 73; N.Y. Bus. Corp. Law § 903; Del. Corp. Law § 251(b), (c).

48. The general attitude of the state securities commissions has been to "rely on the market mechanism to assure fairness as to cash tender offers. . . ." *In re EZ Paint Corp.*, [1971-1978 Transfer Binder] Blue Sky Rep. (CCH) ¶ 71,063, at 67,318 (Wisc. Comm'r Sec., 1973).

49. *See* n. 43, *supra*; *In re Elkhart Lake's Road America, Inc.*, 3 Blue Sky Rep. (CCH) ¶ 71,410 (Wisc. Comm'r Sec., 1977) ("We will not substitute our subjective evaluation of the shares' worth for that of the market"); *In re Proposed Acquisition of CNA Financial Corp. by Loews Corp.*, Findings, Conclusions and Recommendations, Hearing No. 1522 (Ill. Dept. Ins. July 30, 1974) ("'fairness' is an elusive concept at best and the decision of each stockholder . . . to sell or hold his securities is as good an evaluation as any"); *In re Hein-Weiner Corp.*, 3 Blue Sky L. Rep. (CCH) ¶ 71,448, at 68,473, 68,479 (Wisc. Comm'r Sec., 1979) ("It is not the province of the Commissioner to determine whether a proposed takeover offer is desirable from a social or economic standpoint or whether the interests of the state or local community, or the employees or management of the target company, might be adversely affected by a successful takeover"). *See generally* Lipton & Steinberger, *supra* n. 36, at 254-58.

If that is the law and that is what has happened, why the issue? Primarily, because price is rarely the only issue. Most major takeovers raise other issues such as:

- a) antitrust,⁵⁰
- b) regulatory approval,⁵¹
- c) disclosures (actually failures to make material disclosures) by the raider,⁵²
- d) conflict of interest by those advising or financing the raider,⁵³
- e) impact on constituencies other than the shareholders of the target,⁵⁴
- f) poor quality of the raider's securities in an exchange offer.⁵⁵

50. *E.g.*, *Berman v. Gerber Products Co.*, *supra* n. 3; *Babcock & Wilcox Co. v. United Technologies Corp.*, *supra* n. 26; *Carrier Corp. v. United Technologies Corp.*, *supra* n. 26.

51. *See e.g.*, *Babcock & Wilcox Co. v. United Technologies Corp.*, *supra* n. 26 (question of need for approval of Nuclear Regulatory Commission). Examples of offers raising potential regulatory problems include the 1977 offer by Northwest Industries, Inc. for The Coca-Cola Bottling Company of Los Angeles (possible need for FCC approval; *see* Lipton & Steinberger, *supra* n. 36, at 170), the American Express offer for McGraw-Hill (possible need for FCC approval; *see*, *American Express Gets a Loan*, *New York Times*, Jan. 12, 1979, at § IV, p. 1, col. 4; *McGraw-Hill Replies to Suit*, *N.Y. Times*, Jan. 25, 1979, at § IV, p. 5, col. 6), and the recent attempts to buy National Airlines (possible need for CAB approval; *see*, *Airline Files to Control National Air*, *N.Y. Times*, July 29, 1978, at 23, col. 3; *Separate Study Set on Eastern Air's Bid For National Air*, *Wall St. J.*, Dec. 22, 1978, at 8, col. 1). *See generally* Lipton & Steinberger, *supra* n. 36, at 169-72.

52. *E.g.*, *Berman v. Gerber Products Co.*, *supra* n. 26; *Jewelcor Inc. v. Pearlman*, *supra* n. 38, at 233.

53. *E.g.*, *Humana, Inc. v. American Medicorp, Inc.*, *supra* n. 6 (alleged conflict of interest of investment banker); *Washington Steel Corporation v. TW Corp.*, Civ. No. 79-0166 (3d Cir. July 20, 1979) (alleged breach of fiduciary duty by financing bank). During the recent American Express bid for McGraw-Hill, McGraw-Hill asserted that there were conflicts of interest as a result of both the President of Amex' service on the McGraw-Hill board of directors, and the participation of McGraw-Hill's bank, Morgan Guaranty Trust Company, in the financing of the offer. *See*, *McGraw Rift: Focus on Role of a Director*, *N.Y. Times*, Jan. 18, 1979, at § IV, p. 1, col. 3; *McGraw-Hill Puts Outside Directors in Legal Limbo*, *Wall St. J.*, Feb. 2, 1979, at 12, col. 3; *McGraw-Hill Bid Raises Questions on Bank's Role*, *N.Y. Times*, Jan. 23, 1979, at § IV, p. 1, col. 1; *Some Banks Accused of Conflicts of Interest in Hostile Takeovers*, *Wall St. J.*, Mar. 16, 1979, at 1, col. 6.

54. *E.g.*, *Herald Co. v. Seawell*, *supra* n. 7 (impact of newspaper takeover on employees and the community). *See also* text accompanying nn. 30-31 *supra* (adverse reaction of authors and editors to attempted takeovers of Houghton Mifflin and McGraw-Hill).

55. *E.g.*, *Humana, Inc. v. American Medicorp, Inc.*, *supra* n. 6, at 92,823, 92,824; *In re Pabst Brewing Co.*, 3 Blue Sky L. Rep. (CCH) ¶ 71,415, at 68,354, 68,359-64 (Wisc. Comm'r Sec., June 6, 1978). During the recent exchange offer by Occidental Petroleum for Mead, Mead contended that the Occidental securities offered in exchange were a "bad investment". *See* The Takeover Crisis, *supra* n. 8, at 35.

At a recent NACD conference, NACD President I. Cummings advised directors to consider, when faced with a tender offer, such price related factors as whether the current market price was depressed and whether a better bid might be expected, and such non-price related factors as the effect of the offer on joint ventures, financing arrangements, and relationships with customers, suppliers, creditors and employees. *See*, *Heat on Directors*, *supra* n. 2, at 4.

In a negotiated merger these issues are sorted out in the screening and negotiating stages. One or more of these issues frequently cause the demise of a merger that both parties desire. In an unsolicited tender offer there is no opportunity to fully evaluate and negotiate them and, as noted above, the dynamics of the tender offer, as distinguished from the negotiated merger where there is an opportunity for careful advance consideration by the directors, assisted by counsel, accountants, investment bankers and other experts, often resulting in the holders of a majority of the shares of the target being coerced into accepting the tender offer without full exploration and consideration of the issues. In addition the directors of the target must take into account the impact on the target if they fail to take action to block a tender offer which they believe is or may be illegal and such tender offer is in fact subsequently enjoined or otherwise determined to have been illegal.⁵⁶ The failure of the target to attempt to defeat a tender offer which is later blocked by government or other action may result in loss of key employees, disaffection of customers and suppliers and other problems, with the result that the business of the target is damaged and the shareholders never get the opportunity to sell at the tender offer price. One possible result of such a situation might be a large arbitrage position, sufficient to determine control of the target, that is dumped by the arbitrageurs and purchased by a new raider, at a low price, who then is able to take over the target at a lower price than could have been obtained if the target was able to seek a buyer. The target of an unsolicited tender offer must successfully litigate or be faced with a *fait accompli* in much less time than a reasonable study of the same questions takes in a negotiated merger.⁵⁷ Thus the directors of the target are faced with two basic questions beyond price:

56. See nn. 59 and 65, *infra*.

57. Wachtell, *Special Tender Offer Litigation Tactics*, 32 Bus. Law. 1433 (1977), describes the lightning-fast timetable which governs in tender offer litigation:

You are operating in a pressure atmosphere where you have constant surprise. You have very little turnaround time. The company goes running for counsel: help us. You have to commence litigation immediately. You have to get out your deposition notices. You have to make your motions for expedited discovery. You have to set up your teams for taking what could be two or three sets of simultaneous depositions, often in different cities. You have to be prepared to flow all the information you're getting from depositions and documents into affidavits and briefs almost simultaneously with the taking of the depositions and the review of the documents. You have to be scheduling your applications for temporary restraining orders, stays, preliminary injunctions and the like. You are essentially compressing into a span of four, five or six days what would normally be months and months, if not years, of typical big case litigation, including analysis of antitrust ramifications, industry studies, competitive lines of products and the like. It is unique.

Should (or must) they consider the legality and other policy aspects of the takeover (or an aborted takeover) or merely close their eyes and leave it to the shareholders and the government?⁵⁸

Should (or must) they consider the impact of the takeover (or an aborted takeover) on constituencies other than the shareholders and is this an independent justification for rejection?

After five decades of continuous efforts both to raise the consciousness of directors with respect to antitrust, disclosure and other issues of national policy, and to impose on corporations and their directors obligations to employees, customers and communities, it is impossible to contemplate a rule that would vitiate these concerns when the question is solely whether the shareholders may have an opportunity immediately to realize a premium over the current market price for their shares. It can be argued that the directors

58. *E.g.*, when the directors of Reliance Electric Co. were recently confronted with a proposed tender offer by Exxon Corp. they decided neither to endorse nor oppose the offer, maintaining that "the stockholders of Reliance should determine for themselves whether to accept the offer if and when made by Exxon." See, *Reliance Electric Doesn't Oppose Exxon's Proposal*, Wall St. J., June 13, 1979, at 6, col. 1. In contrast, the board of Carrier Corp. fought United Technologies' proposed tender offer by, among other things, filing an antitrust action. See Carrier Corporation's *Notice of Special Meeting of Stockholders*, July 5, 1979. The government did indeed seek to enjoin the Exxon offer for Reliance. The following excerpt from an affidavit Felix G. Rohatyn submitted on behalf of Reliance in *FTC v. Exxon Corp.*, No. 79-1975 (D.C.D.C. 1979) illustrates the point made in the text that the impact on the target of a determination that a tender offer is illegal may be severe:

6. We believe that if the purchase of the shares is not consummated by Exxon there will be extremely confused trading in Reliance stock for an indefinite period. There is likely to be heavy selling which would result in a drastic reduction of the price of Reliance stock. In such a market, Reliance would be unable to make a satisfactory equity offering of the type which had been an integral part of its financing program. This would make it necessary for Reliance to achieve its refinancing, at least at the first stage, entirely through a debt placement. This would be significantly more costly to Reliance because of the inability of Reliance to improve its equity base. In addition, Reliance would have reduced flexibility in future financial planning. As the costs to the Company increase, Reliance's ability to compete effectively would be negatively affected.

7. During the period following collapse of the proposed acquisition the volatile trading in Reliance's stock would create a high level of probability that a third party, possibly foreign, could obtain control of the Company by purchasing stock at distressed prices. The mere fact that Reliance had experienced a substantial change in the composition of its shareholder body and had been identified as a desirable acquisition target would increase the probability that it would not be able to remain an independent entity following a failure to complete the proposed acquisition by Exxon.

8. It is also apparent that if the purchase of the shares is not completed and litigation continues, Reliance will be injured by the continuing uncertainty which will not only plague its financial planning but will undoubtedly harm its ability to attract and retain qualified personnel. As long as there is uncertainty about the future ownership and control of Reliance, its management will lack both direction and incentive in planning and implementing Reliance's future activities. As the uncertainty continues, Reliance will inevitably lose ground as an effective entity in its areas of operation; a company in limbo cannot remain an effective competitor.

Also see n. 61, *infra*.

should and must consider these issues,⁵⁹ which are not for the shareholders to decide directly any more than decisions to produce the Edsel, introduce Crest, buy the Xerox patents, compete with IBM, or file a bankruptcy petition were questions for direct answer by the shareholders of Ford, Procter & Gamble, Haloid, GE, and W.T. Grant. A takeover bid is no different than any other fundamental business decision. Many corporations annually or periodically face decisions with respect to capital expenditures, new product introductions, adoption of new processes, termination or disposition of businesses or bankruptcy,⁶⁰ that may have as significant an impact on the market value of the corporation as a takeover bid. As long as matters such as capital expenditures, discontinuances of businesses and bankruptcy are for the reasonable business judgment of the directors, there is no reason to put acceptance or rejection of a takeover bid on any different basis.⁶¹ If the shareholders do not like the directors' decisions, they have the right and power to change the directors.

What the Directors Should Do

If we accept the premises that the directors of a target do not have an absolute duty to accept a takeover bid and that there is no absolute requirement that the question be referred for direct action by the shareholders, we are left only with the questions as to how the directors of a target should approach a takeover bid.

- 1) Are the management directors disqualified?
- 2) Should the independent directors or a committee of independent directors obtain separate legal and investment banking advice?
- 3) Must an investment banker be consulted or may the directors reach their own decision?
- 4) May the directors litigate any legal issues that may exist, even minor issues?
- 5) If the directors determine that the takeover is not in the best interests of the target, may they acquire a company that would create an antitrust or regulatory problem for the raider, issue additional shares

59. See e.g., *Gould v. American-Hawaiian Steamship Co.*, F.2d 761, 776-77 (3d Cir. 1976) (even disinterested directors are liable for failure to act to prevent violation of securities laws).

60. See n. 10, *supra*.

61. The courts have recognized in analogous areas that, even in extreme cases, the directors, not the shareholders, must make the business decisions for the corporation. See e.g., *Burks v. Lasker*, 99 S. Ct. 1831 (1979) (committee of independent directors can stop derivative suit against other directors); *Abbey v. Control Data Corp.*, *supra* n. 10 ("most important corporate decisions are to be made by the corporation's board of directors," and thus committee of independent directors can make decision to terminate derivative suit against other directors); *Auerbach v. Bennett*, No. 323 (N.Y. July 9, 1979) (decision by committee of independent directors to terminate derivative action is beyond judicial inquiry under the business judgment doctrine).

of the target to a big brother or purchase shares of the target at a premium for the purpose of defeating the takeover?

6) What standard should govern the directors' determination?

There are some takeover bids so devoid of antitrust or other legal issues and so attractive in price that no competent director would reject them. There are some takeover bids—particularly partial offers and exchange offers—that are so bad that only a negligent director would fail to oppose them. Our problem rests not with the extreme takeover bids which are so rare that they do not warrant special rules, but with the vast majority of takeover bids as to which reasonable men may differ as to price or the other issues. As to these, so long as the directors act in good faith and on a reasonable basis, their decision to accept or reject a takeover bid should not be subject to being second guessed. As noted above, as far as is known no director has ever been held liable for the rejection of a takeover bid and, if the guidelines set forth below are followed, it is hoped that none ever will.

Since we are dealing with takeovers which by definition are within a broad band of discretion, and since some might believe that there are conflicts between management's self-interest in preserving the independence of a target company and the directors' decision to accept or reject a takeover bid, it may be helpful to follow those procedures which in other areas have proven to eliminate or minimize conflicts and produce well founded objective decisions. Thus:

- A) Management (usually with the help of investment bankers and outside legal counsel) should make a full presentation of all of the factors relevant to the consideration by the directors of the takeover bid, including:
 - (1) historical financial results and present financial condition
 - (2) projections for the next two to five years and the ability to fund related capital expenditures
 - (3) business plans, status of research and development and new product prospects
 - (4) market or replacement value of the assets
 - (5) management depth and succession
 - (6) can a better price be obtained now
 - (7) timing of a sale; can a better price be obtained later
 - (8) stock market information such as historical and comparative price earnings ratios, historical market prices and relationship to the overall market, and comparative premiums for sale of control
 - (9) impact on employees, customers, suppliers and others that have a relationship with the target

- (10) any antitrust and other legal and regulatory issues that are raised by the offer
 - (11) an analysis of the raider and its management and in the case of a partial offer or an exchange offer pro forma financial statements and a comparative qualitative analysis of the business and securities of both companies.
- B) An independent investment banker or other expert should opine as to the adequacy of the price offered and management's presentation.⁶²
- C) Outside legal counsel should opine as to the antitrust and other legal and regulatory issues in the takeover and as to whether the directors have received adequate information on which to base a reasonable decision.⁶³
- D) If a majority of the directors are officers or otherwise might be deemed to be personally interested, other than as shareholders, a committee of independent directors, although not in theory necessary, from a litigation strategy standpoint may be desirable.⁶⁴ The exigencies and pressures of a takeover battle are such that it is desirable to avoid proliferation of committees, counsel and investment bankers. The target will be best served if it is advised by one investment banker and one outside law firm.
- E) It is reasonable for the directors of a target to reject a takeover on any one of the following grounds:
- (1) inadequate price
 - (2) wrong time to sell
 - (3) illegality
 - (4) adverse impact on constituencies other than the shareholders

62. See e.g., *Kaplan v. Goldsamt*, *supra* n. 4, at 568 (to extent that directors relied on responsible investment banker's reports, individuals cannot be held accountable for improper conduct); *Danziger v. Kennecott Copper Corp.*, *supra* n. 4, at 7, col. 1, *aff'd on the opinion below*, 400 N.Y.S.2d 724 (reliance on investment banker's report evidence of directors' thorough consideration of transaction). The investment banker's opinion must be adequately prepared, however. In *In re Royal Industries, Inc.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863 (C.D. Cal. 1976), the court held that it was misleading for the target to include in a press release the statement that it had been "guided" in its decision to reject the offer by an investment banker's report, because the report had been prepared "virtually overnight and without the necessary time and deliberation for a fair evaluation. . . ." *Id.* at 91, 139-40.

See generally Lipton & Steinberger, *supra* n. 36, at 291-92.

63. *Cf.*, *Tannenbaum v. Zeller*, 552 F.2d 402, 416-29 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977) (in finding that directors of mutual fund did not breach fiduciary duty by decision to forego recapture of brokerage commissions, court stressed that "every administrative, judicial and legislative development pertaining to recapture" had been brought to board's attention, and stressed need for advice of outside counsel). See also Leech & Mundheim, *The Outside Director of the Public Corporation* 27 (1976).

64. See n. 51, *supra*.

- (5) risk of nonconsummation⁶⁵
- (6) failure to provide equally for all shareholders
- (7) doubt as to quality of the raider's securities in an exchange offer.

Once the directors have properly determined that a takeover should be rejected they may take any reasonable action to accomplish this purpose,⁶⁶ including litigation,⁶⁷ complaints to governmental authorities,⁶⁸ the acquisition of a company to create an antitrust or regulatory problem for the raider,⁶⁹

65. Directors may properly take into account that even if the price is right, if the partner is wrong because of legal or other problems, the takeover may be enjoined or abandoned by the raider and the target may have suffered serious damage through employee, customer, or supplier disaffections without the shareholders having enjoyed the premium they thought they would get. This is a major factor in negotiated deals where one of the very early, if not first, steps is to determine whether antitrust or other legal problems make the merger impractical. It is even more important in takeover situations. *See* n. 59, *supra*.

66. *See* Northwest Industries, Inc. v. B.F. Goodrich Co., *supra* n. 4, at 712-13 ("[M]anagement has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or its stockholders. . . . After [making a carefully considered decision] the company may then take any step not forbidden by law to counter the attempted capture"); *Berman v. Gerber Products Co.*, *supra* n. 3, at 1323.

67. *See* n. 66, *supra*.

68. *Cf.* Leech & Mundheim, *supra* n. 63, at 25-27:

Despite . . . obstacles to effective outside director action, it nevertheless may be desirable to establish a committee of outside directors whose major function would be to determine, from time to time, whether continuation of the fight against the tender offer makes sense. Management would inform the committee about its reasons for contesting the tender offer and about any other relevant facts. The committee would also meet separately with the company's investment bankers and outside counsel. The separate meetings with the outside professional consultants should help give the committee a sense of the available information on which the conclusion to continue the fight is based. Moreover, the need to deal with the outside directors and to answer their questions should remind the outside consultants of their responsibility to the corporation and place on them the burden of furnishing full information to the committee.

The committee of outside directors may also have to consider whether it will meet separately with representatives of the offeror.

As set forth in the text we do not accept the Leech and Mundheim position. Indeed, we do not believe that a takeover bid presents the type of self-interest conflict that warrants abstention by the management directors or deference to an independent committee. *See*, *Tyco Laboratories, Inc. v. Kimball*, 444 F. Supp. 292 (E.D. Pa. 1977): "Thus, this Court is required to decide whether the directors' interest in retaining control allows for the corporation, as represented by its shareholders, to be substituted for the board of directors, in the formula for determining whether there has been a deception under section 10(b). This Court finds that the directors' interest in retaining control is not a sufficient interest to permit this Court to change the formula."

69. *E.g.*, *Anaconda Co. v. Crane Co.*, *supra* n. 4; *Altman v. Knight*, 431 F. Supp. 309 (S.D.N.Y. 1977). *But see*, *Royal Industries, Inc. v. Monogram Industries, Inc.*, *supra* n. 62, at 91,131, 91,136-37 ("If a tender offer target makes a defensive acquisition whose compelling reason or sole, controlling or primary purpose is to block a tender offer, the acquired company or its management violate . . . their fiduciary duties to their shareholders. . . .")

the issuance of shares to a big brother,⁷⁰ or the premium purchase of shares of the target from the raider.⁷¹

While in theory there should be no distinction in judicial treatment of the various tactics that may be selected by a target to defeat an unsolicited takeover, the courts appear to be forging a pragmatic distinction. Where the target asserts its legal rights through litigation and complaints to government authorities the standard seems to be the business judgment rule.⁷² Where the target issues stock to a big brother, buys a company to create an antitrust block, purchases its shares from a raider at a premium or takes similar action, the standard seems to be a primary purpose rule—the action will be sustained unless the primary purpose was to keep the management in office rather than to serve the best interests of the company and its shareholders.⁷³ It may be argued that where the primary purpose test has been applied, the cases really turned on the courts' belief that the directors had not acted in good faith or on a reasonable basis, but rather than reach those issues, the court based the decision on the primary purpose test. Even where the courts have found a defensive tactic to have been improper and held the management directors who had a personal interest liable therefor, they have refused to find any liability on the part of the outside directors who did not benefit.⁷⁴ Where the directors have made a reasonable good-faith decision to reject the takeover on one or more of the bases set forth above, the business judgment rule should apply equally to any and all defensive tactics.

The Directors Meet

The process of consideration by a board of directors of a takeover bid is illustrated by the minutes of a recent meeting of the Board of Target Corporation.

"A special meeting of the Board of Directors of Target Corporation was held at the office of the Corporation at 10:00 A.M. on June 25, 1979. All of the directors were present. Also present were Mr. Thomas Thompson, Executive Vice President—Finance; Mr. Karl Freeman, Executive Vice President and General Counsel; Messrs. Robert Sachs and Stephen Redhill of Sachs,

70. See e.g., *Northwest Industries, Inc. v. B.F. Goodrich Co.*, *supra* n. 4; *Klaus v. Hi-Shear Corp.*, *supra* n. 9. But see *Applied Digital Data Systems, Inc. v. Milgo Electronic Corp.*, 425 F. Supp. 1145 (S.D.N.Y. 1977) (target's sale of unissued shares for the purpose of defeating tender offer violates § 14(e) if done without a valid business purpose).

71. E.g., *Heine v. The Signal Cos.*, *supra* n. 9; *Cheff v. Mathes*, *supra* n. 9.

72. E.g., *Berman v. Gerber Products Co.*, *supra* n. 3, at 1319–23; *Humana, Inc. v. American Medicorp, Inc.*, *supra* n. 6, at 92,823, 92,833; *Anaconda Co. v. Crane Co.*, *supra* n. 4.

73. E.g., *Cheff v. Mathes*, *supra* n. 9, at 554–56; *Anaconda Co. v. Crane Co.*, *supra* n. 4, at 1219–20; *Podesta v. Calumet Industries, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,433, at 93,549, 93,551–57 (N.D. Ill. 1978); *Royal Industries, Inc. v. Monogram Industries, Inc.*, *supra* n. 62, at 91,131, 91,135–38; *Klaus v. Hi-Shear Corp.*, *supra* n. 9, at 233–34. See generally *Fleischer, Tender Offers: Defenses, Responses and Planning* 83–85, 147–52 (1978).

74. E.g., *Consolidated Amusement Co. v. Rugoff*, *supra* n. 5, at 94,475, 94,485–86. See also *Cheff v. Mathes*, *supra* n. 9, at 553 (discussing lower court decision).

Morgan & Co., the Corporation's investment banker; Messrs. Joseph Lipton and Martin Flom of Skadden & Wachtell, special counsel to the Corporation, and Mr. Richard Martens of Cromwell & Polk, special counsel to Sachs, Morgan & Co.

"The Chairman stated that the business of the Special Meeting was consideration of the June 20, 1979 proposal by Raider Inc. to acquire all of the shares of the Corporation for \$75 per share in cash. He noted that prior to the announcement of the June 20 proposal the market price of the shares was \$40 and that the current market price is \$68. He stated that this was one of the most serious matters that the Board of Directors of the Corporation had ever faced. He suggested that the Board take as much time as it deemed appropriate and said that arrangements had been made to continue the meeting through the day and thereafter if the Board so desired. He also expressed the desire that each director reach his or her own individual judgment and that no director feel in any way obligated to agree with the management of the Corporation. He requested that each director feel free to comment on the June 20 proposal and the presentations of the financial and legal advisers and that each director feel free to raise questions at any time.

"The Chairman stated that since 9 of the 13 directors were not employed by the Corporation and he and the other officer-directors did not feel any personal conflict of interest, it was management's recommendation that the June 20 proposal be considered by the Board as a whole and that it was not appropriate to establish a special committee of outside directors for that purpose. Mr. Freeman stated that in his opinion and that of Skadden & Wachtell there is no legal requirement that the Board delegate consideration of the June 20 proposal to a special committee or that the Corporation retain investment bankers and legal counsel who have had no prior relationships with the Corporation. The Board concurred unanimously in the management recommendation.

"The Chairman and Mr. Thompson then presented and explained in detail a summary of the Corporation's financial position, earnings and future prospects, a copy of which was distributed to each director. At the conclusion of this report, the Chairman stated that he and the management of the Corporation had complete confidence in both the short-range and the long-range future of the Corporation; that they believe this is not the time to sell or merge the Corporation; that they believe Raider is not the appropriate partner for the Corporation; and that they believe that if the Corporation were to accept the June 20 proposal, there would be serious legal questions with respect to a combination of the Corporation and Raider that would result in long delay before consummation, with a high risk of nonconsummation of the combination because of legal or regulatory prohibition, and that in the interim, the business of the Corporation would have been seriously adversely affected by the uncertainties created by the unresolved situation.

"The Chairman then asked Robert Sachs of Sachs, Morgan & Co. to report to the Board with respect to Sachs, Morgan's opinion of the June 20 proposal. Mr. Sachs introduced his partner, Stephen Redhill, who had participated with him since June 20 in a continuing study of the Corporation and Raider's proposal. Mr. Sachs also introduced Richard Martens, partner of Cromwell & Polk, special counsel to Sachs, Morgan. Mr. Sachs described in detail the study that had been performed by Sachs, Morgan, including the extensive work done for the Corporation prior to the assignment to study the June 20 proposal, and the Sachs, Morgan firm meeting held to discuss the June 20 proposal.

"Mr. Sachs stated that in the opinion of Sachs, Morgan, the June 20 proposal is inadequate from a financial viewpoint. Mr. Sachs further stated that in the opinion of Sachs, Morgan, this is not the appropriate time to undertake the sale or merger of the Corporation.

"Mr. Sachs then explained the analyses and procedures followed by Sachs, Morgan in reaching its conclusion. Director Pell asked Mr. Sachs to describe in more detail the factors that Sachs, Morgan studied and the methodology employed in reaching its opinion. Mr. Sachs gave a lengthy and detailed answer in which he described the various procedures followed by Sachs, Morgan and referred to the various work sheets that had been used in the Sachs, Morgan analysis of comparable acquisitions and the relative price earnings ratios reflected by such acquisitions. Mr. Sachs referred to several recent transactions and stated that in those transactions in which the acquired company had a return on equity comparable to that of the Corporation, the average price earnings ratio of the acquisition price was approximately 15 which would result in a substantially higher price for the Corporation than \$75. Mr. Sachs noted that in several instances of recent transactions where the acquired corporation had a return on equity approximately 75 per cent of that of the Corporation, the acquisition price was at an average price earnings ratio that also would result in a price for the Corporation in excess of \$75 per share. Mr. Sachs noted that the Corporation ranked 29 among the Standard and Poor's 425 industrial companies with respect to return on capital and that the consistency between the Corporation's forecasts and actual results (indeed, that results regularly exceeded forecasts) were highly favorable factors in merger valuation and negotiation.

"Director Smith asked whether Sachs, Morgan had delivered to the Corporation the analyses and other information used by it in its study of the Corporation and Raider's proposal. Mr. Sachs stated that these were internal working documents of Sachs, Morgan and not in form for delivery to the Corporation, although they were present at the meeting and he would be pleased to have the directors look at them and ask questions with respect to them.

"Director Tubbs asked Mr. Sachs whether Sachs, Morgan had taken into account the public policy aspects of a sale of the Corporation to Raider. Mr. Sachs replied that Sachs, Morgan confined its analysis to the financial aspects and that its opinion was based only on its judgment with respect to the present financial condition and future prospects of the Corporation and its judgment with respect to the timing and manner by which the optimum sale price could be achieved, if it were determined to sell or merge.

"Director Stone requested that Mr. Sachs explain the Sachs, Morgan view of the Corporation from an investment standpoint. Mr. Sachs replied that Sachs, Morgan believes the Corporation to be one of the best investment opportunities available today. Based on the recent history of the Corporation, Sachs, Morgan's opinion of the Corporation's management and personnel and Sachs, Morgan's opinion of the various businesses in which the Corporation is engaged, Sachs, Morgan believes that the Corporation will experience better than average growth and market acceptance in the 1980's. Mr. Sachs stated that if no takeover proposal had been made at this time and Sachs, Morgan had been consulted with respect to whether the Corporation should seek a sale or merger, Sachs, Morgan would have advised the Corporation that this is not the time so to do. Mr. Sachs added that Sachs, Morgan was very impressed with the planning and budgeting procedures followed by the Corporation and that Sachs, Morgan has confidence in the Corporation's projections of future earnings.

"Director Peters asked whether Sachs, Morgan had reached a determination as to what would be a fair price for the Corporation at this time. Mr. Sachs stated that Sachs, Morgan had not made such a determination but that Sachs, Morgan is of the opinion that a price higher than \$75 per share could be obtained at this time. Mr. Sachs also noted that Sachs, Morgan believes that there are several companies that would be interested in acquiring the Corporation for more than \$75 per share and that if the Corporation experiences three more years of sustained growth, as predicted, the value of the Corporation would be greatly enhanced.

"The Chairman asked Mr. Joseph Lipton to report on the opinion of Skadden & Wachtell. Mr. Lipton introduced his partner, Martin Flom. Mr. Lipton reviewed the opinion of Skadden & Wachtell, a copy of which had previously been furnished to each director. Mr. Lipton also reviewed in detail the legal issues inherent in a combination of Raider and the Corporation and described why his firm felt that there was a substantial likelihood that those problems would preclude the consummation of such a combination even if the Corporation were to accept the June 20 proposal. Mr. Lipton concluded by stating that the decision as to whether to accept or reject the June 20 proposal was one that the directors should make based on their own judgment; that the directors had before them an adequate basis on which to make the decision; and that while it should be assumed that if the directors were to reject the June

20 proposal, they would be named as defendants in shareholder lawsuits, they would in his firm's opinion be acting entirely properly and within the law and would not ultimately be held liable for such rejection.

"Director Lawton asked Mr. Lipton whether the Board could take the position that it would not pass on the matter and make no recommendation to the shareholders. Mr. Lipton replied that while on a narrow legal basis there was no requirement that the Board take a position, in his opinion the issue is so fundamental that the Board should take a position and that the Board should either accept or reject the June 20 proposal. Mr. Lipton stated that the Board should take all the time it felt appropriate to study and discuss the issue.

"Director Tubbs asked whether there were any precedents sustaining the rejection of an acquisition proposal on the sole ground that there were serious issues as to legality of a combination of the two companies. Mr. Lipton referred to the *Gerber* case and described the court's decision in detail.

"Director Pell asked whether in the opinion of counsel it would be illegal to accept the June 20 proposal. Mr. Lipton replied that his firm had not opined on the issue of whether it would be illegal for the Board to accept the June 20 proposal; that, if the Board deemed, based upon counsel's opinion, that the offer raised serious questions of legality, the issue of whether the Board would nonetheless be entitled to accept the proposal could not be said to be free from doubt. He said that the Board could take such serious legal questions and the consequent risks of nonconsummation of the proposed transaction into account in reaching its overall business judgment determination as to whether to accept or reject the June 20 proposal.

"Director Pell asked Mr. Lipton whether in the opinion of counsel the directors had an adequate basis on which to reach a decision at this time or whether the decision should be postponed. Mr. Lipton stated that the decision itself and the time of the decision were solely for determination by the Board: it was for the Directors to decide in their reasonable judgment how much time was appropriate for them to consider the matter. As previously stated, it was the opinion of counsel that the Board, if it should determine to go forward with its decision, presently had an adequate basis on which to make such decision. Mr. Lipton pointed out that the Board might wish to consider the potential for misunderstanding by shareholders and the public of any delay in reaching a decision and the impact on the market. The Chairman and several other directors voiced concern as to the effect of delay upon employee morale as well.

"Director Tubbs asked whether there were any issues which should be considered by the Board that had not been mentioned. The Chairman stated that he viewed employee morale and the impact on the Corporation of a nonconsummated transaction with Raider to be of great significance. He stated that the greatest risk of a transaction with Raider would be a collapse of employee morale and, if ultimately there were to be no transaction with

Raider, as he believed would be the case, the Corporation would have been seriously damaged without the shareholders having received the \$75 price.

"Director Jones stated that on financial grounds he felt the long range interest of the Corporation would be best served by rejecting the June 20 proposal. Additionally, he expressed deep concern about the conduct of Raider in making its proposal in that Raider had obtained 80 percent of the funds necessary for the acquisition from the Fifth National Bank which is the principal bank for the Corporation and which had confidential information about the Corporation and that Raider had just prior to making the proposal attempted to hire the former Chairman of the Corporation as a consultant. Director Jones stated that he was so troubled by the ethics of Raider that he believed that Raider was not a company with which the Corporation should negotiate or contract. Director Jones noted that the nonconsummation of the transaction with Raider would be harmful to the Corporation in that he believed that going forward with such transaction would have a serious adverse effect on suppliers, customers and others on whom the Corporation is dependent for both products and sales.

"The Chairman noted that, although some shareholders had been quoted in support of the proposal, the Corporation had also received a number of letters from shareholders who were opposed to an acquisition of the Corporation by Raider.

"Director Jones asked whether if there was a new offer by a company other than Raider, would the Board consider it. The Chairman stated that it was his opinion that any bona fide offer must be considered by the Board and that if any such offers were presented to him he would refer them to the Board. The Chairman further stated that while he believes that it is important to its business that the Corporation remain an independent entity, if a new offer was extremely attractive from a financial standpoint, came from a responsible company with good employee, customer, supplier and community relationships, and there was a relatively low risk of nonconsummation of the transaction, it would be his recommendation that such an offer be carefully considered. The Chairman expressed his belief that an offer from the right company under the right circumstances might be understood and accepted by the employees, suppliers and customers and accordingly, there could be circumstances where an acquisition would present only minimal risk of harm to the Corporation and its shareholders if such a transaction were not consummated.

"Director Tubbs stated that he felt that he had all of the information and opinions necessary for him to reach a conclusion and that it appeared to him that the other directors felt the same way.

"Director Tubbs moved that the June 20 proposal be rejected and this motion was seconded by Director Jones. The Chairman requested legal

counsel to state such resolution for consideration by the Board, which Mr. Freeman did. The Chairman asked whether there was any further discussion.

"The Chairman called for a vote and the following resolution was unanimously adopted by an individual poll of the directors:

"RESOLVED that based on the advice of the Corporation's management, legal counsel and investment bankers, the Board of Directors has determined that the proposal by Raider to acquire the Corporation for \$75 cash per share of common stock as set forth in Raider's letter to the Board of Directors, dated June 20, 1979, is not in the best interests of the Corporation and its shareholders and that the Chairman of the Board is authorized and directed to inform Raider that such proposal has been rejected by the Board of Directors.

"There being no further business the meeting was adjourned at 4:00 P.M."

Conclusion

The answers to the questions with which we started are:

- 1) Directors are not required to accept any takeover bid that represents a substantial premium over market.
- 2) When faced with a takeover bid the directors are not required to declare an open auction and sell the company to the highest bidder.
- 3) The directors should consider the impact of the takeover on employees, customers, suppliers, and the community. National policy is a proper consideration.
- 4) If the directors believe that a takeover is not in the best interests of the company as a business enterprise, there is no requirement that the takeover bid be submitted by the directors to the shareholders.
- 5) The directors may not ignore clear legal issues. The directors may litigate any issue which they reasonably believe to be pertinent.
- 6,7,8) A company may have a policy of remaining an independent business entity. The directors may implement that policy with shark-repellent charter amendments, standstill agreements, premium purchases from potential raiders, specially lobbied local takeover laws, and special provisions in employee benefit plans and material contracts.

- 9) While the management directors are not disqualified from participating in the decision to accept or reject a takeover bid, procedures should be followed that assure both the appearance and the actuality of a good faith decision on a reasonable basis.
- 10,11) The advice of an investment banker as to the financial issues and legal counsel as to the legal issues is desirable. Prior consultation with investment bankers and legal counsel who have experience with mergers and takeovers so that the company and its directors are adequately prepared to deal with a takeover bid, if one should happen, is also desirable.
- 12) The business judgment rule applies to takeovers in the same manner as it applies to other major business decisions.
- *) The fear of lawsuits should not deter directors from rejecting a takeover that they believe not to be desirable.

Defeated Tender Offers 1974 to June 1979*

<u>Target</u>	<u>Offering Company</u>
(a) Missouri Portland Cement Co.	Cargill, Inc.
ICM Realty	Cabot, Cabot & Forbes Land Trust
Towle Manufacturing Co.	Nortek, Inc.
Funding Systems Corp.	Equimark Corp.
(b) Latrobe Steel Co.	Eastmet Corp.
(c) Dictaphone Corp.	Northern Electric Co., Ltd.
RSC Industries, Inc.	Hoskins Manufacturing Co. (Armada Corp.)
(d) Sterndent Corp.	Magus Corp. (Cable Funding Corp.)
(e) Vail Associates, Inc.	Contran Corp.
(f) Inspiration Consolidated Copper	Anglo-American Corp. of S. Africa
(g) GSC Enterprises, Inc.	Sierra Capital Corp., Clyde Engle, Robert Weston
Boyertown Burial Casket Co.	Amedco, Inc.
National Paragon Corp.	R. T. French Co.
Craddock-Terry Shoe Corp.	Caressa, Inc.
Pargas, Inc.	Empire Gas Corp.
(h) Unitek Corp.	Airco, Inc.
Foremost McKesson Inc.	Sharon Steel Corp.
(i) Braden Industries, Inc.	Valley Industries, Inc.
(j) Sabine Royalty Corp.	Hamilton Brothers Corp.
Universal Leaf Tobacco Co., Inc.	Congoleum Corp.
Baird-Atomic	Xonics
Sonesta International Hotel Corp.	Loews Corp.
Sonesta International Hotel Corp.	Minneapolis Shareholders Group
Gerber Products Co.	Anderson, Clayton & Co.
(k) Detroit International Bridge	Wesco Financial Corp.
(l) Pabst Brewing Co.	APL Corp.
(m) Electro-Nite Co.	Yates Industries, Inc.
Property Trust of America	Federated Reinsurance Corporation
Marshall Field & Co.	Carter Hawley Hale Stores, Inc.
(n) Rowan Companies, Inc.	CBI Industries, Inc.
Mead Corp.	Occidental Petroleum Corp.
Wurlitzer Co.	Xcor International Inc.
McGraw-Hill Inc.	American Express Inc.
Ludlow Corporation	AMBG Corporation
(o) Chicago Rivet & Machine Co.	Mite Holdings Inc.
(p) Sunshine Mining Co.	Hunt International Resources Corp.
F. W. Woolworth Co.	Brascan Ltd.

*See p. 134 for footnotes to above exhibit

EXHIBIT A

Announcement	Market Price One Mo. Before Ann.	Market Price One Week Before Ann.	Offering Price	Premium	Market Price Aug. 10, 1979
12/19/73	\$18.40	\$17.80	\$19.20	1.348x	\$30.000(t)
2/4/74	14.87	16.87	13.50	0.800	11.375
2/20/74	7.00	7.25	11.50	1.586	28.250
3/15/74	2.62	2.62	3.00	1.145	2.500
6/7/74	6.25	6.25	11.00	1.760	14.280(t)
9/24/74	7.12	8.37	12.00	1.434	28.000(t)
12/19/74	1.00	0.87	2.00	2.299	3.125
2/13/75	8.75	9.25	14.00	1.514	21.625
4/28/75	5.75	6.62	10.00	1.511	11.250
5/28/75	34.25	31.75	32.00	1.008	33.000(t)
6/12/75	1.00	1.25	1.50	1.200	1.150(t)
12/22/75	10.50	10.50	16.00	1.524	11.500(q)
3/24/76	8.50	8.50	12.75	1.500	2.375
4/7/76	6.75	6.75	9.50	1.407	10.375
5/5/76	13.00	15.37	18.50	1.204	18.500
5/7/76	24.00	23.12	30.00	1.298	59.140(t)
5/17/76	15.50	16.62	27.00	1.625	24.000
6/29/76	5.12	4.75	7.25	1.526	7.000(r)
9/22/76	21.50	22.19	30.00	1.352	40.125(s)
10/8/76	12.13	11.94	16.25	1.362	23.125(s)
1/27/77	2.38	2.50	4.00	1.600	6.375
4/6/77	3.00	3.25	7.00	2.154	12.000
7/1/77	5.25	5.25	7.00	1.333	12.000
8/1/77	29.75	32.62	37.00	1.134	28.125
9/29/77	17.00	17.25	20.00	1.159	25.000(t)
10/20/77	25.25	24.25	40.00	1.649	12.875
12/14/77	7.75	7.75	10.00	1.290	14.250
1/19/78	5.12	4.75	6.00	1.263	6.188
2/1/78	32.75	29.62	42.00	1.418	17.875
7/3/78	17.75	22.37	24.50	1.095	27.875
8/11/78	21.50	23.25	35.00	1.505	26.750
9/25/78	11.75	18.50	22.00	1.189	8.875
1/9/79	24.12	24.37	34.00	1.395	26.625
2/9/79	12.37	13.12	19.00	1.448	16.125
2/12/79	22.00	28.62	31.00	1.083	20.375
2/14/79	11.12	12.87	15.00	1.166	14.375
4/9/79	22.00	23.25	35.00	1.505	25.875

FOOTNOTES:

- (a) Subsequently acquired by H. K. Porter Company through a \$26 per share tender offer in January 1976 and a merger in which each share of Missouri Portland received \$30 principal amount of 10% subordinated debentures. Missouri stock split 5-4 in January 1974.
- (b) Subsequently acquired by merger by LSC, Inc. (The Timken Company) in January 1975 at the rate of .48 shares of Timken per share of Latrobe, valued at \$14.28 per share.
- (c) Subsequently acquired by PB Holding Corp., a subsidiary of Pitney-Bowes Inc., in December 1978 at \$28 per share.
- (d) Cooper Laboratories Inc. obtained approximately 22% in November 1978 by open market purchases. Merger discussions are continuing concerning Cooper's \$28 offer for the rest of Sterndent's common. Cooper revised the offer in August 1979 from \$28 cash to \$3 cash and \$25 in 10% 20-year notes.
- (e) Goliad Oil and Gas Co. acquired 400,000 shares in September 1976 at \$14 per share.
- (f) Subsequently acquired by Hudson Bay Mining and Smelting, an indirect subsidiary of Anglo American, in July 1978 for \$33 per share.
- (g) Subsequently acquired by merger by 13 dissident shareholders including Engle and Weston in October 1977 at the rate of \$1.15 face value of 8½% capital notes per share.
- (h) Subsequently acquired by Bristol-Myers in November 1977 at the rate of 1.733 shares of Bristol-Myers for each share of Unitek, valued at \$59.14 per share.
- (i) Valley Industries obtained approximately 23% pursuant to its offer, increasing its holdings to 28%. Braden partially liquidated in January 1977 with a liquidating distribution of \$7.52.
- (j) Rejected a tender offer by Hamilton Brothers Petroleum Corp. for \$60 a share in September 1976. Sabine signed a letter of intent for a tax-free merger, but negotiations broke down on price.
- (k) Wesco obtained approximately 14.3% pursuant to its offer, increasing its holdings to 24.9%. Subsequently, Central Cartage Co. and Fallbridge Holdings Ltd. acquired approximately 49.5% in open market purchases and offered \$25 per share for the remainder. The offer is currently enjoined.
- (l) Price represents principal amount of 10% debenture offered in exchange for each Pabst share.
- (m) Yates obtained approximately 8.1% pursuant to its offer, increasing its holdings to 20.8%.
- (n) Schlumberger acquired approximately 18% in October 1978 by open market purchases.
- (o) Mite Corporation had agreed to make a tender offer for \$31 a share in February 1979, but withdrew the offer in March 1979.
- (p) Hunt International Resources Corp. had owned 28% since October 1977. Sunshine Mining Co. repurchased these shares in June 1979 subsequent to an unsuccessful takeover bid in March 1979.
- (q) Last bid recorded on May 23, 1979.
- (r) Last bid recorded on March 13, 1979.
- (s) Offer price and market prices prior to offer reflect two-for-one stock split.
- (t) Represents value of final tender offer or merger.

January 4, 1979

Memorandum with respect to Treatment by
a Target Company of a Takeover Proposal

The following outlines the legal and practical considerations in the case of a takeover proposal or attempt:

1. There is no legal requirement that a target discuss acquisition or engage in acquisition negotiations with anyone who proposes such discussions or negotiations. There is no duty to negotiate even when a prospective acquiror indicates that it would offer a large premium if the target would agree to an acquisition.

2. The target should not permit the raider to misperceive the target's intentions. Many takeover attempts are attributable to the failure of the target to reject firmly and unequivocally the first approach. The target's equivocation misleads the raider into believing that it has a chance for a negotiated acquisition. The raider then invests time and effort in studying and developing a proposal and the management of the raider commits its prestige to accomplishing the acquisition. When the target does finally reject, the raider loses sight of the problems of a takeover attempt and proceeds with a tender offer where, if there had been an early clear-cut rejection, the raider would have abandoned the effort.

3. There is no requirement for public announcement by a target of rejected approaches requesting acquisition discussions. (However, there should be no insider trading at times when the insiders know that acquisition approaches are being made and rejected.)

4. If a raider makes a specific firm acquisition proposal, it should be considered by the target's board of directors and, except under special circumstances, such proposal should be announced publicly.

5. The target's board of directors has no duty to accept an acquisition proposal or to take a position on a takeover attempt. There is no case that has held the directors of a target liable for the rejection of an acquisition proposal or the defeat of a takeover attempt.

6. When considering an acquisition proposal or takeover attempt, the directors of a target must act in good faith and on a reasonable basis. The target's management and/or investment banker should put together the financial and business information (including management's five-year

projections and management's valuation of the target's assets on the basis of what they could be sold for) appropriate for consideration by the target's board of the adequacy of the price proposed by the raider.

7. It is reasonable for the directors of a target to reject an acquisition proposal or to seek to defeat a takeover attempt on any one of three bases:

(a) the price is inadequate in that it does not reflect the value of the target if the target were to determine to seek to be acquired or to liquidate, or

(b) the belief that the timing is wrong and that a better deal could be obtained in the future, if then desired, or

(c) illegality, e.g., the acquisition would violate the antitrust or other laws or the takeover attempt violates the disclosure or other provisions of the federal securities or other laws.

Even if the price is adequate or unusually high and there is no determination that the timing is wrong, the target has an absolute right to reject an offer or seek to defeat a takeover attempt if the acquisition would violate the antitrust or other laws.

8. In addition to the above bases for rejection of an acquisition proposal, it is reasonable for the directors of a target to refuse to consider an acquisition proposal that is uncertain or conditioned in an unusual manner or that is for less than all of the outstanding shares of the target.

9. While there is no legal requirement that the directors of a target obtain the advice of an investment banker or legal counsel, reliance by the directors of a target on the advice of an independent investment banker and independent legal counsel has been held, in a number of cases, to establish the requisite good faith and reasonable basis for rejection of an acquisition proposal or action to defeat a takeover attempt. With respect to rejection on the basis of illegality, except in a very clear case, the opinion of counsel should be obtained.

Attached is an excerpt from Lipton & Steinberger, Takeovers and Freezeouts, which discusses and cites some of the case law on which this memorandum is predicated.

Martin Lipton

6.3. Responding to pre-offer takeover attempts.

6.3.1. **Friendly approach.** As long as it is acting in good faith, the management and board of directors of a target have no legal duty to engage in discussions or to negotiate with respect to the sale of the target, but management should advise the board of directors of any approaches. See *Berman v. Gerber Products Co.*, *supra*. Friendly discussions are frequently misunderstood by the potential raider, and the termination of such discussions often results in a hostile offer. Such discussions should therefore be avoided and, assuming such is the fact, management should be authorized to inform any prospective raider that the target is not for sale and there is no interest in discussing the subject. Advance preparation of the board of directors and management in this regard is highly desirable. See generally *Management's Responsibility*, *supra*.

6.3.2. **Bear-hug approaches.** Although management has a duty to bring firm proposals to the board, and the board has the duty to consider carefully such proposals, there is no legal duty to sell the target. The response to a proposal can vary depending on the particular circumstances, and may range from outright rejection to discussions and/or negotiations. *Northwest Industries, Inc. v. B.F. Goodrich Co.*, *supra* at 712 ("management has responsibility to *oppose* offers which, in its best judgment, are detrimental to the company or its stockholders"); *Selama-Dindings Plantations, Ltd. v. Durham*, 216 F. Supp. 104 (S.D. Ohio 1963), *aff'd*, 337 F.2d 949 (6th Cir. 1964) (depending upon circumstances, directors have duty to investigate potential raider and to advise shareholders); *Berman v. Gerber Products Co.*, *supra* at 93,958 (target has affirmative duty not to refrain from bringing action to enjoin tender offer on antitrust and securities law disclosure grounds even though target's investment banker has advised that offer price is substantial). See also *Cummings v. United Artists Theatre Circuit, Inc.* 237 Md. 1, 204 A.2d 795 (Md. Ct. App. 1964). The board of directors should prevent an acquisition by those who it may have reason to know would loot or mismanage the assets of the target. *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940). In a decision upholding

an acquisition by a target to defeat a takeover, a federal district court in Illinois said

[M]anagement has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or to its stockholders. In arriving at such a judgment, management should be scrupulously fair . . . [and their] informed opinion should result from that strict impartiality which is required by their fiduciary duties. After taking these steps, the company may then take any step not forbidden by law to counter the attempted capture. *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712-13 (N.D. Ill. 1969)

Careful preparation of the board for consideration of a takeover offer is necessary; frequently it is desirable to have an investment banker's opinion as to the adequacy of the offer. See *Kaplan v. Goldsamt, supra*, at 6.2.8.2, to the effect that the courts will not second guess a good faith decision by the board as to value. If the board's decision is made in good faith and is reasonably based on the facts presented, there is no liability for rejection of a takeover offer. *Danziger v. Kennecott Copper Corp., supra*, although involving the converse situation—the propriety of directors authorizing a tender offer—demonstrates the value of an independent investment banker's opinion in a tender offer situation. *Danziger* involved an attempt by Kennecott shareholders to enjoin preliminarily the Kennecott tender offer for Carborundum. The essence of the shareholders' claims was that the Kennecott directors, in reaching a quick decision to offer for Carborundum at an aggregate price of nearly \$600,000,000 (a price far in excess of Carborundum's book value and historical market price), “failed to thoroughly investigate the relevant factors and consider the best interests of Kennecott. . . . In the few days available to the [directors] to study the matter, they cannot possibly have given the type of detailed attention and study to such an important acquisition that the law requires.” In response, the court stated:

Kennecott's opposing papers include an extensive and detailed report on the proposed purchase. This analytical report was prepared by the First Boston Corporation, an independent financial adviser, at the request of Kennecott's

board of directors. First Boston recommended the purchase. Thus, it is clear that Kennecott did thoroughly investigate the relevant factors and considered its own interests before deciding to make the tender offer. Kennecott explains that the \$66 per share price was calculated to outbid another offeror which had previously made an offer of over \$60 per share. . . .

[The New York Business Corporation Law] imposes a duty on corporate directors to discharge their duties "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." On the papers submitted, there is no showing that Kennecott's directors departed from this high standard in reaching their decision to offer to purchase Carborundum shares. It appears that the directors were thorough in their deliberations despite the relatively short period of time available for the decision-making process.

But see *Royal Industries, Inc. v. Monogram Industries, Inc.*, *supra*, in which the Court found that a target's press release, which stated that the target was "guided" in its decision to reject the offer by an investment banker's report, was misleading because it failed to state that the investment banker had prepared such report "virtually overnight and without the necessary time and deliberation for fair evaluation" and because, in any event, the board's decision to oppose was not "guided" by the investment banker's report but rather by the self interest of the target's management and directors. To avoid the *Royal Industries* problem, it is desirable that the company's investment banker keep up to date on the company so that it can render a considered opinion on short notice if the need arises. See 6.1.2(c). But see *Elfenbein v. Braunschweiler*, Bench Opinion, 75 Civ. 2202 (S.D.N.Y. June 2, 1978) and discussion at 8.4.2.

6.3.3. Responding to accumulations through open-market and other purchases. Pre-offer accumulations have the purposes, among others, of recouping the raider's expenses in the event the raider is topped by a competing offeror, and, if such purchases are sufficiently large, of discouraging other suitors of the target. In addition, in certain cases open-market and other accumulations

have resulted in an actual shift in control of the target or have given the raider additional leverage with the target. Typical litigation attacks the raider's disclosure of "investment" intent, raises the usual antitrust and margin claims and alleges a "creeping tender offer." See 1.5.2 and 2.3.1.7.

6.3.4. Public announcement of the raider's approach. The question of whether the target must make a public announcement of the raider's approach depends upon various factors. If the proposal has meaningful conditions or is otherwise "iffy", a strong argument can be made that no disclosure by the target is required. If, however, the proposal does not have meaningful conditions and specifies a price, it would appear that disclosure is required. In any event, target and insider trading is prohibited pending announcement or resolution of the question whether there will be a "real" offer. No announcement need be made of invitations to negotiate. In *Berman v. Gerber Products Co.*, *supra*, the court said that overtures that are not firm offers are not material information that is required to be disclosed under Section 14(e). See discussion of announcement of specific offers at 6.4.1.

For a general discussion of disclosure obligations by public companies, see *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971); and *SEC v. Geon Industries, Inc.*, *supra* (condemning selective disclosure of preliminary negotiations relating to potential merger of Geon but expressly noting that the holding did not mean that public disclosure of preliminary negotiations is either necessary or appropriate); see also Freund, *Selected Acquisition Problems under Rules 10b-5 and 10b-6 and under Section 16(b)*, in Mundheim, Fleischer & Vandegrift, ed., *Eighth Annual Institute on Securities Regulation* (1977). The NYSE Company Manual and Amex Company Guide each contain guidelines with respect to disclosure obligations of listed companies, see discussions at 4.1.1 and 4.2.1, respectively.

6.3.5. Considerations in responding to takeover attempts. The Williams Act does not compel the board of directors of a target to take a position with respect to an offer. *Berman v. Gerber Products Co.*, *supra*. Under state law the management of a target company must act in accordance with what it reasonably believes

to be the best interests of the target's shareholders. The decision is essentially an economic and financial one and the board of the target must act in an objective manner toward that end. The recommendation of a course of conduct by truly independent outside advisors, *e.g.*, investment bankers and/or independent directors, is most helpful in sustaining target company decisions (see 6.3.2). Among the factors to be considered in responding to a takeover attempt are:

(a) the adequacy of the offering price given the present value and future earnings prospects of the target;

(b) the nature of the consideration offered by the raider, *e.g.*, cash or securities (and the value and prospects of such securities);

(c) whether the raider is seeking all of the target's stock or only a portion, and if it is a partial offer, what the effect will be on remaining shareholders (*e.g.*, market liquidity and price; effect on relationships with customers and suppliers and, consequently, on target's business; future prospects of a "freezeout"), see 6.5.2.5;

(d) whether this is the right time to sell the target (a reasonable good faith decision as to timing is a sufficient basis in and of itself on which to reject a takeover offer);

(e) the availability of other alternatives (See 8.4.2 with respect to the factors to be taken into account by the investment banker advising the board, all of which are appropriate for the board to independently consider); and

(f) the legality of the takeover offer (in *Berman v. Gerber Products Co.*, *supra*, the court held that the target had an absolute right to litigate the takeover offer which the board of the target in good faith believed to violate the securities and antitrust laws).

Management may wish to delay the raider's tender offer in order to gain time to negotiate a defensive merger or White Knight tender offer. See *Commonwealth Oil Refining Co. v. Tesoro Petroleum Corp.*, *supra*, and *Jewelcor, Inc. v. Pearlman*, *supra*. However, it should be noted that *Grossman, Faber & Miller P.A. v. Cable Funding Corp.*, CCH Fed. Sec. L. Rep. ¶ 94,913 (D. Del. 1974), a pre-*Green* decision, held that if target company management engages in a campaign to defeat one tender offer and insure the success of a competing tender offer for personal reasons, rather than in the best interests of the target and its shareholders, such conduct

might be deemed a scheme to defraud within Rule 10b-5 as well as a breach of common law fiduciary duty. See also *Klaus v. Hi-Shear Corp.*, *supra*; and *Del Noce v. Delyar Corp.*, CCH Fed. Sec. L. Rep. ¶ 95,670 (S.D.N.Y. 1976). With respect to disclosures of the target in connection with an attempt to defeat competing tender offers, see *SEC v. Thermal Power Co.*, *supra*. Among other things, the complaint in *Thermal Power* sets forth the proposition that where management recommends one offer over a competing offer, failure to disclose advantages flowing to members of management by virtue thereof is a violation of Rule 10b-5 and Section 14(e). Specifically, the SEC alleged a failure to disclose that the president of the target had reached an agreement with the "favored" offeror to retain his position following the recommended exchange offer and that the target's directors who recommended a tax-free exchange offer over competing cash tender offers had a low tax basis in their stock as compared to the tax basis of the target's public shareholders.

6.3.6. "Rule of reason." In *Monogram Industries, Inc. v. Royal Industries, Inc.*, Civ. No. 76 3356-R (C.D. Cal. Nov. 17, 1976 and Dec. 13, 1976), the court held that improperly motivated defensive maneuvers may be preliminarily enjoined as violations of Section 14(e) and/or breaches of fiduciary duty. This decision was presaged by such cases as *Anaconda Co. v. Crane Co.*, *supra*; *Grossman, Faber & Miller P.A. v. Cable Funding Corp.*, *supra*; and *Condec Corp. v. Lunkenheimer*, *supra*. Note, however, that the Section 14(e) basis is questionable in light of *Green*.

In *Monogram*, the court preliminarily enjoined Royal from:

- (a) holding a meeting of stockholders to vote on proposed amendments to Royal's charter to increase to 90% the percentage stockholder vote required to effect a business combination with the holder of 30% or more of Royal's stock;
- (b) acquiring another corporation which had an anti-trust action pending against Monogram and which Royal alleged to be a competitor of Monogram;
- (c) making any payments under the acceleration features of Royal's deferred compensation plans, which plans

had been adopted several years prior to the Monogram tender offer and provided for immediate payment of substantial sums if an offeror acquired more than 25% of Royal's stock in a transaction not approved by a majority of Royal's board of directors;

(d) prosecuting Royal's most recently commenced lawsuit against Monogram in the Delaware Court of Chancery, which suit was one of a total of nine initiated by Royal in the six and one half weeks since Monogram announced its intention to make the offer; and

(e) commencing or financing any additional litigation related to Monogram's tender offer, other than in the United States District Court for the Central District of California where most of the tender offer litigation was being conducted.

The court, finding that the proposed charter amendment, the proposed acquisition and the acceleration features of the deferred compensation plans all had as their "sole, primary, controlling, principal and compelling purpose" the blocking of tender offers and the maintenance of Royal's officers and directors in their positions, stated that the proposed charter amendment and acquisition raised "serious questions" as to violations of Section 14(e) and breach of fiduciary duty, and the acceleration provisions constituted a breach of fiduciary duty. The court held that Royal, by commencing the litigation in Delaware to avoid prosecution of a related suit in the Central District of California (see *Royal Industries, Inc. v. Monogram Industries, Inc.*, *supra*) and to promote vexatious litigation, had violated Section 14(e), and that further litigation relating to the offer, other than in the Central District of California, would be vexatious and unnecessarily costly.

In determining a defensive strategy, it must be remembered that, in certain circumstances, more may turn out to be less.

January 28, 1981

To Our Clients

Response to Takeover Bids

Attached is the edited version of the update of my article on "Response to Takeover Bids" as it will appear in the April issue of The Business Lawyer.

M. Lipton

1/23/81

TAKEOVER BIDS IN THE TARGET'S
BOARDROOM; AN UPDATE AFTER ONE YEAR

By Martin Lipton*

Last year, in Takeover Bids in the Target's Board-
room,¹ this author argued that

(1) the business judgment rule applies to the consideration by the board of directors of a target of an unsolicited takeover bid,²

(2) there is no requirement that the board of directors of a target submit to the shareholders any unsolicited takeover bid; on the contrary a company can have an express policy of continuing as an independent entity,³

(3) once the board of directors has in good faith and on a reasonable basis determined to reject a takeover bid, the target may take any reasonable action to accomplish this purpose,⁴

(4) there is no real difference between the business judgment rule and the primary purpose test (the test courts often say is violated when they determine that a defensive action was improper because it was

for the primary purpose of keeping management in office) as applied to the rejection of, or defending against, a takeover bid -- "where the primary purpose test has been applied, the cases really turned on the courts' belief that the directors had not acted in good faith or on a reasonable basis," rather than a philosophical distinction between the two standards.⁵

A year ago there was little direct judicial authority to support these positions. During the past year several significant decisions have been rendered which provide that support. Additionally, several commentators have aligned themselves with the positions taken in Takeover Bids.

I. Judicial Developments.

In Panter v. Marshall Field & Co.,⁶ a stockholder action attacking the rejection of a takeover proposal and the defensive measures (i.e., lawsuit and acquisition program) taken by the board of directors to foreclose the takeover, the court held that the business judgment rule governs the consideration of a takeover bid by the board of directors of a target. The court said:

Directors of a publicly owned corporation do not act outside of the law when they, in good faith, decide that it is in the best interest of the company and its shareholders that it remain an independent business entity. Having

so determined, they can authorize management to oppose offers which, in their best judgment are detrimental to the company and its shareholders. 7/

The court agreed with the view set forth in Takeover Bids that where directors reach their decision to reject a takeover bid after full consideration of all of the interests affected by the proposal and after receiving antitrust and securities law advice from outside counsel, they can not be held to have breached their fiduciary duties. The court also applied the business judgment rule in evaluating the propriety of acquisitions by the target which were alleged to have been made for the purpose of creating an antitrust impediment to the takeover:

As to the acquisitions which defendants authorized [target] management to make . . . each was consummated after defendants considered business projections by management[,], received the advice of lawyers and experts, and consulted with accountants and investment bankers. Despite a great deal of straining with financial data, reports and statistics, plaintiffs have not produced evidence which could prove that any of these acquisitions were unsound business ventures. 8/

In Johnson v. Trueblood,⁹ plaintiffs owning 47 percent of the outstanding shares of a financially-troubled closely-held corporation alleged that defendants, owners of the remaining 53 percent interest, in order to retain control of the corporation breached their fiduciary duty by refusing

plaintiffs' offers to make loans and to purchase additional stock and instead caused the corporation to enter into transactions which were less advantageous to the corporation, but which retained the defendants' control. The district court had instructed the jury that the business judgment rule protects a director's decision involving retention of control so long as other rational business reasons supported the decision and that the rule is rebutted only by a showing that the director's sole or primary purpose was to retain control. The plaintiffs appealed, arguing that they only needed to prove that control was a motive in the director's decision in order to rebut the business judgment rule. The Third Circuit held that under Delaware law the business judgment rule applied and that plaintiff

at a minimum . . . must make a showing that the sole or primary motive of the defendant [director] was to retain control. If he [plaintiff] makes [such] a showing . . . , the burden then shifts to the defendant [director] to show that the transaction in question had a valid corporate business purpose. 10/

The Third Circuit said that to permit the business judgment rule to be overcome by a mere showing that control was a purpose of a challenged action would, in effect, destroy the rule since, realistically, corporate directors are always motivated at least in part by the desire to retain office, even when acting on business questions which do not have a

direct impact on control. The Third Circuit also said that the business judgment rule validates actions "arguably taken for the benefit of the corporation" despite the desire to retain office by the directors who authorized those actions.¹¹

In the latter part of 1980, the Second Circuit decided two cases which also support the positions taken in Takeover Bids.

In Treadway Companies, Inc. v. Care Corporation,¹² Treadway had sold a large block of its common stock to Fair Lanes, Inc., selected as a white knight to rescue Treadway from a threatened takeover by Care. The sale was made to facilitate a proposed Treadway-Fair Lanes merger and to defeat the attempt by Care (owner of one-third of the Treadway stock) to take control of Treadway's board of directors at the upcoming annual meeting. The district court had enjoined the voting of Fair Lanes' Treadway shares on the ground that Treadway's primary motivation in consummating the sale was to protect its incumbent management against Care's takeover effort. The Second Circuit reversed, ruling that Care had not established any basis under New Jersey law (construed in light of general corporation law, including the law of Delaware), for overturning the business judgment of the Treadway directors.

The Second Circuit stated that the business judgment rule, "which presumes that directors have acted properly,"¹³ applies both to the determination that a threatened takeover would be detrimental to the target and to the choice of particular defensive measures, including the issuance and sale of stock, to oppose such a detrimental takeover. Thus, a party challenging a defensive transaction has the burden of proving that the directors of the target "acted in bad faith, or in furtherance of their own interests, or for some other improper purpose."¹⁴ Even if that party carries its burden, the directors' action is still protected if they show that they approved the challenged transactions for "a proper corporate purpose and not merely for the directors' selfish purposes."¹⁵ The directors need not also prove that the actual terms of the transactions were fair. The Second Circuit further made clear that the substance of the directors' deliberations will not be scrutinized once it is apparent that business judgment was in fact exercised.

Since the conduct of the Treadway directors which was complained of would have led to a change of control of Treadway and, consequently, to the severance of the directors' controlling relationship with Treadway, the Second Circuit decision left open the question whether the same reasoning would be applied where the transactions were for the purpose

of keeping a target an independent company, with the management and directors of the target continuing in office. This question was answered in Crouse-Hinds Co. v. InterNorth Inc.,¹⁶ with the Second Circuit holding that the mere fact that the directors of a target will retain control by authorizing a transaction (an exchange offer to assure consummation of a defensive acquisition) to defeat a takeover bid does not remove the protection of the business judgment rule or shift the burden of proof to the directors. The district court in Crouse-Hinds had read Treadway as holding that where the directors of a target would retain office as the result of a defensive action to defeat a takeover the burden of proof shifted to the directors. The Second Circuit rejected the district court's interpretation of Treadway:

We find no basis in the present case for the district court's conclusion that InterNorth carried its burden of demonstrating self-interest or bad faith on the part of the Crouse-Hinds directors. As his starting point, the district judge gave his consideration to the decision in Treadway, in which we found that because the Treadway directors, other than the chairman, were not to remain in office after the merger, perpetuation of their control could hardly have been their motivation for actions in furtherance of the merger . . . Unfortunately, the district judge inferred from this that a quite different proposition must also be true -- i.e., that if the directors are to remain on the board after the merger, perpetuation of their control must be presumed to be their motivation. This inference has no basis in either law or logic. Treadway did not disturb the normal

requirement that a complaining shareholder present evidence of the directors' interest in order to shift the burden of proof to them.

In short, when the tender offeror has presented the target company with an obvious reason [e.g., inadequacy of price, possible illegality or interference with an existing contract] to oppose the tender offer, the offeror cannot, on the theory that the target's management opposes the offer for some other, unstated, improper purpose, obtain an injunction against the opposition without presenting strong evidence to support its theory. We find no such evidence here. 17/

With respect to the speed with which the Crouse-Hinds board of directors reached its decision to oppose the InterNorth tender offer, the Second Circuit said:

The fact that the initial decision to oppose the [t]ender [o]ffer was made in four days does not prove that either that decision or the subsequent [defensive transaction] stemmed from a control motivation. Such decisions are required to be made promptly . . . and are normally made quickly; and the district court recognized that this decision was not made without Crouse-Hind's having consulted its expert advisers in an effort to be objective. We note further that the [defensive transaction], which is of course the precise target of the counterclaims, was not entered into until eleven days after announcement of the [t]ender [o]ffer. 18/

The Second Circuit decisions in Treadway and Crouse-Hinds were adumbrated in its earlier decision in Rodman v. Grant Foundation,¹⁹ in which the Second Circuit indicated that a strong showing of an "entrenchment of management motivation" would be necessary to overcome the normal judicial reluctance to second-guess the business decisions of a board of directors. In Rodman, the plaintiffs alleged that proxy material soliciting stockholder approval of purchases by the company of large amounts of its own stock failed to disclose that "'the principal, if not the sole reason . . .'" for the repurchases was to entrench management's control of the company.²⁰ In affirming the district court's finding that full disclosure of the repurchases had been made, the Second Circuit said that "the effect of the stock purchases on company control was self-evident from the very size of the transaction, involving as it did over ten percent of the outstanding common stock."²¹ The Second Circuit agreed with the lower court's holding that "corporate control is recognized to be of universal interest to corporate officers . . .," and concluded that "[i]n the absence of some ulterior wrongful design hinging upon so-called 'entrenchment', the directors were not required to put forth in the proxy materials an analysis of their otherwise obvious interest in company control."²²

In addition, in Lewis v. McGraw,²³ the Second Circuit held that shareholders may not maintain a cause of action for damages under section 14(e) of the Williams Act where a proposed tender offer is defeated and never in fact made. The court explained:

[O]ne element of a cause of action under § 14(e) is a showing "that there was misrepresentation upon which the target corporation shareholders relied." Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973) (emphasis supplied). In the instant case, the target's shareholders simply could not have relied upon McGraw-Hill's statements, whether true or false, since they were never given an opportunity to tender their shares. 24/

II. Commentators' Views.

In the 1980 edition to A. Fleischer, Jr., Tender Offers: Defenses, Responses, and Planning,²⁵ the author agrees with the rationalization of the business judgment rule and primary purpose test put forward in Takeover Bids and states:

In a few cases, the courts have applied both the primary purpose test and the business judgment rule without discussing how the two differ, if at all. These cases should not be dismissed as aberrational, for although the primary purpose test is stricter sounding than the business judgment rule, it may well be that there is no real distinction between the two. All courts, no matter which test they apply, seem to review the entire environment of the transaction, and ask the same questions. Why did the directors act? What factors did they take into account? How

carefully did they exercise their business judgment? Moreover, it is hard to see how these questions could be answered in such a way as to lead to liability under one test and not the other. Where the facts show that the primary purpose of a board in opposing an offer is to perpetuate itself in power, it would be inconsistent for a court to find that they had acted in "good faith" and had exercised "reasonable business judgment." Conversely, most courts seem to decide whether the primary purpose of the board was to achieve a corporate goal, or to maintain itself in power, by examining the alleged business reason for the action taken by the board. Only if the justification is implausible will the court hold that the board's primary purpose was improper. In short, it seems that both the business judgment rule and the primary purpose test essentially demand no more than that directors act, in good faith and with due care, like reasonable businessmen.

A number of other commentators have also supported the positions set forth in Takeover Bids. Shortly after Takeover Bids was published, Securities and Exchange Commission Chairman Harold Williams noted his agreement, but also argued that the decision with respect to a takeover bid should be made by a committee of independent directors of the target:

It is my view that a court -- in reviewing such a well-monitored, fully-considered and documented special committee [of independent directors] determination to reject and resist an acquisition or tender offer bid -- should and would give substantial deference to that decision and to any legal and ethical acts to resist the bid which are reasonably commensurate to the existing threat to the corporation's and its shareholders' interests, provided that the acts themselves are not inconsistent with the corporation's viability. 26/

The difference between Chairman Williams' position and the position taken in Takeover Bids is that Chairman Williams would have a special committee of independent directors in every case, while Takeover Bids argues that such a committee should be resorted to only in the rare case where there is a very significant conflict of interest involving a majority of the directors of the target. Thus, Takeover Bids recommends:

If a majority of the directors are officers or otherwise might be deemed to be personally interested, other than as shareholders, a committee of independent directors, although not in theory necessary, from a litigation strategy standpoint may be desirable. The exigencies and pressures of a takeover battle are such that it is desirable to avoid proliferation of committees, counsel and investment bankers. The target will be best served if it is advised by one investment banker and one outside law firm. 27/

Chairman Williams also endorsed the position taken in Takeover Bids that in reviewing a takeover the directors of a target may properly consider the adverse impact of the takeover on employees, suppliers, customers, the public and the national economy.²⁸

While some commentators argue for stricter standards,²⁹ it may be assumed that the weight of authority will be in accord with Treadway and Crouse-Hinds, which is exactly where it should be.³⁰ As noted in Takeover Bids, the history of takeover decisions is no different than the

history of new product decisions.³¹ There are both Edsels and Xeroxes. It would be as impractical for the courts to second-guess takeover decisions as it would be to second-guess new product decisions.

Takeover Bids analyzed the 36 unsolicited tender offers that were rejected and defeated by the target between the end of 1973 and June 1979 and showed that in more than 50% of the cases as of August 1979 the shareholders were better off than if the tender offer had been successful. At the end of November 1980 this was true in an even higher percentage of the defeated tender offers. In addition to the examples provided by defeated tender offers, there are numerous examples of other situations where the shareholders of a target have benefitted from the target's decision to reject or avoid a takeover:

- In January 1977, Viacom rejected a \$20 takeover bid, reflecting a premium of 95 percent over the then market price of \$10.25, by Storer Broadcasting; at the end of November 1980, Viacom was at \$57.25.

- In October 1978, Freeport Minerals purchased for \$14.00, reflecting a premium of 19 percent over the then market price of \$11.78, about 10% of its

shares from Denison Mines, which had accumulated the shares through market purchases; at the end of November 1980, Freeport Minerals was at \$61.25.

- In June 1978, Bache purchased for \$10.50, reflecting a premium of 26 percent over the then market price of \$8.13, about 7.5 percent of its shares from certain private investors, who had accumulated the shares through market purchases; at the end of November 1980, Bache was at \$23.63.

- In January 1979, Bunker-Ramo entered into a standstill agreement whereby Fairchild Industries purchased from Martin Marietta 20.6 percent of Bunker-Ramo's shares at \$23.50, reflecting a premium of 32 percent over the then market price of \$17.88; at the end of November 1980, Bunker-Ramo was at \$39.

- In April 1978, ASARCO entered into a standstill agreement whereby Bendix purchased from ASARCO 14.2 percent of its shares at \$23, reflecting a premium of 22 percent over the then market price of \$18.88; at the end of November 1980, ASARCO was at \$48.³²

Since it received so much attention, the American Express offer for McGraw-Hill is worthy of special note. Many arbitrageurs and professional investors felt that the \$40 per share offer, reflecting a 50 percent premium over the pre-offer market price of \$26, mandated acceptance. While the decision of the McGraw-Hill directors to reject the offer was publicly criticized by those investors and attacked in several shareholder lawsuits, within less than two years the directors' decision was completely vindicated with the shares selling in the market for more than the \$40 offer price. When taxes and current control premiums are considered, the benefit of the directors' decision to the McGraw-Hill shareholders becomes even more dramatic. Thus, the McGraw-Hill case, which when the bid was made was argued by some to be the one which would establish that a target's board did not have discretion to reject a takeover bid, has become cogent evidence of the validity of the premises of Takeover Bids, not just in court but also in the marketplace.³³

III. Procedure to be Followed by the Board of Directors.

The cases decided during the past year emphasize the point made in Takeover Bids as to the importance of the procedure to be followed by the board of directors of a target in considering a takeover bid. The new tender offer

rules adopted by the SEC in November 1979 also highlight this point through the rules' requirement that a target's board consider and respond to a tender offer³⁴ and that the target disclose the reasons for the board's decision. Thus, what was said in Takeover Bids warrants repetition:

A) Management (usually with the help of investment bankers and outside legal counsel) should make a full presentation of all of the factors relevant to the consideration by the directors of the takeover bid, including:

- (1) historical financial results and present financial condition
- (2) projections for the next two to five years and the ability to fund related capital expenditures
- (3) business plans, status of research and development and new product prospects
- (4) market or replacement value of the assets
- (5) management depth and succession
- (6) can a better price be obtained now
- (7) timing of a sale; can a better price be obtained later
- (8) stock market information such as historical and comparative price earnings ratios, historical market prices and relationship to the overall market, and comparative premiums for sale of control
- (9) impact on employees, customers, suppliers and others that have a relationship with the target

- (10) any antitrust and other legal and regulatory issues that are raised by the offer
 - (11) an analysis of the raider and its management and in the case of a partial offer or an exchange offer pro forma financial statements and a comparative qualitative analysis of the business and securities of both companies.
- B) An independent investment banker or other expert should opine as to the adequacy of the price offered and management's presentation.
- C) Outside legal counsel should opine as to the antitrust and other legal and regulatory issues in the takeover and as to whether the directors have received adequate information on which to base a reasonable decision.
- D) If a majority of the directors are officers or otherwise might be deemed to be personally interested, other than as shareholders, a committee of independent directors, although not in theory necessary, from a litigation strategy standpoint may be desirable. The exigencies and pressures of a takeover battle are such that it is desirable to avoid proliferation of committees, counsel and investment bankers. The target will be best served if it is advised by one investment banker and one outside law firm.
- E) It is reasonable for the directors of a target to reject a takeover on any one of the following grounds:
- (1) inadequate price
 - (2) wrong time to sell
 - (3) illegality
 - (4) adverse impact on constituencies other than the shareholders

- (5) risk of nonconsummation
- (6) failure to provide equally for all shareholders
- (7) doubt as to quality of the raider's securities in an exchange offer.

Once the directors have properly determined that a takeover should be rejected they may take any reasonable action to accomplish this purpose, including litigation, complaints to governmental authorities, the acquisition of a company to create an antitrust or regulatory problem for the raider, the issuance of shares to a big brother, or the premium purchase of shares of the target from the raider. 35/

Footnotes

* Member of the New York Bar. Mr. Lipton's associate, Ilan Reich, assisted in the preparation of this article. Mr. Lipton has participated in several of the matters mentioned in this article.

1. Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979) [hereinafter "Takeover Bids"].

2. Id. at 131.

3. Id. at 130.

4. Id. at 123.

5. Id. at 124.

6. 486 F. Supp. 1168 (N.D. Ill. 1980), appeal docketed, No. 80-1375 (7th Cir. March 21, 1980).

7. Id. at 1186. In an amicus brief submitted to the Seventh Circuit on the appeal of the Marshall Field case, the SEC has taken the position that, if the management of a company adopts a policy that it will resist "any and all" takeover efforts because the management believes that the company should remain independent, then such policy would be a material disclosure item. While it is not clear whether the SEC position would require disclosure only in the face of a proposed tender offer, as in the Marshall Field case, or generally even in

the absence of a tender offer or takeover proposal, as a practical matter the literal SEC position is not very meaningful in that very few companies would decide to reject "any and all" tender offers no matter what the price and no matter what the circumstances of the company. Most companies follow a general policy of preferring to remain independent. This is a valid and legal policy. It does not in any way negate the good faith of the board of directors. As set forth in Takeover Bids, absent such a policy companies would constantly be in play; boards of directors would spend an inordinate amount of time considering takeover or liquidation proposals; they would have serious employee, customer, supplier and community relations problems; and long-range planning would be very difficult. Takeover Bids, supra n.1, at 109-10. It is a reasonable business judgment for the management and board of directors of a company to take the position that the company wishes to remain independent and will not pursue takeover or liquidation proposals. This position does not require special disclosure. However, if a company adopts a policy to resist "any and all" takeovers no matter what the price and no matter what the circumstances, then special disclosure may be required. In addition, in order for such a position to meet the business judgment rule it would be necessary for the board of directors to have reached that position on a justi-

liable basis, i.e., the good-faith belief that the business of the company would be affected adversely in the absence of such a position. Where a business is heavily dependent on maintaining stable relations with employees, customers, suppliers or others, such a good-faith belief might possibly be demonstrated. Each such situation must be approached on a case-by-case basis.

8. 486 F. Supp. at 1194.

9. 629 F.2d 287 (3d Cir. 1980), vacated on other grounds, 629 F.2d 302 (3d Cir. 1980) (per curiam).

10. Id. at 293.

11. Id. at 292.

12. [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,603 (2d Cir. 1980), rehearing denied, [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,705 (2d Cir. 1980) [hereinafter "Treadway"].

13. Id. at 98,210.

14. Id.

15. Id. at 98,211.

16. No. 80-7865 (2d Cir. Nov. 14, 1980) [hereinafter "Crouse-Hinds"].

17. Id. at 307-311.
18. Id. at 310 n.24.
19. 608 F.2d 64 (2d Cir. 1979) [hereinafter "Rodman"].
20. Id. at 70.
21. Id. at 71.
22. Id.
23. 619 F.2d 192 (2d Cir. 1980), cert. denied, 49 U.S.L.W. 3332 (1980).
24. 619 F.2d at 195. A similar result was reached in Marshall Field, supra n.6, at 1190-91. Query the effect of SEC Rule 14d-2(b), 3 Fed. Sec. L. Rep. (CCH) ¶ 24,282A?
25. A. Fleischer, Jr., Tender Offers: Defenses, Responses, and Planning, 88-4 (1980 edition).
26. Speech by Chairman Harold M. Williams, Securities and Exchange Commission, Tender Offers and the Corporate Directors, reprinted in [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,445, at 82,881 (speech before the Seventh Annual Securities Regulation Institute, San Diego, Cal., Jan. 17, 1980).

April 9, 1981

To Our Clients:

Takeovers; Some Recent Experiences
And Important Lessons

1. Takeovers in the \$2-5 billion range are possible. Prior to this year it was generally assumed that companies with a market value in excess of \$1 billion were relatively safe from a non-negotiated takeover. The Seagram offer for St. Joe and the Socal bearhug of Amax show that this assumption is no longer valid.
2. While there are white knights for \$2-5 billion deals who can act in 10-20 days, it is axiomatic that it is much more difficult to find a white knight for a \$2-5 billion deal than for the \$100 million to \$1 billion deals that were typical during the past 5 years. Therefore advance preparation is essential. Potential white knights should be identified and the financial information necessary for white knight negotiations should be kept current. Natural resource companies should keep their reserve reports and appraisals up to date. Close coordination between a company and its investment banker is essential. Whether or not advance contact with a potential white knight is desirable is a question for individual determination and no generalization is possible. We continue to believe that it carries significant risk of provoking undesired takeover proposals.
3. Cash self-tender offers and preferred stock exchange offers are more likely to be effective in defeating tender offers for large companies than for small companies. With small companies unless such transactions result in a majority of the stock being in friendly hands, the net effect is to make the overall cost of the takeover lower and thus make it easier rather than more difficult. With the larger companies this is not a significant factor. Also, it is unlikely that the arbitrage of a \$2-5 billion takeover will exceed 10% of the target's shares. Therefore the Street does not control the destiny of the target. If the target has a good story and the institutions can be induced to maintain their investment positions, a restructuring of the capitalization of the target can be effective.

April 9, 1981

4. A raider who springs a tender offer without prior contact with the target is most unlikely to be able to induce the target to enter into discussions with the raider. Where the raider is prepared to negotiate a higher price, the way to achieve negotiations is through an increase in the offer price at the right time. Failure to do so leaves too much room for white knights and foregoes an opportunity to change the psychology of the situation. The shibboleth enjoining bidding against oneself really has no place in a takeover situation. The best time for such a move is after a litigation victory or just prior to a meeting of the target's board. A raider normally cannot litigate its way to a successful takeover.
5. The NYSE 18-1/2% rule (requiring, on pain of delisting, a shareholder vote to approve issuance of more than 18-1/2% of a company's stock) negates one of the most effective takeover defenses. Frequently a target is able to place 25-35% of its stock in friendly hands at a price in excess of the takeover bid, but is prevented from doing so by the NYSE rule. Where the target's board of directors, on the advice of the target's investment bankers, determines that such a placement is in the best interests of the shareholders, there is no legal reason not to go forward. Delisting is one of the elements to be considered by the board, but should not be overriding in the board's determination. NYSE listed companies would be well advised to seek repeal of the NYSE 18-1/2% rule. The rule was adopted prior to the current wave of takeover activity and operates against the shareholders best interests rather than to protect them as originally intended.
6. Despite dicta to the contrary in the St. Joe case, liquidation at a price substantially higher than the takeover bid is a viable alternative and is legal and proper. It is the diametric opposite of entrenchment of management. It can and should be used in appropriate situations.
7. Executive incentive plans and severance arrangements should be amended to protect executives in the event of a takeover. If this is not done prior to a takeover bid, there is danger that it will not be understood as being appropriate and in the best interests of the company and its shareholders. These amendments have become fairly standard and have been adopted by a large number of companies.

M. Lipton

December 13, 1982

To Our Clients:

Takeovers: Protecting Shareholders Against Front-End Loaded Tender Offers and Bust-Up Proxy Fights

For the past year we have been recommending that corporations consider protecting against front-end loaded tender offers by amending their charters to include a requirement that the second step in a hostile takeover be for cash at the same price as the first step.

We have also been recommending that corporations protect against raiders who purchase 5 to 20% of the stock of a target in the market and then seek to have the target ransom the shares or run to a white knight in order to avoid a proxy fight in which the raider will seek control on the promise of a takeover, liquidation, self-tender, special dividend or other transaction that would presumably enhance the value of the stock of the target.

As the annual meeting season approaches we renew those recommendations. Front-end loaded takeovers and bust-up proxy fights are not in the best interests of shareholders. Given the present frequency of these transactions, we believe every corporation should consider our recommendations. In that connection it should be noted that our recommendations are not shark repellants -- they will not deter an all cash bid for all of the shares of a corporation, but they do deter the types of raids they are designed to protect against. It should also be noted that while there is a significant possibility that many institutional shareholders will not vote for our recommendations, if there is any possibility of obtaining the requisite vote there is at present almost no downside risk to seeking shareholder approval. These amendments reflect strength rather than weakness and sophistication rather than naivete. The large number of corporations that will submit these types of charter amendments to shareholders in 1983 and the current absence of significant takeover activity (with almost no likelihood of imminent revival) indicate that even the failure to obtain the requisite vote is not going to attract takeover proposals. In essence this is a window period in which the potential benefits of our recommendations far outweigh any detriments. We think that almost all corporations should attempt to take advantage of this opportunity.

M. Lipton

To Our Clients:

Share Purchase Rights Plans
("Poison Pills")

1. A Rights Plan is legal. A Rights Plan is within the business judgment of the board of directors. As the Supreme Court of Delaware says in Moran v. Household Int'l (No. 37, Nov. 19, 1985)

"here we have a defensive mechanism adopted to ward off possible future advances and not a mechanism adopted in reaction to a specific threat. This distinguishing factor does not result in the Directors losing the protection of the business judgment rule. To the contrary, pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment. Therefore, in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule".

2. A Rights Plan does not change the fiduciary standards to be followed by the board of directors in deciding whether to accept or reject a takeover bid. In the words of the Supreme Court of Delaware, the board "will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the Rights Plan."

3. A Rights Plan is a reasonable defense against abusive takeover tactics. In the words of the Supreme Court of Delaware, "the directors reasonably believed Household was vulnerable to coercive acquisition techniques and adopted a reasonable defensive mechanism to protect itself."

4. A Rights Plan does not cause a decline in the price of the stock of a company that adopts it. Numerous investment banker studies of stock prices before and after adoption show no attributable decline.

5. A Rights Plan should be adopted before a company becomes a target.

6. Takeover entrepreneurs and speculators hate Rights Plans and are continuing their campaign to outlaw them. Witness the attached Wall Street Journal editorial. While Rights Plans do not prevent all takeovers, they do protect against abusive takeover tactics and they do deter bust-up, bootstrap, two-tier, junk bond takeovers. Naturally those who profit from these takeovers at the expense of American business, workers and communities, and whose wildly speculative activities threaten our entire economic system, oppose anything that restricts their activities. There is no stronger argument for implementing a Rights Plan now.

M. Lipton

Et Tu, Delaware?

The tiny state of Delaware has been a titan in the corporate world. For 50 years, it has been the state of choice for incorporations because its corporate charter and courts have catered to the needs of the market. Its legal rules are aimed at efficiency, and investors feel most safe going with a Delaware company. Until now.

On Tuesday, the Delaware Supreme Court upheld a ruling giving management nearly carte blanche to force poison pills down the throats of shareholders. These anti-takeover provisions discourage changes in ownership, which means that shareholders will not be able to count on the "market for corporate control" to ensure that managers perform well. The result will be fewer takeovers, more entrenched managements and, it is not too much to fear, could eventually lead to European-style ossification of the nation's economy.

The case, *Moran vs. Household International*, upholds the use of a "flip-over" rights plan. This provision gives shareholders the right to buy \$200 of an acquirer's stock for \$100 upon a merger; the threat to potential raiders is, in no uncertain terms, that the takeover won't pay. Although Sir James Goldsmith overcame a similar provision adopted by Crown Zellerbach, John Moran, a director and major shareholder of Household International, opposed the poison pill because the major effect is to decrease radically the chances of a takeover.

The court said the rights plan is indeed a "preventive mechanism to ward off future advances." But the directors could adopt the plan and invoke the "business judgment rule" to protect themselves from any shareholder suits. This rule says that managers should be left free to make business decisions, good and bad, without the courts constantly second-guessing them. Even when it comes to fighting takeovers, the Delaware court says, "a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment."

This view of the business judgment rule is precisely the problem with the court's decision. Managers get the protection of the rule because courts assume they are meeting their fiduciary duties to shareholders. One of these duties is the pledge not to act self-interestedly at the expense of the company. But, as Seventh Circuit Court of Appeals Judge Frank Easterbrook and University of Chicago law Prof. Daniel Fischel have argued in law-review articles, there is always a conflict when there is a possible takeover: Managers are fighting to keep their jobs, but it might be in the interests of shareholders to get a new set of managers. The Delaware Chancery Court recently voided a poison pill adopted by Revlon Inc. in its unsuccessful takeover defense, but only because a lockup was made in the heat of a takeover battle instead of in advance of battle, as in *Household International*.

The Delaware courts are losing sight of the fact that a corporation is based on a set of contracts between shareholders and managers, including that managers will act in the best interests of shareholders. But we suspect most Household International shareholders agree with Mr. Moran that the poison pill is a lousy idea. Proof is that the directors had considered asking shareholders to approve a fair price amendment (a poison pill that requires in excess of majority shareholder approval of a hostile takeover that involves buying only some shares at a premium), but backed off from the idea when a proxy solicitation consultant reported that shareholders might vote no.

The trial court heard evidence that shareholders get an average 30% price premium when there is a tender offer and the SEC filed a brief on behalf of Mr. Moran warning that the plan "would deprive shareholders of an opportunity to consider virtually all hostile tender offers." Yet the Delaware Supreme Court endorsed the trial court's view that "shareholders do not possess a contractual right to receive takeover bids." Shareholders do have a right to expect that managers won't entrench themselves.

As we have argued before, shareholders should have to approve any defensive tactic by managers ("Shareholders Know Best," Nov. 1). An SEC study last month found that managers do not even ask shareholders to approve poison pills that seriously jeopardize the chances of takeover, no doubt because the shareholders wouldn't approve. New owners think they can run things more profitably, and so are willing to pay dearly for the right to control the firm. The capital markets, which make billions available for takeovers, are in effect disciplining corporate managers. The result is better-run corporations.

So why is Delaware helping to stop takeovers? One reason may be that managers choose where to incorporate, and will go to the state that best helps them keep their jobs. But this is a shortsighted view. Investors want to invest in corporations that will make them money. They will not want to invest in Delaware-based corporations if that means there is little chance of a profitable takeover. This would be a problem for Delaware, which has been getting almost 20% of its revenues from incorporation fees and franchise taxes.

There is a way for the Delaware Legislature to keep the state's enviable record as a place to incorporate, and keep collecting incorporation revenue. The state lawmakers might consider changing the corporate charter to make it harder for managers to dispense poison pills without exposing these strategies to shareholder approval.

November 19, 1986

To Our Clients:

The Poison Pill on the First Anniversary of Household

In the year since the Supreme Court of Delaware upheld the legality of the Poison Pill in the Household case over 300 companies have adopted Pills. The attached list of companies which have adopted Pills through November 14, 1986 includes 145 (or 29%) of the Fortune 500 companies, 72 (or 36%) of the Fortune 200 companies, 127 (or 31.8%) of the companies included in the S&P 400 Industrials Price Index and 145 (or 29%) of the companies included on the S&P 500.

As might be expected, with a major innovation adopted by a large number of companies, particularly one that counterbalances coercive takeover tactics, the Household case was the beginning of the litigation attacks on the Pill, not the end. As also might be expected, there has been a mixed bag of decisions with a few lower courts, applying the laws of states other than Delaware, accepting arguments that were rejected by the Supreme Court of Delaware. On balance, it appears that most courts will follow Household and today there is relatively little doubt as to legality, even with respect to the flip-in provision that has caused the most difficulty in the courts.

Within the past few weeks two important Pill decisions have been handed down. In a second opinion in the CTS case, the Seventh Circuit, applying Indiana law, held that Indiana would follow Delaware and sustain the Pill even against the discrimination argument that the NL case found to invalidate the Pill under New Jersey law. The decision is particularly significant in that it was written by Judge Posner, a leading proponent of the law and economics concepts originated at the University of Chicago when he was a professor. The Pill is an anathema to the Chicago School.

In the Gelco case, decided last week, the Federal District Court for Minnesota sustained a Pill with both a flip-over and a flip-in. The Court held,

(1) the adoption of a Pill is a legitimate exercise of business judgment by a board of directors -- particularly when adopted in advance of a takeover bid;

(2) in deciding whether or not to redeem a Pill the board of directors is subject to regular fiduciary duties.

(3) if the board of directors, following appropriate procedures, determines that a tender offer at a premium over market is inadequate, there is no requirement that the board redeem the Pill;

(4) the refusal of the board to redeem a Pill is a reasonable response to a hostile bid that the board, on the advice of its investment banker, determines to be inadequate even though the bid is cash for all the shares;

(5) in determining that a takeover bid is inadequate the board may properly conclude "that current market values are not reflective of the company's intrinsic worth especially in view of anticipated benefits of [a] restructuring program";

(6) reasonableness of a board's "decision involving defensive tactics may properly involve numerous concerns, including: 'nature and timing of the offer, questions of illegality, the impact on constituencies other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation and the quality of securities being offered in the exchange.'"

We believe that the Gelco decision is a correct statement of the law and reflects what the vast majority of courts will hold in cases where the target's board has a majority of independent directors, acts on the advice of an untainted investment banker, and determines to seek to remain an independent company.

Having been unsuccessful in court, the opponents of the Pill are seeking to destroy its effectiveness by sponsoring restrictive SEC rules and presenting proxy statement proposals to subject the Pill to a form of shareholder referendum. The outcome of these efforts remains to be seen. However, the opponents have failed to make a persuasive legal, economic or practical case and it may reasonably be expected that so long as the Pill is the only effective counterbalance to coercive takeover tactics, it will survive and thrive.

M. Lipton
E.S. Robinson

COMPANIES ADOPTING RIGHTS PLANS

<u>Company</u>	<u>Announcement Date</u>
A.H. Belo	03/10/86
ADC Telecommunications	09/23/86
AMCORE Financial	02/14/86
AMF	05/09/85
AMR Corp.	02/13/86
Adams-Russell	06/18/86
Alcoa	03/07/86
Allegheny International	03/06/86
Allied Stores	10/10/86
Allied-Signal	05/30/86
America West Air	07/28/86
American Brands	06/10/86
American Can	10/28/86
American Cyanimid	03/10/86
American Stores	08/12/86
American-President	03/26/86
Ames Dept. Stores	10/16/86
Amfac	07/11/86
Amsted Industries	05/30/85
Anadarko Petroleum	09/10/86
Anchor Hocking	07/31/86
Anderson, Greenwood	03/13/86
Anheuser-Busch	12/18/85
Anthony Industries	02/28/86
Apache Corp.	01/10/86
Arco	05/27/86
Armco	06/27/86
Armstrong World Industries	03/11/86
Arvin	05/30/86
Asarco	04/07/85
Ashland Oil	05/15/86
Associated Dry Goods	07/01/86
Avery International	01/29/86
Baker International	05/29/86
Ball Corp.	07/22/86
Bank Building & Equipment	11/06/86
Bank of New York	12/10/85
Barnes Group	07/16/86
Barry Wright Corp.	03/27/86
Becton Dickinson	04/11/86
Berkey	11/03/86
Black & Decker	04/17/86

<u>Company</u>	<u>Announcement Date</u>
Boise Cascade	01/06/86
Borden	01/29/86
Borg-Warner	02/25/86
Bowater	04/22/86
Bradley Real Estate Trust	04/11/86
Brown Group, Inc.	03/06/86
Brunswick	03/17/86
Burlington Industries	10/21/86
Burlington Northern	07/10/86
Burndy Corp.	01/13/86
Burroughs	03/07/86
C.P. Rehab	06/10/86
C.R. Bard	10/09/85
CBI Industries	03/04/86
CSX Corp.	04/29/86
CTS (back end plan)	04/23/86
CTS Corp.	03/24/86
Cabot	11/14/86
Callahan Mining	06/20/86
Carpenter Technology	06/12/86
Carson Pirie Scott	03/31/86
Caterpillar	11/12/86
Centex	09/18/86
Champion International	03/20/86
Cincinnati Bell	10/20/86
Citadel Holding	04/15/86
Cluett, Peabody	08/15/85
Colgate-Palmolive	10/11/84
ConAgra	07/10/86
Conna Corp.	05/01/86
Conna Corp.	03/18/86
Consolidated Freightways	10/27/86
Control Data	09/26/86
Cordis	09/12/86
Corning Glass Works	07/02/86
Crane Co.	05/19/86
Crown Zellerbach	07/19/84
Crystal Brands	05/22/86
Cummins Engine	09/10/86
Cyprus Minerals	05/09/86
DSC Communications	05/12/86
Dana Corp.	07/14/86
Dart & Kraft	09/05/85
Data General	10/06/86
Dayco	05/29/86
Dayton Hudson	09/11/86
Delta Airlines	10/23/86
Dennison	04/23/86
Dexter	10/24/86

CompanyAnnouncement Date

Diamond Shamrock	10/30/86
Dicomed Corp.	05/15/86
Donaldson Co.	02/21/86
Dorsey	05/23/86
Dravo	04/04/86
Dresser Industries	04/17/86
Duriron	08/01/86
Dynamics Corp. of America	01/30/86
Eagle-Picher	11/05/86
Eastern Air Lines	01/31/86
Eastern Co.	08/13/86
Eaton	09/27/85
Economics Laboratory	02/14/86
Educational Computer	07/25/86
Emery Air Freight	06/11/86
Emhart Corp.	02/28/86
Enserch	04/15/86
Ex-Cell-O Corp.	05/22/86
FMC	02/24/86
FPL Group	06/16/86
Fairfield Communities	08/06/86
Famous Restaurants	09/03/86
Federal Mogul	07/30/86
Federated Department Stores	01/23/86
Ferro Corp.	03/21/86
Firestone Tire & Rubber	10/21/86
First Mississippi	05/13/86
Fleming	06/24/86
Flow General	11/25/85
Foote, Cone & Belding	02/27/86
Freedom Federal Savings	10/02/86
GATX	05/15/86
Galaxy Carpet	08/14/86
Gelco	05/06/86
General Host	02/21/85
General Mills	02/24/86
General Signal	03/07/86
George Banta Company	07/29/86
Gerber Products	03/19/86
Gillette	12/30/85
Goodyear	07/02/86
Great Lakes International	05/23/85
Great Northern Nekoosa	03/05/86
Great Western Financial	06/24/86
Green Tree Acceptance	10/09/85
Greyhound	04/01/86
Grolier, Inc.	08/08/86
Guardsman Chemicals	08/08/86
H.B. Fuller	07/17/86
HBO & Co.	07/14/86

CompanyAnnouncement Date

Halliburton	05/21/86
Hartmarx Corporation	01/16/86
Hayes-Albion	03/24/86
Health Care USA	07/08/85
Hecla Mining	05/09/86
Helmerich & Payne, Inc.	01/10/86
Hexcel	08/14/86
Holiday Corp.	09/12/86
Home Group Inc.	01/30/86
Hon Industries	08/05/86
Honeywell	02/18/86
Hospital Corp. of America	02/14/86
Household International	08/14/84
Huffy	10/24/86
Hughes Tool	01/23/86
IPCO Corporation	01/30/86
IU International	09/11/86
Indiana Energy	08/07/86
Indiana Gas & Electric	09/18/86
Insilco	01/16/86
Instrument Systems	04/02/86
Interco	09/24/85
Interlake	06/26/86
International Minerals & Chemical	03/19/86
International Multifoods	09/08/86
International Paper	12/19/85
Invacare	08/05/86
J.C. Penney	01/28/86
J.L. Clark	04/14/86
J.P. Stevens	07/22/86
Jamesway	07/14/86
Jerrico	10/06/86
Jerrico	10/18/84
Johnson Controls	11/19/84
Joy Manufacturing	05/20/86
Kansas City Southern	04/16/86
Kellwood Co.	05/29/86
Kenner Parker Toys	04/22/86
Kerr-McGee	07/08/86
Knight-Ridder	06/27/86
Koppers Company	02/24/86
Kroger Co.	02/28/86
Kysor Industrial	04/28/86
LaClede Gas	03/27/86
Lamaur, Inc.	02/20/86
Landmark Savings	10/15/86
Lear Siegler	04/09/86
Lee Data	09/19/86
Libbey-Owens-Ford	04/29/86
Longs Drugstores	08/19/86

CompanyAnnouncement Date

Louisiana Land & Exploration	05/27/86
Lucky Stores	08/25/86
M-A-Com	07/29/86
Manitowoc	09/08/86
Mapco	06/12/86
Mark Controls	05/01/86
Marsh Supermarkets	07/10/86
Martin Marietta	07/24/86
Material Sciences	06/17/86
Mattel	11/06/86
May Department Stores	02/21/86
Mayflower Group	05/23/86
Maytag	08/21/86
McDermott International	12/18/85
McDonald's	09/15/85
McGraw-Hill	01/29/86
McKesson	05/08/86
McNeil Corp.	06/27/86
Mead	11/03/86
MedTronic	04/23/86
Meritor Financial	07/17/86
Michigan National Bank	07/10/85
Midwest Financial Group	06/18/86
Mobil	04/25/86
Modine Mfg.	10/15/86
Mohasco	02/19/86
Monsanto	01/24/86
Moore McCormack	05/12/86
Morrison Knudsen	06/12/86
Morse Shoe	09/05/86
Morton Thiokol	03/29/85
Mosinee Paper	06/26/86
Murray Ohio Mfg.	10/17/86
NCR	07/16/86
NL Industries	04/23/86
Nalco Chemical	07/24/86
Nash-Finch Co.	03/25/86
Nashua	08/22/86
National Convenience Stores	06/05/86
National Distillers	02/27/86
National Education	10/29/86
National Intergroup	03/03/86
Network Systems	07/17/86
Nicolet Instrument	04/28/86
Nortek	03/31/86
Norton	06/26/86
Occidental Petroleum	10/21/86
Olin Corp.	02/27/86
Outboard Marine	06/13/86
Owens-Corning Fiberglass	06/19/86

CompanyAnnouncement Date

Owens-Illinois	09/10/84
PHH Group	03/17/86
PPG Industries, Inc.	12/19/85
PSA Inc	07/01/86
Pancho's Mexican Buffet	03/07/86
Panhandle Eastern	03/11/86
Phillips Petroleum	02/06/85
Phillips-Van Heusen	06/10/86
Pillsbury	01/09/86
Pitney Bowes	02/10/86
Planning Research	04/04/86
Polaroid	09/09/86
Ponderosa	10/30/86
Preway	08/14/86
Princeville Development	08/15/86
Production Operators	04/09/86
Purolator Courier	01/30/86
Quaker Oats	07/09/86
Quanex	09/02/86
Questar	03/14/86
R.R. Donnelly & Sons	07/24/86
RCA	09/09/85
RTE Corp.	06/24/86
Ralston Purina	01/17/86
Raymond Engineering	01/13/86
Raytheon	06/25/86
Republic Gypsum	05/06/86
Research-Cottrell	04/14/86
Revlon	08/20/85
Rexham	03/26/86
Rexnord	05/01/86
Rohr Industries	08/15/86
Roper	10/01/86
Rorer Group	02/07/85
Rospatch Corp.	04/29/86
Rubbermaid	06/24/86
Ryan Homes	07/01/86
Ryder System	02/28/86
Safety-Kleen	08/14/86
Safeway Stores	02/12/86
Santa Fe-Southern Pacific	01/28/86
Schering-Plough	11/11/85
Scott Paper	07/16/86
Sea-Land	12/11/85
Sealed Power	06/25/86
Sonat	01/23/86
Southland	10/24/86
Southwest Airlines	07/14/86
Southwest Forest Industries	10/23/84
Square D Co.	01/07/86

CompanyAnnouncement Date

Squibb	10/29/86
Staley Continental	04/08/86
Stanley Works	02/26/86
Stop & Shop	09/30/86
Sun Electric	03/12/86
Sundstrand	04/18/86
Supermarkets General	02/25/86
Sysco	05/15/86
TRE Corp.	05/23/86
TRW	12/11/85
Talley Industries	04/30/86
Tambrands	12/18/85
Tandem Computers	05/20/85
Tandy	08/18/86
Telecredit	06/26/86
Tesoro Petroleum	11/27/85
Texaco	12/10/85
Texas Eastern	02/28/86
Texas Industries	07/18/86
Textron	03/10/86
Time Inc.	04/29/86
Toro	04/08/86
Trans World	04/23/86
Transamerica	07/17/86
Transco	01/08/86
Travelers	07/11/86
Tribune Co.	02/18/86
Trus Joist	05/08/86
U.S. Home	06/27/86
U.S. Shoe	03/27/86
UGI Corp.	04/29/86
UNC Resources	10/25/85
US Air	01/15/86
US Life	06/24/86
USG Corp.	03/20/86
Union Camp	02/26/86
United Technologies	12/16/85
United Telecommunications	08/12/86
Upjohn	06/17/86
Valero Energy	11/15/85
Varian Associates	08/22/86
Viacom	01/23/86
Victory Markets	06/04/86
Wainoco Oil	02/21/85
Walgreen	07/09/86
Watkins-Johnson	10/08/86
Westchester Financial Services	02/14/86
Willamette Industries	08/14/86
Williams Cos.	01/27/86
Wm. E. Wright	09/22/85

Company

Announcement Date

Woodhead Industries
Wrather Corp.
Yellow Freightways
Zayre
Zenith
Zurn Industries

05/19/86
08/08/86
10/28/86
11/13/86
10/03/86
05/20/86

June 1, 1987

To Our Clients:

The Proposed Delaware Takeover Statute

The Delaware Bar is considering introducing a takeover statute similar to the Indiana statute upheld by the Supreme Court in the CTS case.

The Delaware statute would be applicable to all Delaware corporations without regard to where they are headquartered or where their shareholders reside.

There is still an open question as to whether applicability of the statute will require a shareholder vote or only board action.

The Delaware statute will lengthen the tender offer period from 20 business days to 50 calendar days. The tradeoff for the additional time is a mandatory shareholder vote on the tender offer -- a vote that management will lose unless it presents a restructuring alternative that provides greater value to the shareholders.

Further, the mere existence of the statute will enable raiders to argue that it is the principal test for a tender offer and that defenses designed to keep a company independent should be held to a higher legal standard than at present.

The statute would be greatly improved by the addition of two provisions:

(1) Only those shareholders who were such on the date a raider first disclosed that it might seek control are eligible to vote. This would eliminate arbitrageurs making the vote a sure thing.

(2) An express recognition of the holding of the Delaware Supreme Court in the Unocal case that in considering a takeover bid the directors of the target may take into account constituencies other than the shareholders, such as employees, customers, suppliers, creditors and the community at large.

Delaware should be urged to make these additions.

M. Lipton

July 14, 1987

To Our Clients:

A Second Generation Share Purchase Rights Plan

In the four years since we developed it, the share purchase rights plan ("poison pill") has proved to be the most effective protection against abusive takeover tactics. It has been upheld by most courts that have considered it. It has been adopted by over 400 companies. But the dynamics of takeovers have changed; the takeover frenzy continues and it is necessary to develop new means to deal with new takeover tactics and the attacks by institutional investors on what they deem to be interference with shareholder determination of takeover matters. We believe that we have developed a new plan designed to cope with the new problems. We recommend that consideration be given to substituting it for the original plan.

In addition to the attacks on the basic legality of the pill, raiders have argued -- so far without success -- that the directors of a target that is protected by a pill have a special fiduciary duty to redeem the pill to permit a cash offer for all the outstanding shares of the target.

Apart from legal attacks on the pill, during the 1987 annual meeting season certain institutional investors proposed proxy resolutions asking for a shareholder referendum on the adoption of the pill. While the resolutions attracted on the average only 20% of the outstanding shares and were in every case defeated, the institutions are planning an expanded proxy campaign in 1988. Also, the SEC continues its opposition to the pill and several of the takeover reform bills now pending in Congress would curb the use of the pill.

The market price of the shares of many companies that adopted a pill in 1985 or 1986 has appreciated substantially since the pill was adopted and, therefore, the exercise price of the rights could be reevaluated with a view to increasing it to accord with current market prices and the company's current prospects.

In light of the foregoing, this is clearly an appropriate time to reexamine the pill.

The pill is made more effective by adding a flip-in at the 20% acquisition threshold. This will prevent a raider from sweeping the street or otherwise acquiring control through market purchases or a partial tender offer. It also protects the shareholders in a case where the raider avoids the effect of the flip-over by not doing a second-

step merger after acquiring control. We believe that the special shareholder meeting procedure described below resolves previous questions about the judicial reaction to the flip-in.

The shareholder democracy and fiduciary duty arguments are answered by providing for a shareholder vote if a non-abusive takeover is proposed. To accomplish this, we have added a new provision that if a bidder (who does not hold more than 1% of the shares of the company and therefore is not a greenmailer or a free rider seeking to profit by putting the company in play) proposes to acquire all of the shares of the company for cash at a fair price and has financing or financing commitments, then the company will, if requested by the bidder, hold a special shareholder meeting to vote on a resolution requesting the board of directors to accept the bidder's proposal. A prospective bidder who holds more than 1% could not avail itself of this provision unless it sold down to 1% before making the request. The bidder would have to furnish an investment banker's opinion addressed to the shareholders of the company that the price proposed by the bidder is fair. The bidder would also have to bear one-half of the company's costs of the special shareholder meeting.

In connection with the special shareholder meeting, the bidder could submit any information it wished for inclusion in the company's proxy statement and could mail its own proxy material if it so desired. The company could include any information it wished in its proxy material, including information relating to the "fairness" of the price proposed by the bidder and information about any alternative transactions. There would be no restriction on the board of directors determining that the company should remain independent and unstructured and concurrently with the proxy solicitation for the special shareholder meeting asserting any litigation or other defenses the company wishes. We recognize that obtaining an injunction against a tender offer is made more difficult by providing for the special shareholder meeting in that the courts will be reluctant to stop a tender offer that the shareholders are about to vote upon; however, we think this is a fair trade-off for the protections of the new pill. Nor would there be any restriction on the bidder pursuing whatever takeover tactics, including litigation to invalidate the pill or require the board of directors to redeem it, it wishes.

To assure sufficient time to consider the bidder's proposal and to seek and evaluate alternatives and to prepare the proxy material, but also to avoid undue delay, the special shareholder meeting would be required to be held not

later than 120 days nor earlier than 90 days after the bidder's request (except that if the bidder's request is received after an annual or special shareholder meeting has been scheduled, the meeting requested by the bidder could be held not later than 120 days after the earlier scheduled meeting). We recognize that the meeting procedure permits the vote to be heavily influenced by arbitrageurs (and the bidder and its allies) who purchase after the announcement of the bidder's proposal but before the record date. However, absent statutory authority, there is a substantial question as to the legality of a record date prior to the first announcement of the bidder's proposal and it would raise other legal questions to restrict purchases by the bidder after it makes its request or to deprive the bidder of voting rights on those purchases.

If a majority of the company's outstanding shares vote in favor of the resolution at the special shareholder meeting, the pill would be redeemed so as to permit consummation of the bidder's proposal or a competing better proposal. If following an approving vote the company does not enter into a cash merger agreement with the bidder -- and there would be no obligation to do so -- the bidder could make a tender offer unaffected by the pill, provided the tender offer is for all the shares at a cash price not less than the price the shareholders voted upon. The bidder

might actually start its tender offer when it makes the request for the special shareholder meeting or at any time thereafter. If the bidder does so, it could structure the timing so that it consummates its tender offer immediately following the meeting.

To the extent that the new pill channels takeover activity into the special shareholder meeting procedure, it will be more effective than the original pill in discouraging abusive takeover tactics and will provide more time for a target to deal with the cash offer for all shares against which there is today no practical defense other than drastic restructuring. The new pill recognizes the realities of a market dominated by institutional investors and a regulatory system that tolerates junk-bond-financed corporate raiders who are able to put almost any company into play and whose activities invariably result in a bust-up of the target, whether by the raider, a white knight or the target itself in a restructuring. The new pill does not prevent takeovers. Like its predecessor it protects against the worst takeover abuses, it gives all parties a reasonable period of time in which to make decisions on such a fundamentally important question as a takeover, and it strengthens the ability of the board of directors of a target to obtain the best result for the shareholders.

We recognize that the new pill assures a raider that it can obtain a shareholder vote on a proposed takeover, and, therefore, might be said to promote takeovers. However, as a practical matter, a raider can obtain a shareholder vote, or the pragmatic equivalent of a shareholder vote, on a proposed takeover apart from the special shareholder meeting provisions in the new pill. For most major public companies with substantial institutional ownership there is no absolute takeover defense, other than management control of a majority of the voting stock. Therefore, those companies and their shareholders are best served by a pill that provides the most effective protection against takeover abuses and removes much of the profit incentive for a raider putting a company in play. On balance, we believe that, if universally adopted, the new pill would decrease substantially hostile takeover activity.

The new pill borrows from the special shareholder meeting concept of, but is more balanced than, the Indiana-type control share acquisition statute recently upheld by the Supreme Court in the CTS case. The new pill would reduce the pressure for Delaware and other states to enact the Indiana-type statute with all of its drawbacks. Unlike the new pill, the Indiana-type statute does not deter raiders from free-riding or seeking greenmail by accumulating an up to 20% position and then putting the target in

play. To avail itself of the special shareholder meeting, the bidder cannot hold more than 1% when it requests the meeting, and can buy more than 1% only after the shareholders of the target have been protected by public disclosure of the bidder's proposal. However, prior to the vote at the special shareholder meeting neither the bidder, nor anyone else, could cross the pill's 20% threshold without triggering the nonredeemability and flip-in provisions of the pill at that level.

The Indiana-type statute does not protect shareholders from two-tier offers, partial offers, unfair second-step freeze-out mergers and being locked into minority positions. The new pill prevents or protects against all of these abuses.

The Indiana-type statute provides only 50 days to evaluate an offer and to seek and evaluate alternatives, a period that is clearly inadequate for the creation and accomplishment of a complex restructuring or the search for, and negotiation of, an alternative acquisition and the preparation and SEC clearance of the requisite proxy material. The new pill does not affect the bidder's voting rights or otherwise prevent a tender offer by the bidder from being completed in the 20 business day period set under the Williams Act. Therefore the pill is not inconsistent with

the Williams Act and does not create the sort of preemption question that is thought to limit Indiana-type statutes to the 50-day period. The new pill only establishes a 90 to 120 day period if a bidder desires to avail itself of the special shareholder meeting procedure. If the bidder does not elect to avail itself of this procedure, subject to the other provisions of the pill, it may proceed with a tender offer, open market accumulation or bear hug just as it would at present.

As in the case of the original pill, and most significant legal innovations, there can be no assurance that all courts will agree that the new pill is legal. It is our opinion that it is legal and that it is within the business judgment of the board of directors to substitute the new pill for the original pill.

We are advising our clients to consider substituting the new pill for their existing pill and, in that connection, where appropriate, to set the exercise price of the new rights to reflect the current market price of the common stock. Companies that have first generation pills can in most cases amend such pills to add the second generation pill provisions without redeeming their pills. However, the substitution of a new exercise price in place of the existing exercise price of a company's rights would require that

the original pill be redeemed and the new pill issued in the same manner as the original pill.

M. Lipton

September 2, 1987

To Our Clients

Proposed Delaware Takeover Defense Stock Redemption StatuteIntroduction

A proposed amendment to the Delaware corporate law would permit Delaware corporations to redeem common stock held by persons who intend to greenmail them or put them "in play" at the lesser of the fair value of the common stock or the average price paid by the acquiror during the previous year. This proposal may provide Delaware corporations with a useful takeover defense in some situations, but we are concerned it will not be effective. In any event, it is not sufficient to protect corporations and their shareholders against abusive takeover tactics and junk bond, bust-up takeovers. It is hoped that this proposal will not divert Delaware from enacting meaningful takeover legislation. We recommend that Delaware adopt the New York type statute that deters bust-up takeovers and the Ohio type statute that affirms the right of a company to remain independent.

Section 151(b) of the Delaware General Corporation Law now permits a corporation which has a governmental license or franchise to conduct its business conditioned upon some or all of the holders of its stock possessing

prescribed qualifications, to have a charter provision providing that its stock is subject to redemption by the corporation to the extent necessary to prevent the loss of such license or franchise or to reinstate it. The proposal would expand Section 151 to permit redemption by the corporation whenever a two-thirds majority of the independent outside directors and a two-thirds majority of the full board conclude (1) that the holder intends to obtain a short-term gain from greenmail or to cause the corporation to enter into a transaction that is not in the long-term interests of the corporation and its stockholders or (2) that the holder's ownership of the stock is causing or is likely to cause a material adverse impact on the corporation's business or prospects, including the impairment of the corporation's relationships with its customers or its ability to maintain its competitive position. These expanded redemption provisions would be applicable to all Delaware corporations which did not "opt out" of its coverage by charter amendment.

The text of the proposed amendment is attached as an appendix. It is loosely based upon a provision in the Connecticut insurance laws that makes the stock of Connecticut insurers subject to redemption at its fair price if the board of directors determines that the stockholder being redeemed fails to meet the prescribed licensing qualifications or otherwise fails to obtain necessary regulatory approvals.

Potential Risks

There is a danger that directors will be exposed to personal liability. In view of the exposure to personal damage suits seeking substantial amounts, boards of directors would be extremely reluctant to exercise the redemption power. The directors would face not an amorphous "class" litigation, but a highly-motivated action by an individual who would be able to show an actual, readily determinable loss.* Furthermore, a board's decision to redeem would be attacked as a breach of its duty of loyalty and, accordingly, board members would not be shielded from liability for monetary damages even if the corporation's charter had been amended to conform with the recent Delaware legislation regarding director and officer liability; only a further -- and highly unlikely -- amendment to the Delaware law eliminating any liability for wrongful redemption (such as by making appraisal the exclusive remedy) could fully protect directors.

The market effect of the proposal is unknown. Potential redemption at the average price paid if a stockholder (including institutional holders) were to support or

* Damages could be measured by the difference between the redemption price and the market price on the date of redemption or the difference between the redemption price and a premium price subsequently paid upon a change of control, plus carrying costs and related fees and expenses.

join in a proposal to restructure or merge a company, is such an extreme penalty that it might depress the trading price and affect the marketability of a company's stock. The reaction of institutional investors and the effect on the market would have to be considered by a board in determining whether to propose a charter amendment to opt out of the statute.

In view of the current interest in one share-one vote and the SEC's "all holders" rulemaking response to Unocal's exclusionary self-tender offer, it seems inevitable that a Delaware forced redemption statute would generate substantial controversy at the SEC and in Congress and could even impel Congress to seek to preempt a broad range of state statutes in this area.

Insufficient Defense to Current Takeover Abuses

The Supreme Court of Delaware has held that a board of directors of a target company has the right, in the proper exercise of its fiduciary duty, to reject a takeover bid and seek to preserve the company's independence. What is needed is a statutory approach to assist boards of directors to protect their companies and shareholders from inadequate or ill-timed takeovers.

The redemption proposal, standing alone, does not provide sufficient protection. Raiders will simply adjust their tactics to avoid the reach of the statute. They will disclaim any intent to seek greenmail or destabilize the corporation for "short-term" gain and claim that their only purpose is an acquisition at a premium price. Indeed, T. Boone Pickens, who in recent weeks has disclosed accumulations or intentions to accumulate positions in Boeing, Singer and Newmont, has now proposed to acquire all of Newmont after having accumulated 9.9% of its stock. If Pickens were simultaneously to disclose both his acquisition proposal and his accumulation, then notwithstanding his history and the Unocal case's characterization of his past actions, one could not be certain that the proposed statute would protect directors who were to authorize a redemption of his Newmont shares.

Recommended Approach

Hence, even if the redemption statute were to be adopted, it should be part of a broader package. The Delaware legislature should consider adopting the approach enacted by seven states, including New York. This approach establishes a five-year freeze on second-step mergers

between a company and a 10% stockholder* unless approved by the board of directors before the acquisition of the 10% stake. Unlike the redemption proposal, this statute addresses the junk bond, bust-up takeover by denying the raider the ability to reach the assets of the target to repay the takeover financing.

We also recommend that the Delaware legislature adopt the portion of the Ohio statute that permits a board faced with a takeover bid to consider a range of factors, including the interests of the corporation's employees, suppliers, creditors, customers and communities which it serves, as well as the long-term interests of the corporation and its shareholders.

Unlike the precedents provided by the New York and Ohio statutes for our recommended approach, the Connecticut insurance company statute is a weak precedent for the redemption proposal. The Connecticut statute can be distinguished by the long tradition of extensive state regulation of insurance companies, including the universal requirement that a state agency approve transfers of "control," defined to mean stock positions of as little as 5%. Furthermore, like the very narrow redemption power presently permitted

* While New York established a 20% threshold for an interested stockholder, we recommend the 10% threshold adopted by New Jersey and four other states.

under Delaware law to be included in corporate charters, the basis for the redemption power in the Connecticut statute is linked to the qualifications to be licensed, which affects the fundamental ability of a regulated corporation to operate as a going concern. There is no precedent for such redemption power in the case of industrial or service corporations generally.

Drafting Issues

Determination of intention to greenmail or put company into play. As noted above, this standard may be ineffective against a raider who takes precautions to avoid its reach. Since this basis for redeeming the raider's stock depends upon the subjective intent of the raider, it will be difficult for a board to redeem the stock of a raider who expressly disclaims such intent, unless such raider's mere presence as a shareholder can reasonably be said to materially adversely impact the corporation. Furthermore, while it is appropriate for a board of directors, in determining what course of action to take, to consider the long-term interests of the corporation and its stockholders, this proposal would authorize a board to redeem the stock of anyone -- whether a greenmailer, an arbitrageur or

a long-term stockholder who supports a corporate restructuring* -- who seeks a "short-term" gain. In this respect it is so extreme that one may expect the courts to construe it narrowly.

Pricing. A redemption price formula that is based upon the fair value of the stock as determined by the board but limited to no more than the average price paid by the raider in the last year may well be viewed as overly harsh. On the other hand, a market-price-based redemption provision, by giving the raider the benefit of the increase in market price that his actions have generated, would obviously be a less effective deterrent than the cost-based model. One possible compromise would be a redemption price based upon the market price prior to the first public disclosure of the raider's position or proposal.

Procedures. The proposed statute is silent on the procedures for redemption. The provisions of the Connecticut statute should be considered. Connecticut provides for a written warning to the raider prior to board action and a 30-day notice period of the redemption date (although upon the corporation setting aside the redemption price, the

* As proposed, the statute would subject to redemption the shares held by institutional investors who support a proxy fight by a group proposing a new slate of directors who would approve a restructuring.

rights of the raider terminate with respect to such shares other than to receive the redemption price and dividends to the redemption date). The Connecticut statute also provides that court appraisal of the value of the redeemed shares is the shareholder's exclusive remedy. Only if Delaware were to adopt this approach would the directors be fully protected from liability.

Limitations on other corporate repurchases. The proposed redemption statute may unduly limit the board's authority to repurchase shares under circumstances that, in the board's view, justify a price higher than the statutory redemption price. Read in conjunction with present Section 160(a)(2), which prohibits the purchase of shares that are redeemable at the corporation's option for more than the redemption price, the proposed statute could preclude a corporation from repurchasing its shares at a price above the redemption price under circumstances which would not be considered "greenmail." As such it may prevent perfectly legitimate transactions.

Effective Date. While the statute is drafted to be effective as of the announcement of its consideration, it is unclear what this means. It is also not clear whether it is proper to make subject to redemption shares acquired before a statute becomes effective. The Connecticut statute

applies to shares the beneficial ownership of which is acquired after the effective date.

Conclusion

Delaware should as soon as possible enact legislation to protect against takeover abuses. The best protection would be provided by a combination of a New York type statute that imposes a five-year prohibition on a second-step merger following an unapproved acquisition of 10% of the target's shares and a statutory recognition of the right of directors of the target to reject a takeover on the basis of "long-term interests as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation."

M. Lipton
G.A. Katz
M.W. Schwartz
E.S. Robinson
G.J. Shrock

AppendixText of Proposed Delaware Redemption Statute

Unless the certificate otherwise provides, any stock held by an existing stockholder may be redeemed by the corporation if a two-thirds majority of the independent outside directors and a two-thirds majority of the entire board of directors conclude that the ownership of the corporation's stock by such stockholder is intended to cause the corporation to repurchase the stock owned by such stockholder, or to cause the corporation to take action or enter into a transaction or series of transactions intended to provide such stockholder with short-term financial gain under circumstances where such two-thirds majorities determine that the best long-term interests of the corporation and its stockholders would not be served by taking such action or entering into such transactions or series of transactions at that time, or determine that such ownership is causing or reasonably likely to cause a material adverse impact (including, but not limited to, loss or threat of loss of any license or franchise from a governmental agency to conduct its business, loss or threat of loss of any membership in a national securities exchange, impairment of relationships with customers, or impairment of the corporation's ability to maintain its competitive position) on the business or prospects of the corporation.

This section shall not apply to, and no power to redeem pursuant to this section shall be conferred on, any corporation the board of directors of which does not contain at least two independent outside directors.

Any stock redeemed pursuant to this section may be redeemed for consideration in the form of cash, property or rights, including securities of the same or another corporation, having a value equal to the fair value of such stock as determined by the board of directors, but in no event greater than the average price per share paid for all of the stock of the corporation held by the stockholder whose stock is redeemed, which stock has been acquired during the year preceeding the determination, multiplied by the number of shares redeemed. In the absence of actual fraud, the judgment of the directors as to the value of the consideration for the redeemed stock shall be conclusive.

The Court of Chancery is hereby vested with the exclusive jurisdiction to determine the validity of any redemption of stock pursuant to this section.

This Act shall be effective as of [date of announcement of consideration of amendment].

November 18, 1987

To Our Clients:

Takeovers: No Requirement to Auction a Company

In a definitive and extremely significant decision, the Delaware Supreme Court in the Newmont case has held that there is no requirement that the directors of a target company auction the company to the highest bidder. The directors have the right to reject the takeover bid and determine to keep the company independent. In evaluating a takeover bid the directors may consider,

- the inadequacy of the bid,
- the nature and timing of the offer,
- questions of illegality,
- the impact on constituencies other than the shareholders,
- the risk of non-consummation, and
- the basic stockholder interests at stake, including the past actions of the bidder in other takeover contests.

The decision also makes clear that a company may have a policy of remaining independent and take reasonable action to implement that policy.

M. Lipton

February 2, 1988

To Our Clients:

Much Ado About Nothing; The Delaware Takeover Law

The much discussed and heavily lobbied Delaware takeover statute today became law with a December 23, 1987 effective date.

The statute is quite simple. If someone crosses the 15% threshold without the approval of the board of directors of the target, it is barred from a business combination with the target for three years, unless

(1) it jumps from below 15% to at least 85% of the target's stock in a tender offer (excluding from the denominator shares controlled by the target's management) or

(2) it obtains the approval of two-thirds of the shares it does not own.

It will be a rare situation where a tender offer will not attract 85% of the target's non-management controlled stock. Only where a single large holder or a group holds about 10% or more, and is prepared to not accept the tender and risk becoming a minority shareholder, will the 85% threshold not be obtained. If there is a large holder, with 10 to 15%, the bidder may follow an alternative strategy and tender for only 51% instead of 100% and state its intention to follow the tender with a cash merger on the assumption that since the remaining shareholders will not want to continue as minority shareholders in a company now controlled by the bidder, the bidder can obtain the approval of two-thirds of the remaining shares.

Since the delay before a raider can effect a squeeze-out merger is only three years, it is easy in today's markets to structure bank or junk-bond financing that will permit the raider to follow either of the strategies described above, and not be in default if it should fail to achieve either the 85% or two-thirds goal.

The 15% threshold before the statute is triggered, leaves ample room for raiders to continue to accumulate a 10 to 15% position and then put the target in play. This has been and continues to be virtually a no-lose proposition for raiders. Either the raider acquires the target at the

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raider's price and then profits by busting it up or the target restructures or finds a white knight at a price that gives the raider a large profit.

The Delaware law does deter two-tier bids where the raider's financing will not accommodate a three-year delay before the raider can squeeze-out the remaining shareholders. However, this form of abusive takeover had become obsolete long before Delaware started to consider adopting a takeover statute.

Since the Delaware statute does not displace other protections against abusive takeovers such as the poison pill, the statute may be summed up as innocuous and there is no reason why Delaware corporations should opt out of it.

M. Lipton

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March 31, 1988

To Our Clients:

The Takeover Frenzy

1988 has witnessed an amazing resurgence of takeover activity. Less than six months after the October 19 market crash takeover activity is higher than at any time before the crash. So far this year more than \$72 billion of takeover bids have been announced, twice that of this time last year. There is no one explanation for the renewed takeover frenzy. However, it is possible to identify a number of factors that contribute. Some of the factors overlap and some are more significant than others. In combination they explain today's takeover activity.

Cultural changes. There is no longer any cultural barrier to a hostile takeover bid. Corporate raiders are glorified on the covers of magazines and on television. This year has seen J.P. Morgan act for a Swiss company, Hoffman LaRoche, in a tender offer for Sterling Drug, a long-time Morgan banking client; Shearson Lehman Hutton join as an equity partner with a British company to make a hostile bid for Koppers; General Electric, a pillar of the Business Roundtable and the corporate establishment make a hostile bid for a small appliance manufacturer, Roper; Emhart, a major company in Hartford Connecticut, become the first company in a close business community like Hartford to

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make a hostile bid for another company in the same community; the spread of takeover activity to continental Europe and the concomitant willingness of European companies to make hostile bids in the U.S.; and the beginning of Japanese participation with the Bridgestone white knight bid of \$80 per share (\$2.6 billion) for Firestone after a hostile bid of \$58 per share (\$1.9 billion) by Pirelli and Michelin.

Director attitudes. Boardroom attitudes have changed. Management is no longer restrained by fear that directors will look askance at a proposal to make a hostile bid. Many companies believe that if they are not taking over others and not increasing their size and leverage they will become targets. To remain independent they have become raiders. Target directors are less willing to fight to remain independent and seem more concerned to avoid being embarrassed by a charge of failure to maximize shareholder values than to preserve independence.

Availability of financing. First Boston developed the bridge loan to compete with Drexel Burnham's junk bonds. Now all the investment banks provide bridge loans to be refunded with junk bonds and the major commercial banks are competing with the investment banks to provide takeover financing. A fair estimate of the aggregate equity funds for acquisitions held by the scores of leverage buyout funds

(many started since October 19) is more than \$25 billion. Leveraged at five-to-one, which is quite low compared to the ten-to-one in many recent transactions, the \$25 billion would support \$125 billion of acquisitions. Money to finance takeovers is available in unlimited amounts.

Cheap dollar and cheap companies. The decline in the dollar against the yen and the European currencies, lower market prices post-October 19 and lower price-earnings ratios for U.S. companies than for those of most non-U.S. companies makes U.S. companies cheap. This has created a unique opportunity for non-U.S. companies to bid for U.S. companies such as the tender offers this year by Hoffman LaRoche for Sterling Drug, BAT Industries for Farmers Group, Campeau for Federated Department Stores, Pirelli for Firestone, Beazer for Koppers and Hachette for Grolier. The U.S. is still the safest safe haven and there is still a great desire by foreigners to diversify into the U.S.

Strength of U.S. economy. The October 19 crash did not (at least not yet) result in a recession. It merely lowered stock market prices to a level where they became attractive to corporate strategic buyers. The economy today appears strong with more concern about inflation than recession. Inflation encourages acquisitions in that assets appreciate in value and the debt incurred to buy the assets decreases in value.

Retreat of the raiders, return of the strategic buyers. For several years prior to 1988, takeovers were dominated by corporate raiders and their junk-bond-financed, boot-strap, bust-up takeovers. The 1987 change in the tax law eliminating devices which allowed a raider to liquidate a target on a tax favored basis has reduced the incentive for bust-up takeovers and in many cases results in a price advantage to a buyer who does not plan to resell a significant part of the acquired assets. Similarly, an internal restructuring of a company has become more competitive in price with a bust-up takeover. Thus, the bust-up raiders have taken to the sidelines. They still go on to the playing field, but not so often. This has brought back the strategic buyers. Less competition from raiders, lower market prices post-October 19 and fear that the next Administration may be restrictive of takeovers have combined to make hostile bidders of acquirors who previously would undertake only a negotiated acquisition.

Institutional investor control. With the ownership of a majority of the shares of most major companies in the hands of institutional investors it has become virtually impossible to defend against a takeover. The institutions have become activists in opposing takeover defenses, voting for corporate raiders in proxy fights and forcing companies to auction themselves to the high bidder. One is hard

pressed to name even one company which during the past three years became the target of a cash tender offer for all of its shares and managed to remain independent and unrestructured. Today institutional investors are not just insisting on a takeover premium when a company is put in play, they are actively promoting takeovers.

Permissive attitude of the regulators and the courts. The SEC, FRB, ICC, CAB, FCC and the Administration generally favor takeovers, oppose legislation that would restrict takeovers and enforce the law (or refuses to enforce the law) in a manner that favors the raider over the target. There is a sharp tilt of the playing field in favor of the raider. The only effective brakes on takeover activity -- the poison pill and state takeover statutes -- are under constant attack by the SEC and the Administration. The courts have caught takeover fever and do not hesitate to second-guess directors who are seeking to preserve the independence of their company. Whereas once the main focus of takeover litigation was the target's effort to enjoin the raider, today it is the raider's efforts to enjoin a restructuring defense by the target.

Market encouragement of leverage. The standards for the ratio of debt to equity have reversed so substantially that where once it was thought too risky to have debt

greater than half of equity, today debt ten times equity is applauded. The highly leveraged company is accorded a premium price in the market. The stub shares of highly leveraged, restructured companies sell at prices not based on earnings or assets, but as calls on what the earnings might be in five years or more. The premium for leverage is a major factor in promoting takeovers. Indeed, the market today so deeply discounts unleveraged future growth that there is a significant disincentive to invest in research and development and new plants and equipment.

The attraction of LBOs. The LBO gives management a greater equity stake than the customary stock incentives in most public companies. For professional managers there is a great attraction to getting away from worrying about quarter-to-quarter earnings performance and instead being able to manage with the objective of maximizing cash flow. Many managers today believe that if a company is subject to being raided there is no reason not to be preemptive and attempt a leveraged buyout. With the huge amount of LBO capital available there is great momentum behind the LBO movement. It has become a major factor in the rationalization of American business. It continues to grow at a very rapid pace.

The takeover infrastructure. Almost every large company has an acquisition staff. All the major law firms and accounting firms have merger and acquisition departments. Takeovers are the most profitable investment banking activity. So profitable that the major commercial banks have developed large merger and acquisition departments to compete with the investment banks. Boutique investment banking firms are springing up and, large and small, all the firms want to be merchant bankers with direct equity participation in takeovers. The expanding infrastructure is a driving force in expanding takeover activity.

Decline of community and union opposition. The days of the Bartlesville prayer meetings and the Pittsburgh union demonstrations are gone. Today, except for the attack by the state of Pennsylvania and the city of Pittsburgh on Shearson Lehman for participating as an equity partner with Beazer in its hostile bid for Koppers, communities rarely come forward to protest the takeover of local companies. Indeed, as illustrated by the efforts of the United Airlines and PanAm unions to takeover those companies, unions have become raiders.

Takeovers have become a world-wide phenomenon. The current resurgence following the October 19 crash is explained by some on the basis of one or two factors. At any

one point in time one or two factors may be dominant. However, after 15 years of world-wide growth of takeovers the conclusion is inescapable -- they are not a temporary aberration. They reflect a universal fundamental aspect of public ownership of major business entities in democratic societies. The debate as to whether takeovers are good or bad, whether they enhance efficiency, whether they impede long-term planning, whether they create dangerous levels of leverage, whether they are essential counter-balances to trade deficits, will continue. Respected opinion is lined up on either side of each issue. However one feels about these issues, the fact is takeovers have become a major aspect of the free-world economies.

M. Lipton

May 21, 1988

To Our Clients:

Delaware Clarifies Fiduciary Duties
of Directors in a Takeover Situation

The recency of the takeover phenomenon and the happenstance nature of takeover litigation results in an absence of a body of judicial opinions that would enable a comprehensive synthesis of the law governing the fiduciary duties of the directors of a company faced with a takeover. This has resulted in much confusion. Some have argued that the courts have abandoned the traditional business judgment rule in takeover situations. Some have argued that the directors of a takeover target have only one duty -- to act as auctioneers and get the highest price obtainable.

In the past year there have been a number of cases reaffirming the application of the business judgment rule to takeover decisions by directors. These cases have rejected the argument that the only question is the short-term interests of the shareholders. The courts have now made it clear that the directors of a takeover target may properly determine to reject the takeover bid and decide to remain an

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independent company -- and in reaching that decision may take into account the adequacy of the bid; timing factors; risk of nonconsummation; effect on employees, customers, suppliers and communities; and the past history of the bidder.

Now one of the most troublesome questions also has been laid to rest. Some had read the Transunion and Revlon cases to mean that the directors of a company who had determined to sell the company had an absolute duty to get the highest possible price and that in this circumstance there was no room for the exercise of discretion. In the Fairchild Camera case decided on May 19 the Delaware Chancery Court said it:

is certainly incorrect to assert that [Revlon] recognized a duty on the part of directors when a corporation is "for sale," to get the highest available price. Rather, the duty can only be to try in good faith, in such a setting to get the best available transaction for the shareholders. Directors are not insurers.

The Fairchild Camera court went further and laid to rest the fear that the Transunion case undercut the business judgment rule, the court saying,

In my opinion, where a disinterested board in good faith considers the significance of the decision called for, the available information of which it and its

advisors are aware and the time constraints imposed upon it, and in those circumstances, the board makes a decision that it is in the best interests of the corporation to act, that decision itself is entitled to the benefits of the business judgment rule.

M. Lipton

November 3, 1988

To Our Clients:

The Interco Case

The Tuesday, November 1, decision in the Interco case came as a surprise. If it is affirmed by the Delaware Supreme Court, which yesterday scheduled an appeal for November 30, it could be the death knell for restructuring as a response to a cash tender offer for all the shares of a company, which the board of directors determines is inadequate.

The Delaware Chancery Court in Interco held that the company could not use its poison pill as a shield against the inadequate offer until it had completed the distribution to its shareholders of the dividend to be paid as part of its restructuring. Rather, the Court said, after the restructuring plan has been developed and adopted, the pill must be redeemed so that the tender offer could go forward before the distribution. This despite the fact that the Court found no fault with the restructuring plan and no reason to doubt that the Interco board reasonably concluded that the hostile tender offer was inadequate and that the restructuring plan was preferable. Further, there was no finding of entrenchment -- indeed, the restructuring plan did not roll up management's shareholdings into a blocking position and Interco was as much subject to takeover after the restructuring as before.

While the Court in the Interco case pays lip service to the doctrines that companies do not have to have permanent for sale signs and that an auction sale is not the only response a target of a hostile cash bid for all its shares can make, the practical effect of the decision is just that. I believe it flies in the face of the Delaware Supreme Court decisions in the Unocal and Newmont cases. If it is not reversed by the Delaware Supreme Court, it will be a dagger aimed at the hearts of all Delaware corporations and a further fueling of the takeover frenzy.

The Interco case and the failure of Delaware to enact an effective takeover statute, raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.

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It should be noted that press reports to the contrary notwithstanding, the Interco case did not cast any doubt on the legality of the poison pill. The pill remains the most effective means of dealing with abusive takeover tactics. But unless Interco is reversed by the Delaware Supreme Court its benefits to targets and their shareholders will be significantly curtailed.

M. Lipton

November 8, 1988

To Our Clients:

Just Say No

In the Pillsbury case, decided yesterday, the Delaware Court of Chancery endorsed the "just say no" response to a cash tender offer for all shares that the target's board acting in good faith and on a reasonable basis determined to be inadequate. The Court said that the target's "exploration of alternatives may go on indefinitely" and a poison pill may be kept in place to protect the target's ability to continue the exploration. The Court read the Interco case (now on appeal to the Delaware Supreme Court) as holding that a pill must be redeemed only when the target has selected an alternative and the tender offer is "arguably comparable" to the alternative. The Pillsbury decision did not take into account the spin-off alternative Pillsbury announced yesterday and the bidder for Pillsbury is going back to the Court to argue that since an alternative -- valued in the market at less than the cash bid -- has now been selected, the Court should now order the pill redeemed.

M. Lipton

December 17, 1988

To Our Clients:

You Can't Just Say No
In Delaware No More

The Pillsbury decision yesterday fulfills the threat to Delaware corporations presaged by the Interco decision. In Pillsbury a single Delaware judge substituted his judgment for the business judgment of the Pillsbury Board of Directors and sentenced Pillsbury to death as an independent company. The death sentence was passed despite the fact that the Pillsbury Board was not found to be acting in bad faith or negligently and despite the fact that the Pillsbury Board, on the advice of independent investment bankers, had determined that the takeover bid on the table was inadequate and was asking for \$5 per share more as the price for a negotiated merger.

The Pillsbury decision confirms the fear that the Delaware judges have abandoned the Business Judgment Rule in takeover cases and will substitute their business judgment for that of a target company's board of directors, even though the board is acting in good faith and on a reasonable basis.

The effect of the Pillsbury decision will be disastrous for American business and the American economy. It will fuel the takeover frenzy. It guarantees that any highest cash bid for all the shares of a company will result in the bidder acquiring the target. It even threatens the effective use of the poison pill as a means of achieving the time and circumstances necessary for a target's board to obtain the highest value for the shareholders. The Pillsbury decision means that the constant threat of takeover will be ever present for Delaware corporations, and, to survive, they will have to satisfy the demands of institutional investors and arbitrageurs for short-term stock price performance by increasing their leverage to dangerous levels and decreasing research, development and capital investment to levels that will ultimately destroy their ability to compete in world markets.

The Pillsbury decision shows that Delaware either does not understand, or does not care about, the long-range macroeconomic problems of the takeover frenzy and the concomitant deequitization of American business and its forced refocus on short-range stock market performance. Unless Delaware acts quickly to correct the Pillsbury decision, the only avenues open to the half of major American companies incorporated in Delaware will be federal legislation of the type now being considered by the Treasury Department or leaving Delaware for a more hospitable state of incorporation.

While the institutional investors and speculators who profit from the Pillsbury decision and the takeover frenzy will likely oppose a company lowering its takeover profile by leaving Delaware, the necessary votes are probably obtainable (witness Time and Inco) if the migration is accompanied by a special dividend or reasonable restructuring. In this connection, a company should consider a dividend of Share Price Protection Preferred Stock.

M. Lipton

A New System of Corporate Governance: The Quinquennial Election of Directors

Martin Lipton and Steven A. Rosenblum[†]

INTRODUCTION

Corporate governance is a means, not an end. Before we can speak intelligently about corporate governance, we must define its goals. In much of the recent academic literature on corporate governance, however, the goals are either ill-defined or assumed without examination. Academic writers commonly assume that a corporate governance system should be designed primarily to ensure that the actions of a corporation's managers and directors accurately reflect the wishes of its stockholders.¹ This assumption rests in turn on the premise that stockholders, as owners of the corporation, have the intrinsic right to dictate the corporation's course and receive its profits. Once this premise is accepted, the recognition of the separation of ownership and management as the central characteristic of the modern public corporation² leads inexorably to the conclusion that the central goal of corporate governance is to discipline managers, that is, make managers conform their actions to the desires of stockholders.

This line of academic analysis has coincided with the rise of hostile takeovers. Ignoring the quite varied sources and motivations of hostile acquirors, academic writers have embraced the hostile takeover as the free-market device to rid corporations of bad managers and give stockholders their entitled profit in the pro-

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¹ See, for example, Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv L Rev 1161, 1191, 1201 (1981) (managerial passivity in response to takeovers best serves stockholder interests); Ronald J. Gilson and Reinier Kraakman, *Reinventing the Outside Director: An Agenda For Institutional Investors* 31-32, 38, 46-48 (John M. Olin Program in Law and Economics, Stanford University Law School, 1990) (on file with U Chi L Rev) (proposing a corps of professional outside directors dependent on institutional stockholders, not management, for their positions); Louis Lowenstein, *What's Wrong with Wall Street: Short-term Gain and the Absentee Shareholder* 209-18 (Addison-Wesley, 1988) (institutional stockholders should nominate 20-25 percent of board, to encourage their participation in corporate governance).

² See generally Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Harcourt, Brace & World, rev ed 1968).

cess.³ Accordingly, these writers have proposed corporate governance rules designed to ensure that corporate managers and directors cannot impede a hostile takeover.

Upon examination, however, the unspoken premises of this body of academic literature are seriously flawed. First, there is no basis for the assumption of intrinsic rights and entitlements in the corporate structure. The Anglo-American corporate form is a creation of the state, conceived originally as a privilege to be conferred on specified entities for the public good and welfare. While the corporate form became more widely available as the economy demanded it, and is now generally available to any business, it remains a legal creation. As with any legal construct, we must justify the rules governing it on the basis of economic and social utility, not intrinsic rights. If alteration of those rules benefits the economic system and, in the long run, the corporations themselves, notions of "intrinsic rights" should not stand in the way.

Second, the academic literature has vastly overstated the benefits of the hostile takeover. Even if one accepts the priority of disciplining managers, the hostile takeover has proven a particularly destructive and inefficient means of such discipline. Hostile takeovers have not led managers to manage more effectively or to create more successful business enterprises. Instead, together with the increasing dominance of institutional stockholders, hostile takeover activity has led to an inordinate focus on short-term results and a dangerous overleveraging of the American and British economies, the ill effects of which are only beginning to emerge.

The present lull in hostile takeover activity provides an opportunity to reexamine our system of corporate governance relatively free of the high emotions of the 1980s. But the need for reexamination remains pressing. While the pace of hostile takeover activity has slowed, reflecting in part the current recession, hostile takeovers remain very much a part of the corporate landscape and managerial thinking. Moreover, the growing power of institutional stockholders, and their increasing willingness to exercise that

³ See, for example, Easterbrook and Fischel, 94 Harv L Rev at 1198 (cited in note 1) (managerial passivity in response to tender offers forces managers to put stockholder wealth ahead of their desires to protect their own positions); Lucian A. Bebchuk, *The Case For Facilitating Competing Tender Offers*, 95 Harv L Rev 1028 (1982) (supporting a rule of auctioneering, rather than passivity, in which incumbent management solicits competing bids); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan L Rev 819, 878-79 (1981) (proposing a rule that limits management's ability to interfere with stockholders' decision to accept or reject tender offers).

power, create pressures on corporate managers as great as those imposed by the last takeover wave. With the early corporate governance agenda of institutional stockholders focusing on opposition to takeover defenses and promotion of short-term profits, it is imperative that we reach a collective judgment as to the appropriate goals of corporate governance and the best means of meeting those goals.

This Article rejects the approach, which we will refer to as the "managerial discipline model," that assumes that conformity to stockholder wishes and protection of hostile takeovers are the primary goals of corporate governance. Instead, this Article argues that the ultimate goal of corporate governance is the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy. Corporate governance is a means of ordering the relationships and interests of the corporation's constituents: stockholders, management, employees, customers, suppliers, other stakeholders and the public. The legal rules that constitute a corporate governance system provide the framework for this ordering. This Article argues that the legal rules, the *system* of corporate governance, should encourage the ordering of these relationships and interests around the long-term operating success of the corporation. For it is this goal that will ultimately be the most beneficial to the greatest number of corporate constituents, including stockholders, and to our economy and society as a whole.

The system of corporate governance we propose places particular emphasis on the need for cooperation between managers and their principal institutional stockholders. The relationship between managers and stockholders is a problematic one in the modern public corporation, one that is dominated alternately by apathy and confrontation. The academic focus on the discipline of managers threatens to exacerbate the confrontational side of the relationship. What is needed is a system that will lead managers and stockholders to work cooperatively towards the corporation's long-term business success.

Part I of this Article examines the premises and flaws of the managerial discipline model of corporate governance. Part II examines the interest of the corporation in its long-term success as a business enterprise, and the harm to corporate and national interests inflicted by the short-termism that has resulted from changes in the nature of stock ownership and the rise in hostile takeover activity. Part III considers alternative approaches to corporate governance exemplified by the Japanese and German systems, and

suggests some of the practical constraints in implementing these approaches in the United States and United Kingdom economies. Part IV proposes a new corporate governance system for the United States and the United Kingdom, designed to balance the need for a long-term orientation with the need for managerial accountability. This proposal would replace annual elections of directors with quinquennial elections; bar nonconsensual changes in control between elections; provide major stockholders with direct access to the corporate proxy machinery in connection with the quinquennial election; provide for a detailed five-year report, which would be independently evaluated by an outside advisor, analyzing the corporation's prior five-year performance and setting forth its prospective five-year plan; and tie significant management compensation awards, as well as significant penalties, to the corporation's performance against the five-year plan.

I. THE MANAGERIAL DISCIPLINE MODEL

The academic community has generally embraced the managerial discipline model of corporate governance, which seeks to conform managerial behavior to the wishes of the corporation's stockholders and to prevent managers and directors from impeding hostile takeovers.⁴ Judicial norms, for the most part, have also followed the view of the supremacy of the stockholder in the corporate structure.⁵ Within the last few years, statutory and case law, largely at the urging of non-academic commentators, has begun to give legal recognition to the importance of long-term planning and non-stockholder constituencies in the health of corporations and the corporate economy.⁶ This recognition, however, has been spo-

⁴ For examples of the academic view, see sources cited in notes 1 and 3.

⁵ For examples of the judicial view, see *Dynamics Corp. of America v CTS Corp.*, 794 F2d 250, 256 (7th Cir 1986) (primary criterion for judging legality of poison pill is "the goal of stockholder wealth maximization"), rev'd on other grounds, 481 US 69 (1987); *Revlon Inc. v MacAndrews & Forbes Holdings, Inc.*, 506 A2d 173, 182, 184 n 16 (Del 1986) (after deciding to sell company, directors may only consider interests of the stockholders); *Dodge v Ford Motor Co.*, 204 Mich 459, 170 NW 668, 684 (1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

⁶ For examples of commentators' views, see Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U Pa L Rev 1, 35-43 (1987); William H. Steinbrink, *Management's Response to the Takeover Attempt*, 28 Case W Res L Rev 882 (1978); Nicholas F. Brady, Secretary of the Treasury, *Remarks before the Business Council* (Feb 22, 1990) (on file with U Chi L Rev). For examples of judicial decisions, see *Paramount Communications, Inc. v Time Inc.*, 571 A2d 1140, 1153 (Del 1989) (In evaluating a takeover bid, directors need not maximize short-term stock price and may consider "the impact on 'constituencies' other than shareholders . . .") (quoting *Unocal Corp. v Mesa Petroleum Co.*, 493 A2d 946, 955 (Del 1985)); *TW Services, Inc. v SWT Acquisition Corp.*, [1989

radic and non-systematic, and has engendered much criticism from academic circles.⁷

In this Part, we analyze three intellectual underpinnings of the managerial discipline model: the paradigm of the stockholder as property owner; the notion that managers are self-interested and require external discipline in order to run their companies well; and the view that the hostile takeover is an effective instrument of discipline. We conclude that each of these concepts is deeply flawed, and that the managerial discipline model is thus inadequate as the basis for a system of corporate governance.

A. The Stockholder as Property Owner

The managerial discipline model of corporate governance rests in large part on the paradigm of the stockholder as owner of the corporation, standing in much the same relationship to the corporation as the owner of any item of private property stands to that property.⁸ One of the fundamental principles of a capitalist legal system is that the owner of private property may do with that property as he wishes, so long as he does not harm third parties. Once one accepts the premise that stockholders own the corporation in the same manner as they own any other private property,

Transfer Binder] Fed Secur L Rptr (CCH) ¶ 94,334 at 92,173 (Del Chanc 1989) (directors need not pursue immediate maximization of share value by redeeming rights plan at expense of long-term business plan).

Chancellor William T. Allen of the Delaware Chancery Court noted in a recent speech, "The assumption that we want corporation law to more perfectly align manager action with shareholder interest is fundamental to the traditional legal view of the domain of corporation law. But that assumption was tested in the takeover setting in the 1980s and guess what? As George Gershwin put it, it ain't necessarily so." William T. Allen, *Competing Conceptions of the Corporation in American Law* 9 (Rocco J. Tresolini Lecture in Law, Lehigh University, Oct 29, 1990) (on file with U Chi L Rev). Because about 50 percent of the major public companies are incorporated in Delaware, the Delaware courts, more than any others, have been compelled to be the judicial arbiters of the corporate governance debate. Chancellor Allen, in his decisions and speeches, has demonstrated a keen understanding of corporate governance issues and the ramifications of judicial decisions on the business and policies of corporations. Together with the Delaware Supreme Court, he has fashioned a series of decisions, including the *Time* and *TW Services* cases cited above, that have enabled boards of directors to blunt, if not defeat, some of the ill effects of the takeover wave of the 1980s.

⁷ See, for example, Easterbrook and Fischel, 94 Harv L Rev at 1190-92 (cited in note 1) (criticizing the view of some commentators that, in responding to a tender offer, the target board should consider the interests of various non-investor groups); Gilson, 33 Stan L Rev at 862-65 (cited in note 3) (rejecting the argument that responsiveness to non-stockholder constituencies justifies management discretion in preventing tender offers).

⁸ See, for example, Frank H. Easterbrook and Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 Bus Law 1733, 1733 (1981) ("corporations exist and conduct their affairs for the benefit of the shareholders").

the conclusion that the wishes of the stockholders must be the paramount focus of the corporation follows, constrained only by the limitation on injuring third parties embodied in concepts such as environmental or products liability tort principles. From this starting point, the descriptive observation that separation of ownership and management is the central characteristic of the modern public corporation leads to the normative conclusion that the primary goal of corporate governance is to ensure that managerial actions conform to the wishes of stockholders. If the corporation is simply private property for the stockholders to do with as they please, the directors and managers of the corporation should, ideally, be no more than implementers of the stockholders' desires.

This line of reasoning, however, suffers from two major flaws. First, the corporation, particularly the modern public corporation, is not private property like any other private property.⁹ Rather, it is the central productive element of the economies of the United States and the United Kingdom. The health and stability of these economies depends on the ability of corporations to maintain healthy and stable business operations over the long term and to compete in world markets.¹⁰ The corporation affects the destinies of employees, communities, suppliers, and customers. All these constituencies contribute to, and have a stake in, the operation, success, and direction of the corporation. Moreover, the nation and the economy as a whole have a direct interest in ensuring an environment that will allow the private corporation to maintain its long-term health and stability. Rules of corporate ownership and governance must take account of many more interests than do the rules governing less complex property.

The origins of the public corporation reinforce this contrast with ordinary private property. Corporations came into being in England and the United States as quasi-public entities, granted legislative charters to serve specific public as well as private purposes.¹¹ Companies such as the British East India Company and

⁹ Professor Berle divides property into two classifications: (1) consumption property and (2) productive property—"property devoted to production, manufacture, service or commerce, and designed to offer, for a price, goods or services to the public from which a holder expects to derive a return." Berle and Means, *The Modern Corporation* at xi (cited in note 2).

¹⁰ *Capitalism*, *The Economist* 5, 6 (May 5, 1990) ("Capitalism") ("The proper 'micro' in microeconomics is the individual firm. How well it does, multiplied by thousands and millions of times, determines how well the economy does.").

¹¹ Berle and Means, *The Modern Corporation* at 120 (cited in note 2). For an overview of the corporation in American law, see generally Lawrence M. Friedman, *A History of American Law* 511-25 (Simon & Schuster, 2d ed 1985).

the Hudson Bay Company were political instrumentalities as well as profit-making enterprises.¹² Legislatures granted charters to early American corporations so that religious, educational, and charitable organizations could hold property and act as independent legal entities. Later charters established banks, canal companies, aqueduct companies, and other businesses essential for trade and city development.¹³ General incorporation statutes did not become predominant until the late nineteenth century.¹⁴ This authorization of general incorporation rights reflected a policy choice to encourage the general aggregation of capital by freeing the owner/stockholders from the risk of unlimited liability.

Given the corporation's origins as a historical and legal construct created for specific public policy reasons, the state naturally may choose to condition the use of the corporate form upon compliance with rules that advance societal goals, even if those goals clash with stockholder interests. For example, corporations must observe laws governing polluting, worker safety, child labor, the right of workers to unionize, foreign corrupt practices, product safety, and a host of other corporate behavior that affects society at large. There is no a priori reason why rules of corporate governance should not similarly take account of public purposes. To the extent there is an intrinsic nature to the corporation, it is more akin to that of a citizen, with responsibilities as well as rights, than to that of a piece of private property.

Second, the managerial discipline model tends to ignore or dismiss the implications for corporate governance of the changing nature of corporate ownership. Just as the corporation is not analogous to ordinary private property, neither is the stockholder in the modern public corporation analogous to the owner of ordinary private property. The stockholder owns an interest in a share of stock, a financial investment granting no direct control over the properties, equipment, contract rights, organizational structure, and other elements that make up the corporation itself. That share may entitle the stockholder to a percentage of the profits and

¹² Samuel Williston, *History of the Law of Business Corporations Before 1800*, 2 Harv L Rev 105, 108-11 (1888).

¹³ James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970* 13-20 (Virginia, 1970); Ronald E. Seavoy, *The Origins of the American Business Corporation, (1784-1855)* 5-7 (Greenwood, 1982). See also *Liggett Co. v Lee*, 288 US 517, 545 (1933) (Brandeis dissenting) (early charters granted only when necessary to procure some specific community benefit).

¹⁴ See Berle and Means, *The Modern Corporation* at 126-27 (cited in note 2) (discussing the appearance of the early general incorporation statutes).

residual value of the corporation, but the stockholder's intrinsic ownership interest is a financial interest, on which there is a return in the form of dividends or appreciation in trading price, rather than the "use and enjoyment" interest of the owner of a piece of personal property.

Moreover, unlike the stockholder/manager of the nineteenth century corporation or the modern incorporated proprietorship, the stockholder of the modern public corporation does not behave as a traditional owner of property. The stockholder/managers of a closely held corporation have an interest in developing the corporation, nurturing its business, preserving its strength, and ensuring its future. Their shares are not publicly traded and are usually not traded at all. In contrast, the stockholder/investors of the modern publicly held corporation view the corporation more as the holder of a betting slip views a racehorse.¹⁵ Just as the bettor does not really care about the fate of the racehorse as long as it provides him a financial payoff, so too the stockholder/investor does not really care about the fate of the corporation as long as the stock generates a profit.

The paradigm of the stockholder as the owner of private property, then, does not provide a compelling basis for the managerial discipline model of corporate governance. The economic and political justifications for our legal rules of private property do not transfer automatically to the rules governing the relationship between stockholder and corporation.¹⁶ It is simply not a sufficient or compelling answer to the question of why the desires of stockholders must be the paramount and controlling focus of the corporation to say that the stockholders are the owners of the corporation. Of course, stockholders deserve a prominent voice in corporate governance.¹⁷ Indeed, the proposal for a revised corporate governance system advanced in Part IV looks to stockholders to provide real and ultimate control over the corporation's direction. But the ordering of relationships among corporate constituents that is corporate governance cannot blindly follow the maxim that stockholders own the corporation and must be free to do with it as they please.

¹⁵ *Capitalism* at 8 (cited in note 10).

¹⁶ As Chancellor Allen states, "The premise of 'ownership' simply assumes but does not justify an answer." Allen, *Competing Conceptions of the Corporation in American Law* at 15 (cited in note 6).

¹⁷ Professors Gilson and Kraakman assert that "managerialist rhetoric" views the institutional investor as less than a real stockholder, and one whose interests "may be appropriately ignored." Gilson and Kraakman, *Reinventing the Outside Director* at 1 (cited in note 1). This argument is a straw man.

Rather, we must examine, justify, and if necessary modify our corporate governance system in terms of its impact on stockholders, the corporation and its other constituents, and the health of our economic system and society as a whole.

B. The Need for External Discipline

The managerial discipline model assumes that managers are inherently self-interested and that, left to their own devices, they will act selfishly and to the detriment of the corporation and its other constituencies, particularly the stockholders.¹⁸ This bias, however, is simply unfounded. In our experience, most managers and directors act diligently and in good faith to develop and maintain the business success of the corporations they manage or direct.¹⁹ Only the rare manager or director steals, whether literally or figuratively, from the corporation for personal gain. Certainly, the problem does not warrant the obsession of many academic writers with the issue. Of course, diligence and good faith do not ensure good or successful management. But the kind of discipline contemplated by the managerial discipline model, primarily the threat of takeover or replacement, is directed at the misperceived problem of managerial selfishness, not managerial ability.

Proponents of the managerial discipline model tend to view any action taken by managers that conflicts with the wishes of the stockholders as evidence of managerial self-interest. Thus, they characterize the adoption of antitakeover devices as management entrenchment,²⁰ and business acquisitions that hurt short-term earnings as managerial self-aggrandizement.²¹ In so doing, they ignore the possibility that, to the extent these actions conflict with the wishes of stockholders, the divergence may simply reflect dif-

¹⁸ See, for example, Easterbrook and Fischel, 94 Harv L Rev at 1169-70 (cited in note 1) (discipline necessary because some managers "will find it advantageous to shirk responsibilities, consume perquisites, or otherwise take more than the corporation promised to give them"); Gilson, 33 Stan L Rev at 836 (cited in note 3) (managers "can be expected, if otherwise unconstrained, to maximize their own welfare rather than the shareholders'").

¹⁹ See also Jay W. Lorsch, *Pawns or Potentates: The Reality of America's Corporate Boards* 30 (Harvard Business School Press, 1989) ("America's boards are made up of, by and large, responsible and dedicated directors who take their duties seriously.").

²⁰ See, for example, Easterbrook and Fischel, 94 Harv L Rev at 1175 (cited in note 1) (To protect their salaries and status, managers of target company "may disguise a policy of resistance to all offers as a policy of searching for a better offer than any made so far.").

²¹ See, for example, Michael C. Jensen and Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, Harv Bus Rev 36, 45 (May-June 1990) ("Executives are invariably tempted to acquire other companies and expand the diversity of the empire, even though acquisitions often reduce shareholder wealth.").

fering perspectives as to the appropriate direction and business plan of the corporation. While a stockholder seeking a short-term premium may object to takeover impediments, antitakeover provisions can be a quite rational tool for a board of directors seeking to preserve the corporation in the face of an attempted takeover that is likely to be detrimental to the long-term health of its business. Similarly, while a stockholder with a short-term investment horizon may object to a business combination that initially hurts the corporation's earnings per share, the business combination may reflect the good faith judgment of the corporation's directors and managers that the step is necessary to position the corporation to prosper over the long term.

The managerial discipline model also dismisses the substantial common law and statutory legal strictures already in place that address overt self-dealing or self-interestedness. Transactions with the corporation in which a director or manager has a personal financial interest receive close scrutiny.²² Insider trading rules²³ and short-swing profit recovery²⁴ guard against the misuse of information in stock trading by directors and managers. Moreover, substantial existing financial and social incentives motivate directors and managers to seek the business success of the corporations they direct or manage. Incentive compensation based on appreciation of the stock of the corporation, or based on increasing earnings and exceeding budget targets, provides managers with financial rewards

²² See, for example, *Fliegler v Lawrence*, 361 A2d 218, 221 (Del 1976) (where defendants stood on both sides of transaction, burden was on defendants to demonstrate transaction's intrinsic fairness to the acquiring firm and its stockholders); *AC Acquisitions Corp. v Anderson, Clayton and Co.*, 519 A2d 103, 111 (Del Chanc 1986) (board with financial interest in transaction adverse to corporation bears burden of proving the transaction's intrinsic or objective fairness); *Guth v Loft, Inc.*, 23 Del Chanc 255, 5 A2d 503, 510 (1939) (rule demands of a director the most scrupulous observance of his duty to "refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers"). In addition to case law, approximately three-quarters of the states have enacted statutory provisions governing contracts with interested directors. See, for example, 8 Del Code Ann § 144 (1990).

²³ Section 10(b) of the Securities Exchange Act of 1934, 15 USC § 78j (1988), and Rule 10b-5 promulgated thereunder, require that an insider who possesses material nonpublic information about a company make appropriate disclosure of the information or abstain from trading in the company's stock. See *In re Cady, Roberts & Co.*, 40 SEC 907, 911 (1961).

²⁴ Section 16(b) of the Securities Exchange Act of 1934, 15 USC § 78p(b), provides for a rule of strict liability, entitling an issuer to recover any profits realized by a director, officer, or beneficial owner of ten percent of an issuer's outstanding stock, from the purchase or sale of any equity security of the issuer.

tied to the success of the corporation.²⁵ An executive's social status, and the respect of fellow executives, typically depend in large part on the success of the corporation he or she manages. Independent directors' reputations, and to some extent their opportunities to serve on other boards, are tied to the business success of their corporations.²⁶

The managerial discipline model's emphasis on reining in managerial self-interest is thus just as flawed as its emphasis on conforming the actions of managers to the desires of the stockholders. The greater problem, or challenge, is to design a system that gives managers the opportunity and the incentive to work in partnership with stockholders and the corporation's other constituencies in improving the long-term business performance of the corporation. The quinquennial proposal advanced in Part IV addresses this problem.

C. Hostile Takeovers as an Instrument of Discipline

Academic proponents of the managerial discipline model of corporate governance tend to embrace the hostile takeover as the primary instrument of managerial discipline. They argue that bad, inefficient, or self-interested managers, or managers who fail to heed the wishes of the stockholders, will find themselves vulnerable to a hostile takeover. If the state does not permit incumbent management to interfere with stockholders' freedom to accept tender offers, the argument continues, the fear of a hostile takeover will make bad managers good, inefficient managers efficient, and self-interested managers responsive to stockholder desires.²⁷ In

²⁵ The quinquennial proposal set forth in Part IV suggests tying these financial incentives to the performance of the corporation over five-year periods as part of the effort to reorient the corporation towards long-term business performance. See Part IV.E.

²⁶ See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J Pol Econ 288, 294 & n 3 (1980) (discussing market for outside directors: "Like the professional outside director, the welfare of the outside auditor depends largely on 'reputation.'"). But see Gilson and Kraakman, *Reinventing the Outside Director* at 22-23 & nn 41-42 (cited in note 1) (arguing that no effective market for outside directors exists). While perhaps not as developed as the market for outside auditors, our experience is that reputation is important in creating opportunities for outside directors.

²⁷ See, for example, Gilson & Kraakman, *Reinventing the Outside Director* at 12-13 (cited in note 1) (mere threat of hostile offer is likely to improve target management); Easterbrook and Fischel, 94 Harv L Rev at 1169 (cited in note 1) ("tender bidding process polices managers whether or not a tender offer occurs"); ALI, *Principles of Corporate Governance: Analysis and Recommendations* part VI at 98 (Tent Draft No 10, 1990) ("[T]ender offers are mechanisms through which market review of the effectiveness of management's delegated discretion can operate."). See also *Finnegan v Campeau Corp.*, 915 F2d 824, 831 (2d Cir 1990) ("Congress realized 'that takeover bids should not be discouraged

practice, however, the hostile takeover is not a particularly effective or efficient means of motivating or disciplining managers.

The enthusiasm for the hostile takeover as the primary instrument of managerial discipline rests heavily on the efficient capital markets theory that has dominated the academic literature over the last two decades. This theory holds, in essence, that the market price of a corporation's stock at any given time accurately reflects all available information about the corporation and its anticipated future income stream. Accordingly, the argument continues, the market can neither undervalue nor overvalue a corporation's worth.²⁸ The willingness of an acquiror to pay a premium to the market price, then, necessarily implies that the acquiror can increase the value of the corporation by managing the assets better, thus demonstrating the inefficiency of the existing management.

In recent years, however, the efficient capital markets theory has become increasingly discredited, especially since the stock market crash of October 1987.²⁹ A growing body of economic literature now accepts that the stock market can and does misprice particular stocks, groups of stocks, and even stocks in general for extended periods of time.³⁰ The new literature recognizes the great degree of subjectivity, and even irrationality, among investors who set the demand for and the price of stocks.³¹ Recent literature also

because they serve a useful purpose in providing a check on entrenched but inefficient management.'") (quoting legislative history of the Williams Act, S Rep No 90-550, 90th Cong, 1st Sess 3 (1967)).

²⁸ See, for example, Easterbrook and Fischel, 36 Bus Law at 1734 (cited in note 8) ("[T]he notion that stock is priced in the market at less than its true value is implausible."); Werner F.M. De Bondt and Richard H. Thaler, *A Mean-Reverting Walk Down Wall Street*, 3 J Econ Persp 189, 189 (1989) ("Few propositions in economics are held with more fervor than the view that financial markets are 'efficient' and that the prices of securities in such markets are equal to their intrinsic values.").

²⁹ Andrei Shleifer and Lawrence H. Summers, *The Noise Trader Approach to Finance*, 4 J Econ Persp 19, 29 (1990) ("[S]tock in the efficient markets hypothesis—at least as it has traditionally been formulated—crashed along with the rest of the market on October 19, 1987," when "a 22 percent devaluation of the American corporate sector" occurred in one day.).

³⁰ See Stephen F. LeRoy, *Efficient Capital Markets and Martingales*, 27 J Econ Lit 1583, 1616 (1989) ("The most radical revision in efficient-markets reasoning will involve those implications of market efficiency that depend on asset prices equaling or closely approximating fundamental values. The evidence suggests that, contrary to the assertion of this version of efficient markets theory, such large discrepancies between price and fundamental value regularly occur."); E. Victor Morgan and Ann D. Morgan, *The Stock Market and Mergers in the United Kingdom* 74 (David Hume Institute, 1990) ("There are powerful reasons for believing that equity markets, in the UK and elsewhere, are unlikely to be fundamental-valuation efficient but, in view of the difficulty of testing and the paucity of factual evidence, the question must remain open.").

³¹ See, for example, Shleifer and Summers, 4 J Econ Persp at 19-20 (cited in note 29)

examines the effects on pricing of varying levels of information among investors, varying investor time horizons, varying evaluations of future prospects and risks, and the greater cost and risk of arbitraging long-term mispricing than short-term mispricing.³² Moreover, tax and accounting effects can cause a corporation's stock to be underpriced in the market compared to its worth to an acquiror.³³ These factors all support the conclusion that the public market may often undervalue the shares of a corporation relative to the worth an acquiror would place on the shares, even in the absence of any efficiency gains from the acquisition.

Professors Shleifer and Summers suggest that another source of takeover activity may be the ability of an acquiror to realize gains from a "breach of trust" with the corporation's other constit-

("Our approach rests on two assumptions. First, some investors are not fully rational and their demand for risky assets is affected by their beliefs or sentiments that are not fully justified by fundamental news. Second, arbitrage—defined as trading by fully rational investors not subject to such sentiment—is risky and therefore limited."); Gavin C. Reid, *Efficient Markets and the Rationale of Takeovers* 19-23 (David Hume Institute, 1990) (describing "bubbles," in which "prices rise rapidly without apparent good reason, trading volumes accelerate, and prices finally crash," and "fads," in which "social convention or fashion makes certain assets desirable"); De Bondt and Thaler, 3 J Econ Persp at 199-200 (cited in note 28) (discussing how "faulty risk perceptions," "a tendency to overreact to recent earnings trends," and "biased" immediate price reaction to negative events may result in market undervaluation of a corporation's shares: "For companies that experience a series of 'bad events,' the price correction may take several years.").

³² See Jean A. Crockett, *Takeover Attempts, Economic Welfare, and the Role of Outside Directors* (Rodney L. White Center for Financial Research, Wharton School of Finance, 1989) (on file with U Chi L Rev) (stock prices can undervalue corporations because of information imperfections and short-term investment horizons); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 Yale L J 1235, 1295 (1990) (heterogeneous investor valuations create a downward sloping demand curve for a corporation's shares, which implies that takeover premiums "may be natural market phenomena rather than evidence of efficiency gains from acquisitions"); Andrei Shleifer and Robert W. Vishny, *The New Theory of the Firm: Equilibrium Short Horizons of Investors and Firms*, 80 Am Econ Rev Pap & Proc 148 (1990) (greater cost of arbitrage in long-term assets compared to short-term assets results in greater mispricing of long-term assets in equilibrium).

³³ Tax rules (particularly the tax deductibility of interest payments and non-deductibility of dividend payments) and accounting conventions (particularly the capitalization of acquisition costs in contrast to the current charge for the costs of starting a new business, research and development, and introducing new products) encouraged the acquisitions and leveraging of the last decade and require reexamination, although we do not undertake that task here. See Crockett, *Takeover Attempts* at 5-6 (cited in note 32) ("When we look at the impact on the economy as a whole, the increment in after-tax earnings for the surviving firm [in a leveraged transaction] must be offset against the loss to the Treasury and ultimately the taxpayers. The effect is primarily an income transfer hard to justify on equity grounds. Furthermore, it is possible that the overall economy will suffer if the higher leverage leads to a higher rate of bankruptcies or serious financial difficulties in the next recession.").

uents.³⁴ They point out that a corporation enters into implicit contracts with constituents such as employees and suppliers. In some circumstances, these implicit contracts may become a liability, but incumbent managers remain committed to upholding them because of the trust relationship between the managers and stakeholders. "In these cases ousting the managers is a prerequisite to realizing the gains from the breach. . . . The resulting wealth gains show up as the takeover premia."³⁵ To the extent such breaches of trust account for the takeover premium, the takeover represents a wealth transfer and not an efficiency gain. In this manner, "hostile takeovers can be privately beneficial and take place even when they are not socially desirable."³⁶

A number of other factors also contributed to the hostile takeover explosion of the 1980s. For example, the relative ease of obtaining acquisition financing and leveraged buyout fund capital allowed acquirors to make risky acquisitions with little of their own money invested, and thus little downside risk to themselves.³⁷ The ease of obtaining financing also extended to takeover arbitrageurs, who facilitated hostile transactions.³⁸ And the arrogance and ego of corporate raiders, seeking to do a bigger or better deal than the one just announced in the financial press, may also have helped fuel the takeover wave.³⁹ In sum, it is simply wrong to suggest that

³⁴ Andrei Shleifer and Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in Alan J. Auerbach, ed, *Corporate Takeovers: Causes and Consequences* 33 (Chicago, 1988). See also J. Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L Rev 1, 63 (1987) ("A hostile acquisition enables a firm's shareholders to renege on the bargain they initially struck with their managers. In so doing, a hostile acquisition enables the shareholders to appropriate the bulk of any organizational rent the firm earns, even when that rent results from joint investments by shareholders and managers.").

³⁵ Shleifer and Summers, *Breach of Trust in Hostile Takeovers*, in Auerbach, ed, *Corporate Takeovers* at 41 (cited in note 34).

³⁶ *Id.* at 34.

³⁷ See, for example, Richard L. Stern and Edward F. Cone, *Scarlett O'Hara comes to Wall Street*, *Forbes* 37 (Sept 21, 1987) (investment banks, commercial banks, and insurance companies fight to finance LBOs); Sarah Bartlett, *Need A Quick Billion or Two? Just Ask Your Banker*, *Bus Week* 98 (Oct 26, 1987) (big banks providing loans for mergers and LBOs quickly and in huge amounts); Robert L. Messineo, *Proposed SEC Rules May Impact LBO Funds*, *NY L J* 5 (Sept 21, 1989) (\$20 billion committed to LBO funds is used to finance sizeable transactions on an expeditious basis).

³⁸ See, for example, Allan Sloan, *An Extra Slice of the Pie*, *Forbes* 32 (Feb 9, 1987) (leading takeover arbitrageur Ivan Boesky, together with Drexel Burnham Lambert, raised \$350 million in equity and \$660 million in debt for Boesky's takeover arbitrage partnership).

³⁹ See Reid, *Efficient Markets and the Rationale of Takeovers* at 34 (cited in note 31) ("[I]s it not possible that 'noise trading' is also going on, with pathological propensities to 'do a deal' over-riding considerations of net benefit, and thus of efficiency?").

bad, inefficient, or self-interested management is the sole or primary source of this takeover activity.

The anecdotal evidence supports this conclusion. In recent years, well-managed corporations have been just as likely as poorly managed corporations to become the target of a hostile takeover. For example, AMR Corporation (the parent of American Airlines) became the subject of a takeover attempt by Donald Trump, although the chairman of AMR is generally recognized as the best manager in the airline industry.⁴⁰ Georgia-Pacific Corporation acquired Great Northern Nekoosa Corporation even though Great Northern Nekoosa's return to stockholders for the prior ten years exceeded that of Georgia-Pacific and the industry as a whole.⁴¹ Georgia-Pacific's stock price and earnings have since declined.⁴² Even noted raider Sir Gordon White, Chairman of Hanson Industries, in defending hostile takeover activity, notes: "There are a large number of companies which are regarded, by and large, as well run. Of course, these companies can be taken over as the result of a hostile bid but the shareholders can and do demand a very high price."⁴³

If poor or inefficient management is not the primary impetus for hostile takeovers, it follows that takeovers do not generally motivate managers to manage better or more efficiently. Rather, the hostile takeover motivates managers to combat the undervaluation of their stock by leveraging the corporation, avoiding investments that do not immediately add to reported earnings, selling assets, or otherwise boosting short-term earnings, regardless of the possible harm to the corporation over the long term.⁴⁴ Even to the extent

⁴⁰ See Judith H. Dobrzynski, *Why Even Well-Run Companies Can Be Easy Prey*, *Bus Week* 56 (Oct 23, 1989); Erik Hedegaard, *Fasten Your Seatbelt, Bob, It's Going to be a BUMPY Year*, *M Inc.* 61 (Jan 1991) ("American Airlines' Robert Crandall is considered the best in the business.").

⁴¹ See Great Northern Nekoosa Corporation Letter to Shareowners (Nov 13, 1989), filed with the Securities and Exchange Commission as Exhibit 15 to Great Northern Nekoosa Corporation Schedule 14D-9 (on file with U Chi L Rev).

⁴² Jacqueline Bueno, *Georgia-Pacific Earnings, Stock Price Take a Tumble*, *Atlanta Bus Chron* 3A (Sept 3, 1990). The authors' law firm represented AMR and Great Northern Nekoosa in these takeover matters. While these two examples do not demonstrate that all takeovers are bad, they do undercut any close linkage between takeovers and incentives for competent management.

⁴³ Sir Gordon White, *Why Management Must Be Accountable*, *Financial Times* § 1 at 11 (July 12, 1990).

⁴⁴ See, for example, Richard Lambert and Anatole Kaletsky, *Jam Today Is What Shareholders Want*, *Financial Times* § 1 at 21 (July 12, 1989) ("The last-ditch defence against hostile takeovers has thus been for existing managements to steal the raider's thunder by arranging a leveraged buy-out and recapitalisation themselves. . . . Ironically, in many cases it is the existing management, rather than the outside raider, that ultimately leads a company up with greater debts and becomes the more ruthless liquidator."); Chris-

mismanagement does contribute to hostile takeover activity, the threat of a hostile takeover is far more likely to create an attitude of defensiveness on the part of managers than to create an openness to the kind of change and new ideas that might serve to improve business performance.⁴⁵ Some hostile takeovers may replace bad managers with new ones who may or may not be better. But the threat of a hostile takeover is unlikely to improve the performance of bad managers.⁴⁶ Finally, as we discuss in Part II, hostile takeovers and related short-termism have imposed substantial ancillary societal costs.

In sum, the managerial discipline model of corporate governance is not compelling. We must turn, then, to the examination of the corporation's proper place in our economy and society, the challenges for corporate governance, and the question of how best to reconcile the interests of the corporation's various constituents and our economy and society as a whole.

II. THE INTEREST OF THE CORPORATION IN ITS LONG-TERM SUCCESS AND THE SOCIETAL COST OF SHORT-TERMISM

In this Part, we offer an alternative to the managerial discipline model. We argue that the corporation has an independent interest in its own long-term business success. Classical economic theory suggests that this interest, multiplied by many individual

topher Farrell, *The Bills Are Coming Due*, Bus Week 84 (Sept 11, 1989) (USG Corp. "beat back a takeover raid last year through a \$2.2 billion recapitalization. . . . USG has slashed its research-and-development staff and expenditures in half, nearly halved capital spending, cut its work force from 21,000 to 16,000, reduced the management ranks by 10%, and sold assets worth \$600 million—including highly profitable Masonite Corp. . . . Competitors smell blood.").

⁴⁵ John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Colum L Rev 1145, 1242-43 (1984) (The work of Douglas McGregor and "a legion of other social scientists" suggests that "management will be more effective if it creates an environment that stresses support and encouragement rather than constant threats of dismissal. . . . In this view, the constructive deterrent value of the takeover lies more in its ability to function as the corporate guillotine, amputating swiftly and finally an inefficient management, and less in its general deterrent effect as a motivating force by which marginal managements are spurred to greater effort.").

⁴⁶ Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 Colum L Rev 1461, 1497-99 (1989) (threat of a takeover may make some managers more efficient, but "the takeover market neither adequately aligns the interests of managers and shareholders, nor adequately addresses the problem of managerial inefficiency"); Coffee, 84 Colum L Rev at 1192-95 (cited in note 45) (capital market is only an effective monitor in cases of massive managerial failure); Michael L. Dertouzos, Richard K. Lester and Robert M. Solow, *Made in America: Regaining the Productive Edge* 39 (MIT, 1989) ("Only an extraordinary optimist could believe, for example, that the current wave of takeover activity is an efficient way to deal with the organizational deficiencies of American industries.").

firms, is also society's interest and therefore supplies the proper organizing principle of corporate governance. The ascendancy of the institutional stockholder and the hostile takeover, however, creates an emphasis on short-term results that makes it increasingly difficult for the corporation to maintain the long-term focus necessary to its own and society's well-being. The efficient capital markets theory that underlies academic support for takeovers, and that dismisses the distinction between short-term and long-term interests, has become increasingly discredited. The short-term bias imposed by institutional stockholders and takeover activity is real, and this short-term bias has substantial corporate and societal costs. In this context, the priorities of the managerial discipline model threaten to exacerbate the problems of short-termism. Instead, our rules of corporate governance require the sort of fundamental reform that will align the interests of all corporate constituents toward the long term.

A. The Interest of the Corporation as a Business Enterprise

At the most basic level, the corporation is no more than a specific legal form of business enterprise. It is a concatenation of factors of production—property, equipment, employees, contract rights, and the like—organized to produce goods and services efficiently. To the extent that the enterprise is able to attract and retain consumers of its products or services who are willing to pay the enterprise more than it costs to produce the products or services, the enterprise will make a profit. The greater the amount of goods or services the enterprise can sell, and the greater the difference between what the consumer is willing to pay and what the goods or services cost to produce, the greater the profit that inures to the enterprise. Viewed in this light, the corporate enterprise has an independent interest of its own in the successful operation of its business, with success measured in terms of present and expected profit. The notion of “the best interest of the corporation” refers to this interest in the present and continuing vitality of the enterprise.⁴⁷

Classical economic theory looks to the profit interest of proprietors to ensure the health of business enterprises and, in turn, of

⁴⁷ *TW Services, Inc. v SWT Acquisition Corp.*, [1989 Transfer Binder] Fed Sec L Rptr (CCH) ¶ 94,334 at 92,178 (Del Chanc 1989) (“[D]irectors . . . may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected.”).

the national economy.⁴⁸ This theory holds that the profit motive drives each proprietor to produce better goods and services more efficiently than his competitors. As long as private actors have virtually complete freedom to use their resources as they wish, classical economic theory's invisible hand will cause the best and most efficient producers to flourish, direct each factor of production to its best and most efficient use, and lead the economy as a whole to thrive. This is the basis on which the legal and social system justifies granting free rein to the individual's economic self-interest.

This theory, however, originated in a time when most proprietors owned and managed their own enterprises.⁴⁹ Proprietor and enterprise shared identical interests; by making the enterprise more successful and profitable, the proprietor reaped a personal profit. Moreover, the enterprise typically represented the bulk of the proprietor's economic wealth. The proprietor could not simply set it aside and turn to some other investment or pursuit without losing much of his wealth. Accordingly, self-interest dictated that the proprietor seek to develop and maintain the long-term operating success of the enterprise.

The separation of ownership and management dramatically alters this theoretical model. No longer does the profit motive of the corporate owner, with her highly liquid stake and betting-slip mentality, automatically promote the long-term health of the enterprise. Nor does the self-interest and profit motive of the manager, typically insulated from risk by her small ownership stake and by limited liability, automatically create the most efficient and profitable corporation possible.

The managerial discipline model focuses sharply on the potential divergence between managers' interests and the corporation's interest. But, in so doing, it fails to recognize or consider the implications of the potential divergence between stockholders' interests and the corporation's interest. Indeed, most of the academic literature *defines* the interest of the corporation in terms of the desires of stockholders, thereby assuming away the potential divergence.⁵⁰ As discussed above, however, there is no intrinsic reason that the conformity to the wishes of the stockholders must be the central

⁴⁸ Adam Smith, *The Wealth of Nations* Book 4, ch 2 at 419-20 (Methuen, 6th ed 1950) (originally published 1776).

⁴⁹ Id. See also Berle and Means, *The Modern Corporation* at 303-08 (cited in note 2).

⁵⁰ See, for example, Easterbrook and Fischel, 36 *Bus Law* at 1733 (cited in note 8) ("The purpose of corporations law is to establish organizing principles under which shareholders may conduct the enterprise for their own benefit.").

goal of the corporation.⁵¹ Rather, the justification for granting free rein to owner or stockholder self-interest, and defining that self-interest as the interest of the corporation, rests on the classical economic model in which the stockholder/owner/proprietor links her long-term economic well-being to the long-term health of the business enterprise. As and when the underpinnings of this model change, the conclusions and policy decisions generated by the model must be reexamined.

An obvious example of the need to reexamine the model and make periodic adjustments is provided by the development of anti-trust laws in the United States and the United Kingdom. These laws, responding to the modern corporation's ability to distort markets through monopolization or anticompetitive pricing, represent an effort to realign the market into conformity with the assumptions of the classical model. Similarly, the separation of ownership and management, and the changing nature of ownership, have undermined the invisible hand model. A corporate governance system based on this model accordingly becomes problematic. Ultimately, the corporate governance system must realign the interests of the corporation's stockholders, managers, and other constituencies to promote the long-term health of the business enterprise. Only then will the pursuit of private interest again serve the public interest as posited by classical economic theory.

B. Short-Termism and the Bias of Institutional Stockholders

The growing dominance of institutional shareholdings, and the structure within which institutional stockholders now operate, has virtually ensured the divergence of the interests of stockholders and those of the corporation. Institutions now hold more than 45 percent of total equities in the United States, and approximately 52 percent of equity in the 500 largest companies.⁵² The concentration of institutional ownership in the United Kingdom is even greater, exceeding 63 percent.⁵³ Institutional stockholders have little incentive or inclination to behave like traditional owners in the classical economic model—that is, to work actively towards the

⁵¹ See Part I.A.

⁵² Carolyn Kay Brancato, *The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project* 21 and Table 7 (Center for Law and Economic Studies, Columbia University School of Law, 1990) (on file with U Chi L Rev).

⁵³ See William Taylor, *Can Big Owners Make a Difference?*, Harv Bus Rev 70 (Sept-Oct 1990).

long-term operating success of the corporation. They tend to focus instead on the current market price of the corporation's stock. Most institutional stockholders will support a hostile takeover, a sale of assets, a leveraging recapitalization, or any other transaction that boosts the immediate price of the corporation's stock.

The critique of short-term bias is a critique not of the motives or integrity of institutional stockholders, but of the system that has failed to respond to the changing nature of stock ownership. While proposing a corps of professional directors to be nominated and elected by institutional stockholders, Professors Gilson and Kraakman recognize that institutional stockholders currently have little opportunity or incentive to take an interest in the long-term business development of the corporations whose stock they own.⁵⁴ However, they would accept the short-term bias of institutional stockholders and seek to guarantee that the board of directors, in the name of heeding the wishes of stockholders, reflects this bias. In contrast, this Article suggests that the corporate governance system must attempt to counteract this short-term bias and realign the interests of stockholders with the interest of the corporation as an ongoing business enterprise.

Several constraints operate on the institutional stockholder to produce a short-term bias. First, as their stock portfolios have grown in size, institutional stockholders have increasingly lost the ability to assess adequately the business performance of each portfolio company.⁵⁵ For these stockholders, the market price of the corporation's stock has become the only important valuation measure for the corporation, and any step that boosts the short-term price of a portfolio company's stock has become viewed as intrinsically desirable.

Second, institutional stockholders assess the performance of the investment managers who control their stock portfolios over a short time frame, typically quarter to quarter or year to year, on the basis of the change in the portfolio's market value during the specified time period.⁵⁶ The investment manager trying to outperform the market average in each quarter or each year will al-

⁵⁴ Gilson & Kraakman, *Reinventing the Outside Director* at 6-8 (cited in note 1).

⁵⁵ *Id.* at 6-7 (growth of funds under the management of institutional investors whose investment strategy is simply to track the general performance of the market reflects the inability or unwillingness of those stockholders to track the performance of individual corporations); Taylor, Harv Bus Rev at 72 (cited in note 53) ("Of the \$40 billion in equities owned by the New York funds [three pension funds for retired state and local employees], \$30 billion are in indexed portfolios.").

⁵⁶ See Dertouzos, Lester, and Solow, *Made in America* at 62 (cited in note 46) (fund

ways have an incentive to accept, even seek, a short-term premium for a portfolio stock.⁵⁷ This competition among investment managers exacerbates a situation analogous to the "prisoner's dilemma," in which cooperation produces optimal results but rational, self-interested behavior does not.⁵⁸ Even if the investment manager understands that stockholders as a whole would be better off encouraging and promoting the long-term business development of all corporations, he will still accept, even seek, short-term premiums on his portfolio stocks in an effort to outperform competing investment managers in any given quarter or year.

Finally, the institutional stockholder faces liability constraints. The typical institutional stockholder has a fiduciary duty to the beneficiaries of its portfolio and must act solely in their interest.⁵⁹ While fiduciary status does not intrinsically require a short-term orientation, to the extent the courts and government agencies such as the Department of Labor have accepted the managerial discipline model's short-term bias, the institutional stockholder may fear exposure to liability if it fails to seek or accept the short-term premium for its portfolio shares.⁶⁰

managers rapidly turn over stock holdings since judged on current value of investment portfolio). See also Lipton, 136 U Pa L Rev at 7-8 (cited in note 6).

⁵⁷ See Crockett, *Takeover Attempts* at 8 & n 8 (cited in note 32) (short time horizons of institutional stockholders result from "emphasis . . . placed on short-term performance in evaluating and rewarding fund managers").

⁵⁸ See generally Anatol Rapoport and Albert M. Chammah, *Prisoner's Dilemma: A Study in Conflict and Cooperation* (Michigan, 1965).

⁵⁹ The Department of Labor (DOL) views the Employee Retirement Income Security Act of 1974 (ERISA), 29 USC §§ 1001 et seq (1988), as requiring plan fiduciaries to consider only the economic interests of the plan participants and beneficiaries in the shares held by the plan when deciding whether to tender shares in a tender offer. While the DOL has stated that plan fiduciaries may weigh the long-term value of the target company in this decision, it also warns that it will monitor plan fiduciaries to ensure that they do not violate ERISA's requirements and are aware of the liability that can result from any such violations. See *Press Briefing on ERISA and Takeovers*, in 6 Pension & Profit Sharing (Prentice-Hall) ¶ 135,649 at 136,971 (1989). See also David George Ball, Assistant Secretary, Pension & Welfare Benefits Administration, *The Importance of Corporate Governance* (speech to United Shareholders' Association, Sept 17, 1990) (on file with U Chi L Rev). In practice, the DOL's statements have resulted in pressure on plan fiduciaries to tender their shares for the immediate premium, in order to avoid liability for incorrectly assessing the long-term value of the target corporation and its prospective return to stockholders.

⁶⁰ See, for example, statement of David Walker, Assistant Secretary of Labor, in 6 Pension and Profit Sharing at 136,971 (cited in note 59) (plan fiduciaries must look solely to economic interests of the pension plan, with purpose of maximizing retirement income for beneficiaries); Thomas Gilroy and Brien D. Ward, *The Institutional Investor's Duty Under ERISA to Vote Corporate Proxies*, in *Proxy Contests, Institutional Investor Initiatives, Management Responses 1990* 853, 866 (PLI, 1990) (DOL generally claims that ERISA's prudence requirement "obligates the fiduciary to consider only economic factors that affect the value of the plan's investment. For example, the decision to vote for a shareholder initi-

Commentators outside of academic circles have for some time noted the problem of short-termism.⁶¹ Because of the influence of the efficient capital markets theory, however, the academic literature has tended to ignore the problem. Under the efficient capital markets theory, the short-term price of a stock reflects the present value of the corporation's long-term results. Adherents of this theory thus define out of existence the distinction between short-term and long-term values or investor orientations.⁶²

It is only with the recent undermining of the efficient capital markets theory⁶³ that the academic literature, particularly the economic literature, has begun to examine the effects of short-term biases and short-term investment horizons. Professors Shleifer and Vishny, for example, have demonstrated that the short time horizons of arbitrage investors, who focus on short-term assets because they are relatively less expensive to arbitrage, may result in severe market underpricing of a corporation's equity. This phenomenon in turn imposes a short time horizon on managers, who avoid long-term investments that depress share prices over the short term and that thus make the corporation vulnerable to hostile takeover.⁶⁴ They conclude that the "clustering" of arbitrage on the trading of short-term assets "leads to systematically more accurate pricing of short-term assets than of long-term assets, even though efficient capital allocation and managerial evaluation might be better served by the opposite bias."⁶⁵

Other academic writers identify additional sources of short-term pressures and biases. Stephen LeRoy points to the recent literature on cognitive psychology for the proposition that stockholders "systematically overweight current information and underweight background information,"⁶⁶ thus producing an artificially

ative in the belief that it will support management's commitment to stimulate job growth in a targeted sector of the economy may, in the DOL's view, violate [the fiduciary duty]."). ERISA provides that a plan fiduciary is "personally liable" for any breach of fiduciary duty. ERISA § 409(a), 29 USC § 1109(a). This provision may be enforced either by a plan participant or beneficiary or by the Department of Labor. ERISA § 502(a)(2), 29 USC § 1132(a)(2).

⁶¹ See, for example, John G. Smale, *What About Shareowners' Responsibility?*, Wall St J 24 (Oct 16, 1987) ("by focusing on the short term, our publicly held business enterprises will see their competitive position decay"); Alan Greenspan, *Takeovers Rooted in Fear*, Wall St J 28 (Sept 27, 1985) ("Excessively high discount factors place a disproportionate share of the value of a company's stock on near-term earnings and dividend flows.").

⁶² See note 28 and accompanying text.

⁶³ See notes 29-32 and accompanying text.

⁶⁴ Shleifer and Vishny, 80 Am Econ Rev Pap & Proc at 148 (cited in note 32).

⁶⁵ Id at 153.

⁶⁶ LeRoy, 27 J Econ Lit at 1616 (cited in note 30).

high discount rate for future earnings estimates. Jeremy Stein cites "informational asymmetry" as leading to undervaluation of productive assets that do not contribute to current earnings, forcing managers to take short-term steps such as selling the asset or leveraging against it in order to "signal" the value of the asset.⁶⁷

The anecdotal evidence, particularly in connection with the reaction of share prices to short-term earnings, also supports the view of a short-term bias in the market. Recent examples include Tambrands Inc., whose share price dropped precipitously on the announcement of a capital spending and marketing program that caused analysts to reduce 1990 and 1991 earnings estimates. An investment banker explained, "'Some of their marketing programs were just a little more long-term in nature' than had been expected. . . . 'Some analysts were expecting more immediacy in terms of earnings growth.'"⁶⁸ Similarly, Motorola Inc.'s share price plunged following the announcement of lower-than-expected earnings for the third quarter of 1990, due primarily to substantial research and development expenses, notwithstanding the fact that Motorola's historical strategy of investing for the future had "helped move it from an old-line television and radio maker in the 1950s and 1960s into a global leader in wireless communications."⁶⁹ An 83-year old investment manager, who had been investing in Motorola since 1955, said he had seen the mistake before: "'I have never tried to pinpoint the exact amount of quarterly earnings ahead,' he said. 'That's not important to me.'"⁷⁰ Given the dominance of institutional shareholdings, these market reactions are clearly an indication of the institutional stockholders' response to these short-term earnings declines. A report on Warren Buffett's investment in Wells Fargo Corporation highlighted the scarcity of long-term institutional investors when it quoted a broker who said, "Buffett is a long term investor with a three to five year time horizon—a time frame that most institutional investors can't afford."⁷¹

Disagreeing with the assertion that institutional shareholders hold a short-term perspective, a study commissioned in the United

⁶⁷ Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J Pol Econ 61, 62-63 (1988).

⁶⁸ Lourdes Lee Valeriano, *Estimates Lowered for Tambrands; Share Price Sags*, Wall St J A10 (Nov 16, 1990).

⁶⁹ Robert L. Rose, *Motorola Profit Report Depresses Stock*, Wall St J A8 (Oct 10, 1990).

⁷⁰ Id.

⁷¹ *Buffett's Stake in Wells Fargo Doesn't Mean Stock's Bottomed*, Portfolio Letter 3 (Oct 29, 1990).

Kingdom by the Institutional Fund Managers' Association argues that managers and directors themselves generate a short-term outlook, in part because they *wrongly* believe that institutional investors share this bias.⁷² While evidence of the actual short-term bias of institutional stockholders is strong, the adverse consequences of short-termism may flow just as easily from a *perceived* short-term bias. To the extent the quinquennial proposal outlined in Part IV can promote a continuing dialogue between managers and institutional stockholders, any misperceptions that exist can be minimized.

The focus on the short term has come at the expense of the long-term planning, investment and business development of the corporation. When managers seek to boost the short-term earnings and stock price, the easiest expenditures to forego are investments in the future. Thus, corporations have sacrificed research and development expenses, capital expenditures, market development, and new business ventures, simply because they promise to pay off only in the long term.⁷³ David Walker of the Bank of England points to "an attitude that attention to the longer run is a luxury and risk that can be indulged only within tight limits, especially by companies that see themselves as potential takeover targets."⁷⁴ Instead, managers channel resources to projects expected to produce immediate results, or to financial measures, such as stock repurchase programs, designed to boost short-term earnings. The long-

⁷² Paul Marsh, *Short-Termism on Trial* 50-53 (Institutional Fund Managers' Association, 1990).

⁷³ See *R & D Spending Growth Continues to Slow*, Res Tech Mgmt 2 (Mar-Apr 1990) (period from 1980-85 saw annual rate of increase in American corporate research and development spending of 8.2%, while period from 1985-90 shows real increases averaging less than one-fifth that rate); *NSF Implicates LBOs in Corporate R&D Cuts—Others Not So Sure*, Res Tech Mgmt 2 (May-June 1989) (National Science Foundation's 1987 survey indicates that acquisitions, mergers, and other restructurings hurt the research and development performance of those industries in which they occurred); Bronwyn H. Hall, *The Impact of Corporate Restructuring on Industrial Research and Development*, in Martin Neil Baily and Clifford Winston, eds, *Brookings Papers on Economic Activity: Microeconomics 1990* 85, 123 (Brookings, 1990) ("Regardless of whether one believes that leverage is efficiency enhancing or that it leads to a decline in productive investment, the link between leverage and reduced R & D spending has been established."). But see Margaret Mendenhall Blair, *A Surprising Culprit Behind the Rush to Leverage*, Brookings Rev 19 (Winter 1989/90) (citing high real interest rates, rather than short-term bias, as chief deterrent to new investment and chief cause of shift to debt financing). It is unclear, however, whether interest rates would have been so high during the 1980s but for the speculative binge of which the takeover and leveraging wave was a part.

⁷⁴ David Walker, *Capital Markets and Industry*, Bank of England Q Bull 573 (Dec 1985), quoted in Morgan and Morgan, *The Stock Market and Mergers in the United Kingdom* at 94-95 (cited in note 30).

term adverse effect of these measures on the ability of our corporations to compete against business enterprises whose ownership structures, and whose countries' economies, promote investment in the future is apparent and becoming more severe.

In his monumental study of global competition, Michael E. Porter identifies the growth of institutional investors in the United States to a position of dominance over the major business corporations as the most significant factor in the decline of American industry:

Unlike institutional investors in nearly every other advanced nation, who view their shareholdings as nearly permanent and exercise their ownership rights accordingly, American institutions are under pressure to demonstrate quarterly appreciation. Pension consultants have grown up that collect fees by assisting funds in changing asset managers whose recent performance is deemed inadequate. Asset managers, in turn, reward their employees based on the appreciation of their portfolio in the last quarter or year. With a strong incentive to find companies whose shares will appreciate in the near term and incomplete information about long-term prospects, portfolio managers turn to quarterly earnings performance as perhaps the single biggest influence on buy/sell decisions.

...

Managers have become preoccupied with heading off takeovers through boosting near-term earnings or restructuring. While restructuring has often led to beneficial sales of underperforming assets, cost cutting, and sometimes the weeding out of poor managements, the completion of restructuring starts the same pressures running again. The taking on of substantial debt in the course of restructuring, with proceeds paid to shareholders instead of invested in the business as was the case in highly leveraged Japanese companies, often leads to risk aversion and a slowing of true strategic innovation.⁷⁵

The focus on the short term has also led to the overleveraging of our economy.⁷⁶ The last decade saw an unprecedented wave of

⁷⁵ Michael E. Porter, *The Competitive Advantage of Nations* 528-29 (Macmillan, 1990).

⁷⁶ See Farrell, *Bus Week* at 84 (cited in note 44) (There "is growing evidence that steep leverage is beginning to hobble management, a worrisome trend because Corporate America, in this decade, has retired nearly \$500 billion in equity while piling on almost \$1 trillion in debt."). While determining the "right" level of debt is difficult, the leveraging wave of the last decade is particularly disturbing in that, historically, in times of economic expansion,

leveraged transactions, in the form of debt-financed acquisitions, leveraged buyouts, and leveraged recapitalizations. These transactions resulted in large measure from the demand for short-term stock premiums, regardless of the long-term consequences. In the rush to profit from leveraging or breaking up the corporation, acquirors and stockholders ignored the long-term implications of these actions. Leveraged transactions allow the acquiror to pay a premium to acquire a corporation using the corporation's own assets as collateral. They allow the corporation to boost short-term value by paying stockholders a large special dividend, or to boost short-term stock prices by repurchasing a large portion of its stock. But these leveraged transactions also exacerbate the need to cut expenditures and future investments in order to produce short-term cash flow, and leave our corporations less able to weather economic downturns. The bankruptcies and workouts now in the news are the legacy of these leveraged transactions.⁷⁷

The increasing activism of institutional stockholders may well worsen the corporations' preoccupation with the short term. Influential groups such as the Council of Institutional Investors, the California Public Employees' Retirement System (CalPERS), and the United Shareholders' Association have historically promoted takeovers. Organized by these groups, large numbers of institutional stockholders have increasingly embarked on proxy voting agenda designed to remove takeover defenses and other impediments to takeover premiums.⁷⁸ While takeover defenses have no intrinsic merit, they often provide the only means by which a cor-

debt levels have decreased, providing a cushion for the next downturn. See Henry Kaufman, *The Great Debt Overload Will Keep the Recovery Feeble*, *Fortune* 23 (Dec 31, 1990) ("The credit quality of American corporations deteriorated throughout the just-ended business expansion. That is unprecedented; normally the financial condition of business improves when the economy grows.").

⁷⁷ See *Business Failures Increase 14.5% in First 9 Months*, *Wall St J* B2 (Nov 2, 1990) (recent report by Dun & Bradstreet indicates that United States business failures rose 14.5% in the first nine months of 1990, to 43,836); Sharon Reier, *A Banquet for Fat Cats: Bankruptcy*, *Financial World* 36 (Oct 16, 1990) (blaming LBOs for the fact that the past two years have produced 13 of the nation's 25 largest bankruptcies, accounting for close to \$50 billion in assets); Daniel Wise, *Workouts, Bankruptcy Work Replacing Junk Bonds Practices*, *NY L J* 1 (Nov 2, 1989); Fred R. Bleakley, *Many Firms Find Debt They Piled On in 1980s Is a Cruel Taskmaster*, *Wall St J* A1 (Oct 9, 1990) (belt tightening engendered by debt load is forcing cutbacks in capital expenditures, new ventures, and new product lines, and could deepen the unfolding slump in the United States economy).

⁷⁸ See Investor Responsibility Research Center, Inc., *Major 1990 Corporate Governance Shareholder Proposals* (Feb 20, 1990) (on file with U Chi L Rev) (listing by sponsor proposals to redeem rights plans, opt out of state antitakeover laws, prohibit greenmail, ban golden parachutes, reduce supermajority requirements, etc.).

poration and its directors and managers can seek to protect the long-term business needs of the enterprise against the pressure for short-term premiums. To the extent these defenses are removed without taking steps to reorient the stockholders' perspective to the long term, the ill effects of the current short-term bias will be exacerbated.

Similarly, CalPERS and the United Shareholders' Association have proposed comprehensive revisions of the SEC's proxy rules, intended to increase the role of institutional investors in the proxy process and corporate governance.⁷⁹ Any reform in this area, however, must be part of a larger effort to reorient stockholders toward a long-term perspective. Otherwise, the increased activism of institutions in the proxy process is likely to promote a continued short-term outlook, with all its negative consequences.⁸⁰

C. Hostile Takeovers and Short-Termism

The hostile takeover wave of the last decade both caused and resulted from stockholders' short-term bias. A dominant stockholder population anxious to accept a takeover premium encourages the hostile acquiror with the likelihood that a premium bid will succeed or that a higher bid will prevail, allowing the first potential acquiror to profit on shares of the corporation it purchased prior to making its bid. Moreover, the short-term bias tends to result in greater discounting by the market of the long-term profits of the firm, leaving the market valuation of the corporation well below the true value of the enterprise. The acquiror is thus able to make a bid that is below the corporation's value (measured in terms of the future income streams but discounted at a lower rate than that typically produced by the short-term bias). Yet the bid,

⁷⁹ See letter from CalPERS to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission (Nov 3, 1989), reprinted in *Institutional Investors: Passive Fiduciaries to Activist Owners* 454 (PLI, 1990); letter from United Shareholders' Association to Edward H. Fleischman, Commissioner, Securities and Exchange Commission (Mar 20, 1990), reprinted in *id.* at 485. Compare letter from The Business Roundtable to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission (Dec 17, 1990) (on file with U Chi L Rev) (opposing revisions to the proxy rules).

⁸⁰ Philip R. Lochner, Jr., Commissioner, Securities and Exchange Commission, *Improving Corporate Governance for the Nineties: The Role of Institutional Investors and Proxy Reform* 6 (speech to City Club, Sept 20, 1990) (on file with U Chi L Rev) (If proposed proxy reforms are adopted and provide institutional stockholders with greater power to influence boards, institutions might "use their newfound muscle . . . to break up and sell off companies in order to yield higher short-term returns.").

so long as it is at a premium to the market, is likely to be well received by stockholders.

At the same time, takeover activity has fueled the short-term orientation of institutional stockholders. Takeover premiums provide the fast return on financial equity investments that institutional stockholders desire. Support of hostile takeover activity has provided a focal point for the expression of short-term interests, exemplified by the spate of stockholder-sponsored proxy proposals in opposition to rights plans and other takeover defenses.⁸¹ And the threat of hostile takeovers fuels the pressure on directors and managers to increase short-term earnings and cash flow, regardless of the impact on long-term business planning and development.

The hostile takeover activity of the last decade has also imposed severe dislocations and costs on the corporation's non-stockholder constituencies. A hostile takeover often brings with it staff reductions and layoffs. It may involve selling off operating units or shutting down offices or operations. These actions frequently harm the communities affected.⁸² The hostile takeover may also contract the relevant product market, causing disruptions or dislocations for customers and suppliers. These costs, while not by themselves dispositive, add further weight to the case for corporate governance reforms that will discourage the reemergence of takeover mania.

D. The Interests of Other Constituencies

Largely in response to the impact of hostile takeover activity on the corporation's non-stockholder constituencies, twenty-nine state legislatures have enacted legislation permitting boards of directors to consider and act on the interests of these various corpo-

⁸¹ See Investor Responsibility Research Center, Inc., *Major 1990 Corporate Governance Shareholder Proposals* (cited in note 78); Emile Geylein and Richard Koenig, *Pension Funds Plot Against Takeover Law*, Wall St J C1 (Apr 5, 1989) (describing attempts of three large pension funds, through stockholder proposals, to cause corporations to opt out of Delaware antitakeover statute).

⁸² See, for example, Susan C. Faludi, *Safeway LBO Yields Vast Profits but Extracts a Heavy Human Toll*, Wall St J A1 (May 16, 1990) (following Safeway's defensive LBO, 63,000 workers and managers were laid off); George Anders, *Morgan Stanley Found A Gold Mine of Fees By Buying Burlington*, Wall St J A1 (Dec 14, 1990) (highly leveraged takeover of Burlington Industries, Inc., to rescue the company from the advances of corporate raider Asher Edelman, resulted in the selling off of twenty of Burlington's businesses and the shrinking of Burlington's work force from 44,000 before the bid to 27,500 several years later); Shleifer and Summers, *Breach of Trust in Hostile Takeovers* in Auerbach, ed, *Corporate Takeovers* at 50-51 (cited in note 34) (describing community costs to Youngstown, Ohio following acquisitions of Youngstown Sheet and Tube and Lykes Steamship Company).

rate constituencies.⁸³ Some have criticized these statutes on the basis that they call upon directors to set social policy, a task beyond the directors' proper powers.⁸⁴ Constituency statutes, however, should not be viewed as giving directors a mandate to make social policy. Rather, they merely permit directors to take into account the interest and role of non-stockholder constituencies in the corporation's long-term vitality. Suppliers, customers, employees and communities all prosper in the long run if the enterprise prospers in the long run: suppliers retain a strong consumer of their products, customers retain a strong producer of desired goods or services, employees retain a healthy employer, and communities retain a vital contributor to their economic and fiscal health. Constituency statutes empower a board of directors to consider these interests in adopting a "just say no" response to a takeover bid: if the board determines that it best serves the corporation's long-term interests to remain independent, it can refuse to remove impediments to the bid.

Constituency statutes, then, are best understood as a means of permitting boards of directors to consider the interests of the corporation as a business enterprise, rather than solely the desires of the stockholders. They respond to the divergence of the stockholders' interests and the corporation's interests resulting from the separation of ownership and management and from the dominance of institutional ownership. They are, however, at best a stopgap measure. The real need is for a realignment of the interests of stockholders and corporations around the long-term health of the business enterprise. In the next Part, we seek better models for carrying out this task.

⁸³ The concept that the interests of non-stockholder constituencies should be taken into account in the takeover context was developed in academic literature and case law prior to the enactment of constituency statutes. See, for example, Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus Law 101, 130 (1979); *Unocal Corp. v Mesa Petroleum Co.*, 493 A2d 946, 955 (Del 1985). For examples of constituency statutes following this concept, see Ill Ann Stat ch 32, § 8.85 (Smith-Hurd Supp 1990); NJ Stat Ann § 14A: 6-1 (West Supp 1990); NY Bus Corp Law § 717 (Law Co-op Supp 1989); 15 Pa Cons Stat Ann § 1721(c) (Purdon Supp 1990).

⁸⁴ See, for example, Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 Bus Law 2253, 2270 (1990) ("[A]llocations of wealth (which essentially a balancing of the interests of various constituencies would be) are *political* decisions" which are "beyond the general pale of [directors'] perceived mandate from society.") (emphasis in original). See also *Amanda Acquisition Corp. v Universal Foods Corp.*, 877 F2d 496, 500 & n 5 (7th Cir 1989) (Easterbrook) (no policy need to protect non-stockholder corporate constituencies, because acquiror is no more likely than incumbent management to injure these constituencies).

III. THE REALIGNMENT OF INTERESTS: LESSONS FROM HOME AND ABROAD

A long-term view on the part of stockholders and managers is necessary to permit public corporations in the United States and the United Kingdom to invest in the future, maintain their vitality, and compete in the world economy.⁸⁵ Corporations must be permitted to sacrifice some immediate value to investments in capital assets, research and development, new ventures, or market share. To the extent the corporation is not permitted to invest in the future, it will inevitably lose customers and profits to those corporations that are permitted to do so.⁸⁶ In this Part, we discuss elements of the Japanese and German systems of corporate governance, and the "patient capital" approach of American investor Warren Buffett, to demonstrate the advantages of long-term emphasis.

A. The Need for a Long-Term View

The long-term health of the business enterprise is ultimately in the best interests of stockholders, the corporation's other constituencies, and the economy as a whole. The institutional stockholder typically invests in a large number of stocks whose overall performance, like that of index funds, tends to mirror the performance of the market and the economy.⁸⁷ Moreover, the large institu-

⁸⁵ Brady, *Remarks before the Business Council* at 2 (cited in note 6) (American corporations "can't innovate and produce the products needed to capture world markets by focusing on results one quarter at a time."); Alan O. Sykes, *Corporate Takeovers—the Need for Fundamental Rethinking* 21 (David Hume Institute, 1990) ("The inevitable consequence of 'City' short-termism is long-term damage to the City on the back of far greater long-term damage to the [United Kingdom's] corporate sector as a whole."); Lord Alexander of Weedon, Q.C., Chairman of National Westminster Bank and former Chairman of the City Takeover Panel, *The Changing Nature of Finance* 9 (speech for the Lombard Association 60th Anniversary Dinner, Oct 4, 1990) (on file with U Chi L Rev) ("Concern about takeovers may inhibit medium- to long-term planning and, as some say, research and development. The future of companies may undoubtedly be settled on the basis of short-term considerations.").

⁸⁶ See, for example, John J. Curran, *Hard Lessons from the Debt Decade*, *Fortune* 76 (June 18, 1990) ("Says Douglas Watson, head of industrial ratings at Moody's Investors Service: 'I've been seeing signs that once a company leverages, it invites predatory behavior from its rivals.' For example, most major supermarket chains are stocked to their fluorescent lights with debt. Thus they're in no shape to respond as A&P, one of the few grocers with a clean balance sheet, aggressively expands into their markets.").

⁸⁷ Gilson and Kraakman, *Reinventing the Outside Director* at 6-8 (cited in note 1) (institutional investors increasingly "hold the market," whether through indexing or simply by virtue of the size of their portfolios, thereby eliminating the likelihood of benefits from active trading).

tional stockholder is a long-term investor in the market as a whole. Unless it divests itself of equities altogether, it will have an equity stake in a substantial portfolio of corporations regardless of how long it maintains a stake in any one corporation. To the extent the economy as a whole thrives over the long term, the portfolio should thrive, regardless of the performance of, or the availability of take-over premiums for, any individual stock.

Professors Gilson and Kraakman cite several studies for the proposition that takeovers provide long-term benefits to stockholders. "[O]n average," they claim, "target shareholders lose significantly when offers are defeated and the company is not subsequently acquired by an alternative bidder. . . . [T]he data resolves the charge that a favorable orientation to premium tender offers reflects a short-term orientation."⁸⁸ It is unclear, however, why one should limit the sample to companies "not subsequently acquired by an alternative bidder." The corporation that defeats a takeover bid retains the value of control, on which it may realize a premium by selling the corporation at any time. The corporation that is acquired, of course, loses the asset of control.

More importantly, all the studies cited by Professors Gilson and Kraakman necessarily measure stock market effects within the existing system of corporate governance. In the current environment, corporations that successfully defeat a takeover attempt (as well as corporations seeking to avoid a takeover attempt) may take steps to boost short-term earnings or value whether or not these steps are in the long-term interests of the corporation. The studies cannot measure the benefits of a new system that would encourage all the corporation's constituencies to work toward the long-term success of the corporate enterprise. It may well be rational under the current system for any individual investment manager to focus on short-term results,⁸⁹ but the short-term bias remains irrational for the economy as a whole.

The takeover activity of the last decade did not enhance the development of productive assets. Instead, it produced a reshuffling of assets, large gains to the sponsors of and advisors to the reshuffling, large gains (and losses) to the arbitrageurs who bet on the outcome of the transactions, substantial societal dislocations, and a legacy of heavy debt burdens.⁹⁰ In some cases takeovers did

⁸⁸ Id at 11 & n 16.

⁸⁹ See text at notes 55-60.

⁹⁰ Lester C. Thurow, *Let's Put Capitalists Back into Capitalism*, Sloan Mgmt Rev 67, 68 (Fall 1988) (lack of productivity growth during takeover era demonstrates that acquisi-

shift assets to more efficient uses, but the studies that claim takeovers generally have this positive effect tend to measure very short time spans, not long-term effects.⁹¹ Even some proponents of hostile takeovers doubt that they are the best way to bolster the long-term health and productivity of our corporate economy.⁹² The healthy economies of Japan and Germany result in large part from effective, stable management and long-term capital investment.⁹³ Unless the corporate governance systems of the United States and the United Kingdom can engender a similar long-term orientation, the relative health of American and British corporations, and the relative wealth of their stockholders, will inevitably erode.

The following illustrations are not intended to imply that either the Japanese or German corporate regime can or should be transplanted to the American or British corporate setting. Rather, these examples are meant to demonstrate successful alternatives to the managerial discipline model of corporate governance.

B. Japan and Germany

There are many reasons for the economic health and success of Japan and Germany relative to the United States and the United Kingdom.⁹⁴ It is not possible, of course, to determine pre-

tions are a redistributive activity, not a productive activity); Stout, 99 Yale L J 1235 (cited in note 32) (takeover premiums may be a natural market phenomenon rather than evidence of efficiency gains).

⁹¹ See, for example, Gregg A. Jarrell, James A. Brickley, and Jeffrey M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J Econ Persp 48, 66 (1988) ("premiums in takeovers represent real wealth gains and are not simply wealth redistributions"); Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, Midland Corp Fin J 6, 6 (1986) (attributing takeovers to "productive entrepreneurial activity that improves the control and management of assets and helps move assets to more productive uses").

⁹² See, for example, Gilson and Kraakman, *Reinventing the Outside Director* at 14 (cited in note 1) ("the hostile takeover is an expensive and inexact tool for monitoring managers that is better suited for correcting mistakes than preventing them").

⁹³ See Evan Herbert, *How Japanese Companies Set R&D Directions*, Res Tech Mgmt 28 (Sept-Oct 1990) (Japanese corporate governance system enables corporations to suffer prolonged losses until R&D pays off); Brian O'Reilly, *America's Place in World Competition*, Fortune 80 (Nov 6, 1989) (In 1987, Japan's capital spending was approximately 22 percent of GDP, West Germany's was approximately 17 percent of GDP, and the United States' and the United Kingdom's were approximately 13 percent of GDP.).

⁹⁴ Factors that have been cited include higher levels of saving, lower costs of capital, and cultural work ethics. See generally G.C. Allen, *The Japanese Economy* (St. Martin's, 1981) (emphasizing the importance of political and social factors in Japan's economic growth); Porter, *The Competitive Advantage of Nations* at 368-82 (cited in note 75) (education, research, and worker commitment, as well as corporate governance structure and nature of capital markets, contributed to German economic success).

cisely the degree to which any given factor has contributed to this success. Many commentators agree, however, that an important factor is their corporate governance schemes.⁹⁵ At a minimum, Japan and Germany provide notable examples of alternatives to the managerial discipline model of corporate governance, chosen by two countries whose modern economies have been among the most successful in the world. Japan and Germany have created systems akin to what has been termed "proprietor-capitalism," the sort of capitalism envisioned by classical economic theory, in which stockholders are knowledgeable and actively involved in ensuring the quality of management.⁹⁶ These systems stand in contrast to the "punter-capitalism" of the United States and the United Kingdom, in which stockholders typically remain uninvolved in assessing and developing the business operations and management of their corporations, except when it comes to the opportunity to receive the short-term premium of a takeover.⁹⁷

1. Japan: Control through the *keiretsu*.

The Japanese model centers around the *keiretsu*, a voluntary grouping of firms and financial institutions with cross-shareholdings and business relationships:

[Members of the *keiretsu*] hold non-controlling stock in each other's firms. In addition, shares are owned by banks and life insurance companies with the expectation of assured long-term business relationships. In Japan, corporations and financial institutions together hold about two-thirds of all stock listed on all exchanges. Often the majority of shares in a corporation are collectively owned by members of the same industrial group or *keiretsu*.⁹⁸

This cross-shareholding, together with major shareholdings by the corporation's lenders, provides stability and a long-term orientation for Japanese corporations, leaving roughly 25 percent of

⁹⁵ See, for example, *Capitalism* at 17 (cited in note 10); Sykes, *Corporate Takeovers* at 12-13 (cited in note 85); Dertouzos, Lester, and Solow, *Made in America* at 61-62 (cited in note 46); Brady, *Remarks before the Business Council* (cited in note 6); Jonathan Charkham, *The American Corporation and the Institutional Investor: Are There Lessons From Abroad? Hands Across the Sea*, 1988 Colum Bus L Rev 765, 766.

⁹⁶ *Capitalism* at 7 (cited in note 10).

⁹⁷ *Id.*

⁹⁸ Aron Viner, *Mergers, Acquisitions and Corporate Governance in Japan*, in Joseph C.F. Lufkin and David Gallagher, eds, *International Corporate Governance* 27 (Euromoney Books, 1990).

shares available for everyday trading.⁹⁹ The concentration of shareholdings creates a monitoring body that can assess the business performance of the corporation and its managers.¹⁰⁰ But the business relationships among the *keiretsu*, primarily lending, customer, and supplier relationships, ensure the alignment of interests around the long-term business health and vitality of the corporation. This structure insulates the management of Japanese corporations against the short-term pressures felt by managers in the United States and the United Kingdom.¹⁰¹

2. Germany: Control through bank intermediation.

While quite different from that of Japan, the German corporate governance structure leads to the same result. Stock ownership of public corporations in Germany is largely through bank intermediaries that vote the shares they hold for others. Voluntary delegation of voting rights to portfolio-managing banks is the norm among private investors, except for major stockholders. For widely-held corporations these banks account for over 90 percent of voting rights, with the three largest banks controlling the voting rights of over 40 percent of all shares.¹⁰² The banks also own shares in their own right and often hold seats on corporate supervisory boards,

⁹⁹ *Capitalism* at 17 (cited in note 10). See also Tony Shale, *Reawakening the Sleeping Giant*, *Euromoney* 14, 17 (Nov 1990) ("of the 1,612 companies presently listed on the Tokyo Stock Exchange, 1,100 belong to *keiretsu* groupings and account for 78% of market capitalisation").

¹⁰⁰ See Ramseyer, 35 *UCLA L Rev* at 49-50 (cited in note 34) (Japanese shareholders have greater incentive to monitor managers as they generally hold large blocks of stock due to the cross-shareholding practices in Japan. In addition, Japanese banks have proved to be effective monitors of the corporations with which they have ongoing financial dealings.).

¹⁰¹ See *id.* at 21-32 (Several factors combine to make hostile acquisitions in Japan a relatively unprofitable, and therefore, rare occurrence: (1) the practice of cross-shareholding in corporation stocks increases the cost of obtaining a controlling block of shares; (2) the higher leverage of Japanese firms gives the lending bank the ability to bargain with the potential acquiror for a portion of the gains; and (3) the absence of a provision in Japanese law allowing the acquiror to cash out minority shareholders after the bid permits shareholders to free-ride on any efficiency gains resulting from the acquisition.). See also Martin Lip-ton, *Paying the Price of Takeover Money* 34, *Manhattan, inc.* (May 1989) (quoting a 1988 speech by Masaaki Kurokawa, the chairman of Nomura Securities International: "Japanese top management need not concentrate on short-term-profit schemes for the sole purpose of appeasing its investors. In the United States, by contrast, each quarter's profit statement brings around renewed panic or exaltation, as investors concentrate on short-term results rather than long-term profit and investment. Japan's separation of management and investors, however, allows freer investment in long-term physical assets, which, of course, contributes to Japan's strong economic performance.").

¹⁰² Hermann H. Kalfass, *The American Corporation and The Institutional Investor: Are There Lessons From Abroad? The German Experience*, 1988 *Colum Bus L Rev* 775, 782-83.

adding to their enormous power.¹⁰³ Like the *keiretsu*, the German structure insulates management from short-term pressures. It concentrates the control of shareholdings within a group capable of effective monitoring, but oriented toward the long-term business health of the corporation.¹⁰⁴

3. Applicability of the Japanese and German examples.

Even if we favored the full-scale transplantation of the Japanese or German models into the Anglo-American corporate environment, which we do not, we recognize that present antitrust and banking statutes would forbid it and that the American and British political systems would probably reject the concentration of corporate power in such small groups.¹⁰⁵ But some of the concepts of the Japanese and German structures can be applied to the American and British systems. Professors Gilson and Kraakman describe the Japanese and German structures as the "banker model." They dismiss the banker model as "inapposite to the circumstances of the American institutional investor," claiming that it "unifies, rather than bridges, ownership and control."¹⁰⁶

¹⁰³ Id at 783 ("It is hardly possible for private investors to effectively control the exercise of voting rights by banks, and in practice they do not do so. This enables banks to pursue their own interests when exercising voting rights, for instance, voting with a view to their lending or investment business."); Dirk Schmalenbach, *Federal Republic of Germany*, in Lufkin and Gallagher, eds, *International Corporate Governance* at 109, 111 (cited in note 98) ("As a general rule the banks tend to exercise their power in support of management which . . . will often make shareholder activism and attempts by shareholders to maximise shareholder value in a way which is contrary to the present policy of management, seem futile. . . . In their role as lenders the banks prefer a long-term increase in the substance of the company rather than the distribution of high yield dividends.").

¹⁰⁴ See, for example, Kallfass, 1988 Colum Bus L Rev at 790-91 (cited in note 102) ("Bank representatives are thus involved in filling positions on managing boards and in making important business decisions. The resulting stability of control reduces the pressures on managers, freeing them to pursue medium to long-term corporate objectives."); Porter, *The Competitive Advantage of Nations* at 376 (cited in note 75) ("Sustained commitment to the business is reinforced by the nature of German capital markets. Many company shares are held by banks and other long-term holders, who often play a prominent role on boards. . . . The concern for quarterly earnings, in preference to actions required to sustain the long-term position, has been all but absent, in contrast to the United States."); Andrew Fisher, *Banks Facing Up to Foreign Competition*, *The Banker* 22, 39 (Apr 1987) ("The country's two biggest banks, Deutsche and Dresdner, played important roles in the nursing back to health of Germany's largest shipping group, Hapag-Lloyd. . . . At AEG, the electrical and electronics giant now controlled by Daimler-Benz, banks were also instrumental in preventing a collapse into bankruptcy.").

¹⁰⁵ See Gilson and Kraakman, *Reinventing the Outside Director* at 28 & n 52 (cited in note 1) (noting political and cultural barriers to use of Japanese and German structures in the United States and United Kingdom).

¹⁰⁶ Id at 27.

The German banks and the Japanese *keiretsu*, however, constitute monitors, not managers, of the public corporation. Ownership and management remain separate, but the structure of stock ownership ensures the alignment of the interests of the managers and stockholders around the long-term interests of the business enterprise, and creates a stockholder presence capable of shielding management from short-term pressures and monitoring managerial performance. There is no reason that the systems of the United States and United Kingdom cannot be reconstructed, by far less radical means, to serve the same goals: alignment of stockholder and corporate interests around the long-term health of the corporation as a business enterprise, insulation of management from short-term financial pressures, and effective monitoring of the long-term business performance of the corporation's managers.

C. Leveraged Buyouts

In the United States and the United Kingdom, the replacement of public with private ownership structures, particularly through leveraged buyouts (LBOs), has become a common means of reuniting ownership and management, and has been cited as a means of improving corporate efficiency.¹⁰⁷ Substantial equity stakes for managers, active monitoring by the LBO sponsor/investor, and freedom from the preoccupation with reported quarterly earnings and takeover defenses often combine to cause substantial improvement in the newly private corporation's business operations.¹⁰⁸ The financial incentives and risks for the management of the post-LBO corporation can motivate quite effectively: the manager who takes personal loans, perhaps even mortgages his house, to participate in the equity of a buyout has a more direct financial stake in the corporation's success than the manager who is insulated from personal financial risk.

¹⁰⁷ Michael C. Jensen, *Eclipse of the Public Corporation*, Harv Bus Rev 61, 65 (Sept-Oct 1989) ("[T]hese organizations' resolution of the owner-manager conflict explains how they can motivate the same people, managing the same resources, to perform so much more effectively under private ownership than in the publicly held corporate form."); Frank H. Easterbrook and Daniel R. Fischel, *Corporate Control Transactions*, 91 Yale L J 698, 706 (1982) (when firms go private they eliminate or substantially reduce the separation of ownership and control).

¹⁰⁸ See, for example, Brett Duval Fromson, *Life After Debt: How LBOs Do It*, Fortune 91 (Mar 13, 1989) (describing how O.M. Scott & Sons, Borg-Warner, and other companies substantially improved their operating performances in response to the pressures and opportunities created by LBOs).

The current recession demonstrates, however, that LBOs also entail enormous risks for corporations and the economy as a whole. Overleveraging engendered by the LBO wave has left many corporations in dire straits as the economic growth of the 1980s has slowed or reversed.¹⁰⁹ Even those newly private corporations that are not facing bankruptcy often find that massive debt and interest payments siphon off the cash they need to invest in productive uses. The debt burden of the LBO arguably forces managers to operate efficiently in order to meet their payments.¹¹⁰ But LBO debt imposes a decidedly short-term discipline. Lenders in an LBO, unlike the lender/stockholders of the German and Japanese systems, are attracted by the initial transaction fees and seek a quick repayment of their loans.¹¹¹ The LBO thus replaces the short-termism of the institutional stockholder and the hostile takeover with the short-termism caused by the need to pay down debt quickly.

Even proponents of the LBO as a promoter of efficiency recognize that "the LBO capital structure is simply inappropriate . . . for large numbers of public corporations that require the cash flow flexibility to fund [research and development] or to compete in growing markets."¹¹² Moreover, the corporation taken private in an LBO typically goes public again within a matter of a few years.¹¹³ Indeed, taking the LBO company public is the only way the LBO investor can realize the 30-40 percent annual equity returns promised by LBO sponsors. Returns at that level depend on high leverage and quick resale of the equity. Thus, the LBO does not offer a widely applicable, long-term answer to the problems of corporate governance.

D. Patient Capital

A more promising model for the United States and the United Kingdom is the "patient capital" philosophy exemplified by Warren Buffett and Berkshire Hathaway, of which Mr. Buffett is chairman. Like the LBO sponsor and management investor, Mr. Buffett

¹⁰⁹ See sources cited in note 77.

¹¹⁰ Jensen, *Harv Bus Rev* at 66-67 (cited in note 107).

¹¹¹ See Staff of House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, 101st Cong, 1st Sess, *Leveraged Buyouts and the Pot of Gold: 1989 Update* 148 (Committee Print, 1989) (testimony of L.W. Seidman, FDIC Chairman) (substantial origination fees and selling fees are significant inducements to banks' competition to lend for LBOs).

¹¹² Gilson and Kraakman, *Reinventing the Outside Director* at 25-26 (cited in note 1).

¹¹³ See Louis Lowenstein, *Management Buyouts*, 85 *Colum L Rev* 730, 731 (1985); Leslie Wayne, *'Reverse LBO's' Bring Riches*, *NY Times* D1 (Apr 23, 1987).

serves the role of a knowledgeable and motivated monitor for the companies in which he and his company invest. But he invests in unleveraged companies and has a time horizon far beyond that of the typical LBO investor. He treats "almost all [Berkshire Hathaway's] investments as long-term ownership commitments."¹¹⁴ Mr. Buffett says: "[W]e have no interest at all in selling any good businesses that Berkshire owns, and are very reluctant to sell sub-par businesses as long as we expect them to generate at least some cash and as long as we feel good about their managers and labor relations."¹¹⁵

This investment strategy has produced astonishing results. Berkshire Hathaway's return has far exceeded that of the market and almost any investment manager: "Since Mr. Buffett took over Berkshire, \$10,000 invested in its shares has grown to be worth about \$1.5 m[illion], a compound growth rate of 23% a year."¹¹⁶ The patient capital approach teaches that long-term investment in successful business enterprises can provide a highly attractive return, over a much longer period, when contrasted with a preoccupation with short-term results and takeover premiums. As *The Economist* concludes, "Whenever a typical money manager claims that at least his betting-slip ways produce results, remind him gently of Warren Buffett."¹¹⁷

IV. THE QUINQUENNIAL PROPOSAL

In this Part we describe our proposal for reform of the American and British corporate governance systems. This proposal, the quinquennial system, seeks to make stockholders and managers think and act like long-term owners by combining the patient capital approach of Warren Buffett, the long-term monitoring approach of the Japanese and German ownership structures, and the financial incentives for managers of the LBO. The quinquennial system would permit the delegation of control of the corporation to its managers for sufficiently long periods of time to allow them to make the decisions necessary for the long-term health of their corporation. At the same time, it would force managers to develop and justify their long-term plans for the corporation, and would evaluate and compensate managers based on their ability to imple-

¹¹⁴ *Capitalism* at 15 (cited in note 10).

¹¹⁵ *Id.* (quoting statements of Warren Buffett in Berkshire Hathaway Annual Report to Stockholders).

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 16.

ment those plans successfully. The system would motivate stockholders, directors and managers to work cooperatively towards the long-term business success of the corporation. And, if it ultimately became necessary, it would allow stockholders to remove incompetent or venal management and to force the sale or restructuring of the corporation if that is determined, after sufficient time and study, to be the best alternative.

The first section of this Part sketches the broad outlines of the quinquennial system. Succeeding sections provide a detailed description of each element of the proposal: the operation of stockholder meetings, the use of the proxy machinery, public reporting requirements, managerial compensation, rules governing takeovers, and the role of outside directors. The final section discusses the steps necessary to implement the system. We have presented the basic concept of the quinquennial system before.¹¹⁸ Here we present it in fully developed form, as a response to the concerns outlined in the preceding Parts.

A. The Quinquennial Concept

The essence of the quinquennial proposal is to convert every fifth annual meeting of stockholders into a meaningful referendum on essential questions of corporate strategy and control, and to limit severely the ability of stockholders to effect changes in control between quinquennial meetings. Stockholders would elect directors for five-year terms. Directors seeking reelection would stand on the corporation's record for the past five years and its strategic plan for the next five years. Stockholders would base their determination of whether to oppose incumbent directors, and focus any challenge they determined to mount, on the same issues. Between these quinquennial election meetings, stockholders could remove directors only for personal illegal conduct or willful malfeasance, or if the corporation were guilty of such conduct. The board would have to consent to any takeover between quinquennial meetings. Potential acquirors could, however, make unsolicited acquisition proposals in conjunction with the quinquennial meeting, in which case the meeting would become a referendum on the proposals. In connection with the quinquennial meeting, any stockholder or group of stockholders owning five percent or more of the

¹¹⁸ Martin Lipton, *An End to Hostile Takeovers and Short-Termism*, Financial Times § 1 at 21 (June 27, 1990); Martin Lipton, *Quinquennial Election of Directors: A Proposal for Discussion*, Wachtell, Lipton, Rosen & Katz Memorandum to Clients (Apr 9, 1990) (on file with U Chi L Rev).

corporation's outstanding shares, or shares having a market value of five million dollars or more, would have the same access as the incumbent board to the corporate proxy machinery, in support of any candidates they wished to nominate. This access would include corporate payment of proxy contest expenses to the same extent as incumbent expenditures.

In the year of the quinquennial meeting, within 75 days after the corporation's fiscal year ends, the corporation would send to its stockholders a detailed report on its performance over the prior five years compared to its strategic plan, together with industry averages and other relevant data. The report would also detail the corporation's projections for the next five years, the assumptions underlying those projections, expected returns on stockholder investment, and the management compensation plan. At the same time, an investment bank, accounting firm, or other outside advisor selected by the board would send stockholders a detailed, independent evaluation of both the corporation's performance for the prior five years and its projections for the next five years. Stockholders would have 60 days after the mailing of the report and evaluation to decide whether they wish to nominate candidates for election as directors.

Because the quinquennial proposal would eliminate coercive takeovers, it would also eliminate the panoply of private takeover defenses and state legislation. It would make moot the issue of whether and the extent to which directors can consider non-stockholder constituencies: decisions on takeover bids would lie in the hands of the stockholders at the quinquennial meetings, and would be at the discretion of the board between meetings. It would also affirm the "one-share, one-vote" provisions currently embodied in Rule 19c-4 under the Securities Exchange Act.¹¹⁹ In sum, it would make the quinquennial election a true, unobstructed stockholders' referendum on the corporation's performance and plans.

The quinquennial system would strengthen the board's independence by requiring a majority of outside directors. The system would look to outside directors to provide an effective monitoring function over the operations of the corporation. The increased

¹¹⁹ 17 CFR § 240.19c-4 (1990) (Rule 19c-4 seeks to deter corporate action, including issuance of new class of securities, which "[has] the effect of nullifying, restricting, or disparately reducing the per share voting rights" of existing common stock shareholders.). But see *The Business Roundtable v SEC*, 905 F2d 406 (DC Cir 1990) (Rule 19c-4 invalidated because SEC exceeded its authority under the Securities Exchange Act of 1934 in adopting the Rule.).

ability of stockholders to replace directors at the quinquennial meeting would lead directors (and, at the directors' insistence, managers) to work far more closely with major stockholders than they typically now do. To avoid the risk of replacement at the quinquennial meeting, directors would carefully monitor the corporation's progress against its long-term plan and maintain a close dialogue with stockholders with respect to the corporation's ongoing performance. Meanwhile, the five-year period between elections, and the extremely limited ability to replace directors otherwise, would leave stockholders with little choice but to work cooperatively with directors during the five-year period, within a structure that focuses all parties on the long-term business performance of the corporation.

Lack of information for outside directors, as well as lack of time or expertise to evaluate corporate information, often limits directors' ability to monitor managerial performance.¹²⁰ The five-year report would lower the information barrier for directors as well as stockholders, and encourage managers and outside advisors to consult more often with outside directors on the corporation's performance and direction. Many corporations today present their directors with an in-depth annual review by management and outside advisors of the corporation's business plan and objectives, its historical success or failure in meeting these objectives, and the steps it plans to take in the future. The quinquennial system would encourage this type of healthy in-depth analysis.

The quinquennial system would make the corporation's five-year performance, including its success in meeting its five-year plan, the sole basis for incentive compensation. It would eliminate the annual or biannual incentive awards now common. Managers would receive substantial rewards, well in excess of current compensation levels, only if the corporation met or exceeded its goals. Given the increased demands on their time and resources, outside directors would receive more compensation than they now generally do, with an incentive system similar in concept to management's.

The quinquennial system would benefit the corporation's other constituencies, which prosper if the enterprise's business op-

¹²⁰ See, for example, Lorsch, *Pawns or Potentates* at 55-58 (cited in note 19); Gilson and Kraakman, *Reinventing the Outside Director* at 22 (cited in note 1). See also William L. Cary and Melvin A. Eisenberg, *Cases and Materials on Corporations* 215-16 (Foundation, 5th ed 1980).

erations prosper over the long term.¹²¹ Moreover, by eliminating hostile takeovers and removing the pressure for excessive leveraging, the quinquennial system would ameliorate the societal dislocations that resulted from the takeover and leveraged buyout wave of the last decade.¹²²

At the outset, we suggest limiting the quinquennial system to large corporations, such as the Standard and Poor's 500 or the Business Week 1000, which are more heavily held by institutional investors. After experience with these corporations, the quinquennial system could then apply to a broader group.

The quinquennial proposal would not entrench directors or managers. It is not designed to prevent changes in corporate control, but rather to channel nonconsensual changes in control into a more healthy forum. The primary defect of the takeover activity of the past decade is not that it allowed for the replacement of directors and managers, but that it forced an external, short-term focus on companies, directors, managers, *and* their stockholders. The quinquennial system, by making the corporate proxy machinery available to substantial stockholders who wish to nominate a competing slate of directors, would actually enhance the ability of stockholders to replace incumbent directors and to change corporate strategy. But it would provide this opportunity within a framework that permits the corporation to carry out long-term plans, and permits stockholders to assess their results before deciding whether they are satisfied with their directors' performance. Removal and replacement of directors would occur by means of an orderly stockholder vote, based on full information. The quinquennial framework would thus prevent the hurried decisionmaking imposed on corporations and their stockholders in the context of hostile takeover battles¹²³ and would eliminate the type of abusive, coercive takeover activity prevalent in recent years.

The remainder of this Part develops in more detail the elements of the quinquennial proposal and the rationale underlying each element.

¹²¹ See Part II.D.

¹²² See Parts II.B. and II.C.

¹²³ See 17 CFR § 240.14e-1(a) (1990) (tender offer may be completed in as little as twenty business days). This is hardly a time frame within which to decide intelligently the destiny of the enterprise.

B. The Quinquennial Meeting

1. Rationale for five-year terms.

The five-year period between election meetings affords directors and managers some measure of freedom from the short-term focus now imposed on them by institutional stockholders' pressure for quarterly results and the ever-present takeover threat. Like the four-year terms of American presidents and the six-year terms of senators—as opposed to the two-year terms served by members of the House of Representatives—it encourages a focus on long-term policy decisions.¹²⁴ Yet the period is short enough that directors and managers would feel an ongoing need to report to stockholders on their plans and progress. The period is also short enough to permit development of a realistic business plan for presentation to stockholders in connection with the election meeting; five years is a common yardstick for business planning today. Annual meetings of stockholders would continue for matters other than election of directors.

The five-year time period would also give institutional stockholders enough time to evaluate managers and directors and to plan an effort to replace ineffective directors. Free access to the corporate proxy machinery and to detailed business information, in connection with the quinquennial meeting, would enable institutional stockholders to monitor effectively and knowledgeably. The election of a competing slate of directors would become a realistic and practical alternative for dissatisfied stockholders, giving directors and managers a powerful incentive to work cooperatively with stockholders throughout the period between quinquennial elections.

2. Limited exceptions to the five-year rule.

The five-year period would not be wholly inflexible. As noted above, the quinquennial proposal contemplates that directors would be removable by stockholders during the five-year interim in extreme cases of individual or corporate misconduct or illegality. It would also be possible to provide an “escape valve” for the unusual case where the corporation is doing so poorly that five years might be too long a period to wait for directors to come up for reelection.

¹²⁴ See Gary C. Jacobson, *The Politics of Congressional Elections* 87-91, 216-18 (Little, Brown, 2d ed 1987); M. Kent Jennings and L. Harmon Zeigler, eds, *The Electoral Process* 28-29, 37-38 (Prentice-Hall, 1966) (noting flaws in political system produced by fact that incumbent Representatives usually conduct perpetual campaigns).

For example, the holders of 20 percent of the corporation's shares could be allowed to call an election meeting during the five-year interim if the corporation failed to achieve at least 80 percent of its five-year projections for two consecutive years. Any such meeting would be subject to the same requirements as the quinquennial meeting: major stockholders would have access to the corporate proxy machinery, and the corporation would issue a detailed report together with the advisors' evaluation of that report.

But any exceptions to the five-year rule must operate only in truly exceptional circumstances, or the system would not promote the long-term perspective that is its goal. For example, there should be no exception to the five-year rule for an acquisition proposal from a third party. The incumbent board would consider any proposal made between elections and accept or reject it as the board determines appropriate. The board's determination with respect to the acquisition proposal might become an issue at the next quinquennial meeting, but not before.

C. Access to Corporate Proxy Machinery

1. The need to ensure meaningful elections.

The most commonly cited obstacles to effective corporate democracy are the ability of management to control the corporate proxy machinery and the cost to any one stockholder or group of stockholders of amassing the information necessary to evaluate the performance of managers and directors properly.¹²⁵ The efforts of a single investor or a group of stockholders to evaluate the corporation's business or run a proxy contest may benefit all stockholders, but there is no effective means to eliminate free riders and distribute the costs among all stockholders.¹²⁶ Corporate elections therefore tend to produce a realistic challenge to incumbent directors only in the context of takeover battles, fueling the contention of proponents of the managerial discipline model that hostile takeovers are needed to discipline managers and directors.¹²⁷

¹²⁵ See, for example, Eisenberg, 89 Colum L Rev at 1474-75 (cited in note 46); Jeffrey N. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 Cal L Rev 3, 43-44 (1988).

¹²⁶ See, for example, Eisenberg, 89 Colum L Rev at 1478-79 (cited in note 46); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum L Rev 1549, 1575-76 (1989).

¹²⁷ See Edward Jay Epstein, *Who Owns the Corporation?* 13 (Priority, 1986) (Corporate elections are "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

Corporate elections need not be a sham, however. The quinquennial meeting structure removes the chilling effect of an ever-present takeover threat on long-term planning. Once election contests are no longer simply another short-term coercive takeover tactic, they can become a meaningful referendum on the corporation's business plans and performance. The combination of free access to the corporate proxy machinery, and the provision of the detailed information contemplated by the five-year report, discussed in greater detail below, would effect this restructuring. It would also eliminate the free rider problem, by allocating the costs of the information gathering and the proxy process to the corporation and thus, effectively, to all stockholders.

The quinquennial proposal would grant free access to the corporate proxy machinery in connection with the quinquennial meeting to any stockholder or group of stockholders with at least five percent of the outstanding shares, or shares having an aggregate market value of five million dollars or more. These thresholds are high enough to exclude "gadfly" stockholders, but low enough not to impede the serious, substantial stockholder who wishes to propose nominees or a slate of directors in an election contest. Access to the corporate proxy machinery would include the corporation's payment of the challenger's proxy expenses, up to the amount that the incumbent directors spend on the proxy contest. This would place institutional stockholders on the same footing as the corporation's board with respect to nomination and election of corporate directors, thereby radically improving the ability of these stockholders to participate meaningfully in the selection of directors.

The quinquennial proposal does not, however, anticipate the frequent, wholesale replacement of directors every five years. The very credibility of the quinquennial election would lead directors and managers to develop a working relationship with the corporation's major stockholders. And once the stockholders are placed in a structure that promotes a focus on the long-term business operations of the corporation, they will be more inclined, except in extreme cases, to try to influence the incumbent directors and managers rather than risk the disruption to business operations of a wholesale change in senior personnel.

The quinquennial proposal would also eliminate SEC Rule 14a-8, which generally allows any holder of \$1,000 worth of a corporation's stock to require inclusion of a proposal in the corpora-

of candidates."'). See also Easterbrook and Fischel, 94 Harv L Rev at 1170-74 (cited in note 1).

tion's proxy statement.¹²⁸ While intended to promote stockholder interest in corporate governance, in practice this rule has become the tool of gadflies who seek to promote special interests.¹²⁹ Stockholders may espouse any cause they wish, but the corporate proxy machinery is rarely the appropriate forum for such expression.

More recently, institutional investors have also used Rule 14a-8 to address voting procedures and takeover-related issues and defenses. The last few years have seen a spate of proposed stockholder resolutions dealing with rights plans, confidential voting, and golden parachutes.¹³⁰ The quinquennial proposal would largely supersede this agenda by eliminating takeover defenses and limiting nonconsensual changes of control to the quinquennial meeting, at which major stockholders or groups of stockholders would have full and free access to the corporate proxy machinery. Moreover, the availability of the quinquennial meeting as a realistic means for institutional stockholders to replace directors would increase responsiveness to institutional concerns during the interim periods. Rule 14a-8, accordingly, would become unnecessary.

2. Proxy access only desirable as part of fundamental reform.

Access to the corporate proxy machinery as contemplated by the quinquennial system is desirable only in conjunction with the other elements of the proposal. Granting substantial stockholders free access (including coverage of reasonable expenses) to the corporate proxy machinery, without reorienting those stockholders away from a strictly short-term perspective, would only exacerbate the short-term pressures and detrimental effects of the takeover activity of recent years. If stockholders continue to view their investment as a gambling chip and any takeover premium as a jackpot, then the stockholders' increased ability to nominate and elect their own directors would only worsen the problems of short-termism.

¹²⁸ 17 CFR § 240.14a-8 (1990).

¹²⁹ See, for example, Jesse H. Choper, John C. Coffee, Jr., and C. Robert Morris, Jr., *Cases and Materials on Corporations* 647 (Little, Brown, 3d ed 1989) (rule recently used to address issues relating to discrimination, nuclear power, pollution, and divestment from South Africa).

¹³⁰ John J. Gavin, *Changes in Corporate Control and Governance Communicated through Proxy Power*, in *Institutional Investors: Passive Fiduciaries to Activist Owners* 91, 95-96 (PLI, 1990) (215 governance proposals submitted by institutional investors and voted upon at annual meetings in 1989); Dennis J. Block and Jonathan M. Hoff, *Emerging Role of The Institutional Investor*, NY L J 5 (Apr 12, 1990) (listing confidential voting, repeal of poison pills, and golden parachutes as top three subjects of governance proposals).

Professors Gilson and Kraakman, for example, propose the development of a class of professional directors elected by and responsible to institutional stockholders, suggesting that these directors could be recruited and monitored by a clearinghouse initiated by one of the existing "shareholders' rights" groups such as the Council of Institutional Investors or United Shareholders' Association.¹³¹ These organizations, however, have been particularly vocal in their short-term orientation and pro-takeover bias.¹³² Gilson and Kraakman's proposal ignores the pressing need for directors to adopt a long-term measure of performance or success. Unless the orientation of institutional stockholders shifts away from the short term, then directors beholden to these stockholders will simply represent a potent constituency seeking a fast return. If selling or busting up the corporation generates this return, so much the better. Only when these stockholders redefine the success of their investment in terms of long-term operating returns, rather than takeover or other short-term premiums, will increasing their power to influence directors and managers promote the long-term health of the corporation.

D. The Five-Year Report

Institutional stockholders typically lack the resources to investigate and evaluate the performance of each company in their portfolios, limiting their ability to participate effectively in corporate governance.¹³³ The five-year report contemplated by the quinquennial proposal would reduce the need for investigation by providing detailed information on the corporation's performance and business plans. The critique of the five-year report by independent advisors would fulfill the evaluation function, minimizing the need for stockholders to expend their own resources in order to judge the validity of the corporation's own report.

¹³¹ Gilson and Kraakman, *Reinventing the Outside Director* at 39-42 & n 71 (cited in note 1). For example, Professor Gilson was co-chairman of the USX Corporation shareholder committee, formed by corporate raider Carl C. Icahn "to press for the rapid sale or spinoff of the USX Corporation's steel business." Gregory A. Robb, *Icahn Group to Urge USX Sale of Steel Unit*, NY Times D5 (Nov 15, 1990).

¹³² See text at notes 78-80.

¹³³ See, for example, Jensen, *Harv Bus Rev* at 66 (cited in note 107) (too costly for institutional investors to become involved in major decisions and long-term strategies of the companies in which they invest); John Plender, *The Limits to Institutional Power*, Financial Times § 1 at 20 (May 22, 1990) (institutional stockholders in the United Kingdom lack industry-specific expertise and information needed to play a role in corporate strategy).

1. The corporation's report.

The quinquennial proposal contemplates that the corporation would continue to issue annual reports as currently required for public corporations. In the quinquennial year, however, the corporation would issue a far more thorough document, resembling the "blue book" evaluation of the corporation typically prepared by a corporation's investment banker or management consultant. First, it would review the corporation's performance for the prior five years against the five-year plan set forth in its prior five-year report, and against the performance of other companies in the corporation's industry, the market in general, and any other relevant indices. A narrative description would evaluate the performance, explain trends, and review the reasons for the corporation's operating successes and failures.

The report would also detail the corporation's five-year business plan, including projections, the assumptions underlying them, the factors likely to affect whether the projections are met, and the corporation's ability to control or influence these factors. These projections should not raise liability concerns in light of the federal safe-harbor rules that protect companies against claims of securities fraud in connection with projections made in good faith.¹³⁴ The SEC might also promulgate special safe-harbor provisions for the five-year report.

The report would discuss the return on investment if the corporation's projections were met, and the dividend stream anticipated by the corporation. If the corporation plans to retain earnings instead of paying them out as dividends, the report would discuss the anticipated uses of these funds. The report would also contain a narrative description of the corporation's five-year strategic plan, the steps the corporation intends to take to accomplish its goals, and the anticipated short-term and long-term implications of the plan for the corporation's financial results.

Some may be concerned that the five-year plan would set goals that could prove too easy to meet in the event of an economic upswing that begins after the plan is drafted.¹³⁵ Each five-year report, however, would compare historical performance not only against the corporation's plan, but also against the performance of other companies in the industry, the market in general, and other relevant measures. These requirements, together with the advisor's

¹³⁴ 17 CFR § 230.175 (1990); 17 CFR § 240.3b-6 (1990).

¹³⁵ Sykes, *Corporate Takeovers* at 43-44 (cited in note 85).

independent report and the likelihood of a continuing dialogue among directors, managers, and stockholders throughout the five-year period, would ensure that managers and directors made every effort to exceed their targets if general economic and other conditions permit.

2. The independent advisor's evaluation.

The separate advisor's report would address the concern that institutional investors might not be able to judge an acceptable five-year plan.¹³⁶ The advisor selected by the board to report to the stockholders could be an investment banking firm, consulting firm, or similar entity that provides other services to the corporation, or a firm engaged solely for the purpose of rendering the evaluation. The advisor's appointment by a board with a majority of outside directors, its direct relationship and responsibility to stockholders, and the importance of its reputation for integrity would work to assure the independence and quality of the advisor's report. If additional assurance of independence is desired, the advisor could be appointed by a committee, such as the audit committee, consisting entirely of outside directors. Moreover, institutional stockholders would quickly determine which advisors' evaluation reports were worthwhile and would lead corporations to select these advisors. Given these practical safeguards, there is no need to disqualify advisors who have prior working relationships with the corporation. These firms may be the most familiar with the corporation and its operations, and therefore the most logical and capable candidates to perform the evaluation.

While the advisor would be free to include such information in the evaluation as the advisor believed necessary, at a minimum the evaluation would: (1) review the previous five years' performance by the corporation, assessing the successes and failures of the corporation and the comparative performance of other corporations, both in the industry and in general; (2) comment on management's explanation of the corporation's performance; (3) review the projections in the corporation's report, as well as the assumptions underlying the projections and the factors likely to affect the corporation's ability to meet the projections; (4) assess the corporation's ability to meet the projections; (5) evaluate the corporation's strategic plan for the next five years; and (6) comment on the stock-

¹³⁶ *Id.* at 44.

holder investment objectives likely to be met by successful implementation of the plan.

The advisor would have the benefit of the same safe harbor as the corporation, and would be permitted a customary indemnification from the corporation, which would exclude acts of negligence. As in the case of independent accountants evaluating a firm's financial reports, possible liability for negligence,¹³⁷ and, more importantly, the concern for reputation, would motivate care by the advisor.

3. Benefits of the report and evaluation.

The report and evaluation would encourage stockholders to view their shares as a stake in the operating performance of the corporation rather than as a mere financial instrument. Along with the long-term orientation imposed by the quinquennial election of directors, the report and evaluation would give institutional stockholders the means to understand the strategic direction and corporate objectives of their portfolio companies, and to intervene or sell their shares if they differ with these plans.¹³⁸

The discipline of the five-year report would also improve the quality of annual reporting. Stockholders would demand annual reports that analyze where the corporation stands within the five-year framework, the causes and consequences of any discrepancies between performance and projections, and what changes, if any, are necessary for the business plan. Managers and directors interested in retaining their positions at the quinquennial meeting

¹³⁷ See, for example, *Schneider v Lazard Freres & Co.*, 159 AD2d 291, 552 NYS2d 571 (1990) (investment bankers who advised a Special Committee of the board of directors in a sale-of-control context could be liable in negligence to the company's stockholders). For criticism of the court's holding, see Herbert M. Wachtell, Eric M. Roth, and Andrew C. Houston, *Investment Banker Liability to Shareholders in the Sale-of-Control Context*, NY L J 1 (Mar 29, 1990); John C. Coffee, Jr., *New York's New Doctrine of 'Constructive Privity'*, NY L J 5 (Jan 25, 1990). See also Rachel Davies, *Bidders Can Sue in Takeover Case*, Financial Times 33 (Oct 30, 1990) (reporting on 1990 English Court of Appeal decision holding that the financial advisors and auditors of a company may be liable to an unwanted takeover bidder for allegedly negligently prepared financial statements and forecasts issued before and during the pendency of the bid, on which the bidder could foreseeably rely in deciding whether to make or increase its offer).

¹³⁸ For excellent suggestions on how to reform corporate reporting, see generally Peter N. McMonnies, ed, *Making Corporate Reports Valuable* (Kogan Page, 1988) (urging reports that encourage a long-term perspective). The study, prepared by the Institute of Chartered Accountants of Scotland, notes the need for an increased level of independent assessment of corporate reports. The study suggests, as is contemplated by the quinquennial proposal, that the assessor's role be expanded far beyond the role of the typical outside accountant in the current corporate reporting scheme. *Id.* at 84.

would naturally provide this sort of useful information in the interim years.

The expanded information contained in the five-year report and evaluation, and the improved quality of annual reporting, would enable analysts to better assess the performance and prospects of each corporation, and would increase investor confidence in the expected performance of an investment. Perceived investment risk to stockholders should decline in turn, resulting in a lower risk premium and a lower cost of capital to the corporation. The additional information would also assist stockholders in more closely matching their investment objectives to the objectives of the corporations in which they invest, thereby further reducing the risk premium and the cost of equity capital. Ultimately, the quinquennial proposal would bring institutional investor knowledge in the United States and the United Kingdom closer to the level now seen in Japan and Germany. This could bring the return on equity demanded by investors in our markets, and the cost of capital, more in line with that of the Japanese and German markets.¹³⁹

Some corporations may argue that the requirements of the five-year report are too onerous, or that wide distribution of projections or the advisor's evaluation would damage the corporation. Well-managed corporations, however, should welcome the five-year reports and the quinquennial proposal as a whole. Most well-managed corporations today develop, at least internally, detailed strategic plans and five-year projections. Any corporation seeking financing must go through such a process; a well-managed corporation and its management should want to develop a detailed long-term strategic plan and measure its performance against this plan.

Nor can the argument that publication of projections and strategic plans would harm the corporation withstand analysis. On the basis of information already available to them, most good analysts can develop projections for the corporations they follow. These projections do not produce the same investor confidence as management's own projections, but they typically come very close to what the corporation itself would prepare. The quinquennial proposal does not require disclosure of trade secrets or competitively

¹³⁹ See, for example, *Short-termism*, part 20, *The Economist* 76 (June 30, 1990) (cost of capital is higher in United States and United Kingdom than in Japan and Germany); Gary Hector, *Why U.S. Banks Are In Retreat*, *Fortune* 95 (May 7, 1990) (from 1983 to 1988 the cost of capital for United States companies was twice that of competitors in Japan and West Germany).

vital business information. Sophisticated investors understand, and the five-year report would emphasize, that projections constitute a framework, not a crystal ball. Even with such a qualification, however, the framework set forth in the projections and the strategic plan would be of great value in assessing the performance and direction of the corporation.

The real objection of some corporations is likely to be their reluctance to establish a concrete framework against which to judge management's performance or to have management publicly critiqued by an outside advisor. Yet an effective system of corporate governance depends on the ability to evaluate the business performance and direction of the corporation and its management. The corporation least willing to expose itself to such an evaluation probably needs it most.

E. Management Compensation

1. Compensation linked to performance.

The revision of compensation structures would reinforce the long-term time horizon contemplated by the quinquennial system by directly aligning the managers' personal financial interests with the long-term success of the corporation. Financial incentives and risks for managers in leveraged buyouts contribute significantly to the performance of those buyouts that succeed.¹⁴⁰ And the dissatisfaction of many managers who want a more significant share of any increase in value generated by the business success of the corporation fuels strong management interest in participating in these buyouts.¹⁴¹

Today, managerial compensation is not adequately related to the long-term results of the corporation's business operations. Observers note the "dearth of financial incentives for top management to make the costly and risky decisions that can promise substantial long-term payoffs for the shareholders."¹⁴² They also complain that high levels of managerial compensation persist in

¹⁴⁰ George Anders, *Leaner and Meaner Leveraged Buy-Outs Make Some Companies Tougher Competitors*, Wall St J A1 (Sept 15, 1988) (financial risks at stake in LBO force management to be more aggressive). See also Jensen, Harv Bus Rev at 69 (cited in note 107).

¹⁴¹ *Capitalism* at 12 (cited in note 10); Sykes, *Corporate Takeovers* at 11-12 (cited in note 85).

¹⁴² Graef S. Crystal, *Cracking the Tax Whip on C.E.O.'s*, NY Times Mag 48 (Supplement on the Business World, Sept 23, 1990); see also Sykes, *Corporate Takeovers* at 11-12 (cited in note 85); Jensen and Murphy, Harv Bus Rev at 39 (cited in note 21).

corporations whose performance is poor, effectively rewarding managers for corporate failure.¹⁴³ To the extent a large portion of an executive's compensation is set regardless of the corporation's success, the executive lacks any financial motive to improve the business performance of the corporation. Incentive compensation plans tied to the corporation's annual performance, or performance over even shorter time periods, reinforce the problems of short-termism.¹⁴⁴

The quinquennial proposal would link significant financial risks and rewards for managers to corporate performance against the corporation's five-year goals. Managers would receive no bonuses or stock awards based on any shorter time period.¹⁴⁵ The specific compensation plan for each corporation would be part of the quinquennial plan submitted to stockholders. It could also be subject to evaluation by a compensation consultant, in a manner similar to the advisor's evaluation of the five-year business plan.

2. An illustrative plan for compensation.

One possible plan would allocate ten percent of the corporation's shares to management, contingent on at least a twelve-percent increase in the market price of the corporation's shares, compounded over the five-year period (a net increase of 76 percent). The actual increase in market price in any given year would be irrelevant; the plan would look only to the five-year average. Managers would receive half the ten-percent stake if the price increase met the twelve-percent target, and an additional one percent of the corporation's shares for each additional one percent per year market price increase above twelve percent, up to the maximum ten percent if the compound growth rate for the five years reached or exceeded 17 percent. The shares would then vest in equal installments over the next five years, thus limiting the possibility of man-

¹⁴³ Crystal, *NY Times Mag* at 48, 54 (cited in note 142); Jensen and Murphy, *Harv Bus Rev* at 39 (cited in note 21); White, *Financial Times* at 11 (cited in note 43).

¹⁴⁴ Dertouzos, Lester, and Solow, *Made in America* at 62 (cited in note 46) ("A chief executive whose compensation is a strong function of his company's financial performance in the current year is naturally going to stress short-term results. Indeed, some executive-compensation schemes may encourage managers to adopt an even shorter time horizon than the capital markets do.").

¹⁴⁵ A number of writers have similarly suggested the need to enhance the financial rewards to managers of corporations achieving successful long-term business results while creating a meaningful financial penalty if the corporation's long-term business performance is poor. See sources cited in note 142. See also Porter, *The Competitive Advantage of Nations* at 529 (cited in note 75).

agement "loading" the first five-year period at the expense of the future. If the corporation did not meet the targeted compound increase in stock price, but otherwise achieved its five-year goals, managers could receive a specified cash bonus. If the corporation fell short of its five-year goals, managers would receive no incentive compensation and no increase in base salary. This compensation plan would encourage successful managers to stay with the corporation, much as the incentive arrangements with managers of leveraged buyout corporations require them to stay on for a minimum period of time. While the time frame for realizing the financial reward would be relatively long, the size of the potential reward would be sufficiently great to lead managers to accept the plan.¹⁴⁶

The quinquennial proposal would also prohibit employment arrangements that inhibit the ability to replace managers in conjunction with the quinquennial meeting, or that create personal incentives in conflict with the focus on the successful long-term business operations of the corporation. Thus, for example, the corporation could not enter into employment contracts with its managers that extend beyond the quinquennial term. Nor could it offer golden parachutes.¹⁴⁷ However, broad-based severance policies that provide for severance payments regardless of whether there has been a change of control would be permitted.

Management compensation and employment arrangements would thus complement the quinquennial system's reorientation of the corporation's constituencies around the corporation's long-term business success. This system would remove the structural impediments to the ability of managers to manage for the long term, while the financial reward structure would create positive incentives to adopt a long-term personal time horizon.

F. The Prohibition on Takeovers and Elimination of Takeover Defenses

The quinquennial election would be the sole means of accomplishing nonconsensual changes of control. Between meetings, di-

¹⁴⁶ See *CEO Roundtable on Corporate Structure and Management Incentives*, 3 *Continental Bank J Applied Corp Fin* 6, 20 (Apr 1990) (Richard Sim, chief executive officer of a company that grants stock options that cannot be exercised for five years, commented, "Unless they're in it for the long haul, they will get discouraged and quit; and that's, quite frankly, just the way I want it.").

¹⁴⁷ "Golden parachute" as used here refers to severance contracts providing for large payments to executives who are fired or leave under other specified circumstances following a change of control or sale of the corporation.

rectors would not be removable except for criminal conduct or willful misfeasance. In addition, no stockholder could acquire more than ten percent of a corporation's stock without the board's consent. The would-be acquiror therefore could not purchase a controlling stake in a corporation and then coerce a "consensual" change of control, making the next quinquennial election a fait accompli.

Correspondingly, the quinquennial system would prohibit takeover defense devices and repeal takeover-related state legislation. It would thus eliminate share purchase rights plans,¹⁴⁸ staggered boards,¹⁴⁹ supermajority "fair price" provisions,¹⁵⁰ standstill provisions,¹⁵¹ control share acquisition statutes,¹⁵² and business combination moratorium statutes.¹⁵³ It would reinstate the substance of SEC Rule 19c-4, limiting the ability of public corporations to issue equity with disproportionate voting rights.¹⁵⁴

¹⁴⁸ Such plans deter control acquisitions not approved by the corporation's board of directors by making inexpensive new shares available to current shareholders other than the acquiror, diluting the acquiror's stake and increasing the leverage of the board in responding to an unsolicited acquisition attempt. Share purchase rights plans were first developed by one of the authors as a response to abusive takeover tactics. In the context of the quinquennial system's restrictions on changes in control, the protections afforded by rights plans would be unnecessary.

¹⁴⁹ In these arrangements, one-third of the board typically comes up for reelection each year. Under Delaware law, members of a staggered board may only be removed for cause, unless the charter provides otherwise. 8 Del Code Ann §§ 141(d), (k) (1990).

¹⁵⁰ These provisions, found in many corporate charters and some state statutes, impose a supermajority voting requirement on mergers, sales of assets, liquidations, and recapitalizations between the corporation and an "interested person" (typically defined as a 10-20 percent stockholder) unless the transaction meets specified price requirements. See, for example, Ill Ann Stat ch 32, § 7.85 (Smith-Hurd 1990).

¹⁵¹ Under these provisions a stockholder agrees to vote with management at election meetings, or agrees not to contest management's proposals or nominees, in exchange for some corporate concession or as a condition to the corporation's sale of newly issued securities to the stockholder.

¹⁵² Control share acquisition statutes provide that shares acquired in a "control share acquisition," defined as the direct or indirect acquisition of shares constituting voting power in the target corporation of at least 20 percent, 33½ percent, or 50 percent, automatically lose their voting rights unless a majority of the disinterested holders of each class of stock approves. See, for example, Ind Code Ann §§ 23-1-42-1 to 21-1-42-11 (West 1989); *CTS Corp. v Dynamics Corp. of America*, 481 US 69 (1987) (upholding constitutionality of Indiana statute).

¹⁵³ New York's statute prohibits certain in-state corporations from entering into a business combination, including certain self-dealing transactions as well as mergers and consolidations, with a 20 percent stockholder for five years after the 20 percent threshold is crossed, unless the board grants approval in advance of the 20 percent acquisition. NY Bus Corp Law § 912 (Law Co-op Supp 1989). See also *Amanda Acquisition Corp. v Universal Foods Corp.*, 877 F2d 496 (7th Cir 1989) (Easterbrook) (upholding constitutionality of similar Wisconsin statute).

¹⁵⁴ See note 119.

The quinquennial proposal would also repeal all constituency statutes. Because hostile takeovers could only occur as a result of stockholder balloting at the quinquennial meeting and, absent bad faith, self-dealing, or fraud, the board's decision to accept or reject a takeover proposal in the interim would not be subject to review, the board would not have to face the issue of whether it could legally consider the interests of non-stockholder constituencies in responding to a takeover attempt. Board, management, and stockholders would focus not on the threat of takeovers, but rather on the long-term business success of the corporation, an orientation that itself protects the interests of non-stockholder constituencies.¹⁵⁵

The elimination of hostile takeovers and takeover defenses would channel all nonconsensual changes of control into the quinquennial meeting. This would allow stockholders to focus more clearly on the rationale for any proposed change of control, its likely consequences and its desirability. Stockholders could make a considered decision free of coercion from the acquiror or interference from the incumbent board or management, making it less likely that institutional investors would replace good managers simply to get a takeover premium. The quinquennial meeting would become an effective referendum on the business and investment sense of the proposed change of control. To the extent more than one bidder emerged at the quinquennial meeting, the corporation could establish auction procedures, and the courts could develop rules on permissible postponements of the meeting in response to material developments.¹⁵⁶

The elimination of takeover battles between quinquennial meetings would also dramatically reduce the amount of management time and other corporate resources now spent on preventing takeovers and developing takeover-related protections. The quinquennial system would insulate directors and managers for substantial enough periods to permit them to develop their future plans, while at the same time creating a periodic forum in which the directors would be totally uninsulated and subject to recall by the stockholders. While it is possible that the quinquennial meeting could become a focal point for hostile takeover activity, the closer relationship between managers and institutional stock-

¹⁵⁵ See Part II.D.

¹⁵⁶ See *MAI Basic Four, Inc. v Prime Computer Inc.*, CA No 10868 (Del Chanc, June 13, 1989) (permitting board to postpone contested election meeting in light of material changes in challengers' takeover bid shortly before scheduled date of meeting).

holders that the quinquennial system fosters would reduce the likelihood of frequent takeover battles. At worst, the quinquennial system would still free the corporation for substantial periods from preoccupation with the threat of a takeover.

The quinquennial proposal would not permit incumbent directors or management to spend corporate funds in litigation or similar challenges to an opposing slate of directors. The SEC through the federal proxy rules, not incumbent management through private litigation, would police false or misleading statements in the opposing sides' proxy materials. The SEC has policed proxy fights quite diligently.¹⁸⁷ Whatever additional enforcement benefit private litigation might add, the principle of neutrality toward quinquennial changes in control that underlies the quinquennial system could not permit one side of the proxy contest to use corporate funds to litigate against the other in a litigation initiated by the incumbents. Incumbents could, however, use corporate funds to defend litigation initiated by the opposition.

Eliminating the takeover battleground should remove much of the current friction between managers and institutional stockholders, which is often centered around takeover battles and antitakeover defenses. Institutional stockholders have mounted anti-poison pill stockholder resolution campaigns. Incumbent boards have adopted a panoply of takeover defenses. Legislatures have enacted antitakeover legislation. Stockholders complain that directors are simply trying to entrench themselves. Managers complain that stockholders only care about takeover premiums. The whole debate engenders a degree of distrust and hostility that undermines the necessary spirit of patience and partnership essential for long-term operating success in today's business world.

Under the quinquennial system, institutional stockholders would have to take at least a five-year perspective, or dispose of their investment. Incumbent directors would have to justify the five-year performance and plans of the corporation or risk being voted out of office at the quinquennial meeting. The frequency of the incumbent directors' vulnerability would diminish, but the vulnerability, when it arises, would be heightened due to the existence of easily measured goals and the elimination of takeover defenses. The net result would be that the focus of directors, managers and

¹⁸⁷ See David A. Sirignano, *Review of Proxy Contests by the Staff of the Securities and Exchange Commission*, in *Proxy Contests, Institutional Investor Initiatives, and Management Responses* 261, 263 (PLI, 1990) (SEC staff acts to "assure that the security holders receive the information they are entitled to under the proxy rules and are not misled.").

stockholders would merge on the corporation's long-term business success.

Mergers, acquisitions, and other business combinations would remain possible during the interim between quinquennial meetings. The incumbent board would retain its duty to examine and evaluate any bona fide acquisition or merger proposal in the context of the corporation's strategic plan. If the directors were to approve an acquisition involving the issuance of securities with more than 25 percent of the corporation's voting power, they would submit the transaction to the corporation's stockholders.¹⁵⁸ If the directors were to reject a merger or acquisition, however, the stockholders' only recourse would be to replace them at the next quinquennial meeting. Because of the unfettered ability of stockholders to approve a change in control at the quinquennial meeting, directors would not be liable for rejecting an acquisition proposal in the interim, except in cases of bad faith, fraud or self-dealing.

The quinquennial system would remove a significant barrier to negotiated transactions, particularly stock-for-stock transactions that make strategic sense and that avoid the dangerous levels of debt that takeover activity has engendered. Directors are currently reluctant to pursue equity mergers for fear they will put the company "in play" and result in the corporation being forced to accept an undesirable business combination.¹⁵⁹ By barring nonconsensual takeovers except at the quinquennial meeting, the new system should eliminate such fears. Moreover, the focus on strategic direction that the quinquennial system promotes will likely encourage corporations to give careful consideration to the role strategic acquisitions, mergers, or combinations might play in the develop-

¹⁵⁸ For examples of similar trigger mechanisms, see ALI, *Principles of Corporate Governance* § 1.32 at 46-47, 101 (cited in note 27); New York Stock Exchange, *Listed Company Manual* § 312.03(c) (July 1989); American Stock Exchange, *Company Guide* § 712 (May 1990); NASDAQ, *Notice to Issuers* (Oct 16, 1990) (announcing amendment to Schedule D, Part III, Section 5(i) of the By-Laws of the National Association of Securities Dealers, Inc., calling for stockholder approval of any issuance of stock in connection with a merger or acquisition equal to 20 percent or more of outstanding voting shares).

¹⁵⁹ See *Paramount Communications, Inc. v Time Inc.*, 571 A2d 1140 (Del 1989). Although the court held that the preplanned equity merger between Time and Warner could proceed, Time was forced to defend itself at great expense against the hostile advances of Paramount. See generally Laura Landro, David B. Hilder, and Randall Smith, *Time Inc.'s Stock Soars \$44 a Share as Wall Street Bets Paramount's Offer Will Derail Merger With Warner*, Wall St J A3, 12 (June 8, 1989) (Paramount's chief executive officer "told analysts that Time 'put itself up for sale' by handing over 60% ownership to Warner shareholders in the proposed Time-Warner merger."). The authors' law firm represented Warner in this transaction.

ment of the corporation's business. The quinquennial system might have a slight chilling effect on riskier acquisitions that, if unsuccessful, would threaten the corporation's ability to meet its five-year goals. On the whole, this chill is as likely to be a positive as a negative consequence.

G. The Role of Outside Directors

1. Incentives for effective monitoring.

The quinquennial proposal would require that a majority of each public corporation's board be composed of directors otherwise unaffiliated with the corporation. Thus, the quinquennial system, like the current system of corporate governance, looks to the outside director as the primary monitor of the business performance of corporate managers. But the quinquennial proposal would make the outside director more vulnerable to replacement by stockholders. Incumbent directors now rarely lose their seats in a proxy fight, except in the context of a tender offer or acquisition proposal. Critics therefore charge that outside directors are not responsive to stockholders because they owe their jobs to management.¹⁶⁰ With the greatly enhanced ability of stockholders to challenge incumbent directors at the quinquennial meeting, directors who are unresponsive to stockholders would likely lose their seats. Outside directors would have an increased incentive to perform an effective monitoring role.

These directors' *ability* to monitor would also increase. Some have pointed to the lack of business information given to outside directors, and the lack of time and expertise to evaluate this information, as major obstacles to the performance of outside directors as effective business monitors.¹⁶¹ The five-year report and evaluation contemplated by the quinquennial proposal, the expanded annual reporting and internal reviews it is likely to engender, and the continuity of a five-year term, would help to remove these barriers. The framework established by the five-year report should also give further impetus to the growing practice of regular, detailed internal and outside advisor reviews, with the entire board, of the corporation's performance, projections, and strategic plan. Directors

¹⁶⁰ See Gilson and Kraakman, *Reinventing the Outside Director* at 21 (cited in note 1). See also Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 Harv L Rev 597, 610 & n 39 (1982) (independent directors are rarely appointed without prior approval of management).

¹⁶¹ Lorsch, *Pawns or Potentates* at 84-88 (cited in note 19). See also Coffee, 84 Colum L Rev at 1202-03 (cited in note 46).

would insist on the sort of interim reporting and analysis that will help them push the corporation toward its five-year goals, and justify any deviation.

Experience in the last few years shows that directors are very responsive to a proxy fight or even the threat of a proxy fight. Several recent proxy fights/consent solicitations have led to concessions by, or the ultimate sale of, the target corporation. For example, BTR plc's combined proxy contest and tender offer for Norton Company resulted in the sale of Norton to a third-party bidder; Georgia-Pacific Corporation's proxy contest and tender offer for Great Northern Nekoosa Corporation resulted in the sale of Great Northern to Georgia-Pacific; Gemini Partners' proxy contest and consent solicitation to take over the board of directors of Healthco International, Inc. resulted in the appointment of three Gemini nominees to the Healthco board and the pending sale of Healthco to a third party; and the threat by Chartwell Associates to commence a proxy fight with Avon Products to nominate four new directors who would seek to sell the company resulted in Avon giving the dissidents two seats on the board and a stronger voice in running the company.¹⁶² The quinquennial meeting, and the knowledge that institutional stockholders would have access to the corporate proxy machinery to challenge directors with whom they are dissatisfied, would strengthen the unity, and thus the power, of the outside directors in taking an active role in monitoring the corporation's business performance. In this manner, the remaining barriers to effective monitoring by outside directors would be lowered.

Given the outside directors' heightened monitoring role, the quinquennial proposal would limit the number of boards on which an outside director could serve to three, and would increase their compensation. In addition to an increase in base compensation, the outside director—like managers—would participate substantially in stock-based incentive compensation tied to the corporation's five-year performance. Such provisions would further motivate the corporation's outside directors to fulfill their role as monitors of the corporation's long-term direction and business performance,

¹⁶² Randall Smith, *Storming the Barricades With a Proxy*, Wall St J C1 (May 10, 1990); *Healthco to Give Gemini Partners L.P. 3 Seats on New Board*, Wall St J C8 (Sept 21, 1990). See also Phillip A. Gelston, *New Developments in Proxy Contests*, in *Tenth Annual Institute: Proxy Statements, Annual Meetings and Disclosure Documents* 651 (Prentice-Hall, 1988) (citing examples of proxy contests to promote a policy of selling or restructuring the company). The authors' law firm represented Norton in its proxy contest with BTR, and Healthco in its proxy contest with Gemini.

and would meet the complaint of some institutional investors as to the minimal share ownership of most outside directors.

2. The perils of special-interest directors.

Professors Gilson and Kraakman argue that traditional outside directors cannot be effective monitors of managerial performance because, through the nomination process and through social ties, they are tied too closely to the management they monitor, and because they are too independent of stockholders.¹⁶³ The first part of this argument reflects a view that managers and directors must have an adversarial relationship in order for the monitoring function to be successful. In fact, the opposite is true. The director-manager relationship must be a cooperative one, not an adversarial one, in order to be effective. While the adversarial director or board may have the ultimate threat of firing to enforce their policies, the likelihood of full and successful responsiveness by managers to the views of directors is much greater when the manager is motivated by respect and friendship than when motivated by fear.¹⁶⁴

The second part of the argument reflects the view that an outside director cannot be responsive to a corporate constituency without being nominated by, or specially designated to represent, that constituency. The quinquennial proposal responds to this concern by aligning the interests of the various corporate constituencies—stockholders, managers, employees, and the corporation itself—around the corporation's long-term business success.

It is not necessary, and indeed it would be divisive, to elect separate classes or groups of directors to represent the various corporate constituencies, or to have any constituency have a separate special right to nominate or advise on the nomination of directors.¹⁶⁵ A board monitors best when it works as a cohesive whole, each director viewing himself as representing all constituencies.¹⁶⁶ Once the corporation's various constituencies all center on the long-term health of the enterprise as their common goal, then traditional outside directors would have ample incentives to work cooperatively with inside directors, management, stockholders, and

¹⁶³ See Gilson and Kraakman, *Reinventing the Outside Director* at 21 (cited in note 1).

¹⁶⁴ See note 45 and accompanying text.

¹⁶⁵ Compare Gilson and Kraakman, *Reinventing the Outside Director* (cited in note 1) (recommending election of professional outside directors by, and beholden to, institutional stockholders).

¹⁶⁶ Lorsch, *Pawns or Potentates* at 41-54 (cited in note 19) (the more directors explicitly agree about in whose interests they are governing, the more they will feel empowered as a group).

the other constituencies to improve the corporation's operating performance. For similar reasons, it is not necessary that the chairman of the board be someone other than the chief executive officer.¹⁶⁷

H. Implementation

The best way to implement the quinquennial system would be through a comprehensive legislative package, adopted in the United States by Congress and the state legislatures and abroad by Parliament in the United Kingdom, or by a Directive of the European Economic Community to all its member states, including the United Kingdom.¹⁶⁸ This comprehensive approach would require the corporate world and the institutional investor world in each country to work together toward adoption of the new system. In this Section, we discuss the roles that various groups in the United States could play to make the quinquennial proposal a reality. We then briefly discuss the implementation of the quinquennial proposal in the United Kingdom.

1. Congress.

The best hope for coordinated nationwide implementation lies with federal legislation. This legislation could take one of three forms: a) a substantive federal corporation law that would essentially replace existing state law; b) legislation that mandates the quinquennial concept but leaves specific implementation to the states; or c) legislation that complements, but does not mandate, implementation at the state level.

We favor the second approach. While a federal law of corporations is within the power of Congress,¹⁶⁹ such radical change is unnecessary. There is no need to transfer the responsibility for, and the burden of, corporation law as a whole to the federal government and judiciary. On the other hand, non-mandatory legislation would encourage but not ensure uniform adoption of the quin-

¹⁶⁷ But see *id.* at 184-85 & n 5 (proposing separation of the offices of chairman of the board and chief executive officer).

¹⁶⁸ EEC legislation may take several forms, including Regulations and Directives. Regulations are immediately binding and directly applicable to all member states. Directives bind member states to achieve certain specific results. The results can be achieved in many ways, usually by enacting the appropriate legislation in that member state.

¹⁶⁹ See, for example, Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 *Bus Law* 1125, 1146 (1976) (substantial federal interest in operation of large corporations would overcome any Tenth Amendment objection to federal chartering of corporations).

quennial proposal. While adoption on a state-by-state basis would have some beneficial effect, the quinquennial system would work best as a national solution.

Federal legislation mandating the quinquennial system, but leaving implementation to the states, would ensure nationwide adoption of the quinquennial system, while preserving state control and administration of corporation laws. This legislation would require that within a specified period of time (perhaps two years), each state amend its corporation law to provide for the quinquennial election of directors; the prohibition of nonconsensual changes in control between election meetings; the abolition of takeover defenses and repeal of state antitakeover legislation; access to the corporate proxy machinery for major stockholders; publication of the quinquennial report and evaluation; and guidelines for permissible corporate compensation schemes. We also suggest interim legislation providing for a temporary moratorium on takeovers between the introduction and adoption of quinquennial legislation. This moratorium addresses the concern that the pendency of the quinquennial legislation might prompt a destructive surge in hostile takeover activity.¹⁷⁰

Federal legislation would implement directly, or delegate to the SEC, necessary revisions to federal proxy and general disclosure laws and rules, the reinstatement of SEC Rule 19c-4, and the repeal of SEC Rule 14a-8. States would maintain whatever other provisions of corporation law they desired, as long as those provisions did not threaten to undercut the quinquennial system. States would also remain responsible for administering their own corporation laws, and state courts would continue to interpret and enforce those laws.

Historically, it has been difficult to achieve the necessary consensus for federal legislation affecting takeovers.¹⁷¹ As a first step toward overcoming this difficulty, Congress could create an advisory panel including representatives of both the corporate and the institutional investor worlds. Congress could require the panel to report back shortly with a fully developed legislative proposal supported by both groups. Alternatively, the Treasury Department's task force on corporate governance could undertake to achieve the necessary consensus.

¹⁷⁰ See Sykes, *Corporate Takeovers* at 44 (cited in note 85).

¹⁷¹ See, for example, Thomas G. Donlan, *Twice Shy: Congress Unlikely to Try Another Anti-Buyout Bill*, *Barron's* 15 (May 1989).

2. States.

If federal legislation initially proves impossible, the next-best alternative would be implementation by individual states. While federal law historically has governed disclosure requirements and proxy procedures, the quinquennial system's proposals in these areas do not conflict with existing federal law and thus could be enacted by the state. The prohibition on nonconsensual changes in control between election meetings is the only element of the quinquennial system that would raise serious constitutional questions if enacted without federal authorization. In light of the obviously legitimate state interest in the quinquennial proposal as a whole, however, enactment of this provision by states should survive any constitutional challenge.¹⁷² Moreover, even if states could not constitutionally ban nonconsensual changes in control between election meetings, they could accomplish much the same purpose by prohibiting removal of directors between quinquennial meetings or limiting the voting rights attached to shares acquired in excess of a specified percentage of outstanding shares without the approval of the corporation's directors.

State-by-state implementation would begin in states with small populations of major public corporations. A variety of competing constituencies and political forces, similar to those found on the national level, tend to operate in Delaware and other states where large numbers of major corporations are incorporated. If these forces block development of the consensus necessary to achieve federal legislation, they would probably also block passage of legislation in these key states. In a state where a limited number of major corporations are incorporated, however, those corporations and their corporate constituencies could combine to secure enactment of the quinquennial system by the state legislature. Success of the system in a few such states would facilitate its wider adoption.

The first step in this process would be for one or a group of the major corporations in a state to work with the state bar groups to develop a legislative proposal. The corporations would also solicit input and support from any of its major stockholders who desired to participate in the process. Support of a legislative corpo-

¹⁷² See *CTS Corp. v Dynamics Corp. of America*, 481 US 69 (1987) (Indiana's interest in protecting its corporations and regulating their internal affairs outweighed any extraterritorial effects of control share acquisition statute); *Amanda Acquisition Corp. v Universal Foods Corp.*, 877 F2d 496, 503, 506 (7th Cir 1989) (following *CTS* in upholding constitutionality of Wisconsin's business combination statute).

rate governance proposal by many of the state's large corporations, their major stockholders, and the state bar groups would virtually guarantee passage.

3. The Securities and Exchange Commission.

Development of the federal proxy and disclosure provisions of the quinquennial system would fall naturally within the domain of the SEC. Congress could delegate to the SEC the job of developing detailed rules governing the five-year report and the advisor's evaluation, just as the SEC has historically developed disclosure and reporting rules under existing securities laws.¹⁷³ The SEC would also develop rules governing the access of major stockholders to the corporate proxy machinery just as it currently develops and enforces the federal proxy rules.¹⁷⁴

The SEC could take the lead in implementation of the quinquennial proposal by developing and advising on federal or state legislative proposals for such implementation. The staff of the SEC has extensive experience with a number of the issues raised by the quinquennial proposal. Representatives of the SEC could serve on the congressional advisory panel charged with developing a federal legislative proposal. Alternatively, the SEC could work with the Treasury task force, or conduct an independent study of the proposal and offer recommendations for improving it.

4. Corporations and institutional investors.

Corporations and institutional investors would serve primarily as advocates for adoption of the quinquennial system. Through public statements, private discussion and legislative lobbying, they could play a key role in developing political support for the proposal. Those who opposed the proposal could engage in similar efforts, encouraging proponents to either accommodate or rebut significant objections.

Business groups such as The Business Roundtable and the National Association of Manufacturers, institutional stockholder groups such as the Council of Institutional Investors, and major public investment funds such as CalPERS, provide preexisting ve-

¹⁷³ See, for example, 17 CFR §§ 240.13a-1, 240.13a-11 and 240.13a-13 (1990) (requiring annual, quarterly, and other reports on prescribed forms); 17 CFR § 240.13d-1 (1990) (requiring disclosure of beneficial ownership in excess of five percent of a corporation's shares); 17 CFR § 239.11 to 239.34 (1990) (setting forth forms prescribing disclosure requirements for registration statements under the Securities Act of 1933).

¹⁷⁴ 17 CFR §§ 240.14a-1 to 240.14a-102 (1990).

hicles for discussion of the quinquennial proposal. The identification of these groups with fixed positions in the corporate governance debate, however, may create obstacles to constructive dialogue. Accordingly, we also encourage discussion among individual corporate leaders and institutional stockholders. The congressional advisory panel, or any other legislatively appointed panel or commission, would provide an appropriate forum for such discussion.

5. The United Kingdom:

Parliament could enact the entire quinquennial system through a comprehensive amendment to the Companies Act, the principal regulatory statute governing public companies in the United Kingdom.¹⁷⁵ The extensive relationships among industry, merchant banks, institutional stockholders, and governmental agencies such as the Bank of England—for example, in their roles on the City Panel on Takeovers and Mergers¹⁷⁶—would permit these groups to work together toward implementation of the new system. Alternatively, the United Kingdom's role as a member of the EEC may make it more appropriate to implement the quinquennial system through an EEC Directive to member states. This approach would be analogous to federal legislation in the United States mandating enactment of the quinquennial system but leaving implementation to the states.

As in the United States, the key would be to gain the support of both the corporate world and the institutional investor world. Recognition of the corporate governance problem is high in the United Kingdom, and the perceived need for reform is great. The quinquennial system responds to the concerns voiced in the United Kingdom by participants in the corporate governance debate; accordingly, adoption of the system may be possible.

¹⁷⁵ Companies Act 1985, II Palmer's Company Law ¶ A-051 at 1011 (1985). See also Companies Act 1989, II Palmer's Company Law ¶ A-110 at 1509 (1989) (incorporating amendments that reflect, among other things, certain EEC directives).

¹⁷⁶ The Takeover Panel is a non-statutory body that regulates takeovers through its interpretations of the City Code on Takeovers and Mergers, an industry code containing general principles and specific rules relating to takeovers. Members of the Takeover Panel include representatives of merchant banks, investment fund managers and institutional investors, professional accountants, the Bank of England, the Securities Association, the Stock Exchange and the Confederation of British Industry. See generally Tony Shea, *Regulation of Takeovers in the United Kingdom*, 16 Brooklyn J Intl L 89 (1990); Lord Alexander of Weedon, Q.C., *Takeovers: The Regulatory Scene*, 1990 J Bus Law 203.

CONCLUSION

The intensity of the corporate governance debate in the United States and the United Kingdom reflects a deep-seated concern with the present system. Virtually all participants in the debate recognize that the present system will not meet our needs in the 1990s and beyond. We cannot afford to repeat the financial chaos of the 1980s or the crises that inevitably follow such a speculative frenzy. While corporate governance is only one factor in determining the success of our business corporations, it is a key factor. It is imperative that we rebuild the corporate governance system to promote the long-term health of the corporations that form the backbone of our free-market economy.

At the theoretical level, this task entails rejection of the managerial discipline model of corporate governance, which places stockholder wishes, stockholder profit, and the promotion of takeovers on an undeserved pedestal. This model encourages the sort of short-term obsessions that continually undermine the ability of American and British companies to compete in world markets over the long term. In place of the managerial discipline model we propose a theory centered on the corporation's own interest in its long-term business success. This interest, when multiplied many times over, in classical economic theory mirrors the interest of all corporate constituencies and society as a whole.

At the practical level, we urge adoption through the coordinated efforts of many actors—state and federal, public and private—of a quinquennial system of corporate governance. This system would reserve essential decisions of corporate control and strategy for stockholders to decide every five years, in a meeting dedicated to rational and unfettered consideration of the corporation's long-term interests. Not all aspects of the quinquennial system would find favor with corporations or with institutional stockholders; it is not designed to meet the wishes of either. But it would meet the needs of our economies, and lead both corporations and institutions to act in the national interest.

February 7, 1994

To Our Clients:

Ten Questions Raised by Paramount

The Paramount decision issued by the Delaware Supreme Court last Friday answers a number of questions that come up in structuring an acquisition or responding to a takeover bid:

1. Question. If the sale of a company is for cash, or securities other than voting stock in a public company that does not have a control group, what standard should be followed by the board of directors.

Answer. The Paramount decision holds that in a sale of control context the directors of the company have one primary objective — “to secure the transaction offering the best value reasonably available for the stockholders.” See Question 5 below.

2. Question. Did Paramount hold that the poison pill is illegal?

Answer. No. Paramount did not invalidate the pill. To the contrary it cites approvingly the Household decision in which the pill was first sustained by the Delaware Supreme Court.

3. Question. Can the target of a hostile takeover bid still just say no?

Answer. Yes. The Paramount decision expressly states that it does not apply to a situation where a company is following its own strategic plan and has not initiated a takeover situation. Where the target of a hostile bid wishes to consider rejecting the bid and remaining independent it is critical that the board of directors follow the correct process and have the advice of an experienced investment banker and legal counsel. The Paramount decision lists the key considerations for the board weighing an acquisition or a takeover:

- (a) the offer’s fairness and feasibility,
 - (b) the proposed financing,
 - (c) the consequences of the financing,
 - (d) questions of illegality,
 - (e) the risk of nonconsummation,
 - (f) the bidder’s identity, prior background and other business experiences,
- and
- (g) the bidder’s business plans for the company and their effects on all stockholder interests.

4. Question. If it is not a sale of control but rather a common stock merger with the combined company being a true public company, can you have no-shop and lock-up provisions?

Answer. Yes. The Paramount decision is expressly limited to the situation of a sale of control. It does not apply to the merger of two companies that results in a public company without a control group. However, the Paramount decision does have much to say about the reasonableness of no-shop and lock-up provisions. In light of the Paramount decision a no-shop provision that is limited to the company not initiating discussions with third parties but does not restrict responses to third party initiatives is indicated. A lock-up option or bust-up fee should also be reasonable in amount and not so material as to foreclose a third party bid. The decision indicates that a combination of a lock-up stock option and a bust-up fee that is not capped at an aggregate reasonable amount is likely to be held invalid. Also questionable are a put alternative to a lock-up stock option as is an alternative permitting noncash exercise. While it can be argued that the Paramount decision discussion of lock-up options, bust-up fees and no-shop provisions is limited to sale of control situations, the underlying theme of the decision signals caution. This is an area where more may well be less and too much may taint the independence of the board and jeopardize the deal.

5. Question. Is there any way to do a deal that is viewed as a sale of control without shopping or conducting an auction?

Answer. Yes. If on the basis of well considered expert advice the board determines it is more likely to get the best value reasonably available by not shopping or auctioning, then the board can authorize the transaction. In this situation the board should document the basis for its determination and should avoid any no-shop, lock-up option of bust-up fee provision that would impede a third party from competing. In the past the Delaware courts have approved a subsequent “market check” as a substitute for shopping prior to entering into an agreement and the Paramount decision does not reject that approach.

6. Question. In evaluating competing bids involving securities can the board decide that it prefers one security over the other?

Answer. Yes, but only within reasonable limits. The Paramount decision says, “a board of directors is not limited to considering only the amount of cash involved, and is not required to ignore totally its view of the future value of a strategic alliance. . . . When assessing the value of non-cash consideration, a board should focus on its value as of the date it will be received by the stockholders. Normally, such value will be determined with the assistance of experts using generally accepted methods of valuation.” (Emphasis added)

7. Question. Does the Paramount decision change the role or duties of the directors?

Answer. No. The court in the Paramount decision cited with approval the prior Delaware cases which basically say that in acquisition transactions the directors must be especially diligent. The decision goes on to say “the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial.”

8. Question. Can a company enter into a merger of equals (that is not a sale of control) in which neither company gets a premium?

Answer. Yes. The language in the Paramount decision that the shareholders of the acquired company must get a premium for the sale of control is expressly limited to the sale of control situations and does not apply to a merger of equals.

9. Question. If a company enters into a strategic merger that is not a sale of control in which the company gets a premium and a third party makes a hostile takeover bid for the company at a higher value to its shareholders, can the company cancel the merger and reject the hostile bid?

Answer. Yes, in theory, but as a practical matter there may be so much shareholder pressure that the company will be forced into the auction mode and be forced to accept the highest bid.

10. Question. In a transaction where it is permitted to use a bust-up fee, what is a reasonable amount?

Answer. The Paramount decision rejects an “unreasonable” bust-up fee but does not give guidance as to what is reasonable. Prior precedent and the Paramount decision’s rejection of a \$100 million bust-up fee as unreasonable when considered together with a lock-up option with a value of more than \$400 million in a \$10 billion transaction, provides some basis for the view that a bust-up fee of up to 2% is sustainable.

M. Lipton

August 28, 1998

Delaware Corporations Should Eliminate "Dead Hand" Provisions

As we noted in our memorandum dated August 11, 1998, in Carmody v. Toll Brothers, the Delaware Chancery Court recently indicated that "dead hand" provisions in rights plans in their "pure" form -- those that deny the winner of a proxy fight the ability to redeem a rights plan for an indefinite period after control of the board of directors changes -- will be found invalid under Delaware law. In light of this decision, we understand that plaintiff law firms that pursue stockholder litigation are considering targeting Delaware corporations who have rights plans with dead hand provisions. If stockholder litigation is commenced and the rights plan is subsequently amended, the plaintiffs in the stockholder litigation may claim that they are entitled to receive compensation for causing the amendment.

Therefore, we recommend that any Delaware corporation that has a dead hand provision in its rights plan proactively amend the plan to eliminate the dead hand provision before stockholder litigation arises. In Toll Brothers, the Chancery Court limited its ruling to pure dead hand provisions, thereby suggesting that dead hand provisions with a limited time period could be valid. However, we recommend that any limited dead hand provision be adopted only in response to a specific threat to the ability of the corporation to obtain the best available deal for its stockholders.

M. Lipton
D. A. Katz

September 10, 2001

Delaware Supreme Court
Affirms Validity of Poison Pills

The Delaware Supreme Court has affirmed the rejection by the Court of Chancery of a series of technical attacks against poison pill rights plans (see our memorandum of October 12, 2000). Fittingly, the opinion was authored by Justice Walsh who, then a Vice Chancellor, rendered the first decision upholding rights plans in the Household case over 15 years ago. Leonard Loventhal Account v. Hilton Hotels Corp., Del. Supr., No. 584, 2000 (Sept. 6, 2001).

The Supreme Court affirmed on the basis of *stare decisis*, emphasizing the “need for stability and continuity in the law and respect for court precedent.” In turning back the attacks on various elements of the plan, the Court stressed that Household had addressed the fundamental question — “whether a board of directors had the power to adopt unilaterally a rights plan the effect of which was to interpose the board between the shareholders and the proponents of a tender offer” — and that it would not entertain even contentions not explicitly passed upon in Household that could not be harmonized with that basic holding. The Court’s analysis makes clear that the courts sought not consider challenges to the validity of rights plan provisions that would undercut Household’s basic holding.

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Shareholder Rights Plan draft in support of the “poison pill”; Univ. Chicago Law School symposium; request for comments; January 28, 2002

January 28, 2002

Pills, Polls and Professors

In the almost twenty years since I introduced the Shareholder Rights Plan (“poison pill”), there has never been a time when it was not under attack. It has withstood all the attacks and has become part of the basic fabric of American corporation law. However, the anti-pill forces are still active and on February 8 and 9 many of the veterans of the Pill Wars and some of their younger colleagues will be participating in a University of Chicago School of Law symposium at which the pill and the laws governing takeovers and corporate governance will be debated.

Today there are three schools of pill traducers, each led by a prominent law school professor, and each advancing a different means and rationale for doing away with the pill. One school endorses a shareholder initiated amendment to the bylaws to require redemption of the pill and to prohibit reissuance. Another, recognizing the likelihood that the bylaw invalidating the pill will be held illegal, at least in Delaware, advances bylaw amendments that do not directly attack the pill, but have the effect of undermining a board’s ability to use it. The third would amend state corporation laws to provide that a raider could make a takeover bid and force a shareholder referendum, which if supported by a majority of the outstanding shares would override the pill and all other structural defenses to the bid.

I am participating in the Chicago debate and in that connection I prepared the attached paper in support of the pill and the ability of the board of a target to “just say no” to a hostile takeover. In a way, this paper summarizes my efforts over a twenty-year period in courts, legislatures and academic publications to counter those who would hang a permanent “For Sale” sign on all public companies. My objective has been to preserve the ability of the board of directors of a target of a hostile takeover bid to control the target’s destiny and, on a properly informed basis, to conclude that the corporation remain independent. I have never been able to understand the persistent refusal of those academics who would hang a “For Sale” sign on public corporations to recognize (i) that there are very significant costs to corporations in being managed as if they are continuously for sale, and (ii) that there is simply no evidence at all that the damage, if any, that the anti-pill academics attribute to the pill is greater than those costs.

[The attached paper](#) is still in draft form and I welcome comments.

M. Lipton

Attachment

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Pills, Polls and Professors Redux

Martin Lipton^{*}

September of this year will mark the twentieth anniversary of the publication of my memorandum recommending that companies adopt the poison pill, which I invented in the summer of 1982 to deal with the takeover abuses that emerged in the 1970s and had become endemic by the end of the decade. The pill prevents a hostile tender offer from being consummated unless and until the board of directors of the target redeems the pill. The pill does not prevent a proxy fight to remove and replace a board of directors that refuses to redeem the pill. It was and is a fundamental aspect of the pill that a proxy fight is the only way in which a raider can override a well-founded decision of the board to reject and block a takeover bid. Now Professor Lucian Bebchuk urges, in his brilliantly presented paper, that basic state corporation law be changed to allow a raider to demand a shareholder referendum whenever a board refuses to redeem a pill.¹ This proposal is one of several that have been advanced over the years to deny the board of a target the ability to craft a strategy to protect corporate interests in the context of a hostile takeover bid. In a rough chronological sequence, the pro-takeover, anti-board-of-directors arguments have been:

1. The law should deny the board the power to be anything but passive in the face of a takeover bid.²

^{*} Partner, Wachtell, Lipton, Rosen & Katz, New York City. I am grateful to my colleagues Laura A. McIntosh, Erin E. Quinn and Paul K. Rowe for their significant contributions to this paper, and to William T. Allen, Andrew R. Brownstein, John A. Eloffson, Daniel A. Neff, Gregory N. Racz, Eric S. Robinson, Steven A. Rosenblum, William D. Savitt, Warren R. Stern, Herbert M. Wachtell and Jeffrey M. Wintner for their helpful comments.

¹ See L. Bebchuk, *The Case for Shareholder Voting and Against Board Control in Corporate Takeovers* (Wkg. Draft Jan. 2002); see also L. Bebchuk & A. Farrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 Va. L. Rev. 111 (2001).

² See F. Easterbrook & D. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981).

2. The law should deny the board the power to frustrate the takeover bid but permit the board to advise the shareholders as to fairness and to seek a higher bid.³
3. The pill is illegal.⁴
4. A pill should require shareholder approval before it is effective.⁵
5. Shareholders can initiate and adopt a bylaw amendment that forces redemption of the pill and precludes adoption of a pill.⁶
6. Given that at least Delaware will probably hold that the shareholder bylaw overruling the pill is not legal, shareholders should initiate and adopt bylaw amendments that do not directly overrule the pill, but make a takeover easier and takeover defense more difficult.⁷
7. Professor Bebchuk's proposal to change the law to permit a bidder-initiated referendum to remove the pill and all other takeover defenses, which would be binding on all the shareholders if it received the support of a majority of the outstanding shares of the target.⁸

³ See L. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 Harv. L. Rev. 1028 (1982); R. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819 (1981); see also *European Parliament and Council Directive on Company Law Concerning Takeover Bids* (Joint Text Approved by the Conciliation Committee on June 6, 2001).

⁴ See *Amalgamated Sugar Co. v. NL Indus., Inc.*, 644 F. Supp. 1229 (S.D.N.Y. 1986)); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985) (in which appellants argued that the board of directors did not have the power to adopt the poison pill and that the board may not usurp shareholders' right to receive hostile tender offers); *Bank of New York Co. v. Irving Bank Corp.*, 536 N.Y.S.2d 923 (N.Y. Sup. Ct. 1988), *aff'd without op.*, 533 N.Y.S. 2d 411 (Table) (N.Y. App. Div. 1st Dep't 1988); see also R. Helman & J. Junewicz, *A Fresh Look at Poison Pills*, 42 Bus. Law. 771 (1987).

⁵ See J. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 Cardozo L. Rev. 511, 549 (1997).

⁶ See *Int'l Bhd. of Teamsters Gen. Fund v. Fleming Cos., Inc.*, 975 P.2d 907 (Okla. 1999); R. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, Columbia Law School Wkg. Paper No. 177 (June 2000); Gordon, *supra* note 5, at 549.

⁷ See J. Coates & B. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 Bus. Law. 1323 (2001).

⁸ See *supra* note 1; cf. *infra* note 65.

This paper discusses the development of the law — primarily Delaware law — governing takeovers, and against that background, rebuts Professor Bebchuk’s referendum proposal. In a way, this paper is the culmination of my efforts over a twenty-year period in courts, legislatures and academic publications to counter those who would hang a permanent “For Sale” sign on all public companies. I have sought to preserve the ability of the board of directors of a target of a hostile takeover bid to control the target’s destiny and, on a properly informed basis, to conclude that the corporation remain independent. I have never been able to understand the persistent refusal of those academics who would hang a “For Sale” sign on public corporations to recognize (i) that there are very significant costs to corporations in being managed as if they are continuously for sale, and (ii) that there is simply no evidence at all that the damage, if any, that the anti-pill academics attribute to the pill is greater than those costs.

Prior to the 1960s, there was little academic discussion or judicial or legislative focus on the legal rules that should apply to the response by a corporation to a takeover bid. With the increase in takeover activity in the 1970s, the topic became a growing concern for lawyers who advised target corporations, but there was still no direct, cogent case law and no meaningful academic debate. From the outset it was clear that there were three constituencies with prime interests in any rule-shaping debate: (1) the shareholders, (2) the corporation as an operating entity, and (3) the employees and other stakeholders. Within each group there were gradations of interests, and the groups and interests overlapped and sometimes collided. In this period, the role of the board of directors and the grounds on which it was to act in responding to a hostile takeover bid were nebulous and had yet to be definitively determined.

In an effort to distill clarity from this confusion, in 1979 I wrote what became the seminal article in the ensuing debate. In *Takeover Bids in the Target’s Boardroom*,⁹ I argued, based on my experience during the 1960s and 1970s in advising boards of directors of corporations that were the targets of hostile takeover bids, that the directors should be governed by the business judgment rule and that in exercising their judgment they should be able to take into account the interests of employees, communities and other constituents, as well as the long-term (and not just the short-term) interests of the shareholders.

This position was quickly rejected by academics opposed to an active board role in the hostile takeover context, who argued for the so-called “Rule of Passivity,” relegating directors to the role of passive observers proscribed from any action other than giving advice to the shareholders. A classic series of articles ensued,¹⁰ with the courts deciding the debate in favor of the business

⁹ M. Lipton, *Takeover Bids in the Target’s Boardroom*, 35 Bus. Law. 101, 130 (1979).

¹⁰ See, e.g., Herzel et al., *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 Corp. L. Rev. 107 (1980); F. Easterbrook & D. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders’ Welfare*, 36 Bus. Law. 1733, 1750 (1981) (arguing that decisions as to tender offers do not involve management of the corporation’s affairs in any meaningful sense).

judgment rule.¹¹ This exchange of articles reflected a fierce public policy debate. The new breed of hostile bids was, on the one hand, wreaking havoc with expectations of managers, employees and communities, and, on the other, enriching the raiders and a new class on Wall Street: the bankers who advised, financed or arbitrated takeovers. The pro-takeover forces found theoretical support for their position among a group of economists who adhered to the efficient market theory, which was argued to offer support for the proposition that shareholder wealth could be maximized by outlawing most forms of takeover defense. Starting from the premise that share prices at all times accurately reflect the intrinsic value of a corporation, efficient market theory partisans contended that the willingness of a bidder to offer a premium price reflects the bidder's ability to manage the assets better or more efficiently. At the same time, they contended that board reluctance to accept a premium price necessarily reflects an instinct of self-preservation rather than conviction that the tender price is inadequate. Defenses, in this view, serve only to entrench incumbents and necessarily to harm shareholders.

The opponents of the efficient market theory pointed out that corporations were not chartered by the states solely to maximize shareholders' short-term gains, and that large corporations could not function in an environment where they were continuously "for sale."¹² The aggregate costs to all shareholders of all

and can be made by the shareholders); Easterbrook & Fischel, *supra* note 2, at 1191, 1198, 1201 (defending their proposal of director passivity in response to tender offers by distinguishing between board's role in tender offers and its role in other situations); M. Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. Rev. 1231 (1980); Gilson, *supra* note 3, at 878-79 (arguing that in the face of a tender offer, management of the target company should take no action other than to: (1) disclose information bearing on the value or attractiveness of the offer, and (2) seek out alternative transactions which it believes may be more favorable to target shareholders); M. Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 Bus. Law. 1017 (1981); Bebchuk, *supra* note 3, at 1054 (arguing that although incumbent management should be barred from actions that obstruct any tender offer, management should diligently seek a higher offer); M. Lipton & A. Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, ABA National Institute on the Dynamics of Corporate Control, Dec. 1983, at 7 (noting that boards must consider the nature of a takeover bid and its effect on the corporate enterprise, including the adequacy of the price, the nature and timing of the offer, the impact on constituencies other than shareholders, the risk of nonconsummation, and the quality of the securities being offered in the exchange); *see also* M. Lipton, *Boards Must Resist*, N.Y. Times, Aug. 9, 1981, at 2F; M. Lipton, *Takeover Abuses Mortgage the Future*, Wall St. J., Apr. 5, 1985.

¹¹ *See Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690 (2d Cir. 1980); *Panter v. Marshall Field*, 646 F.2d 271 (7th Cir. 1981); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Kahn v. MSB Bancorp, Inc.*, 1998 WL 409355 (Del. Ch. 1998), *aff'd*, 734 A.2d 158 (Del. 1999).

¹² Corporation law is designed to protect the "long-term value of capital committed indefinitely to the firm," W. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894,

public companies if they had to operate on this basis would far exceed the costs, if any, in the long run to the shareholders of companies that successfully resist unsolicited takeovers. Those who did not accept the relevance of the efficient market theory to the regulation of takeovers also pointed out, drawing on a growing body of economic literature, that inefficiencies in the market could exist at any given point in time, meaning that share prices did not always reflect intrinsic values.¹³

Those in favor of takeover defenses further argued that a central assumption of efficient market theory proponents — that shareholder responses to tender offers are necessarily informed decisions that rationally reflect the supposed “best” interests of *all* shareholders collectively — is not true. Tender offers are not the functional equivalents of free votes, since the decision *not* to tender (whether into an all-cash, all-shares offer *or* a two-tier, front-end-loaded offer) carries with it economic risks and detriments; not knowing whether the mass of other shareholders will tender or not, the individual holder faces the classic “prisoner’s dilemma” and is effectively stampeded into tendering. The proponents of takeover defenses also observed that many hostile bids were opportunistic attempts to buy assets on the cheap, and that there was no empirical evidence that such takeovers were always (or ever) good for the economy.¹⁴

896-97 (1997), and does not share the short-term horizon of takeover arbitrageurs. *See also* M. Lipton and S. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187 (Winter 1991).

¹³ *See* M. Lipton & S. Rosenblum, *supra* note 12.

¹⁴ *See, e.g.,* M. Lipton, *Corporate Governance in the Age of Finance Corporatism*, U. Pa. L. Rev. 1, 23 (Nov. 1987) (“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, long-term planning, research, and development”); J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, 219, 229 (1994) (arguing that putting great emphasis on shareholders’ immediate values may result in competitive disadvantage compared to other nations’ systems that take a longer-term view); J. Pound, *The Promise of the Governed Corporation*, Harv. Bus. Rev., Mar.-Apr. 1995, at 91, 91 (“Many takeover bids themselves represent flawed decisions by the acquirer”); E. Spencer, *The U.S. Should Stop Playing Poker with Its Future*, Bus. Week, Nov. 17, 1986, at 20, 20 (arguing that Wall Street has adopted the view that “the higher the stock price, the better the management has done its job,” leading managers “to put short-term earnings growth before such interests as market development, product quality, research and development, and customer and employee satisfaction”); Williams, *It’s Time for a Takeover Moratorium*, Fortune, July 22, 1985, at 133, 136 (in which former SEC Chairman Harold Williams commented that takeover activity has resulted in a loss in management effectiveness that “works against corporate and national productivity, the wages of employees, and returns to stockholders. It undermines our economy and our society.”); R. Stern & E. Cone, *Scarlett O’Hara Comes to Wall Street*, Forbes, Sept. 21, 1987, at 37, 37-38 (reporting competition to provide financing for leveraged acquisitions and suggesting that valuations were driven up to insupportable levels); *see also* A. Boyer, *Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons from the Robber Barons*, 50 Wash. & Lee L. Rev.

Moreover, the view that directors were only capable of acting in their self-interest was unsupported by empirical evidence and inconsistent with the assumptions underlying the structure of American corporate law.¹⁵

State legislatures around the country resolved this debate squarely in favor of directorial discretion. Between 1968 and 1982, laws designed to slow or halt the wave of opportunistic takeover activity were enacted in 37 states.¹⁶ Thus, by the early 1980s, both the legislatures and the courts had emphatically rejected the view that directors should be passive in the face of takeover bids.¹⁷ But in 1982, by a razor-thin margin, the United States Supreme Court invalidated the “first generation” of anti-takeover statutes in *Edgar v. MITE Corp.*¹⁸ Now there was nothing to delay the consummation of a tender offer beyond the Williams Act’s twenty business days. Increasingly, boards turned to creative attempts to release short-term value by selling pieces of the business or turning to a “white knight,” but these alternative transactions were often difficult to achieve on the truncated timeline of the Williams Act minimum tender period.

The *MITE* decision coincided with the decision of most institutional investors that they would not vote for charter amendments designed to deter or regulate hostile takeovers, and also with the federal courts’ picking up on an earlier decision by Judge Henry Friendly in which he treated with great skepticism suits brought by targets raising antitrust, disclosure and similar claims to enjoin hostile bids.¹⁹ This left the playing field heavily tipped in favor of the corporate raiders and peddlers of junk bonds. In September 1982, I published a

977, 1004-05 (1993) (explaining that as LBOs increased and junk bonds became popular, a new group of investors entered and expanded the market for low-grade debt).

¹⁵ See, e.g., Del. Gen. Corp. L. § 141(a) (providing that the business and affairs of every Delaware corporation shall be managed by a board of directors). This is an eminently sensible state of affairs; among other advantages, directors have much better (non-public) information and far lower costs of communication than do shareholders.

¹⁶ State Takeover Laws, Investor Responsibility Research Center Inc., at Appendix B-5 (Mar. 1998).

¹⁷ See *supra* note 11.

¹⁸ 457 U.S. 624, 632-34 (1982) (plurality opinion concluding that the Williams Act struck a careful balance between the interests of offerors and target companies, and that any state statute that “upset” this balance was pre-empted).

¹⁹ See *Missouri Portland Cement Co. v. Cargill, Inc.*, 498 F.2d 851 (2d Cir. 1974), *cert. denied*, 419 U.S. 883 (1974); see, e.g., *Scientific Computers, Inc. v. Edudata Corp.*, 599 F. Supp 1092, 1098 (D. Minn. 1984); *American General Corp., et al. v. NLT Corp., et al.*, 1982 WL 1332, *25 (S.D. Tex.) (quoting *Cargill* for the statement that “‘district judges should take arguments of serious harm to a corporation due to jitters in executive suites with a fair amount of salt’”); *Raybestos-Manhattan Inc. v. Hi-Shear Indus.*, 503 F. Supp. 1122, 1134 (E.D.N.Y. 1980) (citing *Cargill* for the proposition that “[t]he Second Circuit has warned district courts to look skeptically on Clayton Act claims raised by target management who become vigilant enforcers of the antitrust laws only when a tender offer threatens their control”).

memorandum describing the “Warrant Dividend Plan.”²⁰ The “warrant” of the Warrant Dividend Plan was a security that could be issued by the board of directors of a target company (before or after it was faced with an unsolicited bid) that would have the effect of increasing the time available to the board to react to an unsolicited bid and allowing the board to maintain control over the process of responding to the bid. Beginning at the end of 1982, in various forms it was used successfully by targets of hostile bids to gain time and maximize shareholder value. Six months later, in 1983, the plan was given its unfortunate nickname by an investment banker who had nothing to do with its creation. When asked by a *Wall Street Journal* reporter what to call a security — modeled on the Warrant Dividend Plan — issued on my advice by Lenox, Inc. to defend against a hostile tender offer, this banker responded flippantly, “a poison pill.”²¹

By whatever name, the pill’s arrival was remarkably timely. As the tide of junk-bond-financed, bootstrap bids, sometimes linked to two-tier, front-end-loaded tenders, rolled on in the mid-1980s, there was increasing recognition that something was needed to redress the balance between the corporate raider and the board of the target. The pill met precisely that need. Nevertheless, the introduction of the pill was viewed as a radical innovation by those who believed that directors should play no active role in the hostile takeover context, and the attacks on the pill’s validity were unrelenting.²²

The increasing use of the pill in 1984-85 set the stage for a decisive confrontation between the forces advocating a free hand for corporate raiders and those supporting the traditional model of the corporation and the business judgment rule. The question remained: Who would act as the decision-maker? At the federal level, Congress had shown no interest in adopting a statutory framework for regulating takeovers beyond the Williams Act; and by 1983 the federal impulse for further regulation, even at the Securities and Exchange Commission level, had petered out. The United States Supreme Court in *Santa Fe Industries, Inc. v. Green* had extinguished the ability of federal judges to federalize substantive takeover law through the securities laws.²³ On the other

²⁰ M. Lipton, *Memorandum: Warrant Dividend Plan* (Sept. 15, 1982) (on file with author).

²¹ F. Allen and S. Swartz, *Lenox Rebuffs Brown-Forman, Adopts Defense*, *Wall St. J.*, June 16, 1983, at 2.

²² See, e.g., Helman & Junewicz, *supra* note 4 (suggesting that the poison pill may be invalid or financially inconsequential); J. Shub, *Shareholder Rights Plans: Do They Render Shareholders Defenseless Against Their Own Management?*, 12 *Del. J. of Corp. L.* 991 (1987) (arguing that a board’s unilateral adoption of a poison pill usurps the right of shareholders to decide whether to sell their stock to a purchaser); K. Master, *Poison Pill Takeover Defense Stirs Controversy, Uncertainty*, *Legal Times*, August 29, 1983, at 1; R. Ferrara and W. Phillips, *Opposition to Poison Pill*, *Legal Times*, Oct. 15, 1984; G. Stevenson, *A Poison Pill That’s Causing a Rash of Lawsuits*, *Bus. Wk.*, Apr. 1, 1985, at 54.

²³ 430 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

hand, the Court's opinion in *MITE* had limited the ability of state legislatures to impose their own statutory regulation in the area.²⁴ Meanwhile, increasing corporate reliance on defensive tactics — and the increasingly shrill objections of their opponents — created a pressing practical need for dependable legal ground rules. The state courts were left as the only institutional actors with the power and will to fashion a comprehensive resolution.

In 1985, the Delaware Supreme Court decided four cases — *Trans Union*,²⁵ *Unocal*,²⁶ *Revlon*²⁷ and *Household*²⁸ — that created the framework that has governed takeover law ever since. The key choices Delaware made in 1985 were the following:

(1) In *Trans Union*, Delaware decisively rejected the efficient market theory and not only permitted, but *required*, directors to make takeover-related decisions based on an informed view of the “intrinsic” value of the corporation — not the value assigned by the stock market.²⁹

(2) In *Unocal*, citing with approval a later version of my 1979 article, *Takeover Bids in the Target's Boardroom*,³⁰ Delaware accepted the utility and appropriateness of “takeover defenses” and the board of directors’ discretion to deploy such defenses, but announced that henceforth they would be reviewed under an enhanced business judgment rule — a tougher and objective “reasonable in relation to the threat posed” test, rather than the pre-existing subjective business judgment rule.³¹

(3) In *Revlon*, Delaware required directors to maximize short-term value once they decided to sell a company for cash; and conversely, Delaware

transactions in securities, particularly where established state policies of corporate regulation would be overridden.”).

²⁴ See *supra* note 18 and accompanying text. The states were, however, active in reversing several federal court rulings that the pill was invalid under state corporate statutes. Every court ruling invalidating pills was legislatively overturned. See, e.g., N.Y. Bus. Corp. Law § 505(a)(2) (legislatively overturning a July 1988 New York State Supreme Court decision invalidating Irving Bank’s flip-in poison pill, see *Irving Bank Corp.*, 536 N.Y.S.2d 923); N.J. Rev. Stat. Ann. § 14A:7-7 (legislatively overturning an August 1986 New York federal district court case applying New Jersey corporate law, which invalidated NL Industries’ flip-in poison pill, see *Amalgamated Sugar Co.*, 644 F. Supp. 1229).

²⁵ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (hereinafter *Trans Union*).

²⁶ 493 A.2d 946.

²⁷ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). The Delaware Supreme Court decided *Revlon* in 1985, although its opinion was issued in 1986.

²⁸ 500 A.2d 1346.

²⁹ 488 A.2d at 875-76.

³⁰ See 493 A.2d at 955 (citing Lipton & Brownstein, *supra* note 10).

³¹ 493 A.2d at 954-55, 957.

decided that it would *not* require directors to maximize short-term value outside this one, relatively narrow situation. Delaware companies were not required to be for sale twenty-four hours a day, seven days a week, and directors could agree to friendly stock mergers without putting the company “in play” or having to “auction” the company.³²

(4) In *Household*, Delaware permitted boards to adopt the poison pill as a structural defense to a takeover bid. *Household* recognized that the pill gave boards the power to “just say no” until such time as the shareholders (if they so wished) replaced the incumbent directors, and established that judicial review of a board’s use of the poison pill would be subject to the enhanced business judgment rule standard of *Unocal*.³³

Clearly, these four crucial decisions represented a set of compromises. Delaware accepted neither the pleas of corporate constituencies for continued application of the deferential business judgment rule to takeover defense, nor endorsed the demands of corporate raiders and academics who sought to outlaw takeover defense. Instead, Delaware chose a middle ground: Takeover defenses were permitted, but they were to be judged, in common law fashion, under a fact-intensive, case-by case analysis in which the directors would effectively bear the burden of showing not merely their good faith but also the “reasonableness” of their chosen response.

Put to the practical test during the half-decade of intense hostile takeover activity that ensued, the new Delaware paradigm has worked well. Contrary to the fears of both sides, *Unocal* and its siblings did not usher in a period in which every takeover defense was either condemned automatically or rubber-stamped. A review of some of the major cases of that period demonstrates the suppleness of the standard and the discriminating manner in which it was applied.³⁴

³² *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1248 (Del. Ch. 1985). Although this implication of *Revlon* was reasonably clear from the opinion, the efficient market partisans refused to acknowledge it as Delaware doctrine until the Delaware Supreme Court had the opportunity to make it an express holding four years later in *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 n.12 (Del. 1989) (hereinafter *Time-Warner*) (a corporate board of directors, the court found “is not under any *per se* duty to maximize shareholder value in the short-term, even in the context of a takeover”; moreover, the court stated that “[i]t is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value”).

³³ See 500 A.2d at 1357.

³⁴ See, e.g., *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987) (upholding special dividend issued to facilitate a “street sweep” to defeat a two-tier offer); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988) (enjoining restructuring adopted in response to unsolicited bid); *AC Acquisitions v. Anderson Clayton*, 519 A.2d 103 (Del. Ch. 1986) (enjoining recapitalization adopted in response to hostile bid).

Of the quartet of 1985 decisions, the one that proved to have the greatest practical impact was undoubtedly *Household*.³⁵ The pill changed everything. Instead of twenty business days, boards now had sufficient time to consider, respond to and craft alternatives to unsolicited bids. And, contrary to the arguments of the plaintiffs in *Household*,³⁶ the pill actually revived the importance of proxy contests as a means of determining a corporation's future. Indeed, the Delaware courts rarely receive the credit they deserve for having been *right* in rejecting the supposed factual, empirical arguments made by the pill's opponents in *Household* as to the predicted effect of the pill on proxy contests. Professors and experts were paraded in the Court of Chancery to testify, among other things, that validation of the pill in Delaware would suppress proxy contests.³⁷ Both the Court of Chancery and the Delaware Supreme Court refused to let themselves be persuaded by these "experts" — and of course with hindsight we can see that the pill simply did not usher in the parade of horrors predicted by its opponents. As the Chancery Court correctly predicted, the pill did not spell the doom of proxy contests.³⁸ A recent review of the economic literature on the shareholder-wealth effects of takeover defenses was undertaken by Professor John Coates.³⁹ He concluded:

Delaware courts should take some comfort from the fact that they resisted strong academic arguments and political efforts that attempted to push them to dramatically repudiate pills and other structural defenses. The empirical case against defenses remains unproven, and, without empirical support, the theoretical case against defenses is not as

³⁵ See G. Stevenson, *A Poison Pill That's Causing a Rash of Lawsuits*, Bus. Week, Apr. 1, 1985, at 53 ("This is probably the single most important corporate law case to come before the courts in years. Legal challenges [to the pill] have proliferated [throughout the United States]. But the [*Household*] case in Delaware is the crucial one. Because so many companies are incorporated there, and because the court is widely respected, its decision will set the tone for rulings in other state and federal courts.").

³⁶ Plaintiffs in *Household* argued that the pill's restriction upon individuals or groups from first acquiring more than 20% of shares before waging a proxy contest would reduce the potency of proxy contests. See 500 A.2d at 1351. Even the SEC filed an *amicus curiae* brief in support of this argument. *Id.* at 1346.

³⁷ See 490 A.2d at 1079.

³⁸ See 490 A.2d 1059, 1080 (Del. Ch. 1985) ("On the evidence presented it is highly conjectural to assume that a particular effort to assert shareholder views in the election of directors or revisions of corporate policy will be frustrated by the proxy feature of the Plan.").

³⁹ J. Coates, *Empirical Evidence on Structural Takeover Defense: Where Do We Stand?*, 54 U. of Miami L. Rev. 783 (2000).

compelling as it might have seemed to hostile commentators [in 1989].⁴⁰

The new rules crafted by the Delaware courts in the four 1985 decisions met with wide acceptance. Corporate raiders did not abandon the market for corporate control;⁴¹ corporations did not seek to reincorporate out of Delaware in order to avoid the new regime; and litigators increasingly chose the Delaware state forum over federal and non-Delaware state courts when there was a need for adjudication. Interestingly, the pill even became a standard feature in initial public offering charters, a context in which management entrenchment is virtually absent.⁴²

But the 1985 Delaware rules were controversial enough — and perceived as insufficiently sensitive to the realities of corporate life — to provoke a legislative reaction in other states. It is a signal fact that, despite Delaware's primacy as a corporate domicile and despite some academic criticism of Delaware as too protective of management,⁴³ the Delaware regime has *not* been broadly embraced by the other states. Instead, a number of states enacted legislation that to a greater or lesser extent rejected the Delaware compromise as too favorable to corporate raiders and hostile bids,⁴⁴ too suspicious of the motives of directors,⁴⁵

⁴⁰ *Id.* at 797. In view of this conclusion by Professor Coates, it is difficult to understand his seeming endorsement of shareholder-initiated bylaws that would curtail defenses against hostile takeovers. See Coates & Faris, *supra* note 7.

⁴¹ As the Delaware Supreme Court noted in 1989, “the spate of takeover litigation . . . readily demonstrates that such ‘poison pills’ do not prevent rival bidders from expressing their interest in acquiring a corporation Because potential bidders know that a pill may not be used to entrench management or to unfairly favor one bidder over another, they have no reason to refrain from bidding if they believe that they can make a profitable offer for control of the corporation.” *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1287 (Del. 1989).

⁴² See R. Daines, *Does Delaware Law Improve Firm Value?*, NYU Center for Law and Business, Wkg. Paper No. CLB-99-011, available at http://papers.ssrn.com/paper.taf?abstract_id=195109 (1999).

⁴³ There is a growing body of academics who view Delaware corporation law as, on balance, highly successful. See, e.g., R. Romano, *The Genius of American Corporate Law* (Wash., D.C.: AEI Press, 1993); R. Daines, *supra* note 42; M. Kahan, *Paramount vs. Paradox: Delaware Supreme Court Jurisprudence*, 19 J. Corp. L. 587 (1994); M. Kahan and E. Rock, *How I Stopped Worrying and Love the Pill* (unpublished manuscript, on file with authors).

⁴⁴ See, e.g., Ind. Code Ann. §§ 23-1-35-1(f) (West Supp. 1990) (Standards of Conduct for Directors), which rejects the *Unocal* compromise as being “inconsistent with the proper application of the business judgment rule under this article. Therefore, the general assembly intends . . . to protect both directors and the validity of corporate action taken by them in the good faith exercise of their business judgment after reasonable investigation.” *Id.* When the Supreme Court upheld Indiana’s control share acquisition statute in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987), the Court ushered in a new era in state activism

and too unresponsive to the legitimate interests of non-shareholder constituencies such as employees and communities. *No* American jurisdiction went further than Delaware and adopted rules, either by statute or judge-made law, that restrict takeover defenses *more* tightly than Delaware. *No* American jurisdiction has ever adopted a framework for takeover law based on the efficient market theory or gone farther than Delaware in that direction.

If anything, after 1985 there was a growing realization that the extreme simplicity of the world view of the anti-board partisans — that there was no place for any interference with the presumed “right” of shareholders to sell the company at any time to a bidder opposed by the board, and that directors should therefore be “passive instrumentalities” — was neither an accurate description of reality nor a desirable goal. Moreover, in 1987, the United States Supreme Court, which in 1982 had rejected states’ efforts to regulate takeovers through so-called “first generation” statutes, effectively switched sides and endorsed “second generation” statutes in *CTS Corp.*⁴⁶ The 1987 market “break,” and the 1990 collapse of Drexel Burnham Lambert, the most prominent financier of hostile bids in the 1980s, further damaged the prestige and persuasiveness of the efficient market theory.

It is perhaps outside the terms of academic argument, but nonetheless suggestive, to recall the subsequent careers of the bidders whose takeover proposals were opposed by boards in some of the high-profile cases of the 1980s. For example, the board of Macmillan, Inc. was harshly criticized by the Delaware courts for opposing Robert Maxwell’s 1988 bid for the company. But in light of the revelations of dishonesty, corporate looting and other wrongdoing that followed Maxwell’s presumed suicide in 1991, does the Macmillan board now look quite so unreasonable in preferring a 20¢ per share lower bid from Maxwell’s rival Henry Kravis? While the Maxwell and Macmillan transaction is perhaps the most thought-provoking example, is there anything in the subsequent business careers of such raider icons of the 1980s as Boone Pickens, Carl Icahn, Paul Bilzerian and Robert Campeau that suggests that corporate law should have been redesigned to put these people in charge of important enterprises and large pools of assets?

In 1988, Delaware adopted its own “second generation” statute. This enactment is Delaware’s only major *legislative* response to the takeover issue, and

regarding takeovers. *See also, e.g.*, 805 ILCS 5/8.85 (Ill.); N.J. Rev. Stat. Ann. § 14A:7-7; N.Y. Bus. Corp. Law § 717(b); Ohio Rev. Code Ann. § 1701.59(E).

⁴⁵ *Unocal* assumed that the “perks” of outside directorship are substantial enough to cause independent directors to be less trustworthy in making takeover-related decisions than garden-variety business decisions. *See* 493 A.2d at 958. I am aware of no research or evidence on this point. It is certainly not self-evident.

⁴⁶ 481 U.S. 69 (holding that the Indiana control share acquisition statute was a legitimate exercise of state authority, and that it did not conflict with federal tender offer regulation).

clearly represents a further rejection of the efficient market theory. Under Section 203,⁴⁷ directors have the statutory power effectively to block potential transfers of control to substantial shareholders by refusing to approve a transaction. While this power is not absolute, it can be overridden only by a very high “supermajority” of 85% of the shareholders; Section 203 is in effect a statutory pill that can be neutered by a tender offer that attracts 85% of the shares. Like the 1985 cases, Section 203 is another Delaware compromise, but clearly one that recognizes that directors should have a major role in determining the corporation’s fate in a takeover situation.

Events of the 1990s have further demonstrated the wisdom of the Delaware compromise. The coercive, highly leveraged, and often destructive attributes of the 1980s takeover market have faded from view. Secure in their ability to resist hostile bids, directors have used this authority to enhance shareholder value. And directors can use this same power to resist a transaction they reasonably believe to be insufficient or unduly speculative — a power of no mean significance, wielded for the protection of the interests of shareholders and, indeed, every corporate constituency. Confirming the position I first advanced in 1979 in *Takeover Bids in the Target’s Boardroom*, the American Law Institute — in *Principles of Corporate Governance* — endorsed Delaware’s takeover jurisprudence as a model for the nation.⁴⁸

⁴⁷ Del. Gen. Corp. L. § 203.

⁴⁸ American Law Institute, *Principles of Corporate Governance* § 6.02 (1994).

§ 6.02 *Action of Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers:*

(a) The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer [§ 1.39], if the action is a reasonable response to the offer.

(b) In considering whether its action is a reasonable response to the offer:

(1) The board may take into account all factors relevant to the best interests of the corporation and shareholders, including, among other things, questions of legality and whether the offer, if successful, would threaten the corporation’s essential economic prospects; and

(2) The board may, in addition to the analysis under § 6.02(b)(1), have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders.

(c) A person who challenges an action of the board on the ground that it fails to satisfy the standards of Subsection (a) has

In the same vein, it warrants notice that Delaware's two major structural features with respect to takeover law — the poison pill and Section 203 — have not given rise to significant case law since the *Household* case. While the *Household* Court announced in 1985 the standard — *Unocal* — under which pill decisions were to be reviewed, there have been only three Delaware Chancery Court decisions requiring a board of directors to redeem a pill, two of which were later disapproved by the Delaware Supreme Court in *Time Warner*.⁴⁹ The only case in which a board of directors was found to have breached its fiduciary duties in connection with its application of Section 203 involved the improper *waiver* of the protections of Section 203 by the directors of a majority-owned subsidiary.⁵⁰ The absence of such case law strongly suggests that both the pill and Section 203 are being utilized responsibly by Delaware boards and that the system they uphold is a healthy one.⁵¹ After twenty years, I can confidently say that the pill has been used; it has not been abused.

the burden of proof that the board's action is an unreasonable response to the offer.

(d) An action that does not meet the standards of Subsection (a) may be enjoined or set aside, but directors who authorize such an action are not subject to liability for damages if their conduct meets the standard of the business judgment rule [§ 4.01(c)].

⁴⁹ The Chancery Court decisions in *City Capital Assocs. Ltd. P'ship v. Interco., Inc.*, 551 A.2d 787 (Del. Ch. 1988) and *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988) were disapproved by the Delaware Supreme Court in *Time Warner*, 571 A.2d 1140. The only other Chancery Court decision requiring a target to redeem a poison pill was in the context of a completed auction of the company in which the two highest bids were on the table and the court found that no corporate purpose would be served by maintaining a poison pill to preclude the possible consummation of a \$90.25 per share bid in favor of a \$90.05 deal supported by the target. *Mills Acquisition Co. v. Macmillan Inc.*, C.A. No. 10168 (Del. Ch. Oct. 17, 1988, revised Oct. 18, 1988), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989).

⁵⁰ *In re Digex, Inc. S'holders Litig.*, Consol. C.A. No. 18336 (Del. Ch. Dec. 13, 2000).

⁵¹ The work of Professor Robert Daines demonstrates that Delaware's post-1985 legal regime has *not* reduced returns to shareholders. See Daines, *supra* note 42, at 26. As Professor Daines summarizes his conclusions:

. . . Delaware corporate law improves firm value and facilitates the sale of public firms. Using Tobin's Q as an estimate of firm value, I find Delaware firms are worth significantly more than similar firms incorporated elsewhere. The result is robust to controls for firm size, diversification, profitability, investment opportunity and industry. Delaware firms also receive significantly more takeover bids and are significantly more likely to be acquired. Firms with strong incentives to choose valuable legal regimes are likely to incorporate in Delaware when

Nevertheless, for reasons that are not supported by history or practice,⁵² the academic community and activist investors have not been satisfied with the Delaware solution and the present state of the law.⁵³ The leading spokesperson for doing away with the pill, Professor Ronald Gilson, argues that shareholders should be permitted to adopt a bylaw that repeals a poison pill previously adopted by the corporation and that prohibits the corporation from adopting a pill in response to a hostile takeover bid.⁵⁴ Professor Gilson would go back to the 1979-82 debate and essentially come down on the side of the Rule of Passivity. Without the pill there is no effective defense against a hostile takeover, and Professor Gilson would doom all targets to being acquired by a raider or a white knight. A full explication of Professor Gilson's thesis and my refutation are available in my response to his article.⁵⁵ It also should be noted that in a reply to

they go public. These results suggest that corporate law affects firm value.

Id. at 1. Professor Daines's study, while starting from the premise of the efficient market theory, nonetheless shows none of the dysfunctional or shareholder-wealth-damaging effects complained of by others.

⁵² See, e.g., J.P. Morgan & Co., *Median Control Premiums: Pill v. No Pill*, July 1997 (study of 300 U.S. transactions from 1993 through 1997 (representing all transactions over \$500 million in which a majority interest was purchased) finding that the median takeover premium paid for companies that had a rights plan in place was nearly 10% higher than for companies that did not have one. J.P. Morgan further found that in hostile deals during the period from 1988 through 1997, the takeover premium paid was 14% greater for companies with rights plans in place); Georgeson & Co. Inc., Georgeson Research, *Mergers & Acquisitions, Poison Pills and Shareholder Value / 1992-1996*, Nov. 1997 (hereinafter *Georgeson Study*) (study of 319 takeover transactions over \$250 million between 1992 through 1996, finding that premiums to acquire companies that had shareholder rights plans six months prior to the first bid were on average eight percentage points higher than premiums paid for target companies without rights plans); R. Comment & G.W. Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. Fin. Econ. 3, 31 tbl. 4 (1995) (confirming premium results); J. Coates, *supra* note 39 (affirming that there is no evidence that the poison pill has ever detracted from shareholder economic welfare).

⁵³ In 1984, total United States merger and acquisition activity was \$196 billion; it grew to \$1.7 trillion in 2000, and with the market decline in 2001, fell to \$800 billion, but still four times the 1984 volume. Merger and acquisition activity as a percent of market capitalization has averaged 10% since 1985 and averaged 12% in 1998-2000. Clearly the pill and takeover defenses have not had an adverse effect on the volume of change of control transactions. Source: *Thompson Financial Securities Data*.

⁵⁴ See Gilson, *supra* note 6.

⁵⁵ See M. Lipton & P. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, New York University Center for Law and Business, Wkg. Paper CLB-01-006 (Apr. 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=268520 (forthcoming in the Feb. 2002 *Delaware Journal of Corporate Law*).

my response,⁵⁶ Professor Gilson essentially acknowledges that his fight is not against the pill's being used to support a "just say no" response to a hostile takeover bid, but instead against a theoretical construct that the pill permits a "just say never" defense. He argues that the marketplace, in the form of shareholder pressure on the board of directors, has prevented the pill from being an absolute bar to a takeover, and therefore the pill does not function as designed. As the creator and principal proponent of the pill, I think it fair to say that the pill was neither designed nor intended to be an absolute bar. It was always contemplated that the possibility of a proxy fight to replace the board would result in the board's taking shareholder desires into account, but that the delay and uncertainty as to the outcome of a proxy fight would give the board the negotiating position it needs to achieve the best possible deal for all the shareholders, which in appropriate cases could be the target's continuing as an independent company. The pill and the proxy contest have proved to yield the perfect balance, both hoped for and intended, between an acquiror and a target. A board cannot say "never," but it can say "no" in order to obtain the best deal for its shareholders. If Professor Gilson's price for *entente cordiale* is a concession that a "design flaw" in the pill forecloses it from being used to achieve the never-intended result of enabling a board of directors to totally and permanently ignore the will of the shareholders and "just say never," the Gilson Theatre of the Twenty Years' Pill Wars can now be closed.

A new participant in the debate, Professor John Coates, recognizing that Delaware would not embrace the Gilsonian views and would strike down the bylaw Professor Gilson proposes, has advanced three bylaws that he believes might stand a better chance to pass the test of legality in Delaware.⁵⁷ Activist shareholder groups are presently attempting to implement variations of the Coates approach.⁵⁸ Although discussion of the legality of these bylaws is outside the scope of this article, there is a serious question of their validity, as even Professor

⁵⁶ R. Gilson, *Lipton & Rowe's Apologia for Delaware: A Short Reply* (Dec. 2001) (unpublished manuscript, on file with author).

⁵⁷ See Coates & Faris, *supra* note 7; *cf. supra* note 39.

⁵⁸ See, e.g., Providence Capital, Inc. Press Release, Sept. 20, 2001, available at <http://providencecapitalnyc.com> (announcing a seminar on a Director Nomination By-law Amendment, in which board members would be disqualified from being renominated if they fail to abide by precatory shareholder votes to eliminate poison pills). Note, however, that these bylaws may not be legal. See L. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 Tul. L. Rev. 409, 437 & nn.121-124, 483 & n.314 (1998) (asserting that bylaws addressing specific business decisions are invalid). Hamermesh argues that the "statutes creating the general authority to adopt by-laws may not be construed to permit stockholders to adopt by-laws directly limiting the managerial power of the board of directors." *Id.* at 419. He concludes that in the short term, investors will continue to press forward with bylaw initiatives, but in the long term, state legislation will likely be enacted to limit stockholders' power to do so. *Id.* at 492.

Coates acknowledges — namely, that the bylaws are in essence conduct-regulating rather than qualification bylaws.⁵⁹

Professor Bebchuk, who in 1982 was an advocate of the “Rule of Passivity,” modified to permit the target’s board to seek a white knight, now accepts the poison pill and acknowledges the right of the board of directors to deploy it in defense of a hostile takeover bid. However, he rejects the fundamental premise of Delaware law and the *Household* case that if shareholders are dissatisfied with the directors’ response to a takeover bid, their remedy is to vote out the incumbent board and replace it with one that will redeem the pill and sell the corporation to the raider or a white knight. Rather, his solution is to change the law to provide that whenever a corporation becomes the target of a hostile bid, the board must submit it to a shareholder referendum. He proposes that if a majority of the outstanding shares vote in favor of the bid, the board must remove the pill and all other structural takeover defenses.⁶⁰

As originally proposed in 1982, and as approved in the *Household* decision, the pill contemplated that a board of directors could not ignore the will of the shareholders with respect to a takeover offer.⁶¹ The pill was structured so that it would not interfere with the right of the shareholders to vote to replace the board and would not impede a raider from instituting a proxy fight to replace the board.⁶² Professor Bebchuk acknowledges in his current work that the fact that the pill requires hostile bidders to prevail in a proxy contest — what he calls the “critical consequence of the pill” — is indeed desirable.⁶³ However, he wants it in the form of a bidder-initiated referendum on the bid, and not on the composition of the board, and at whatever time a bidder determines.⁶⁴

⁵⁹ See L. Hamermesh, *supra* note 58.

⁶⁰ See Bebchuk & Farrell, *supra* note 1.

⁶¹ “When the Household Board of Directors is faced with a tender offer and a request to redeem rights, they will not be able to arbitrarily reject the offer.” 500 A.2d at 1354.

⁶² See, e.g., *Leonard Loventhal Account*, 780 A.2d at 249 (“[A] rights plan would not have the unauthorized effect of restricting stockholders’ rights to conduct a proxy contest.”) (citing *Household*, 500 A.2d at 1355-56); see also *In re Gaylord Corp. S’holders Litig.*, 753 A.2d 462, 470 (Del. Ch. 2000) (“[T]he fact that a company has a poison pill in place is less significant because the proxy fight can operate as a substitute for a tender offer.”); *Stahl v. Apple Bancorp, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 95,412 (Del. Ch. Aug. 9, 1990).

⁶³ L. Bebchuk & O. Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, The Harvard John M. Olin Discussion Paper Series (first draft Feb. 1999; last revised Oct. 2001), available at http://www.law.harvard.edu/programs/olin_center, at 4.

⁶⁴ Similarly, the European Commission’s Committee of Company Law Experts has concluded that “a rule should be introduced, which allows the bidder to break-through mechanisms and structures which may frustrate a bid, as defined in the articles of association and related constitutional documents The threshold for exercising the break-through right should not be set at a percentage higher than 75% of the risk-bearing capital of the company....” See *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*,

For the past year, proponents of Professor Bebchuk's referendum proposal have been citing the fourteen-month resistance by Willamette to a hostile takeover bid by Weyerhaeuser as an example of abuse of the pill and staggered board combination. Weyerhaeuser's first bid was \$48 per share, which it subsequently unilaterally raised to \$50 per share prior to commencing a proxy fight. Willamette's position was that Weyerhaeuser was attempting to acquire it at an inadequate price that did not reflect its true value. Willamette continued to resist after shareholders replaced a third of the board with nominees of Weyerhaeuser committed to a sale of the company and after 64% of the shares were tendered to the all-cash, all-shares offer.⁶⁵ This gave the pill traducers their best argument — that the combination allows a determined board to deny the will of the shareholders not for one year, but for two. However, this argument evaporated after Weyerhaeuser increased its offer from \$50 per share to \$55 per share and finally to \$55.50 per share, which the Willamette board finally accepted as being in the best interests of its shareholders.⁶⁶ The Weyerhaeuser-Willamette deal is no less than a shining example of how a staggered board and poison pill operate to the benefit of shareholders.⁶⁷ The agreed-upon price of \$55.50 represents a

at 7. However, in explaining their conclusion, the European Commission's Committee of Company Law Experts noted in a recent report that U.S. boards of directors are subject to much greater pressure to maximize shareholder value than are their European counterparts. *See Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*, Jan. 10, 2002, at 20, 21, 40. Among the factors cited in support of this proposition by the Committee of Company Law Experts are the following: U.S. boards of directors are judged by their performance in the capital markets; they are subject to pressure from institutional investors; their behavior is painfully public due to disclosure rules and media attention; they may be replaced in a successful proxy contest; and it is relatively easy for shareholders to bring derivative suits against them. *Id.* at 40-41. Further, the Committee argues that the existing U.S. anti-takeover measures arose largely in response to a potential raider's ability to bid for only a portion of a company's outstanding shares; in Europe, a bidder is required to offer to purchase all outstanding shares at an equitable price. *Id.* at 41.

⁶⁵ See J. Carlton and R. Sidel, *Willamette Agrees to Be Bought by Weyerhaeuser*, Wall St. J., Jan. 22, 2002; see also S. Holmes, *It's Time for Willamette to Give In to Weyerhaeuser*, Bus. Week, Jan. 14, 2002, at 30.

⁶⁶ See D. Hassler, *Weyerhaeuser To Buy Willamette for \$7.78 Billion in Cash, Debt*, Bloomberg News, Jan. 21, 2002; B. Virgin, *Weyerhaeuser Finally Wins; Willamette Gives In, Agrees To Be Bought by Rival for \$55.50 a Share*, Seattle Post-Intelligencer, Jan. 2, 2002, at A1 (including a timeline of events in Weyerhaeuser's bid for Willamette).

⁶⁷ BTR Corporation's 1990 acquisition of Norton Corporation provides another illustration that a staggered board affords a board of directors the leverage and time it may need in order to negotiate effectively with a potential acquiror. In BTR-Norton, shortly before the annual meeting of Norton at which BTR's nominees were up for election, Governor Dukakis signed a bill amending the Massachusetts corporation law to mandate that all Massachusetts corporations have a staggered board unless the board determines otherwise. Due to this timely intervention, the Norton board was able to negotiate an additional \$15 per share for its shareholders.

16% increase over Weyerhaeuser's initial bid, and an 11% increase in deal value even after the conclusion of the first proxy fight. Those who would credit shareholder choice for the outcome overlook the fact that in the absence of the staggered board and poison pill, Willamette shareholders would have "chosen" \$48 per share before they ever had the opportunity to receive \$55.50.⁶⁸

Willamette is typical of the experience of the past twenty years, during which very few companies have remained independent after a tender offer combined with a proxy fight to replace the board. The largely theoretical possibility of continued resistance after loss of a proxy fight that worries Professor Bebchuk and his followers does not in any way warrant a change in basic corporate law, which has long permitted shareholders to enjoy a staggered-board charter that protects against changes in management predicated on short-term events.⁶⁹ There are strong policy reasons to assure that management has sufficient time to demonstrate the validity of its strategic plan — indeed, I have argued that this period should be five years, with a referendum on the management's performance and the possibility of a hostile takeover only at the quinquennial election.⁷⁰

There have been a number of instances in which an unsolicited bid has been coupled with a proxy fight to remove the target's board and replace it with a board committed to redeeming the target's pill.⁷¹ In some cases, the target was acquired by the original bidder, and in others, the target sought a white knight and was acquired at a higher price than that offered by the raider that initiated the

⁶⁸ Fifty-one percent of the outstanding shares had been tendered into Weyerhaeuser's \$48-per share offer as of the February 2, 2001 expiration date. *See Weyerhaeuser Extends an Offer*, N.Y. Times, Feb. 2, 2001, at C14.

⁶⁹ Of the 5,000-plus U.S. public companies that responded to the 2001-2002 NACD Public Company Governance Survey, 57% have a classified board. *See National Association of Corporate Directors, 2001-2002 NACD Public Company Governance Survey*, Nov. 2001, at 14. Further, the survey reveals that "[n]early three-quarters of the initial public offering companies tracked in 2001 had classified boards." *Id.* Also, the pill has been adopted by thousands of public companies and has become an essential, commonplace element of the fabric of corporate governance, with no adverse impact on share prices or merger activity. Academic prescriptions for change would upset widespread and settled expectations and practices, and therefore should carry a particularly heavy burden of persuasion.

⁷⁰ *See* Lipton & Rosenblum, *supra* note 12.

⁷¹ The poison pill has decisively shifted the battle for corporate control from the arena of the coercive tender offer to that of the proxy contest. When confronted with a poison pill, a hostile suitor may be forced to make its case by means of a proxy solicitation if it wishes to persuade target shareholders that it is truly in their best interests to accept the offer. Two well-known examples are Georgia-Pacific Corporation's 1989 battle to acquire Great Northern Nekoosa Corporation and AT&T's 1990 fight to acquire NCR. In each case, the target board resisted a takeover, the acquiror commenced or announced the intention to commence a proxy contest, and the merger ultimately was consummated at a significantly higher price per share than that initially offered by the acquiror.

process. In very few instances has a target with a staggered board suffered a first-round loss — had a third of the board replaced with the raider’s nominees — and continued to refuse to surrender its independence. In all other cases, after a first-round loss, or even before, when it became clear that the shareholders would vote to replace a third of the board, the target negotiated a deal. In light of this experience, there does not appear to be any compelling need to change the law to mandate a shareholder referendum whenever a raider demands it.

By contrast, Professor Bebchuk’s proposal carries with it significant dangers. As a practical matter, his proposal, like Professor Gilson’s and like the 1981 Rule of Passivity proposal, would put a “For Sale” sign on all public corporations. Though the difference between a bid-and-referendum and a bid-and-proxy fight may be seen as one of degree, a referendum would create the critical problem of an open invitation for unsolicited bids. The acquiror would have the assurance of a vote on the bid, with little chance for the target to do anything other than declare an auction. Further, the costs of operating as if it were always for sale would be highly detrimental to a company. In general, a company that becomes the target of an unsolicited takeover bid must institute a series of costly programs to protect its business during the period of uncertainty as to the outcome of the bid. To retain key employees, in the face of the usual rush of headhunters seeking to steal away the best employees, expensive bonus and incentive plans are put in place. To placate concerned customers and suppliers, special price and order concessions are granted. Communities postpone or reconsider incentives to retain facilities or obtain new facilities. The company itself postpones major capital expenditures and new strategic initiatives. Creditors delay commitments and seek protection for outstanding loans. All of this imposes enormous costs on the target, which are not recovered no matter what the outcome of the takeover bid; if the bidder is successful, the bidder and its shareholders bear these costs; if the target remains independent, the target and its shareholders bear them. The poison pill alleviates some, but not all, of these concerns and related costs. To change the law to remove the protections of the pill and not protect the target against these costs is unthinkable.

Professor Bebchuk’s attempt to draw support from the decision of the EU to adopt a referendum-type regulation of unsolicited takeover bids is not well-founded. The EU specifically recognizes that its approach is based on a dramatically different set of economic conditions from those in the U.S.⁷² Further, the EU approach parallels closely the “no frustration” of bids approach of the U.K. Takeover Panel. There is no evidence that corporate performance and corporate governance in the U.K. is superior to that in the U.S. Indeed, it is universally recognized that that is not the case.⁷³

⁷² See *supra* note 64.

⁷³ The Committee of Company Law Experts recognizes that it is in effect hanging a “For Sale” sign on all EU public companies and that EU takeover rules will be virtually the opposite of those in the U.S. The Committee believes that, at this stage of the EU markets

Professor Bebchuk's proposal also raises fundamental issues of inconsistency with the existing corporate law allocation of responsibility between the shareholders and the board of directors. Professor Bebchuk would permit either a takeover bid combined with a referendum or a merger proposal that bypasses the target's board and is submitted directly to the target's shareholders. He would permit both cash and securities to be offered. No new financial, economic or jurisprudential reason is advanced to support this radical change in the law. As matters now stand, it is an essential part of the statutory framework of Delaware law and of most, if not all, of the other states that both the directors and shareholders agree to a sale of the company before it can occur.⁷⁴ In short, Delaware law requires that the board make a considered determination of the fairness of a bid before referring to shareholders the question of whether to keep the pill or other takeover protections in place. Under the Delaware statute, there is no contemplation of a control change unapproved by a board of directors. The "shareholder choice" provided by the statute is the right to choose representatives periodically, not the right of perpetual self-governance through instant polls or plebiscites. Directors have a duty to insure that the shareholders get a fair price, and "shareholder choice" independent of the board is not part of the law of mergers and acquisitions. The shareholders' right is to elect or replace the board of directors or to accept or reject a board recommendation.

As the law now stands, when faced with a takeover bid, a board has the duty to determine whether such bid is at a fair price and in the shareholders' best interests.⁷⁵ This is not a burden to be taken lightly. Under *Unocal*⁷⁶ and *Unitrin*,⁷⁷ a board of directors may not merely "assert" that the underlying long-term value of the corporation exceeds the bid on the table;⁷⁸ in the two cases in which a "just say no" defense was actually tried in court, the directors were required to show, through detailed presentations and expert testimony, that their position was reasonable and based on appropriate information.⁷⁹ If a board either

and company consolidation, its recommendations — not the U.S. approach — are what is right for the EU. There is no doubt that, when the EU rules go into effect, there will be a significant increase in EU takeover activity. See *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*, *supra* note 65, at 38-44.

⁷⁴ Except for a "short-form merger" involving a 90% owned subsidiary. See Del. Gen. Corp. L. § 253.

⁷⁵ See *Trans Union*, 488 A.2d 858.

⁷⁶ 493 A.2d 946.

⁷⁷ *Unitrin v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

⁷⁸ Professor Gilson appears to misunderstand the substantive nature of the directors' duty to consider a takeover bid. See Gilson, *supra* note 6, at 13-14.

⁷⁹ See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989); *Moore v. Wallace*, 907 F. Supp. 1545 (D. Del. 1995).

does not believe the takeover bid to be in the best interests of the shareholders, or is unable to make such a decision, it may not, consistent with its fiduciary duty under *Trans Union*,⁸⁰ *Household*⁸¹ and *Quickturn/Mentor Graphics*,⁸² redeem the pill to permit the bid to go forward. It is inconsistent with existing Delaware law for a board, absent a board decision that the bid is fair, to delegate to shareholders in a referendum the fiduciary decision of whether to keep the pill or other takeover protections in place.

There is simply no reason to take the diametric turn in the law urged by Professor Bebchuk. And even if there were, Professor Bebchuk drastically underestimates the number and complexity of the conditions that would need to be applicable to such a referendum in order to protect the corporation and its shareholders from abusive bids. First, there would have to be assurance that the purpose of the bid is to acquire the target rather than to put it in play to profit from a topping bid. This could be accomplished by requiring that the bid represent a premium over the current market price equal to not less than the average of recent comparable acquisition premiums as set forth in an opinion of a recognized financial advisor. Here there would also be two subsidiary issues: Should the target be able to dispute the premium analysis, and should the referendum be denied to a bidder that has acquired more than 1% of the outstanding shares of the target within the twelve months prior to the bid?

Second, the bid could not be overly conditional. Here the principal question is the degree of material adverse change that would warrant the bidder's terminating the bid and walking away. This is a matter that has recently been contested in connection with *negotiated* takeovers.⁸³ To protect the target and its shareholders, the adverse change condition would have to be triggered only for truly material, unforeseen events that have a long-term impact and that are company-specific as distinguished from industry-wide or macroeconomic events.⁸⁴

⁸⁰ 488 A.2d 858.

⁸¹ 500 A.2d 1346.

⁸² *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998); *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 2001 WL 1018749 (Del. Ch. Aug. 16, 2001).

⁸³ Two of the most highly publicized transactions of 2001 include Tyson Foods' acquisition of IBP, *see, e.g.*, H. Henryson, '*IBP v. Tyson*' Teaches Valuable Lessons, N.Y.L.J., July 26, 2001, at 1, and WPP Group's acquisition of Tempus Group, *see, e.g.*, J. Eaglesham, *Ruling Sets High Hurdle for 'MAC Clauses': The Takeover Panel Has Left Little Room for Maneuver*, Fin. Times (London), Nov. 7, 2001, at 24. Both Tyson and WPP tried to walk away from their deals on the basis of material adverse change conditions in the merger agreements. In each case, a court ruled that the intervening events cited by the acquiror did not constitute sufficient justification for terminating the merger agreement and ordered that the merger be consummated.

⁸⁴ Indeed, after the Tyson case, more attention than ever is being paid to material adverse condition provisions in merger agreements. "What might have been boilerplate before may

Third, the obviously necessary condition that the bidder obtain regulatory approval raises another difficult issue: How far should the bidder have to go to obtain regulatory approval, and how much time should be allowed for it to do so? Since the bidder initiates a unilateral process that it knows will be very disruptive and costly to the target, the bidder would have to be required to use its best efforts, including agreeing to any divestitures, business restrictions or expenditures that are necessary to obtain regulatory approval. If it failed to do so, the bidder would be obligated to the target for liquidated damages in an amount equal to a percentage of the offer price sufficient to compensate for the damages caused by the disruption.⁸⁵ This could, for example, equal five percent of the aggregate bid. If the time period during which regulatory approval is being sought is more than six months, and thereafter the raider fails to get the approval, the liquidated damages could be increased by, say, one percent per month to compensate for the greater damage inflicted on the target by the longer period of disruption from uncertainty as to the future of the target. Even with further compensation, it would be necessary to specify a final expiration date that could not be greater than, say, nine months. A related issue is the limitation on the bidder's ability to negotiate with regulators, who would be aware of the strictures imposed by the statutory referendum procedure.

A fourth set of issues involves the proposed consideration. Where all or part of the bid consideration is cash, the bidder would be required to furnish assurance that it has the cash on hand or a loan commitment from a major financial institution that is not qualified by a material adverse change condition that is different from the material adverse change condition in the bid.

now be a point of negotiations.” J. Seiberg, *A Legal Beef, Tyson's Big MAC Attack on IBP Reshaped M&A Law*, *The Daily Deal*, Jan. 18, 2002, at 15 (quoting L. Hamermesh).

⁸⁵ The ill-fated attempt by General Electric Co. to acquire Honeywell International Inc. in 2001 is a situation that received a great deal of attention in which the failure to obtain required regulatory approvals doomed a merger. GE made an unsolicited \$55 per share proposal to Honeywell while the Honeywell board of directors was concluding a special meeting called to approve an extensively negotiated merger with United Technologies at \$50 per share. See, e.g., N. Anthony, *Honeywell's Path to Deal Now Subject to Question*, *Star Trib. (Minn.)*, Oct. 29, 2000, at 1D. The GE merger agreement was signed within two days of the proposal's having been made. But though the U.S. Department of Justice would have permitted the merger, the European Competition Commission rejected GE's divestiture proposal as insufficient, and the parties ultimately canceled their merger agreement. See, e.g., N. Stoll & S. Goldfein, *A Tale of Two Regulators*, *N.Y.L.J.*, July 17, 2001, at 3. Upon termination of the merger agreement, GE agreed to pay Honeywell \$100 million to cover expenses related to the merger. See *Honeywell International; Merger with GE Off*, *Appliance Mfr.*, Nov. 1, 2001, at 18. However, on October 2, 2001, the day that GE and Honeywell announced the termination of their merger agreement, Honeywell stock closed at \$38.05 per share, 30% lower than the \$55 per share value of the GE deal and a total of more than \$13 billion lower than the GE bid, and more than \$9 billion lower than the United Technologies bid.

Where all or part of the bid consideration is securities, the bidder would be required to make the bid through a registered securities dealer. The securities dealer would have “underwriter” liability under Section 11 of the Securities Act and would be expected to perform customary due diligence. Underwriter’s liability and due diligence are not perfect safeguards, but they represent the minimum protection that should be afforded to the target’s shareholders against the pitfalls of Professor Bebchuk’s argument that the market effectively determines the value of the bid to the target’s shareholders, who need only compare the pre-bid share price and the value of the bid.⁸⁶ After all, in almost every case, it would be impossible for all the target’s shareholders to convert all the securities received in the bid into cash at the price on the day the tender offer is consummated. Moreover, shareholders lack information that careful due diligence might reveal; a year ago, for example, Enron stock providing a 20% or better premium would have been considered a “great deal” by the shareholders of most target companies.⁸⁷

Bidders and the banks that finance and advise them will undoubtedly have trouble with these protections for the target and its shareholders. The difficulty of achieving an appropriate balance between the interests of a bidder and those of the target and its shareholders in designing such a bid and referendum structure illustrates that mergers, acquisitions, takeovers and proxy fights and the legal rules applicable to them are complex, with many interdependent variables. That is why, instead of a system of inflexible statutory rules, we have developed a system of negotiation — with the target board and the bidder as the primary negotiating counterparties. It is important to preserve the board’s role as the best negotiator on behalf of the shareholders and not leap headlong into a new regime that has the potential to be seriously disruptive to business and the economy. But to be an effective negotiator — and the record shows that, on balance, boards have been⁸⁸ — the board needs the fundamental power of any successful negotiator: the ability to “just say no” and walk away. The poison pill provides that power, which is why the pill is legal and why it enables directors to do their job effectively.

* * *

It was to protect against tender offers structured by raiders with terms that were inimical to the interests of shareholders, or which under certain circumstances would become inimical to shareholders, that I developed the poison pill. I put that tool in the hands of the board of directors as the only corporate

⁸⁶ See Bebchuk & Hart, *supra* note 63.

⁸⁷ A comprehensive summary of Enron’s dramatic collapse is set forth in *A Chronology of Enron’s Recent Woes*, Wall St. J., Jan. 16, 2002.

⁸⁸ See *Georgeson Study*, *supra* note 52.

organ that could act to protect both the corporation and the shareholders, with those actions subject to the power of a court to ensure that they met the business judgment rule test. As the foregoing discussion of the type of conditions that would be necessary to protect targets and their shareholders in a referendum regime demonstrates, the shareholders would be at a serious disadvantage if they did not have such statutory conditions or the board to negotiate terms on their behalf.

As the pill approaches its twentieth birthday, it is under attack from three groups of professors, each advocating a different form of shareholder poll, but each intended to eviscerate the protections afforded by the pill. The Gilsonians urge the shareholders to approve a bylaw amendment invalidating the pill; the Coatesites would have the shareholders amend bylaws to accomplish the equivalent of invalidating the pill; and the Bebchukers would preserve the pill just long enough for the shareholders to invalidate it in a concurrent tender offer and referendum. Upon reflection, I think it fair to conclude that the three schools of academic opponents of the pill are not really opposed to the idea that the staggered board of the target of a hostile takeover bid may use the pill to “just say no.” Rather, their fundamental disagreement is with the theoretical possibility that the pill may enable a staggered board to “just say never.” However, as the recent Willamette situation and almost every other in which a takeover bid was combined with a proxy fight show, the incidence of a target’s actually saying “never” is so rare as not to be a real-world problem. While each of these professors’ attempts to undermine the protections of the pill is argued with force and considerable logic, none of their arguments comes close to overcoming the cardinal rule of public policy — particularly applicable to corporate law and corporate finance — “If it ain’t broke, don’t fix it.”

June 17, 2003

The Business Judgment Rule is Alive and Well

Two widely reported recent cases from influential courts have refocused attention on the question of whether an independent director who is not alleged to have engaged in self-dealing may face personal liability because of his failure to prevent harm to the corporation. Walt Disney Co. Derivative Litigation, No. 15452 (Del. Ch. May 28, 2003); Abbott Laboratories Derivative Litigation, 325 F.3d 795 (7th Cir. Mar. 28, 2003). In fact, while these two decisions are examples of the heightened scrutiny that all board conduct is subject to in the post-Enron climate, the fundamental principles governing independent director liability have not changed. Each of these cases involve allegations that the directors failed to engage even in normal everyday levels of deliberation and decision-making, and there is no reason to think that directors who do use common sense and appropriate diligence are any more exposed to personal liability today than previously. The Business Judgment Rule is alive and well.

In shareholder litigation arising out of Disney's \$140 million severance payment to its former President, Michael Ovitz, the Delaware Court of Chancery addressed allegations that Disney's outside directors first failed to obtain basic information about the Ovitz contract (i.e., its potential cost in the event of termination), and then, after the directors knew Ovitz was leaving, allowed Eisner, who was alleged to be Ovitz' long-time personal friend, to single-handedly arrange for Ovitz to receive termination benefits beyond those he was entitled to.

The Court found simply that these allegations, if proved, stated a claim on which plaintiffs could recover. The complaint described a company where board process on this issue had completely broken down, in that the Disney directors did not "exercise any business judgment or make any good faith attempt to fulfill the[ir] fiduciary duties." The Court noted that "[i]f the board had taken the time or effort to review [the company's] options [with respect to Ovitz' termination], perhaps with the assistance of expert legal advisors, the business judgment rule might well protect its decision." The problem at Disney was that there was (at least as alleged) simply no process, no inquiry and no decision.

[T]he facts alleged in the new complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude concerning a material corporate decision. . . . [T]he alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury to loss.

In the Abbott opinion, the Seventh Circuit dealt with allegations that the independent directors on the board of Abbott stood by and did nothing during a six year period in which the FDA repeatedly served notice of safety violations at one of Abbott's major divisions. The Seventh Circuit found that shareholder plaintiffs stated a claim by alleging "that the board knew of the problems and decided no action was required." The key to the Court's decision was its view that the allegations, if proved, showed that the directors failed to act "in conscious disregard of a known risk" and that a "systematic failure of the board to exercise oversight" had occurred:

We find that six years of noncompliance, inspections, [FDA] warning letters, and notice in the press, all of which then resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately \$250 million in corporate assets, indicate that the directors' decisions to not act were not made in good faith. . .

The lessons of Disney and Abbott are plain, but they do not include a change in the legal standards governing director conduct. In both cases, the courts were required by the procedural posture of the case to assume all of the plaintiffs' allegations would be proved at trial. And both cases do indicate that what might in the past have been characterized as a breach of the duty of care may now be considered a breach of the duty of good faith, with potential negative consequences for indemnity and insurance. But the following bed-rock principles remain true:

— **Independent board members remain fully protected by the business judgment rule when they make corporate decisions with the exercise of due care.** Due care means that directors have acted to assure themselves that they have the information required to take, or refrain from taking, action; that they devote sufficient time to the consideration of such information; and that they obtain, where useful, advice from experts and counsel. Neither Disney nor Abbott suggests that the advisors usually employed to assist the board need to be supplemented with new ones simply because the board is reviewing conduct of the company's senior management. Nor is there any implication that a special committee of independent directors is necessary, or for that matter even desirable, where there is no conflict involved.

— **Neither Disney, Abbott or any other decision imposes liability on directors who were unaware of issues which subsequently resulted in losses.** Both cases involve clearly apparent "red flags" and problems that were reported in the media..

— **Neither case contemplates director liability where a well-functioning oversight function was in place.** In Abbott, the Court inferred that after six years of repeated notices of regulatory non-compliance, the board should have concluded that internal controls were insufficient.

— **Cases like Disney and Abbott highlight the importance of the board-level record of events.** Minutes that accurately convey the time and effort directors devote to decision-making, even where the outcome is to take no action, are essential to responding to claims that the board has not been doing its duty.

In sum, there is no doubt that the courts are applying a high level of scrutiny to allegations of board misconduct, including failure to exercise oversight where there was clear indication of need for it. **But the courts also continue to recognize that, if large public companies are to attract experienced persons who will not be petrified into excessive risk-aversion by the possibility of personal liability, independent directors must be given adequate judicial protection for their decisions where the record shows that they took the time to deliberate and to exercise oversight.**

Martin Lipton
Paul K. Rowe

January 19, 2004

Some Thoughts for Boards of Directors

The attached paper reflects advice I have been giving to directors and boards concerned about a growing overemphasis on process as a result of the post-Enron reforms embodied in Sarbanes-Oxley, new SEC regulations and new stock exchange rules. Compliance with the new regulations and rules is not that difficult. Process should not, and need not, overwhelm attention to the business of the company, and the new regulations and rules should not, and need not, deter the CEO and the directors from pursuing entrepreneurial opportunities. The business judgment rule is alive and well. The primary focus should be on performance of the business and maximizing shareholder value, not on process.

Martin Lipton

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August 10, 2005

**Delaware Chancellor's Opinion in the Disney/Ovitz Case
Confirms that the Business Judgment Rule is Alive and Well**

Yesterday's decision in the Disney/Ovitz case is an important, and welcome, reaffirmation of fundamental concepts underlying our corporate law. Delaware Chancellor Chandler found that the Disney directors did not breach their fiduciary duties in the 1995 hiring and 1996 termination of Michael Ovitz. The opinion focused carefully on the core question of whether the directors had acted in good faith in what they believed to be the corporation's best interests. The opinion illustrates that no special legal duties or enhanced judicial scrutiny are attached to often difficult and sensitive decisions about executive compensation, hiring and severance – either on the part of the officers and directors charged with responsibility for making these decisions, or the incoming or departing executives themselves.

Importantly, the decision means that the current emphasis on improved governance practices will not boomerang into new bases of personal liability for officers and directors by seeping into, and distorting, long-standing fiduciary duty requirements. ***The Business Judgment Rule is alive and well.*** The Chancellor forcefully stated that aspirational “best practices” are not synonymous with legal requirements that result in liability, and that the protection from liability accorded directors who act honestly is essential to maximizing shareholder and societal value:

“Unlike ideals of corporate governance, a fiduciary's duties do not change over time. How we understand those duties may evolve and become refined, but the duties themselves have not changed, except to the extent that fulfilling a fiduciary duty requires obedience to other positive law. This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices. . . .

Fiduciaries are held by the common law to a high standard in fulfilling their stewardship over the assets of others, a standard that (depending on the circumstances) may not be the same as that contemplated by ideal corporate governance. Yet therein lies perhaps the greatest strength of Delaware's corporation law. Fiduciaries who act faithfully and honestly on behalf of those whose interest they represent are indeed granted wide latitude in their efforts to maximize shareholders' investment. Times may change, but fiduciary duties do not. Indeed, other institutions may develop, pronounce and urge adherence to ideals of corporate best practices. But the development of aspirational ideals, however worthy as goals for human behavior, should not work to distort the legal requirements by which human behavior is actually measured. Nor should the common law of fiduciary duties become a prisoner of narrow definitions or formulaic expressions. . . .

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Even where decision-makers act as faithful servants, however, their ability and the wisdom of their judgments will vary. The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike. That is why, under our corporate law, corporate decision-makers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and abilities dictate, free of *post hoc* penalties from a reviewing court using perfect hindsight. Corporate decisions are made, risks are taken, the results become apparent, capital flows accordingly, and shareholder value is increased. ”

M. Lipton
T.N. Mirvis
P.K. Rowe

December 1, 2005

Key Issues for Directors

The following is an updated list of key issues for directors:

1. Anticipating attacks by activist hedge funds seeking strategy changes by the company to boost the price of the stock, and developing business, financial and legal strategies to avoid or counter them.
2. Recognizing the explosive nature of the executive compensation question, developing specially tailored executive compensation programs to minimize criticism, properly documenting the discussions and decisions of the compensation committee, and disclosing fully all elements of the compensation. At the same time, cutting through the public and political gadflies' criticism of executive compensation to enable the company to attract and retain the best available executives and reward outstanding performance.
3. Understanding that Sarbanes-Oxley and other post-Enron reforms should not cause the board to overreact to the new requirements and procedures by concentrating on process and compliance to the exclusion of the fundamental function of the board to advise on strategy and to monitor performance. The decision in the Disney case revitalized the business judgment rule and alleviates the concern raised by the Enron and WorldCom settlements that the post-Enron reforms would create new criteria for director liability.
4. Developing and following due diligence procedures designed to establish the due diligence defense to personal liability claims predicated on misstatements or omissions in SEC filings. It was weakness of their due diligence defense that led to the personal liability settlements by the Enron and WorldCom directors.
5. Striking the right balance in responding to shareholder corporate governance initiatives, accepting those that do not interfere with management of the business and rejecting those that limit the power of the CEO and the board. Majority voting, which has received very significant shareholder support, is an example of a proposal that should be accommodated. Limits on executive compensation and splitting the role of Chairman and CEO are examples of proposals that should be resisted. The effort being led by some academics to impose management by referendum must be resisted, if the corporate system as we know it is to be preserved.
6. Regularly reviewing that the CEO and senior management are setting "tone at top" that stresses professionalism, integrity, transparency, legal compliance and high ethical standards.
7. Creating the appropriate relationships between the board as a whole and the audit, compensation and nominating-governance committees so that the work of the committees is not duplicated by the board, but the significant actions of the committees are understood by the board as a whole and are integrated into the overall work of the board.
8. Resisting the trend to having the audit committee or a special committee of independent directors investigate almost all whistle-blower complaints, recognizing how disruptive such investigations are, and being judicious in deciding what really warrants investigation. When an investigation is warranted, resorting to outside advisors only when there is a real conflict or real need for special expertise, and continuing to obtain professional advice from the company's officers and regular advisers.

Martin Lipton

June 12, 2006

**Delaware Supreme Court Affirms Disney Case:
the Business Judgment Rule Prevails**

In a unanimous and masterful decision, the Delaware Supreme Court has affirmed the Court of Chancery's rejection of all the stockholder claims challenging the conduct of the Disney directors in the 1995 hiring and 1996 termination of Michael Ovitz (see our memorandum of August 10, 2005).

Justice Jacobs' opinion for the Court is a welcome demonstration that the Delaware courts remain unrattled by the on-going corporate governance debate on executive compensation, succession planning and severance. The opinion hews to settled and fundamental doctrine, and powerfully depicts how little the stockholders' challenges implicated any legal nuances but, rather, failed because under the Business Judgment Rule director decision-making is protected from second guessing by the presumption that the directors acted on an informed basis and in good faith — a presumption that can be overcome only by a factual showing that the directors breached their duties of care and loyalty or acted in bad faith. The opinion is welcome reassurance that the drumbeat of the stockholder activist and academia attacks will not change the fundamental protections that Delaware has always accorded director business decisions.

On the question of the directors' "duty of good faith," the Supreme Court rejected the argument that decision-making without adequate information and deliberation amounts to bad faith. Contrawise, the Court explained that "bad faith" could result from two different forms of behavior: activities motivated by an actual intent to do harm ("substantive bad faith"); or "intentional dereliction of duty, a conscious disregard for one's responsibilities." Importantly, the Court emphasized that gross negligence, even including failure to inform one's self of material facts, *cannot* constitute bad faith. The Court's discussion of the "duty of good faith" signals an effort to limit that concept, and prevent its wholesale employment as the key to unlock the long-standing protections afforded directors under Delaware law.

The Delaware Supreme Court's opinion closes a potentially worrisome chapter in the ongoing development of fiduciary duty law with a note that should be comforting to those concerned about the potential spill-over of the oft-rancorous corporate governance debates into the realm of legal rule and liability standards: that the Delaware courts remain steadfast in drawing the necessary distinctions between "best practices" and liability-producing behavior, and in eschewing what may sometimes seem the popular fix in favor of the well-tested legal doctrines that have encouraged risk-taking and creation of stockholder value. The opinion likewise reflects that the Delaware courts recognize the reality that the corporate boardroom is at times not a perfect laboratory or even a law school classroom.

M. Lipton
T.N. Mirvis
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June 28, 2007

Directors Face-to-Face Meetings with
Institutional Investors on Corporate Governance Policies and Practices

While corporate governance activists are applauding today's announcement by Pfizer "that members of its Boards of Directors will invite its largest institutional shareholders to a meeting where they will have an opportunity to provide comments and perspective on the company's governance policies and practices including executive compensation," *this is another example of corporate governance run amuck*. Since 2002 there has been a steady escalation of demands by corporate governance activists to increase shareholder power over the business decisions of boards of directors. With academic support from Prof. Lucian Bebchuk of the Harvard Law School, activists are seeking to impose prospective and retrospective referenda on basic decisions by boards of directors.

There is no justification for revolutionizing corporate law and corporate practices so that shareholders replace directors as the fundamental arbiters of corporate policy. Basic corporate law and corporate practices, as they have developed and evolved over the past 50 years, is the only proven vehicle for organizing and deploying capital on the large and dynamic scale of the modern United States economy. It should not be overturned by desperate attempts to appease deconstructionist activists.

Martin Lipton

May 12, 2009

**A Crisis Is a Terrible Thing to Waste:
The Proposed “Shareholder Bill of Rights Act of 2009” Is a Serious Mistake**

By Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis ¹

A few weeks ago, Senator Schumer announced his intention to introduce the Shareholder Bill of Rights Act of 2009. The central stated goal of the Act — “to prioritize the long-term health of firms and their shareholders” and create “more long-term stability and profitability within the corporations that are so vital to the health, well-being, and prosperity of the American people and our economy” — is commendable. That goal represents a significant break from the agendas of many self-proclaimed governance experts who, in actuality, have sometimes hijacked the banner of “good governance” to amp up stockholder power in a campaign to press Corporate America away from attention to and investment in the long term.

Short-termism is a disease that infects American business and distorts management and boardroom judgment. But it does not originate in the boardroom. It is bred in the trading rooms of the hedge funds and professional institutional investment managers who control more than 75% of the shares of most major companies. Short-termist pressure bred by stockholder power demanded unsustainable ever-increasing (quarterly) earnings growth, possible only via the shortcut of over-leverage and reduced investment, and the dangerous route of excessive risk. Stability and financial strength to weather economic cycles were sacrificed for immediate satisfaction. That short-termist pressure, in the view of many observers, contributed significantly to the financial and economic crises we face today.

Thus, the legislation’s purpose — to restore the long-term stability of the firm as the ultimate goal of corporate governance — is a salutary and important guidepost.

But the suggested provisions of the Act threaten to encourage the opposite of its stated goal. The Act proposes to enhance stockholder power and thereby would fuel the very stockholder-generated short-termist pressure that, in the view of many observers, contributed significantly to the financial and economic crises we face today. The Act would implement, by federal mandate, a series of yet further empowerments of stockholders: it would require annual stockholder advisory votes on executive compensation, facilitate a federal requirement that stockholders be granted access to every corporation’s proxy to nominate their own candidates to boards of directors, end staggered boards at all companies, require that all directors receive a majority of votes cast to be elected, and order that all public companies split the CEO and board chair positions.

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Increased stockholder power is directly responsible for the short-termist fixation that led to the current crises. The bulk of the specific provisions suggested would increase stockholder power. Stockholder power has already substantially increased over the last twenty years. Concomitantly, our stock markets have become ever-increasingly institutionalized. The undeniable fact is that the true “investors” are now professional money managers who are inherently short-term (even quarterly) focused. That “stockholder” pressure pushed companies to generate high financial returns at levels that were not sustainable, with management’s compensation being tied to producing such returns (at stockholder urging). The increase in stockholder power and stockholder pressure to produce unrealistic profits fueled the pressure to take on increased risk. As the government arguably relaxed regulatory checks on excessive risk taking (or, at minimum, did not respond with increased prudential regulation), the increased stockholder power and pressure for ever higher returns contributed significantly to the current financial and economic crises. That pressure became all the more irresistible as it combined with increased stockholder power to oust or discipline managers and directors — power available to enforce the stockholder and activist investor agenda of ever higher short-term returns.

Furthermore, substantial concerns arise as to whether it is sound to seek to address corporate governance at the federal level in a “one size fits all” mandate, and whether the subjects proposed to be addressed in the Act would, in fact, advance or detract from the goal of re-establishing the long-term outlook necessary for sustained economic health and growth. In particular, the Act raises significant issues for all constituencies concerned with realigning proper corporate governance to facilitate long-term focus and avoiding counterproductive federal intrusion into corporate law traditionally reserved for the states.

1. The corporate governance subjects proposed to be addressed by the Act have traditionally been the province of state law. That model allows for the exploration of a variety of mechanisms, careful evolution, and the development of considerable state legislative and judicial expertise. It is not apparent that replacement of the Brandeisian state “laboratories” with federally mandated rules is sound. Indeed, it seems fair to say that moving corporate governance issues like executive compensation onto the national legislative agenda has not produced thoughtful consideration, but rather has promoted divisive and counterproductive controversy.

2. Beyond that, the federal mandate suggested by the Act is a “one size fits all” fiat that does not respond to the differing needs of different firms or industries. One model of governance for all companies is no more possible than one management structure or one organizational culture. Working out the optimal mix of power allocation between corporate management, boards, stockholders, employees and other relevant stakeholders requires nuanced balance that is inconsistent with federal dictates on a handful of subjects. Good corporate governance requires a holistic approach. It is not readily achievable by picking out and addressing a few topics. Getting corporate governance correct requires attention to all its aspects, and is ill-served by hard and fast rules imposed on certain points (*e.g.*, ending *all* classified board structures, separating CEO-Chairman positions at *all* public firms, mandating the creation of yet another committee at *all* public companies).

3. Importantly, the states have proven themselves responsive to legitimate calls for reform. Delaware has recently amended its corporate statute to permit corporate boards or stockholders to provide for stockholder access to the company's proxy materials for director elections. Delaware, New York and other states have recently amended their laws to facilitate the adoption of majority voting policies for director elections. These state-based initiatives have proceeded thoughtfully, and undoubtedly will produce continued refinement in other states. It would not seem warranted to short circuit these developments by newly federalizing these aspects of corporate governance.

4. Radically altering the respective federal-state roles would seem particularly ill-advised in light of the fact that many of the issues raised in the proposed legislation are already being significantly addressed by voluntary action taken by public companies. The number of companies electing all directors annually has dramatically increased in recent years (reportedly, 64% of S&P 500 and 50% of S&P 1,500 companies now elect all directors each year). Some form of majority voting on directors is now reportedly utilized for 75% of corporate boards. Of the S&P 500, nearly 40% now have split the Chair/CEO roles, and 95% have an independent lead director or the practical equivalent. Corporate boards are already at least 80% comprised of independent directors in 90% of the cases. The TARP legislation has already caused stockholder votes on executive compensation at the hundreds of stockholder meetings held this year by companies accepting TARP funds. Over 20 additional public companies have agreed to hold such advisory votes annually.

5. Perhaps most fundamentally, the legislation's stated ultimate goal of prioritizing "long-term health" and stability of our corporate economic system would be undermined by the proposed specific provisions of the Act. It is essential to recognize that the key contributors to the current crises were the coincidence of increased stockholder pressure for high returns and weakened prudential regulation. Government policy makers appear to have determined that reinstituting sensible prudential regulation (at the federal as well as even international level) is a necessary part of the fix. But enhancing stockholder power — the direction taken in the proposed Stockholder Bill of Rights Act — would exacerbate, not alleviate, an important part of the underlying dynamic that caused the current crises. That course is a serious mistake, especially when the government has done nothing to either encourage (or require) that money managers — the real "stockholders" today — think and act on a long-term basis.

While there can be no claim of a consensus on the point, thoughtful corporate governance observers have recognized the direct causal relationship between the current crises and stockholder-generated short-termism driving over-leverage and excessive risk-taking in pursuit of unsustainable returns, coupled with under-investment in the long term. The November 10, 2008 Statement on the Global Financial Crisis by the International Corporate Governance Network declared that "[i]t is true that shareholders sometimes encouraged companies, including investment banks, to ramp up short-term returns through leverage," and that: "Institutional shareholders must recognize their responsibility to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working. Pension funds and those in a similar position of hiring fund managers should insist that fund managers put sufficient resources into governance that delivers long term value." It is certainly time for the

entire corporate governance movement to recognize that the true interest of the American investor is long-term value creation and stability.

Accordingly, it is submitted that realization of the Act's goal of long-term stability and profitability warrants the embrace of pragmatic measures that would promote long-term value, instead of going along with yet further stockholder empowerment in the absence of any effort to encourage the essential long-termist perspective. Time-phased shareholder voting structures that would provide long-term shareholders a greater number of votes per share should become a permissible option. Quinquennial rather than annual or triennial elections of corporate board members should be revisited. Institutions should discontinue the practice of compensating fund managers based on quarterly performance. Corporate America should discontinue the practice of issuing quarterly earnings guidance as recommended by the Aspen Institute's Corporate Values Strategy Group and as adopted by General Electric and other prominent companies.

The stockholder-centric view exemplified by the heyday of stockholder activism, and embedded in the proposed Act, cannot be the cure for the very short-termist disease it spawned. One vivid and undeniable lesson of the current financial crisis is that not only stockholders are impacted in a meltdown. Employees who devote their lives to building stockholder value are a very painful example. Communities, suppliers, creditors, indeed, the whole range of constituencies who support the creation and maintenance of stock value, are likewise impacted and have a legitimate stake in the governance and reform debate.

There is no simple panacea. The drivers of short-termism have gained considerable momentum in recent years, and shareholder activists have entrenched many corporate governance mandates that exacerbate these pressures – measures that Senator Schumer's proposed Act would not alleviate and may indeed foster. Board members who approve poison pills, classified board structures, supermajority voting requirements and other safeguards against the pressures of hostile takeovers and short-termism face a considerable risk of a "withhold the vote" or "vote no" campaign when they stand for reelection. Influential proxy voting advisory firms carefully monitor companies for any deviations from corporate governance alleged "best practices" and punish disobedient directors with adverse vote recommendations.

It is time to use the opportunity for fresh thinking that the current crisis affords to reconsider fundamental changes that could restore the ability of boards and managers to run America's companies for our long-term best interest. Short-termism has become deeply ingrained. Inertia is a powerful force. But it may be that the astounding losses we have now seen are enough of a stimulus to steer us back. Companies, directors, managers, shareholders, regulators, other market participants, and political leaders should embrace pragmatic measures that promote long-term value, instead of going along with a new frenzy of shareholder activism and misguided corporate governance reforms built on that failed model. This crisis would be a terrible thing to waste.



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COMMENTARY

Schumer's Shareholder Bill Misses the Mark

Corporate managers need to be able to take the long view.

By Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis

Updated May 12, 2009 12:01 a.m. ET

This week New York Sen. Chuck Schumer is expected to introduce the Shareholder Bill of Rights Act of 2009. The stated goal of the legislation -- "to prioritize the long-term health of firms and their shareholders" -- is commendable.

The trouble is that its provisions actually encourage the opposite. In its current form, the bill would require annual votes by stockholders on executive compensation. It would grant stockholders a new right to include their own director nominees in the corporation's proxy statement. The bill would put an end to staggered boards at all companies (the traditional option of electing one-third of the board each year). And it would require that all directors receive a majority of votes cast to be elected. Public companies would be forced to split the CEO and board chair positions.

Excessive stockholder power is precisely what caused the short-term fixation that led to the current financial crisis. As stockholder power increased over the last 20 years, our stock markets also became increasingly institutionalized. The real investors are mostly professional money managers who are focused on the short term.

It is these shareholders who pushed companies to generate returns at levels that were not sustainable. They also made sure high returns were tied to management compensation. The pressure to produce unrealistic profit fueled increased risk-taking. And as the government relaxed checks on excessive risk-taking (or, at a minimum, didn't respond with increased prudential regulation), stockholder demands for ever higher returns grew still further. It was a vicious cycle.

Thoughtful observers of corporate governance have recognized the direct causal relationship between the financial meltdown and the short-term focus that drove reckless risk-taking.

One key observer, the International Corporate Governance Network, issued a statement about the global financial crisis on Nov. 10, 2008. It spelled out the problem of shareholder power: "[i]t is true that shareholders sometimes encouraged companies, including investment banks, to ramp up short-term returns through leverage." It further declared that "[i]nstitutional shareholders must recognize their responsibility to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working." It recommended that pension funds and others seeking to hire fund managers "should insist that fund managers put sufficient resources into governance that delivers long term value."

If government really wants to encourage stability and profitability, the Schumer bill must call for measures that would promote the long-term value perspective. Providing long-term shareholders a greater number of votes per share should become a permissible option. Quinquennial rather than annual or triennial elections of corporate board members should be considered. Institutions should discontinue the practice of compensating fund managers based on quarterly performance. And corporations should follow the lead of General Electric by discontinuing the practice of issuing quarterly earnings guidance.

The stockholder-centric view of the current Schumer bill simply cannot be the cure for the disease it spawned. Though the short-term focus benefited shareholders for a time, when the meltdown happened shareholders weren't the only people hit. Employees who devoted their lives to building stockholder value felt the pain acutely. Communities, suppliers and creditors -- indeed, the whole range of constituencies who support the creation and maintenance of stock value -- were impacted. They have a legitimate stake in this debate.

Let's use the opportunity for fresh thinking that this crisis presents and restore the ability of boards and managers to run America's companies for our long-term best interest. Hopefully, the astounding losses we have witnessed over the past months will steer us back to responsibility.

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**CHAIRMAN & CEO PEER FORUM
BOARD LEADERSHIP IN A NEW REGULATORY ENVIRONMENT
NEW YORK STOCK EXCHANGE**

**FUTURE OF THE BOARD OF DIRECTORS
MARTIN LIPTON
JUNE 23, 2010**

In an effort to think about the board of directors of the future, we need to start with what we expect the board to do today and the rules we have set governing how directors are selected, how they function and how they relate to shareholders – not only the legal rules but also the aspirational “best practices” that we have allowed to influence corporate and director behavior. We also need to look at how corporate management and boards are perceived by the media, the public and elected officials in the post-financial crisis era.

We expect boards to:

- Choose the CEO, monitor his or her performance and have a detailed succession plan in case the CEO becomes unavailable or fails to meet performance expectations.
- Provide business and strategic advice to management and approve the company’s long-term strategy.
- Determine the company’s risk appetite (financial, safety, reputation, etc.) and monitor the management of those risks.
- Monitor the performance of the corporation and evaluate it against the economy as a whole and the performance of peer companies.
- Monitor the corporation’s compliance with legal and regulatory requirements and respond appropriately to “red flags.”
- Take center stage whenever there is a proposed transaction that creates a seeming conflict between the best interests of stockholders and those of management, and sometimes even when the conflict is more imagined than real, including takeovers.
- Set the standards of social responsibility of the company, including human rights, and monitor performance and compliance with those standards.
- Oversee government and community relations.

- Determine executive compensation.
- Interface with shareholders.
- Plan for and deal with crises.
- Approve the company's ethical standards and programs and take responsibility for "tone at the top."
- Monitor and evaluate the board's own performance and seek continuous improvement.

We require the board to be made up of a majority of independent directors. While the rules of the stock exchanges require only a majority, the guidelines of many institutional investors and governance advisory organizations have specified a "substantial" majority or a specific percentage. In fact, many major corporations today have boards whose only non-independent director is the CEO, or that have only one other director who is not independent. Further, the definition of independence is periodically adjusted by governance activists and advisory organizations to be more stringent than the definition in the stock exchanges rules.

It is interesting to note that it is not at all clear that director independence is the fundamental keystone of "good" corporate governance. The world's most successful economy was built by companies that had few, if any, independent directors. It was not until 1956 that the NYSE *recommended* that listed companies have two outside directors and it wasn't until 1977 that they were *required* to have an audit committee of all independent directors. In 1966 when the Standard Oil Company added outside directors, the New York Times reported that it would require the board to rethink its schedule of meeting *every day* at 11 AM.

Independence became the touchstone during the takeover era of the 1970's-1980's. Governance theorists were so convinced that any takeover bid at a premium to market was desirable that they viewed takeover defense with deep suspicion and deemed it a result of structural conflict – as if only managers intent on keeping their jobs could justify not selling the company whenever and however a takeover bid was made. The antidote seemed obvious to those who considered all management incapable of seeing beyond their own personal interests: populating boards with men and women with as little connection to the enterprise as possible, and demonizing any board that saw itself as something more than just auctioneers. The ideal

became a board with as little or no true “skin in the game” in the sense of a felt connection to the business and its long-term viability, continuity and success.

In addition to independence, we think directors should have relevant business experience, leadership ability and the strength of character to challenge management. Finally, we seek gender and ethnic diversity; availability and commitment such that few if any board and committee meetings are missed; and willingness to serve for compensation that does not fully reflect the scope of the expected commitment and the exposure to litigation and reputational damage when something goes wrong.

At the same time as we have set these stringent expectations for performance and personal qualifications, we have allowed the playing field on which the board of directors performs to tilt in favor of shareholders who seek short-term profits rather than long-term growth. To quote the title of a brilliant speech Vice Chancellor Leo Strine of the Delaware Court of Chancery gave at Stanford University last month, “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed For The Long Term Unless Their Powerful Electorates Also Act And Think Long Term?”

Underlying the academic thinking about corporate governance is the “agency theory” first put forth by Adolph Berle in 1931. Ever since, academic writers have embraced the concept that shareholders are the true owners or “principals” of the company, and that corporate directors are their “agents,” with the duty to maximize shareholder wealth and carry out the shareholders’ directions. As Profs. Jay Lorsch and Rakesh Khurana of the Harvard Business School said in an interesting paper on executive compensation published this year,

“Few ideas about business have been as quickly and widely embraced not only by directors and executives, but also by the bankers, consultants, and lawyers who advise them, as well as by the Delaware Court of Chancery. Prominent business organizations switched from advocating a “stakeholder view” in corporate decisionmaking to embracing the “shareholder” maximization imperative. In 1990, for instance, the Business Roundtable, a group of CEOs of the largest U.S. companies, still emphasized in its mission statement that “the directors’ responsibility is to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation or to the long-term interests of its shareholders.” By 1997, the same organization argued that ‘the paramount duty of management and of boards of directors is to the corporation’s stockholders; the interests of other stakeholders are relevant as a derivative of the duty to the stockholders.’”

The combined effect of the agency theory, Sarbanes-Oxley, the stock exchange governance rules, SEC regulations, the Institutional Shareholder Services Company (ISS) and the Council of Institutional Investors (CII) pressure and the corporate governance provisions of the pending financial industry regulation bill is to exalt short-term shareholder interests over that of all the other stakeholders—and of the American economy and the American public. The assumption that empowering shareholders and promoting their interests will lead to better performance and more efficient management of corporations, and that shareholder interests are therefore aligned with those of other stakeholders, is contradicted by the short-term trading objectives of many of the major institutional investors and hedge funds. It was the taking of undue risks in an effort to meet the short-term profits demands of shareholders that was a root cause of the financial crisis.

I might note that in 1979, I published a widely cited article arguing that the stakeholder theory—not the agency theory—should determine the board’s fiduciary duties. Although fiercely attacked by the Chicago School of Law and Economics academics, my article was relied upon by the Delaware Supreme Court in 1985 in the famous Unocal case and has subsequently been embraced by legislation in more than 30 states and enshrined in the new British corporation law. Notwithstanding what is now established law permitting boards to reject short-term goals in favor of long-term objectives, institutional and activist investors, and their advisors like ISS, continue to vote for short-term while paying lip service to long-term.

With this as background, we turn to the question of the day, “what will the board look like and how it will operate in the future.” Here let me emphasize that these are general thoughts applicable to major public corporations and are in no way intended to be a checklist of best practices or legal requirements. Contrary to the course currently being pursued by Congress, the SEC and the governance activists, one size does not fit all and it is bad policy to impose check-the-box governance.

The Directors. There will continue to be a substantial majority of independent directors on corporate boards. There will be significant gender and ethnic diversity. While we will not prescribe percentages for gender diversity, we will be somewhere between (a) the new UK Corporate Governance Code: “The search for board candidates should be conducted, and appointments made, on merit against objective criteria and with due regard for the benefits of

diversity on the board including gender” and (b) the stronger Australian Stock Exchange proposal requiring disclosure of specific diversity objectives and their achievement and (c) the 40% female quota imposed by law in Norway and actively being considered or adopted in other European countries.

The trend to smaller boards will be reversed in order to have a sufficient number of independent directors for the audit, nominating and compensation committees and to add directors who have special expertise and are not necessarily independent. For example, the financial crisis called attention to directors of financial institutions who did not have the expertise to fully understand the risks of complicated derivatives and other hi-tech financial instruments. To remedy the situation, the banking regulators are now insisting that experienced bankers be added to the boards. At Citigroup, Diana Taylor, former N.Y. State Banking Superintendent, became a director last year and last month it was reported that she would chair the nominating and governance committee. Also at Citi, Robert Joss, a former Wells Fargo director and Stanford University Business School dean, became a director and paid consultant. While he does not qualify as an independent director, his appointment to the board makes his experience and expertise available at board and committee meetings as a director and not just as an outside consultant.

A separate risk committee has been mandated for financial institutions and, even if not mandated for non-financial companies, will likely become common at companies where risk plays a significant role. The BP Gulf of Mexico spill, and BP’s acknowledgment that it was not prepared for it, followed a BP Houston refinery explosion in 2005 that resulted in a special review, by a committee chaired by James Baker, that criticized the BP board for not properly monitoring the risk of that type of accident. To assist boards and committees with evaluating and monitoring risks and other specialized issues, there will be greater resort to obtaining opinions of expert consultants. Boards will have regular tutorials by both company employees and outside experts. Board retreats for two or three days will have longer agendas to fulfill the need for director education about specialized issues.

It should be noted that while our courts, even in cases involving multi-billion-dollar losses by financial institutions, have continued to adhere to the customary *Caremark*-case standard for determining whether directors have met their duties of care, earlier this month, the

European Commission, in a consultation paper seeking comments on options to improve corporate governance in financial institutions, suggested strengthening “legal liability of directors via an expanded duty of care”. The possibility that higher standards of care for directors of financial institutions could be extended to all corporations is real. Specialized committees, use of expert consultants, tutorials and expanded director education programs will go a long way to enable boards to meet even a strengthened duty of care.

Looking out even further into the future, the time demands of board service will result in more use of modern conferencing and communication technology so that travel time is reduced, committees can meet conveniently apart from meetings of the whole board and special meetings with outside consultants can be convened whenever needed. In dealing with important issues and crises, companies will have very frequent special meetings and resort widely to outside experts.

As a result of the increased time demands of board service and the need for larger, more diverse boards with special expertise, director recruiting will become an increasingly critical challenge for many corporations.

Executive Compensation. Shareholder advisory voting on executive compensation will be effective for the next proxy season. “Say on Pay” is here and will continue. Combined with new SEC disclosure rules and greater resort to independent compensation consultants, we will have achieved the unfortunate result of transferring the fundamental role of the board to establish executive compensation to institutional investors and ISS and CII and their compatriots.

Ann Yeager, Executive Director of the CII, in a memo, “Red Flags for Say-on-Pay Voting,” posted on the Harvard Law School Forum on Corporate Governance and Finance Regulation, refers to the adoption of say on pay at more than 300 companies in 2010 and goes on to list 10 principal and 15 subsidiary red flags (problematic pay practices) of concern to CII. In effect, a 25 item checklist that boards and compensation committees are instructed to follow on pain of the CII advising its members to vote against the company’s compensation program.

Separation of Chairman and CEO. While separation of Chairman and CEO roles is not mandated by the pending financial industry regulation bill, the bill does require disclosure

of whether the roles are split—something the SEC has already required companies to discuss in proxy statements. In light of the strong support for separation in the activist governance community and the implicit endorsement by Congress and the SEC, pressure through shareholder proxy resolutions will continue to grow. It is reasonable to assume that in a few years separation will be more widespread.

Shareholder Control. While the financial industry regulation bill no longer requires the stock exchanges to adopt majority voting rules, it continues to authorize the SEC to adopt proxy access. In addition, SEC rules permit proxy resolutions designed to induce or force the company to (a) dissolve takeover defenses, (b) make it easier for shareholders to call special shareholder meetings, (c) authorize shareholders to act by written consent instead of a shareholder meeting and conduct campaigns to obtain full control and (d) enable shareholders to shape director nominating procedures and CEO succession planning. Together with NYSE rules, effective this year, that eliminated broker discretionary voting in uncontested elections, activist institutional shareholders will be more able to heavily influence, if not dictate business actions, policies and strategies at most major public companies. This raises the ultimate questions:

- Will we be able to attract the qualified directors we need in light of the limitation on their ability to take actions and adopt policies that shareholders seeking short-term gains object to?
- Will the pressure for short-term performance lead to the “Eclipse of the Public Corporation” a 1989 prognostication by famed Harvard economist, Michael Jensen?
- Will the pressure for short-term gain result in business decisions that so adversely affect stakeholders and the economy that the government becomes intrusive in the management of public corporations other than financial institutions?

While these are reasonable ruminations, I think that they will not come to pass. What will come to pass is that companies and their advisors will adjust to the reality of the new governance regime and the lives of CEOs and boards of directors will become more challenging. And, hopefully, we will over time realize the drawbacks of conceptualizing corporate governance as primarily a means to discipline managers, to arbitrarily limit the compensation of executives and to provide convenient ways for institutional and activist shareholders to dictate corporate policy in order to achieve their short-term profit interests. Instead, we should recognize that the purpose of corporate governance must be to encourage management and

directors to develop policies and procedures that enable them to best perform their duties (and meet our expectations), while not putting them in a straight jacket that dampens risk-taking and discourages investing for long-term growth and true value creation.

February 16, 2011

**Delaware Court Reaffirms the Poison Pill and
Directors' Power to Block Inadequate Offers**

Almost thirty years ago, our Firm announced there was a way—the poison pill—to level the playing field between corporate raiders and a board of directors acting to protect the interests of the corporation and its shareholders. Despite great skepticism about the pill in the legal and banking communities, the Delaware Supreme Court in 1985 agreed with us and affirmed that directors, in the exercise of their business judgment, could properly use the pill to protect the corporation from hostile takeover bids.

Since then, many have continued to criticize the pill, and hostile bidders and plaintiffs' lawyers have continued to litigate to constrain its use. Yesterday, in a historic decision, the Delaware Court of Chancery rejected the broadest challenge to the pill in decades. [*Air Products & Chemicals, Inc. v. Airgas, Inc.*, C.A. No. 5249—CC \(Del. Ch. Feb. 15, 2011\)](#). The decision reaffirms the vitality of the pill. It upholds the primacy of the board of directors in matters of corporate control under bedrock Delaware law. It reinforces that a steadfast board, confident in management's long-term business plan, can block opportunistic bids. We represented the target, Airgas, and its board of directors.

The conduct of the Airgas board, the Chancellor concluded, “serves as a quintessential example” of these fundamental principles: if directors act “in good faith and in accordance with their fiduciary duties,” the Delaware courts will continue to respect a board's “reasonably exercised managerial discretion.” Directors may act to protect the corporation, and all of its shareholders, against the threat of inadequate tender offers. And they may act to protect against the special danger that arises when raiders induce large purchases of shares by arbitrageurs who are focused on a short-term trading profit, and are uninterested in building long-term shareholder value.

The Chancellor could not have been clearer that “the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors.” And it is up to directors, not raiders or short-term speculators, to decide whether a company should be sold: “a board cannot be forced into *Revlon* mode any time a hostile bidder makes a tender offer that is at a premium to market value.” The Chancellor concluded: “in order to have any effectiveness, pills do not—and can not—have a set expiration date.” The poison pill lives.

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November 28, 2011

Key Issues for Directors 2012

For a number of years, as the new year approached, I have prepared a one-page list of the key issues for boards of directors that are newly emerging or will be especially important in the coming year. Each year, the legal rules and aspirational best practices for corporate governance matters, as well as the demands of activist shareholders seeking to influence boards of directors, have increased. So too have the demands of the public with respect to health, safety, environmental and other socio-political issues. In [The Spotlight on Boards](#), I have published a list of the roles and responsibilities that boards today are expected to fulfill. Looking forward to 2012, it is clear that in addition to satisfying these expectations, the key issues that boards will need to address include:

1. Working with management to navigate the dramatic changes in the domestic and world-wide economic, social and political conditions, in order to remain competitive and successful.
2. Coping with the increase in regulations and changes in the general perception of business that have followed the financial crisis. Once it was said, "The business of America is business." Today, it could be said, "The business of America is government, and a dysfunctional government at that."
3. Dealing with populist demands, such as criticism of executive compensation and risk management, in a manner that will preempt increased regulation and avoid escalation of activist demands while at the same time furthering the best interests of the corporation.
4. Organizing the business, and maintaining the collegiality, of the board so that each of the increasingly time-consuming matters that the board is expected to oversee receives the appropriate attention of the directors.
5. Working with management to encourage entrepreneurship, appropriate risk taking, and investment to promote the long-term success of the company, despite the pressures for short-term performance.
6. Retaining and recruiting directors who meet the requirements for experience, expertise, diversity, independence, leadership ability and character, and providing compensation for directors that fairly reflects the significantly increased time and energy that they must now spend in serving as board members.
7. Developing an understanding of shareholder perspectives on the company, as well as coping with the escalating requests of union and public pension funds and other activist shareholders for meetings to discuss governance and business proposals.
8. Developing an understanding of how the company and the board will function in the event of a crisis. Most crises are handled less than optimally because management and the board have not been proactive in planning to deal with crises, and because the board cedes control to outside counsel and consultants.

Martin Lipton

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March 21, 2012

Harvard's Shareholder Rights Project is Wrong

The Harvard Law School Shareholders Rights Project (SRP) recently issued joint press releases with five institutional investors, principally state and municipal pension funds, trumpeting SRP's representation of and advice to these investors during the 2012 proxy season in submitting proposals to more than 80 S&P 500 companies with staggered boards, urging that their boards be declassified. The SRP's "News Alert" issued concurrently reported that 42 of the companies targeted had agreed to include management proposals in their proxy statements to declassify their boards – which reportedly represented one-third of all S&P 500 companies with staggered boards. The SRP statement "commended" those companies for what it called "their responsiveness to shareholder concerns."

This is wrong. According to the Harvard Law School online catalog, the SRP is "a newly established clinical program" that "will provide students with the opportunity to obtain hands-on experience with shareholder rights work by assisting public pension funds in improving governance arrangements at publicly traded firms." Students receive law school credits for involvement in the SRP. The SRP's instructors are two members of the Law School faculty, one of whom (Professor Lucian Bebchuk) has been outspoken in pressing one point of view in the larger corporate governance debate. The SRP's "Template Board Declassification Proposal" cites two of Professor Bebchuk's writings, among others, in making the claim that staggered boards "could be associated with lower firm valuation and/or worse corporate decision-making."

There is no persuasive evidence that declassifying boards enhance stockholder value over the long-term, and it is our experience that the absence of a staggered board makes it significantly harder for a public company to fend off an inadequate, opportunistic takeover bid, and is harmful to companies that focus on long-term value creation. It is surprising that a major legal institution would countenance the formation of a clinical program to advance a narrow agenda that would exacerbate the short-term pressures under which American companies are forced to operate. This is, obviously, a far cry from clinical programs designed to provide educational opportunities while benefiting impoverished or underprivileged segments of society for which legal services are not readily available. Furthermore, the portrayal of such activity as furthering "good governance" is unworthy of the robust debate one would expect from a major legal institution and its affiliated programs. The SRP's success in promoting board declassification is a testament to the enormous pressures from short-term oriented activists and governance advisors that march under the misguided banner that anything that encourages takeover activity is good and anything that facilitates long-term corporate planning and investment is bad.

Staggered boards have been part of the corporate landscape since the beginning of the modern corporation. They remain an important feature to allow American corporations to invest in the future and remain competitive in the global economy. The Harvard Law School SRP efforts to dismantle staggered boards is unwise and unwarranted, and – given its source – inappropriate. As Delaware Chancellor Leo Strine noted in a [2010 article](#): "stockholders who propose long-lasting corporate governance changes should have a substantial, long-term interest that gives them a motive to want the corporation to prosper."

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November 28, 2012

Harvard's Shareholder Rights Project is Still Wrong

A small but influential alliance of activist investor groups, academics and trade unions continues – successfully it must be said – to seek to overhaul corporate governance in America to suit their particular agendas and predilections. We believe that this exercise in corporate deconstruction is detrimental to the economy and society at large. We continue to oppose it.

The Shareholder Rights Project, Harvard Law School's misguided "clinical program" which we have [previously criticized](#), today issued [joint press releases](#) with eight institutional investors, principally state and municipal pension funds, trumpeting their recent successes in eliminating staggered boards and advertising their "hit list" of 74 more companies to be targeted in the upcoming proxy season. Coupled with the new ISS standard for punishing directors who do not immediately accede to shareholder proposals garnering a majority of votes cast (even if they do not attract enough support to be passed) – which we [also recently criticized](#) – this is designed to accelerate the extinction of the staggered board.

While the activist bloc likes to tout annual elections as a "best practice" on their one-size-fits-all corporate governance scorecards, there is no persuasive evidence that declassifying boards enhances shareholder value over the long term. The argument that annual review is necessary for "accountability" is as specious in the corporate setting as it is in the political arena. In seeking to undermine board stewardship, the Shareholder Rights Project and its activist supporters are making an unsubstantiated value judgment: they prefer a governance system which allows for a greater incidence of intervention and control by fund managers, on the belief that alleged principal-agent conflicts between directors and investors are of greater concern than those between fund managers and investors. Whether these assumptions and biases are correct and whether they will help or hurt companies focus on long-term value creation for the benefit of their ultimate investors are, at best, unknown. The essential purpose of corporate governance is to create a system in which long-term output and societal benefit are maximized, creating prosperity for the ultimate beneficiaries of equity investment in publicly-traded corporations. Short-term measurement and compensation of investment managers is not necessarily consistent with these desired results. Indeed the ultimate principals of investment managers – real people saving for all of life's purposes – depend not on opportunism, shareholder "activism" or hostile takeovers, but rather on the long-term compound growth of publicly-traded firms.

As we have said, it is surprising and disappointing that a leading law school would, rather than dispassionately studying such matters without prejudice or predisposition, choose to take up the cudgels of advocacy, advancing a narrow and controversial agenda that would exacerbate the short-term pressures under which U.S. companies are forced to operate. In response to our critiques, the activists resort to *ad hominem* attacks, suggesting that, "as counsel for incumbent directors and managers seeking to insulate themselves from removal" we "advocate for rules and practices that facilitate entrenchment." The fact is that the board-centric model of corporate governance has served this country very well over a sustained period. A compelling argument should be required before those corporate stewards who actually have fiduciary duties, and in many cases large personal and reputational investments in the enterprises they serve, are marginalized in favor of short-term-oriented holders of widely diversified and ever-changing portfolios under the influence of self-appointed governance "experts." Indeed a [just published comprehensive study](#) by a distinguished group of professors at the London School of Economics demonstrates that the statistical analyses relied on by these experts are seriously flawed and that the shareholder-centric governance they are trying to impose was a significant factor in the poor performance by a large number of banks in the financial crisis.

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February 22, 2013

Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy

The activist-hedge-fund attack on Apple—in which one of the most successful, long-term-visionary companies of all time is being told by a money manager that Apple is doing things all wrong and should focus on short-term return of cash—is a clarion call for effective action to deal with the misuse of shareholder power. Institutional investors on average own more than 70% of the shares of the major public companies. Their voting power is being harnessed by a gaggle of activist hedge funds who troll through SEC filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a short-term profit without regard to the impact on the company's long-term prospects. These self-seeking activists are aided and abetted by Harvard Law School Professor Lucian Bebchuk who leads a cohort of academics who have embraced the concept of "shareholder democracy" and close their eyes to the real-world effect of shareholder power, harnessed to activists seeking a quick profit, on a targeted company and the company's employees and other stakeholders. They ignore the fact that it is the stakeholders and investors with a long-term perspective who are the true beneficiaries of most of the funds managed by institutional investors. Although essentially ignored by Professor Bebchuk, there is growing recognition of the fiduciary duties of institutional investors not to seek short-term profits at the expense of the pensioners and employees who are the beneficiaries of the pension and welfare plans and the owners of shares in the managed funds. In a series of brilliant speeches and articles, the problem of short-termism has been laid bare by Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery, e.g., [One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?](#), and is the subject of a continuing Aspen Institute program, [Overcoming Short-Termism](#).

In his drive to enhance the shift of power over the management of companies from directors to shareholders, Professor Bebchuk has announced that he is pursuing empirical studies to prove his thesis that shareholder demand for short-term performance enforced by activist hedge funds is good for the economy. We have been debating director-centric corporate governance versus shareholder-centric corporate governance for more than 25 years. Because they are inconvenient to his theories, Professor Bebchuk rejects the decades of my and my firm's experience in advising corporations and the other evidence of the detrimental effects of pressure for short-term performance. I believe that academics' self-selected stock market statistics are meaningless in evaluating the effects of short-termism. Our debates, which extend over all aspects of corporate governance, have of late focused on my effort to obtain early disclosure of block accumulations by activist hedge funds and my endorsement of an effort to require institutional shareholders to report their holdings two days, rather than 45 days, after each quarter. It is in the context of these efforts, opposed by the activists who benefit from lack of transparency, that Professor Bebchuk has announced his research project.

If Professor Bebchuk is truly interested in meaningful research to determine the impact of an activist attack (and the fear of an activist attack) on a company, he must first put forth a persuasive (or even just coherent) theory as to why the judgments as to corporate strategy

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and operations of short-term-focused professional money managers should take precedence over the judgments of directors and executives charged with maximizing the long-term success of business enterprises. There is nothing persuasive about his view, whether as theory or experience. Furthermore, he must take into account the following:

1. As to all companies that were members of the Fortune 500 during the period January 1, 2000 to December 31, 2012, what was the impact on the price of the shares of a company that missed the “street estimate” or “whisper number” for its earnings for a quarter and what adjustment did each of those companies make to its capital expenditures, investment in research and development and number of employees for the balance of the year of the miss and the following year.
2. For companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period.
3. Interviews with the CEO’s of the Fortune 500 as to whether they agree or disagree with the following statements:
 - a) From the Aspen paper, “We believe that short-term objectives have eroded faith in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy. Restoring that faith critically requires restoring a long-term focus for boards, managers, and most particularly, shareholders—if not voluntarily, then by appropriate regulation.”
 - b) From a 2002 interview with Daniel Vasella, CEO of Novartis in [Fortune Magazine](#), “The practice by which CEOs offer guidance about their expected quarterly earnings performance, analysts set ‘targets’ based on that guidance, and then companies try to meet those targets within the penny is an old one. But in recent years the practice has been so enshrined in the culture of Wall Street that the men and women running public companies often think of little else. They become preoccupied with short-term ‘success,’ a mindset that can hamper or even destroy long-term performance for shareholders. I call this the tyranny of quarterly earnings.”

Martin Lipton

August 8, 2013

Current Thoughts About Activism

A long-term oriented, well-functioning and responsible private sector is the country's core engine for economic growth, national competitiveness, real innovation and sustained employment. Prudent reinvestment of corporate profits into research and development, capital projects and value-creating initiatives furthers these goals. Yet U.S. companies, including well-run, high-performing companies, increasingly face:

- pressure to deliver short-term results at the expense of long-term value, whether through excessive risk-taking, avoiding investments that require long-term horizons or taking on substantial leverage to fund special payouts to shareholders;
- challenges in trying to balance competing interests due to excessively empowered special interest and activist shareholders; and
- significant strain from the misallocation of corporate resources and energy into mandated activist or governance initiatives that provide no meaningful benefit to investors or other critical stakeholders.

These challenges are exacerbated by the ease with which activist hedge funds can, without consequence, advance their own goals and agendas by exploiting the current regulatory and institutional environment and credibly threatening to disrupt corporate functioning if their demands are not met. Activist hedge funds typically focus on immediate steps, such as a leveraged recapitalization, a split-up of the company or sales or spinoffs of assets or businesses that may create an increase in the company's near term stock price, allowing the activist to sell out at a profit, but leave the company to cope with the increased risk and decreased flexibility that these steps may produce.

The power of the activist hedge funds is enhanced by their frequent success in proxy fights and election contests when companies resist the short-term steps the hedge fund is advocating. These proxy contest successes, in turn, are enabled by the outsized power of proxy advisory firms and governance reforms that weaken the ability of corporate boards to resist short-term pressures. The proxy advisory firms are essentially unregulated and often demonstrate a bias in favor of activist shareholders. They also tend to take a one-size-fits-all approach to policy and voting recommendations without regard for or consideration of a company's unique circumstances. This approach includes the potential for across-the-board "withhold votes" from directors if the directors fail to implement any shareholder proposal receiving a majority vote, even if directors believe that the proposal would be inconsistent with their fiduciary duties and the best interests of the company and its shareholders. Further complicating the situation is the fact that an increasing number of institutional investors now invest money with the activist hedge funds or have portfolio managers whose own compensation is based on short-term metrics, and increasingly align themselves with the proposals advanced by hedge fund activists. In this environment, companies can face significant difficulty in effectively managing for the long-term,

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considering the interests of employees and other constituencies, and recruiting top director and executive talent.

Although there is no single solution to these problems, the following perspectives and actions may help to restore a more reasonable balance:

- Recognize that the proper goal of good governance is creating sustainable value for the benefit of all stakeholders, rather than reflexively placing more power in the hands of activist hedge funds or often-transient institutional shareholders who are themselves measured by short-term, quarterly portfolio performance;
- Resist the push to enact legislation, regulations or agency staff interpretations that place more power in the hands of activist hedge funds and other investors with short-term perspectives, and that thereby weaken the ability of corporate boards to resist such short-term pressures; and
- In any new legislation or regulation that is enacted, provide appropriate protections to companies, as opposed to focusing only on new rights for shareholders who already have significant leverage to pressure companies.

Some specific examples of possible steps to implement these general principles may include the following:

- SEC Commissioner Daniel Gallagher recently questioned whether “investment advisors are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms” and expressed “grave concerns” about institutional investors engaging in “rote reliance” on proxy advisory firms’ advice. He attributed this in part to the unintended consequences of two SEC staff no-action letters from 2004, which he noted were not approved by the Commission and did not necessarily represent the views of the Commission or the Commissioners, that had “unduly increased the role of proxy advisory firms in corporate governance” by “essentially mandating the use of third party opinions.” *New Commission-level guidance could replace these staff interpretations and, instead, encourage proxy voting based on individual evaluation of each company and its long-term best interests. Other agencies may also wish to keep in mind this illustration of unintended and undesired outcomes as appropriate.*
- Activist shareholders take advantage of Securities Exchange Act Rule 14a-8 to force the inclusion, year-after-year and notwithstanding prior failures, of corporate governance and business-related shareholder proposals in public company proxy statements that have little connection to effective governance or the creation of long term shareholder value. These proposals can be misused to exert leverage over companies, and dealing with the deluge distracts from the business and requires significant time and resources. *Rule 14a-8 should be revisited to raise the bar on inclusion of shareholder proposals. This could include more substantial and longer-term ownership requirements to be eligible under Rule 14a-8, and exclusion of proposals in subsequent years that did not obtain a truly meaningful level of support (current rules prohibit a company from excluding a repeat*

proposal the following year unless 97% of the shares reject it the first time or 90% of the shares reject it at least three times, standards that are far too low).

- Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co., have disproportionate influence over voting decisions made by every public company's institutional shareholder base and regularly support activist shareholders and hedge funds. Their recommendations and analyses may also contain material inaccuracies, and companies have little visibility into the preparation of these reports and the proxy advisory firms' methodologies. *We believe that the proxy advisory firms should be held to reasonable standards to ensure transparency, accuracy and the absence of conflicts and that the special regulatory treatment given to these firms should end.*
- Activist hedge funds have recently exploited loopholes in existing SEC rules under Section 13(d) of the Securities Exchange Act to accumulate significant, control-influencing stakes in public companies rapidly without timely notice to the market. These techniques are facilitated by the widespread use of derivatives, advanced electronic trading technology and increased trading volumes. Many non-U.S. securities markets have already taken action to address the risks of such rapid, undisclosed accumulations. A rulemaking petition, pending before the SEC since March 2011, would close the derivatives loophole and require acquirers of 5% stakes to disclose such positions to the public within one day, instead of the current ten-day window established forty years ago. *We believe approval of this rulemaking petition will help curb abuses and bring the rules current with contemporary practices and technologies.*
- Companies face significant difficulty engaging with their institutional shareholder base because the current reporting regime does not provide timely information to companies as to who their shareholders are. A second rulemaking petition pending before the SEC, submitted in February 2013, requests that the SEC shorten the deadline for institutional investors to report their positions on Forms 13F from 45 days to two business days after quarter-end and increase the frequency with which shareholders report their position. The petition also supports reform of the Section 13(d) stock accumulation rules. *We believe approval of this rulemaking petition will promote market transparency and facilitate engagement between companies and shareholders.*
- Harvard Law School Professor Lucian Bebchuk has established the Harvard Law School Shareholder Rights Project to promote corporate governance that facilitates activist hedge fund attacks on companies. He has also published several articles and editorials arguing that activist attacks are beneficial to the targeted companies and should be encouraged. His articles and editorials are widely used by activist hedge funds and institutional shareholders to justify their actions. *We believe that the statistics Professor Bebchuk uses do not establish the validity of his claims that activist attacks are beneficial nor justify his uncritical embrace of activists. We believe that attacks, and the threat of attacks, by activist hedge funds and pervasive activism have significant implications for the broader economy and our nation's competitiveness and are major contributors to unemployment and slow growth of GDP. We believe that the recent studies by:*

Professor Pavlos E. Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*

Professor Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*

Professor Colin Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it*

Professor David Larcker and Brian Tavan, *A Real Look at Real World Corporate Governance*

reflect the true effects of activism and that it is in the national interest to reverse the legislation and regulation that promotes activism.

Martin Lipton
Steven A. Rosenblum
Sabastian V. Niles

August 26, 2013

The Bebchuk Syllogism

Empirical studies show that attacks on companies by activist hedge funds benefit, and do not have an adverse effect on, the targets over the five-year period following the attack.

Only anecdotal evidence and claimed real-world experience show that attacks on companies by activist hedge funds have an adverse effect on the targets and other companies that adjust management strategy to avoid attacks.

Empirical studies are better than anecdotal evidence and real-world experience.

Therefore, attacks by activist hedge funds should not be restrained but should be encouraged.

Harvard Law School Professor Lucian A. Bebchuk is now touting this syllogism and his obsession with shareholder-centric corporate governance in an article entitled, “[The Long-Term Effects of Hedge Fund Activism](#).” In evaluating Professor Bebchuk’s article, it should be noted that:

There is heavy reliance in the article on Tobin’s Q (*i.e.*, a ratio of market value to book value, with book value intended to serve as a proxy for replacement value) to measure the performance of the targets of activist attacks, and the article presents the data in a way that makes the statistical analysis appear favorable to Professor Bebchuk’s argument. The article highlights the average Q ratio for companies subject to activist attack in the following five years. Since averages can be skewed by extreme results (as the article acknowledges), focusing on the median outcome would be more appropriate. Indeed, the article presents median results, but does not reference in the text that the median Q ratio for each of the first four years following the attack year is lower than the median Q ratio in the year of the activist attack. Only in year five does the median Q ratio exceed the Q ratio in the attack year. While the article fails to disclose the average holding period of the activists in the study, it is undoubtedly less than five years. So it seems quite speculative, at best, to credit activists with improvements in Q ratios that first occur for the median company only in the fifth year after the attack.

Beyond the highly questionable conclusions Professor Bebchuk draws from his Tobin’s Q statistics, there is also the fundamental question of whether Tobin’s Q is a valid measure of a company’s performance. A 2012 paper by Olin School of Business Professor Philip H. Dybvig, “[Tobin’s q Does Not Measure Firm Performance: Theory, Empirics, and Alternative Measures](#),” points out that Tobin’s Q is inflated by underinvestment, so a high Q is not evidence of better company performance. Companies that forego profitable investment opportunities—including as a result of pressure from activists to return capital to investors or defer investments in R&D and CapEx—can actually have higher Q ratios while reducing shareholder value that would have been generated by those investments. In addition, the use of book value as a proxy for replacement value introduces complications from different accounting decisions, including the timing of write-downs, depreciation methods, valuation of intangibles and similar decisions that can significantly distort a company’s Q ratio. The other metric that Professor Bebchuk relies on in his article—return on assets (ROA)—is highly correlated with Tobin’s Q (indeed, both ratios use the same denominator, and the numerators are substantially related), and thus his ROA statistics suffer from these same shortcomings and add little to the analysis.

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Further undermining the validity of the empirical analysis, the article acknowledges but fails to control for the fact that 47% of the activist targets in the dataset cease to survive as independent companies throughout the measurement period. The study sheds no light on whether the shareholders of those companies would have realized greater value from other strategic alternatives that had a longer-term investment horizon, whether those companies were pressured to sell on account of the activist attack (as other empirical work has argued), or whether shareholder gains from activism are largely driven by the cases that result in sales of control.

Lastly, Professor Bebchuk concedes that his analytical methodology provides no evidence of causation, and thus simply misses the crux of the debate: whether activists can impair long-term value creation. Favorable results would arise under his approach whenever managements of the target companies pursue value-enhancing strategies, even those that run counter to the activists' pressures or were being initiated even before the activist appeared. In addition, improving economic, market, industry and company-specific conditions would also contribute to favorable results independent of activist pressure. Professor Bebchuk also states that the targets in his dataset "tend to be companies whose operating performance was below industry peers or their own historical levels at the time of [activist] intervention"; if true, it is plausible that many companies improved from a historical or cyclical trough position in spite of—rather than as a result of—activist pressures.

These defects, among others, are sufficient in and of themselves to raise serious doubts about the conclusions that Professor Bebchuk draws from his empiricism. But there is a more fundamental flaw in Professor Bebchuk's syllogism: it rejects and denies the evidence, including anecdotal evidence and depth of real-world experience, that he acknowledges in the article comes from a "wide range of prominent writers . . . significant legal academics, noted economists and business school professors, prominent business columnists, important business organizations, and top corporate lawyers."

No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism over a long-term horizon influenced by varying economic, market and firm-specific conditions, is capable of measuring the damage done to American companies and the American economy by the short-term focus that dominates both investment strategy and business-management strategy today. There is no way to study the parallel universe that would exist, and the value that could be created for shareholders and other constituents, if these pressures and constraints were lifted and companies and their boards and managements were free to invest for the long term. The individuals who are directly responsible for the stewardship and management of our major public companies—while committed to serious engagement with their responsible, long-term shareholders—are nearly uniform in their desire to get out from under the short-term constraints imposed by hedge-fund activists and agree, as do many of their long-term shareholders, that doing so would improve the long-term performance of their companies and, ultimately, the country's economy.

Reflecting on Professor Bebchuk's article and failed syllogism, one is reminded of Mark Twain's saying, "There are three kinds of lies: lies, damned lies and statistics."

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Empiricism and Experience; Activism and Short-Termism; the Real World of Business

Harvard Law School Professor Lucian Bebchuk believes that shareholders should be able to control the material decisions of the companies they invest in. Over the years, he has written numerous articles expressing this view, including a 2005 article urging that shareholders should have the power to initiate a shareholder referendum on material corporate business decisions. In addition to his writings and speeches, Prof. Bebchuk has established and directs the Shareholder Rights Project at Harvard Law School for the purpose of managing efforts to dismantle classified boards and do away with other charter or bylaw provisions that restrain or moderate shareholder control of corporations (see “[Harvard’s Shareholder Rights Project is Wrong](#)” and “[Harvard’s Shareholder Rights Project is Still Wrong](#)”). In addition, Prof. Bebchuk has been at the forefront in arguing to the SEC that, despite the specific action of Congress in 2010 to empower the SEC to adopt a rule to require fair and prompt public disclosure of accumulations of shares by activist hedge funds and other blockholders, the SEC should not do so because it would limit the ability of activist hedge funds to attack corporations. In short, Prof. Bebchuk believes that shareholders should have the power to control the fundamental decisions of corporations – even those shareholders who bought their shares only a few days or weeks before they sought to assert their power, and regardless of whether their investment objective is short-term trading gains instead of long-term value creation.

While there is no question that almost every attack, or even rumor of an attack, by an activist hedge fund will result in an immediate increase in the stock market price of the target, such gains are not necessarily indicative of real value creation. To the contrary, the attacks and the efforts by companies to adopt short-term strategies to avoid becoming a target have had very serious adverse effects on the companies, their long-term shareholders, and the American economy. To avoid becoming a target, companies seek to maximize current earnings at the expense of sound balance sheets, capital investment, research and development and job growth. Indicative of the impact of shareholder pressure for short-term performance is the often cited comment by then-Citigroup CEO Chuck Prince in the July 9, 2007 *Financial Times*: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance.” Many commentators have cited pressure to boost short-term performance metrics as one of the causes of the 2008 fiscal crisis, such as Lynne Dallas in her 2012 article in the *Journal of*

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Corporation Law (“[t]he financial crisis of 2007-2009 was preceded by a period of financial firms seeking short-term profit regardless of long-term consequences”) and Sheila Bair in her last speech as FDIC chairman in 2011 (“the overarching lesson of the crisis is the pervasive short-term thinking that helped to bring it about”). Virtually all of the academic and government studies of the fiscal crisis have concluded that shareholder pressure was a contributing cause.

In August of this year, Prof. Bebchuk released an article describing what he characterized as empirical evidence that attacks by activist hedge funds do not harm companies and their long-term shareholders (see “[The Long-Term Effects of Hedge Fund Activism](#)”). I released a paper pointing out serious deficiencies in the methodology, analysis and conclusions that Prof. Bebchuk used and I cited an academic study questioning his statistics, an empirical study to the contrary and real-world experience and anecdotal evidence that activism and its concomitant short-termism destroy long-term value and damage the American economy (see “[The Bebchuk Syllogism](#)”; see also “[Current Thoughts About Activism](#)” and “[Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy](#)”). Apparently, my paper touched a raw nerve. In an attempt to resuscitate his promotion and justification of attacks by activist hedge funds, Prof. Bebchuk has published a new paper (“[Don’t Run Away from the Evidence: A Reply to Wachtell Lipton](#)”) accusing me of running away from the evidence; a serious accusation, but demonstrably untrue. Let’s take a look at some of the evidence (empirical, experiential, and overwhelming) that supports my views.

Empirical Evidence

It should be noted that Prof. Bebchuk’s claim that “supporters of the myopic activists view have failed to back their view with empirical evidence or even to test empirically the validity of their view” is patently false. In fact, numerous empirical studies over the years have produced results that conflict with those Prof. Bebchuk espouses. These other studies generally find that activism has a negative effect or no effect on long-term value, particularly when controlling for the skewing impact of a takeover of the target (which generally occurs at a premium regardless of whether the target is the subject of activism). This fact compels a careful assessment and critical review of his study to determine why his results differ from many prior studies – something I attempted to provide in my previous paper. I have provided below a brief, and admittedly incomplete, sampling of such studies.

Director Contests and Firm Performance

- According to Jonathan Macey and Elaine Buckberg in their 2009 “Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation,” there are “[s]everal studies [that] establish that when dissident directors win board seats, those firms underperform peers by 19% to 40% over the two years following the proxy contest.”
- One of those studies is David Ikenberry and Josef Lakonishok’s “Corporate Governance Through the Proxy Contest” (published in the *Journal of Business* in 1993), which reviewed 97 director election contests during a 20-year period in order to examine the long-term performance of targeted firms subsequent to a proxy contest. Their findings were striking: “When the incumbent board members successfully retain all board seats, cumulative abnormal returns are not significantly different from zero over the next 5 years. Yet, in proxy contests where dissidents obtain one or more seats, abnormal returns following resolution of the contest are significantly negative. Two years following the contest, the cumulative abnormal return has declined by more than 20%. The operating performance of these same firms during the postcontest period is also generally consistent with the pattern observed using stock returns.”
- Michael Fleming obtained similar results when looking at instances where a dissident obtains board representation in “New Evidence on the Effectiveness of the Proxy Mechanism,” a 1995 Federal Reserve Bank of New York research paper. Reviewing a sample of 106 threatened proxy contests between 1977 and 1988, Fleming found statistically significant negative returns of -19.4% in the 24 months following the announcement of a contested election for the 65 firms in his sample where dissidents won board seats – either as a result of a shareholder vote or a settlement. Fleming found that the majority of gains resulting from threatened proxy contests were “attributable to firms which [we]re acquired within one year of the outcome of the proxy contest,” suggesting that the gains were due to payment of a takeover premium (consistent with Greenwood and Schor’s findings described below), *not* from operating improvements or governance changes.
- Lisa Borstadt and Thomas Zwirlein found very similar results in “The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance,” published in *Financial Management* in 1992. These authors examined 142 exchange-traded firms involved in proxy contests for board representation over a 24-year period. They found the following: “A dissident victory in the proxy contest does not necessarily translate

into superior corporate performance. Positive abnormal returns over the proxy contest period are realized by firms in which the dissidents win the proxy contest and the firm is subsequently taken over. In contrast, no abnormal performance over the contest period is observed for the firms in which the dissidents win but the firm is not subsequently taken over. For these firms, large negative (although insignificant) cumulative returns are observed in the postcontest period.”

Shareholder Proposals and Firm Performance

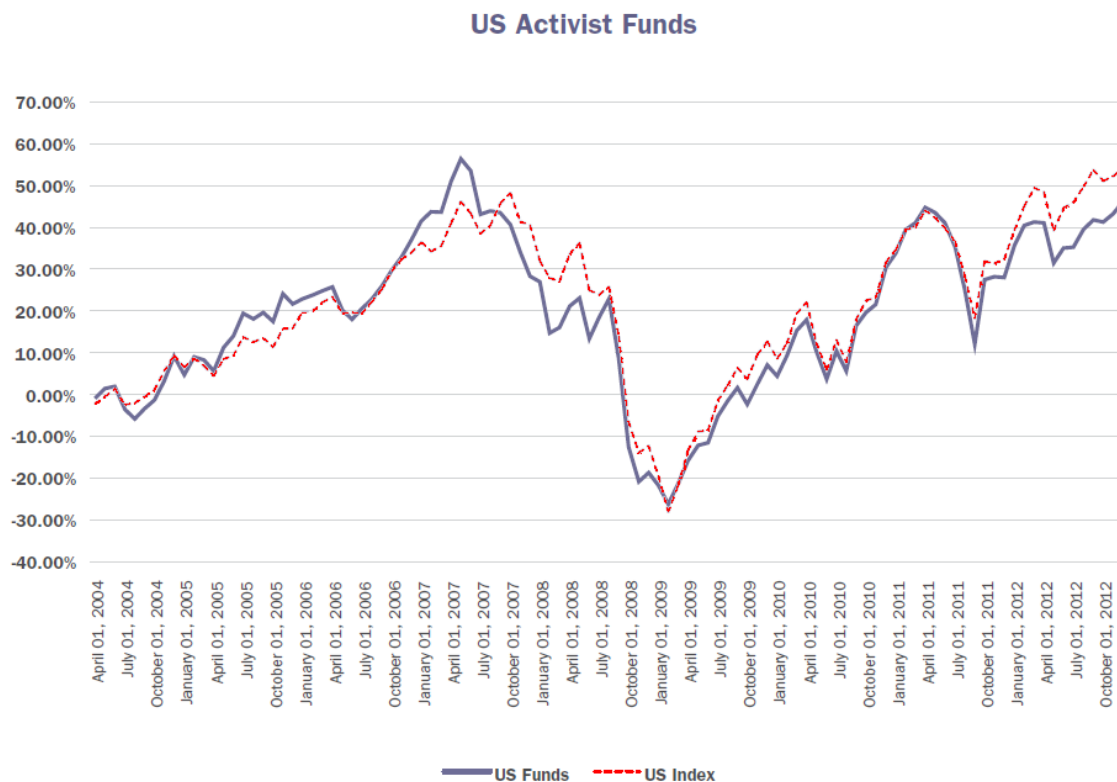
- In “Investor Activism and Takeovers,” published in the *Journal of Financial Economics* in 2009, Robin M. Greenwood and Michael Schor examined Schedule 13D filings by portfolio investors between 1993 and 2006 to investigate the effect of activist interventions on stock returns. They found the following: “[A]ctivism targets earn high returns primarily when they are eventually taken over. However, the majority of activism targets are not acquired and these firms earn average abnormal returns that are not statistically distinguishable from zero. . . . Thus, the returns associated with activism are largely explained by the ability of activists to force target firms into a takeover, thereby collecting a takeover premium.”
- In “Pension Fund Activism and Firm Performance,” published in the *Journal of Financial and Quantitative Analysis* in 1996, Sunil Wahal reviewed 356 “targetings” by the nine most active funds between 1987 and 1993. “Targetings” included both proxy proposals and nonproxy targeting, and were typically initiated by sending a letter to the target firm (either publicly or privately) followed by a telephone call from the activist fund. Wahal found that, while pension funds “are reasonably successful in changing the governance structure of targeted firms,” these changes have no impact on stock performance. According to Wahal, “targeting announcement abnormal returns are not reliably different from zero,” and “[t]he long-term abnormal stock price performance of targeted firms is negative prior to targeting and still is negative after targeting.” Wahal also found that “accounting measures of performance do not suggest improvements in operating or net income either; accounting measures of performance also are negative prior to and after targeting.”
- Two studies released by the U.S. Chamber of Commerce in partnership with Navigant Consulting reviewed shareholder proxy proposals between 2002-2008 and 2009-2012, respectively, for impact on firm performance. The studies, published in May 2009 and May 2013, both focused on shareholder proposals that were identified as “Key Votes” by the AFL-CIO in annual surveys during the respective time periods, including proposals reflecting board declassifications, proxy

access and director removal policies. In the first study, “Analysis of the Wealth Effects of Shareholder Proposals – Volume II,” Joao Dos Santos and Chen Song reviewed 166 shareholder proposals between 2002-2008 and found “no evidence of a statistically significant overall short-run or long-run improvement and some indication of a long-run decrease in market value for the firms in our sample.” In the second study, “Analysis of the Wealth Effects of Shareholder Proposals – Volume III,” which reviewed 97 shareholder proposals between 2009-2012, Allan T. Ingraham and Anna Koyfman came to similar conclusions: “We . . . find no conclusive or pervasive evidence that the shareholder proposals assessed in this study improve firm value or result in an economic benefit to pension plans and plan participants. Given that the proxy process imposes costs on both firms and shareholders, and given that there are no proven benefits in terms of corporate performance, the overall net benefit of these initiatives is likely negative.”

- Andrew K. Prevost and Ramesh P. Rao studied the impact of shareholder activism by public pension funds in their paper “Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?” (published in the *Journal of Business* in 2000), examining a total of 73 firms that received shareholder proposals during the period of 1988-1994. They came to the following conclusions: “Firms that are subject to shareholder proposals only once during the sample period experience transitory declines in returns, but firms that are subject to repeat shareholder proposals experience permanent declines in market returns. . . . Long-term changes in operating performance corroborate the event study results: firms targeted only once exhibit positive but insignificant long-term results, while those targeted repeatedly show strong declining performance.”

- Jonathan M. Karpoff, Paul H. Malatesta and Ralph A. Walkling reviewed 522 shareholder proposals at 269 companies between 1986 and 1990 to determine the impact of shareholder proposals on firm performance in “Corporate Governance and Shareholder Initiatives: Empirical Evidence,” published in the *Journal of Financial Economics* in 1996. After finding that “proposals are targeted at poorly performing firms,” they concluded that, notwithstanding this fact, the “average effect of shareholder corporate governance proposals on stock values is close to, and not significantly different from, zero.” In fact, “[s]ales growth declines for firms that receive proposals in relation to sales growth for control firms,” “[c]hanges in operating return on sales are not significantly larger for proposal firms than their controls, and are not significantly related to the persistence or intensity of proposal pressure, or to the sponsors’ identity,” and “[c]hange in operating ROA are not related to the pressure’s intensity or sponsors’ identity.”

- In “Less is More: Making Institutional Shareholder Activism a Valuable Mechanism of Corporate Governance,” published in the *Yale Journal on Regulation* in 2001, Yale Law School professor Roberta Romano conducted a review of the corporate finance literature on institutional investors’ corporate governance activities, involving seven different empirical studies and a total of over 4,500 individual shareholder proposals. She found that the shareholder proposals had “little or no effect on targeted firms’ performance” over the time periods considered in the studies and proposed that improvements might be achieved if the rules were revised “to require proposal sponsors either to incur the full cost of a losing proposal or a substantial part of the cost.”
- It is particularly noteworthy that CalSTRS, one of the major public employee pension funds and one of the leaders in proxy voting and investing in activist hedge funds, has recently reported that its aggregate investments in activist funds as of October 2012 trailed the United States public equity market, as shown by this chart from its annual report.



If activist funds fail to achieve attractive returns for their own investors, it raises the question whether pension funds and other fiduciary investors are actually promoting the best interests of the beneficiaries of the funds they manage when they invest in activist funds, given the fact that activist funds promote short-termism with its attendant costs to the rest of the market and to the economy as

a whole (see Leo E. Strine’s “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term,” published in *The Business Lawyer* in November 2010). This month the UK Law Commission published a consultation paper responding to a government request, based on the Kay Review discussed below, “To evaluate whether fiduciary duties (as established in law or as applied in practice) [of investment intermediaries] are conducive to investment strategies in the best interests of the ultimate beneficiaries. We are asked to carry out this evaluation against a list of factors, balancing different objectives, **including encouraging long-term investment strategies** [emphasis supplied] and requiring a balance of risk and benefit.”

Takeover Defenses and Firm Value

- Approaching the question from another perspective, William C. Johnson, Jonathan M. Karpoff and Sangho Yi investigated the impact of takeover defenses on firm value in “The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms” (April 29, 2013 working paper, available at <http://papers.ssrn.com/abstract=1923667>). Looking at a sample of 1,219 firms that went public between 1997 and 2005, the authors tested the “bonding hypothesis of takeover defenses” – that is, the theory that “takeover defenses increase the value of managers’ commitments to maintain their promised operating strategy and not to opportunistically exploit their counterparties’ investments in the IPO firm,” which, “in turn, encourages the firm’s counterparties to invest in the business relationship, yielding benefits for the IPO firm.” The authors reported the following findings:

(1) IPO firms deploy more takeover defenses when they have large customers, dependent suppliers, or strategic partners;

(2) The IPO firm’s value is positively related to its use of takeover defenses, particularly when it has large customers, dependent suppliers, and/or strategic partners;

(3) The IPO firm’s subsequent operating performance is positively related to its use of takeover defenses, particularly when it has large customers, dependent suppliers, and/or strategic partners;

(4) When the IPO firm announces its intention to go public, its large customers experience a change in share values that is positively related to the IPO firm's use of takeover defenses; and

(5) After the IPO, the longevity of the IPO firm's business relationship with its large customer is positively related to its use of takeover defenses.

According to the authors, these results are explained by the fact that "takeover defenses ... help to economize on the cost of building and maintaining value-increasing trading relationships between the IPO firm and its counterparties." As a result, "at IPO firms whose values depend heavily on their relationships with customers, suppliers, and strategic partners, takeover defenses appear to increase value by bonding the IPO firm's commitment to these relationships."

- In "The Impact of Antitakeover Amendments on Corporate Financial Performance" (published in *The Financial Review* in 2001), Mark S. Johnson and Ramesh P. Rao examined a sample of 649 antitakeover amendments adopted between 1979 and 1985 to determine the impact of the passage of antitakeover amendments on firm share price. Contrary to the management entrenchment hypothesis, the authors found that "antitakeover amendments are relatively benign events that do not significantly impact managerial behavior," and that "antitakeover amendments are not associated with deleterious effects to shareholders in terms of their impact on various fundamental firm performance measures."

Managerial Behavior and Pressures to Achieve Short-Term Performance

- Jie He and Xuan Tian's "The Dark Side of Analyst Coverage: The Case of Innovation" (forthcoming in the *Journal of Financial Economics*) examined the effect of analyst coverage on firm innovation to investigate how the pressure to achieve short-term performance impacts managerial behavior. The short-term pressures exerted by activist investors are often no different than those generated by stock analysts, and in many instances activist investors merely piggyback on stock analyst commentary when they launch attacks. Examining a sample of 25,860 firm-year observations relating to U.S. listed firms during the period of 1993-2005, He and Tian explored the "innovation output" of firms (as measured in terms of the number of (i) patent applications filed in a given year that are eventually granted and (ii) non-self citations each patent receives in subsequent years) in relation to the intensity of analyst coverage (as measured by the average number of

earnings forecasts issued for the firm each month). The authors found that “an exogenous average loss of one analyst following a firm causes it to generate 18.2% more patents over a three-year window than a similar firm without any decrease in analyst coverage” and that “an exogenous average loss of one analyst following a firm leads it to generate patents receiving 29.4% more non-self citations than a similar firm without any decrease in analyst coverage.” He and Tian determined that this evidence “is consistent with the hypothesis that analysts exert too much pressure on managers to meet short-term goals, impeding firms’ investment in long-term innovative projects.”

- Natalie Mizik published similar findings in “The Theory and Practice of Myopic Management,” featured in the *Journal of Marketing Research* in 2010. In this study, Mizik reviewed the operating performance, marketing spending, R&D spending and stock price performance of 6,642 firms between 1986 and 2005 to assess the financial consequences of the practice of cutting marketing and R&D spending to inflate short-term earnings. In order to isolate firms that were potentially engaging in “myopic management,” Mizik filtered for firms that simultaneously reported greater-than-normal profits, lower-than-normal marketing expenses and lower-than-normal R&D spending. Mizik then compared the stock performance of these “potentially myopic” firms against the performance of “nonmyopic” firms. Potentially myopic firms initially experienced much better stock performance than the firms that failed to meet performance expectations. However, after four years, “the portfolio of potentially myopic firms ha[d] a negative return of -15.7%, far below the return to the two nonmyopic benchmark portfolios (29.2% and 13.3%) and the S&P 500 return of 21.6%.” Mizik concludes that “[m]yopic management might have some short-lived benefits – it leads to higher current-term earnings and stock price – but it damages the long-term financial performance of the firm because the initial gains are followed by greater negative abnormal returns.”

- Aleksandra Kacperczyk’s “With Greater Power Comes Greater Responsibility?” (published in the *Strategic Management Journal* in 2009) tested the effect of takeover protection on the amount of corporate attention paid to shareholders and non-shareholding stakeholders, respectively. Looking at a sample of 878 firms between 1991 and 2002, Kacperczyk found that “an exogenous increase in takeover protection leads to higher corporate attention to community and the natural environment, but has no impact on corporate attention to employees, minorities and customers,” and that “firms that increase their attention to stakeholders experience an increase in long-term

shareholder value,” measured over the two-year and three-year periods following the increase in takeover protection.

- Other empirical studies have shown that pressure from investors with short investment horizons can influence management to engage in financial misreporting. In “Institutional Ownership and Monitoring: Evidence from Financial Misreporting” (published in the *Journal of Corporate Finance* in 2010), Natasha Burns, Simi Kedia and Marc Lipson examined a sample of firms that restated their earnings between 1997 and 2002, finding that ownership by “transient institutions” (those with short investment horizons) are positively related with an increase in the likelihood and severity of an accounting restatement. The authors concluded that “[i]t is precisely these institutions, which trade frequently and therefore are likely to focus management attention on short-term reported performance, that provide incentives to manipulate earnings.”
- Another relevant study coming out of the financial crisis examined whether the corporate governance characteristics of banks impacted the likelihood of banks requiring government “bailout” support during the financial crisis. In “Shareholder Empowerment and Bank Bailouts” (a 2012 working paper), Daniel Ferreira, David Kershaw, Tom Kirchmaier and Edmund Schuster created a “management insulation” index ranking the degree of banks’ management insulation based on their charter and by-law provisions and on the provisions of the applicable state corporate law that make it difficult for shareholders to oust management. They found that, in a sample of U.S. commercial banks, banks in which managers are “fully insulated” from shareholders were roughly 19 to 26 percentage points less likely to receive state bailouts than banks whose managers were subject to stronger shareholder rights. The authors explained that “[b]ank shareholders may have incentives to increase risk taking beyond the socially-optimal level” and that, “in search for higher returns, bank shareholders had incentives to push their banks towards less traditional banking activities.”
- In his article “Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Value?” (published in *Contemporary Accounting Research* in 2001), Brian Bushee examined a sample of 10,380 firm-years between 1980 and 1992 to determine whether institutional investors exhibit preferences for near-term earnings over long-run value. Bushee found that “the level of ownership by institutions with short investment horizons (transient institutions) and by institutions held to stringent fiduciary standards (banks) is positively (negatively) associated with the amount of value

in near-term (long-term) earnings.” Bushee found no evidence that banks “myopically price” firms by overweighting short-term earnings potential and underweighting long-term earnings potential. However, in transient institutions “high levels of transient ownership are associated with an over-(under-) weighting of near-term (long-term) expected earnings and a trading strategy based on this finding generates significant abnormal returns. This finding supports the concerns that many corporate managers have about the adverse effects of an ownership base dominated by short-term-focused institutional investors.”

- The above result is consistent with an earlier empirical study by Bushee that examined the influence of shareholder demographics on earnings management by managers. In “The Influence of Institutional Investors on Myopic R&D Investment Behavior,” published in the *Accounting Review* in 1998, Bushee investigated whether institutional investors create or reduce incentives for corporate managers to reduce investment in research and development to meet short-term earnings goals. Examining a sample of all firm-years between 1983 and 1994 with available data, Bushee found that “a high proportion of ownership by institutions exhibiting transient ownership characteristics (*i.e.*, high portfolio turnover, diversification, and momentum trading) significantly increases the probability that managers reduce R&D to boost earnings.” Bushee believed that “[t]his result supports the widely-argued view that short-term-oriented behavior by institutions creates pressures for managers to sacrifice R&D for the sake of higher current earnings” among those firms with high levels of transient ownership.

- William Pugh, Daniel Page and John Jahera, Jr.’s “Antitakeover Charter Amendments: Effects on Corporate Decisions” (published in the *Journal of Financial Research* in 1992) tested whether managers adopt a longer-term investment strategy after their firm passes antitakeover charter amendments. Examining a sample of firms that adopted antitakeover charter amendments between 1978 and 1985, the authors found that “firms increase spending on fixed capital as a percentage of both sales and assets the year of passage and for several years thereafter,” and that overall results with respect to R&D expenditures “appear to support the managerial myopia hypothesis.”

- A recent survey of 1,038 board members and executives by McKinsey & Company and the Canada Pension Plan Investment Board found startling levels of short-term orientation among corporate executives. As reported in the *Wall Street Journal* on May 22, 2013, this study found the following:

- Sixty-three percent of business leaders indicated the pressure on their senior executives to demonstrate strong short-term financial performance has increased in the past five years.
 - Seventy-nine percent of directors and senior executives said they felt the most pressure to demonstrate strong financial performance over a time period of less than 2 years. Only 7% said they felt pressure to deliver strong financial performance over a horizon of 5 or more years.
 - However, respondents identified innovation and strong financial returns as the top two benefits their company would realize if their senior executives took a longer-term view to business decisions.
 - Yet, almost half of respondents (44%) said that their company's management team currently uses a primary time horizon of less than 3 years when they conduct a formal review of corporate strategy. Seventy-three percent said this primary time horizon should be more than 3 years and 11% said the horizon should be more than 10 years.
- The McKinsey findings are consistent with an earlier study published in the *Financial Analysts Journal* in 2006. In “Value Destruction and Financial Reporting Decisions,” John Graham, Campbell Harvey and Shiva Rajgopal described the results of a survey of 401 senior financial executives. Going a step further than the McKinsey study, the authors asked executives if they would be willing to sacrifice long-term value in order to smooth earnings. An “astonishing 78% admit[ted] they would sacrifice a small, moderate or large amount of value to achieve a smoother earnings path.”

Short-Termism and Macroeconomic Productivity

- The problems discussed above have larger implications than simply the performance of individual firms. In his 2012 book, Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies, Pavlos Masouros used macroeconomic data to show that the shift in corporate governance toward shareholder interests and increasing short-termism in France, Germany, the Netherlands, the UK and the US have contributed to low GDP growth rates in those countries since the early 1970s. Masouros

outlined the unfolding of a “Great Reversal in Corporate Governance” whereby the primacy of shareholder value in the corporate governance pecking order was established, as well as a “Great Reversal in Shareholdership” where the average holding period of shares rapidly decreased, both of which contributed to a dramatic increase in the average equity-payout ratio of firms and a decrease in the average capital retention and reinvestment of profits by firms. Masouros’ prescription for ameliorating this trend away from capital reinvestment is what he calls “Long Governance” – moving toward a system where shareholders are infused with incentives that would allow them to develop long-term horizons that would align their interests with other constituencies and increase companies’ incentives to invest in future productivity.

- In “The Kay Review of UK Equity Markets and Long-Term Decision Making,” published by the UK Department for Business Innovation and Skills in July 2012 (the “Kay Review”), John Kay examined how the structure of the UK equity markets encourages short-termism and discussed the impact on UK businesses and investors. Kay started with the observation that “[a]s a percentage of GDP, research and development expenditure by British business has been in steady decline” and proceeded to explore why this was the case. He then identified a fundamental misalignment of the interests of the UK asset management industry and the ultimate principals, the companies which use equity markets and the individual UK “savers” who provide funds to them: “Returns to beneficial owners, taken as a whole, can be enhanced only by improving the performance of the corporate sector as a whole. Returns to any subset of beneficial owners can be enhanced, at the expense of other investors, by the superior relative performance of their own asset managers. Asset managers search for alpha, risk adjusted outperformance relative to a benchmark. But savers collectively will earn beta, the average return on the asset class.” This misalignment exists because “the time horizons used for decisions to hire or review investment managers are generally significantly shorter than the time horizon over which the saver, or the corporate sponsor of a pension scheme, is looking to maximize a return.” Kay pointed out that “[c]ompetition between asset managers to outperform each other by anticipating the changing whims of market sentiment ... can add nothing, in aggregate, to the value of companies ... and hence nothing to the overall returns to savers.” Predictably, the short-term incentives of asset managers flow down to corporate managers, many of whom are incentivized “to make decisions whose immediate effects are positive even if the long run impact is not” and “whose consequences are likely to be apparent within a short time scale.” After describing the problem in great detail, Kay presented a series of recommendations that he believed “will help to deliver the improvements to equity markets necessary to support sustainable long-term

value creation by British companies,” including the recommendation that “regulation must be directed towards the interests of market users – companies and savers – rather than the concerns of market intermediaries.” The applicability of Kay’s analysis to American equity markets is obvious.

The Evidence of Experience

No matter how much Professor Bebchuk attempts to denigrate what he calls “anecdotal” evidence, the experiences of those with “boots on the ground” must be taken into consideration in combination with the empirical evidence sampled above. Take, for example, some of the statements below from leaders who have firsthand experience with the short-term pressures faced by public company managers and directors.

- Bill George, a professor at Harvard Business School, former chief executive of the medical device company Medtronic, and currently a director of Goldman Sachs and Exxon Mobil, recently said in his August 2013 *New York Times* article, *Activists Seek Short-Term Gain, Not Long-Term Value*: “While activists often cloak their demands in the language of long-term actions, their real goal is a short-term bump in the stock price. They lobby publicly for significant structural changes, hoping to drive up the share price and book quick profits. Then they bail out, leaving corporate management to clean up the mess. Far from shaping up these companies, the activists’ pressure for financial engineering only distracts management from focusing on long-term global competitiveness.”
- Warren Buffet and 27 other highly regarded businesspeople, academics, investment bankers and union leaders expressed concerns about short-termism in “Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management,” a 2009 Aspen Institute policy statement. In this paper, these leaders voiced concern that “boards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation,” and that this trend toward short-term objectives has “eroded faith in corporations continuing to be the foundation of the American free enterprise system.” In particular, they noted that “the focus of some short-term investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managements and boards pursue strategies simply to satisfy those short-term investors,” which “may put a corporation’s future at risk.”

- Dominic Barton, global managing director of McKinsey & Company, described the problem in “Capitalism for the Long-Term,” a 2012 McKinsey publication: “[E]xecutives must do a better job of filtering input and should give more weight to the views of investors with a longer-term, buy-and-hold orientation. . . . If they don’t, short-term capital will beget short-term management through a natural chain of incentives and influence. If CEOs miss their quarterly earnings targets, some big investors agitate for their removal. As a result, CEOs and their top teams work overtime to meet those targets. The unintended upshot is that they manage for only a small portion of their firm’s value. When McKinsey’s finance experts deconstruct the value expectations embedded in share prices, we typically find that 70 to 90 percent of a company’s value is related to cash flows expected three or more years out. If the vast majority of most firms’ value depends on results more than three years from now, but management is preoccupied with what’s reportable three months from now, then capitalism has a problem.”

- Daniel Vasella, former chairman and CEO of Novartis AG, spoke firsthand about the pernicious effects of the pressure created by such short-term expectations in a 2002 *Fortune* article: “Once you get under the domination of making the quarter – even unwittingly – you start to compromise in the gray areas of your business, that wide swath of terrain between the top and bottom lines. Perhaps you’ll begin to sacrifice things (such as funding a promising research-and-development project, incremental improvements to your products, customer service, employee training, expansion into new markets, and yes, community outreach) that are important and that may be vital for your company over the long term.”

A Proposal for Effective Shareholder Engagement

In laying out the evidence above, I do not mean to say that all forms of investor engagement are bad. To the contrary, I believe that collaborative interaction between boards and long-term shareholders can help increase the effectiveness of boards. Consider the observations of John Kay in the Kay Review. Kay encouraged “effective engagement” between asset managers and the companies they invest in. However, he did not hold all forms of engagement equal, arguing instead that all participants in the equity investment chain should act according to the principles of what he calls “stewardship”: “Our approach, which emphasizes relationships based on trust and respect, rooted in analysis and engagement, develops and extends the existing concept of stewardship in equity investment. This extended concept of stewardship requires that the skills and knowledge of

the asset manager be integrated with the supervisory role of those employed in corporate governance: it looks forward to an engagement which is most commonly positive and supportive, and not merely critical.” Kay recommends that company directors “facilitate engagement with shareholders, and in particular institutional shareholders such as asset managers and asset holders, based on open and ongoing dialogue about their long-term concerns and investment objectives.” But, importantly, he also emphasizes that directors should “not allow expectations of market reaction to particular short-term performance metrics to significantly influence company strategy.”

I support Kay’s views on what constitutes “effective engagement” and believe shareholder collaboration with management and directors along these lines could be a value-enhancing development for many companies both in the short-run and long-run.

Standing Firm, Not Running Away

As to Professor Bebchuk’s allegation, I think it is clear that, far from “running away” from the evidence, my views and my colleagues’ views are supported by many highly respected academics, policymakers, investors and business leaders whose empirical analyses and real-world experiences show that most activist interventions contribute to managerial short-termism and harm the innovation and growth potential of American companies. It is also clear that empirical evidence must be considered in context with other forms of evidence, including macroeconomic analysis, real-world experience and common sense, to determine if it tells a story that makes sense in the real world.

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A Response to Bebchuk and Jackson's
Toward a Constitutional Review of the Poison Pill

In a recent [paper](#), Professors Lucian Bebchuk and Robert Jackson have extended Professor Bebchuk's extreme and eccentric campaign against director-centric governance into a new realm—that of the Constitution of the United States. They claim that “serious questions” exist about the constitutionality of the poison pill—or, more precisely, “about the validity of the state-law rules that authorize the use of the poison pill.” It is likely, they argue, that these state-law rules violate the Supremacy Clause of the Constitution, and are thus preempted, because they frustrate the purposes of the Williams Act, the 1968 federal statute that governs tender-offer timing and disclosure.

Bebchuk and Jackson cite leading academic textbooks and articles that either recognize the preeminence of the poison pill in takeover defense or demonstrate the weakness of preemption challenges to state takeover statutes. The scholars authoring these books and articles, we are told, “overlooked” or “ignored” the obvious fact that poison pills may delay tender offers for lengthy periods of time. Bebchuk and Jackson profess “surpris[e]” that the constitutional issue they discuss “has received little attention, or even notice, from commentators,” and assert that it is rather a shocking “oversight” that, despite a “large literature” on Williams Act preemption, “commentators and practitioners” have devoted “little attention to the question of whether the state-law rules with the most powerful antitakeover effect—the rules authorizing use of the poison pill—are preempted.”

And, as far as courts are concerned, Bebchuk and Jackson claim that their discovery of the pill's unconstitutionality is utterly brand new: “litigation based on ... a claim” that “state-law poison-pill rules may well be preempted has not yet been pursued.” Bebchuk and Jackson definitively declare that “*no court* has ever expressly considered a preemption challenge to the validity of state-law poison-pill rules.” (Emphasis added.) It is for this reason, they insist, that “the courts have not yet resolved” the question. Were a preemption challenge to the poison pill to be brought now for the first time, they argue, courts would likely look to whether the pill permits “tender offerors ... a meaningful opportunity to successfully acquire the target and whether shareholders are given an opportunity to evaluate the merits of tender offers.” This test, they posit, the pill would fail.

Bebchuk and Jackson's paper is tendentious and misleading—and, in material respects, simply wrong. It is not a work of serious scholarship. It is an attempt at advocacy, but fails even at that. From their paper, a reader would never know

- that, in 1985, in the landmark *Household* litigation that established the validity of the poison pill, the Delaware Supreme Court [expressly rejected](#) the plaintiff's argument that, were it construed to allow the pill, Delaware law would be preempted by the Williams Act;
- that, in an important [decision](#) in 1995, the United States Court of Appeals for the Fourth Circuit rejected a bidder's preemption challenge to a statute that not only

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authorized poison pills, but also cloaked directors' decisions regarding pills with the powerful protections of a traditional, plain-vanilla, no-heightened-scrutiny business-judgment rule;

- that this Fourth Circuit decision not only explicitly rejected Bebchuk and Jackson's "meaningful opportunity" standard, but also held that a state's "decision to allow management access to a set of defensive mechanisms in the takeover situation"—including, and especially, the pill—in no way "frustrates the Williams Act's goal of investor protection," and is thus not preempted, even if those defensive mechanisms "work to give target management an advantage in the tender offer context";
- that, in the [leading decision](#) addressing Williams Act preemption challenges to state antitakeover laws, the United States Court of Appeals for the Seventh Circuit, in an opinion by Judge Frank Easterbrook, rejected such a challenge in part because "*firms issue and state law enforces poison pills*" and other "devices [that] make tender offers unattractive ([or] even impossible)"—and stated that "[n]one of these devices could be thought preempted by the Williams Act";
- that, in the same decision, the Seventh Circuit held that "rules governing the internal affairs of corporations ... are not preempted by the Williams Act," that "investors have no right to receive tender offers," and that, "[m]ore to the point[,] ... the Williams Act does not create a right to profit from the business of making tender offers";
- that the Seventh and Fourth Circuit decisions represent the law on Williams Act preemption today; and
- that the district court decisions from which Bebchuk and Jackson derive their "meaningful opportunity" standard are based upon an overly expansive and now discredited view of Williams Act preemption that commanded the support of, at most, only three members of the Supreme Court some 32 years ago.

Bebchuk and Jackson's article thus conveys a fanciful vision of Williams Act preemption standards that in no way reflects the true state of the law today. To set the record straight, we set forth here a short history of Supremacy Clause challenges to takeover statutes and to the poison pill.

The Supremacy Clause, the Williams Act, and the Act's History and Purpose

The Constitution's Supremacy Clause provides that "[t]his Constitution, and the Laws of the United States made in Pursuance thereof ... shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." It thus renders a state law ineffective—preempted—whenever that law conflicts with a federal statute.

Whether state law is preempted by federal law turns on Congress’s intent and purpose in enacting the federal law. Preemption can occur in several ways. Congress can expressly preempt state law by explicitly barring state law from applying to a particular matter. State law can also be impliedly preempted. Implied preemption occurs when a state law directly conflicts with federal law—when it is impossible to comply with the requirements of both state and federal law. It also occurs when federal law has so occupied the field, so pervasively regulated a particular subject, that application of state law must be precluded. Finally, implied preemption occurs when a challenged state law “stands as an obstacle to the full accomplishment and execution of the full purposes and objectives of Congress.”

It is on this last prong of preemption that Bebchuk and Jackson hang their hats. They argue that, in enacting the Williams Act in 1968, Congress sought to “give tender offerors a ‘meaningful opportunity for success,’” and to “set[] a floor”—a *substantive* floor—“for the level of protection shareholders must receive in connection with tender offers.” As a result, they say, “current state-law poison pill rules” should be declared preempted because “these rules give hostile offerors *no* practical opportunity for success,” as “they allow incumbents to block a hostile offer from shareholder consideration for long periods of time,” and because the “state-law rules today empower directors to adopt arrangements that permit incumbents, rather than investors, to decide whether shareholders may accept a tender offer.”

These arguments are premised upon a gross overreading of the Williams Act. The Williams Act does *not* give hostile offerors a substantive right to have their offers succeed, and does not even give shareholders a right to receive such offers. And it does not remotely betray any intent to overturn any state law, statutory or decisional, that addresses the fiduciary duties of directors in matters relating to corporate control—or, for that matter, any *substantive* aspect of the relationships among shareholders, directors, and the corporation.

To the contrary, the Williams Act was a simple and narrow law. It was also commendably short, barely over four pages long; so that the reader can see it for himself or herself, we link to it [here](#). It regulates only the *process* of tender offers. It thus addresses the disclosures that offerors must make, and when they must make them. It addresses the timing of offers—how long stockholders must have to withdraw their tendered shares. It addresses the terms of permissible offers, requiring bidders to pay the same price to all tendering shareholders, and requiring, in the event of oversubscription in partial offers, purchases to be prorated among all who tendered shares. Finally, the law contains a broad antifraud provision governing disclosures and practices in connection with tender offers.

Just as nothing in the law’s text suggests that state fiduciary-duty law is to be disturbed, nothing in the legislative history does either. That history is also short and clear; for the reader’s convenience, we have posted the relevant House and Senate reports [here](#) and [here](#). The legislative history makes clear that Congress in 1968 was concerned with unfair tactics of hostile offerors—in particular, the then-burgeoning practice of “Saturday night special” tender offers, by which bidders would suddenly launch a quickly expiring offer over a weekend in order to coerce and stampede shareholders into tendering. As the Supreme Court explained in [Piper v. Chris-Craft Industries](#), quoting the floor statement of a Senate cosponsor:

The legislative history thus shows that Congress was intent upon regulating takeover bidders, theretofore operating covertly, in order to protect the shareholders of target companies. That tender offerors were not the intended beneficiaries of the bill was graphically illustrated by the statements of Senator Kuchel, cosponsor of the legislation in support of requiring takeover bidders, whom he described as “corporate raiders” and “takeover pirates,” to disclose their activities.

“Today there are individuals in our financial community who seek to reduce our proudest businesses into nothing but corporate shells. They seize control of the corporation with unknown sources, sell or trade away the best assets, and later split up the remains among themselves. The tragedy of such collusion is that the corporation can be financially raped without management *or shareholders* having any knowledge of the acquisitions. ... The corporate raider may thus act under a cloak of secrecy while obtaining the shares needed to put him on the road to a successful capture of the company.”

Despite this overarching concern about “corporate raiders” and “takeover pirates” engaging in “financial rape[]” under a “cloak of secrecy,” Congress nevertheless was, as the Court put it in *Piper*, “plainly sensitive to the suggestion that the measure would favor one side or the other in control contests.” And that is why Congress chose to pass only a limited measure governing the *process* of tender offers—in particular, *disclosure*. As the Court in *Piper* explained, the Williams Act’s sponsors

made it clear that the legislation was designed solely to get needed information to the investor, the constant focal point of the committee hearings. Senator Williams articulated this singleness of purpose, even while advocating neutrality:

“We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids. *S. 510 is designed solely to require full and fair disclosure for the benefit of investors.*”

In short, as the Supreme Court explained in [Rondeau v. Mosinee Paper Corp.](#), “[t]he purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information regarding the qualifications and intentions of the offering party.” As a result, nothing about the Williams Act suggests that Congress intended in any way to regulate or restrict the substantive powers of directors to respond to takeover bids, or to otherwise displace the state law that controls a corporation’s internal affairs. To the contrary, as far as those matters were concerned, and apart from matters of disclosure, Congress sought to be neutral and evenhanded—it chose to leave the balance between targets and bidders, as established by state law, *alone*.

Justice White’s Misreading of the Williams Act in *Edgar v. MITE Corp.*

In arguing the contrary, Bebchuk and Jackson rely on an opposing view of the Williams Act that was suggested over 30 years ago by only three Justices of the Supreme Court—a view that has *never* commanded a majority. In 1982 in [Edgar v. MITE Corp.](#), the Supreme Court addressed a constitutional challenge, under the Commerce and Supremacy

Clauses, to a so-called “first generation” takeover statute. The challenged Illinois law prohibited tender offers for the shares of any firm with substantial shareholdings in Illinois unless the offer were approved as fair by the Illinois secretary of state. The Seventh Circuit had struck the law as both violating the Commerce Clause and preempted by the Williams Act.

By a vote of 6 to 3, the Supreme Court affirmed—but *only* reached the Commerce Clause challenge. The Court did *not* render any holding on the Williams Act preemption claim. In an opinion on behalf of only himself, Chief Justice Burger, and Justice Blackmun, however, Justice White wrote that, in his view, the Illinois law conflicted with the Williams Act and thus violated the Supremacy Clause as well. Expressing an expansive view that Bebchuk and Jackson today seek to resurrect, Justice White argued that the “policy of neutrality” and ““evenhandedness”” embodied in the Williams Act meant that “Congress intended to strike a balance [among] the investor, management, and the takeover bidder.” In other words, Justice White argued that Congress intended to strike and enforce its *own* evenhanded balance between targets and bidders—and not simply that Congress sought to be neutral and evenhanded as to the balance already struck by *state* law. Justice White’s view represents a stunningly capacious, and ultimately insupportable, view of the purposes of the Williams Act: as one court of appeals later crisply explained, “it is a big leap from saying that the Williams Act does not itself exhibit much hostility to tender offers to saying that it implicitly forbids states to adopt more hostile regulations.”

Six Justices in *MITE* did not join in Justice White’s leap. Three Justices declined to address the merits at all, finding the case nonjusticiable because it was either moot or unripe. One Justice declined to address preemption because it was unnecessary to do so in light of the Court’s Commerce Clause holding. Two Justices, however, squarely rejected Justice White’s idiosyncratic interpretation of the Williams Act. Justice Stevens refused to join that approach because he was “not persuaded ... that Congress’ decision to follow a policy of neutrality in its own legislation is tantamount to a federal prohibition against state legislation designed to provide special protection for incumbent management.” And Justice Powell “agree[d] with Justice Stevens that the Williams Act’s neutrality policy does not necessarily imply a congressional intent to prohibit state legislation designed to assure—at least in some circumstances—greater protection to interests that include but often are broader than those of incumbent management.”

Even though Justice White’s views of the Williams Act failed to convince a majority, bidders and others immediately seized on those views to launch further attacks on other takeover laws and defensive measures. In fact, in 1984, in *Moran v. Household International, Inc.*—the landmark Delaware litigation establishing the validity of the poison pill—the plaintiffs, citing Justice White’s opinion, [expressly argued](#) in both the Delaware Court of Chancery and the Delaware Supreme Court that, were it construed to authorize the pill, Delaware law would be preempted by the Williams Act because it would “upset[] the neutrality between a tender offeror and target management which Congress sought to establish through the Williams Act.” The plaintiffs even received support from an amicus brief filed by the Securities and Exchange Commission, which stopped short of arguing that Delaware law would be preempted, but nonetheless asserted that the pill was “a practice more extreme than” takeover statutes and would “frustrate the shareholder choice that Congress and the Commission have viewed as being in the shareholder interest.” For its part, in its seminal decision, [the Delaware Supreme Court rejected the preemption challenge to the pill](#), and held that the directors’ actions in approving the pill

“provide[d] an insufficient nexus to the state for there to be state action which may violate the ... Supremacy Clause.”

Second-Generation Takeover Laws Are Upheld:
CTS Corp. v. Dynamics Corp. of America

Justice White’s commodious view of the Williams Act’s preemptive scope fared no better with his colleagues in [*CTS Corp. v. Dynamics Corp. of America*](#), a 1987 decision that represents the Supreme Court’s only other encounter with takeover defense. *CTS* presented Commerce Clause and Supremacy Clause challenges to a “second generation” takeover statute—an Indiana statute that provided that a bidder’s shares lose their voting power unless either the target’s directors approved the acquisition, or the target shareholders not affiliated with the bidder or management did so. The Seventh Circuit struck down this law as well, again on both Commerce Clause and preemption grounds.

This time, however, the Supreme Court reversed, and upheld the statute by a 6-to-3 vote. Justice White dissented—and was the *only* Justice who argued that the Indiana law was preempted. Justice Powell’s opinion for the Court squarely rejected the preemption claim. In doing so, the Court pointedly noted that Justice White’s “opinion in *MITE* did not represent the views of a majority of the Court”—that it was joined “*only* by Chief Justice Burger and by Justice Blackmun,” and that “[t]wo Justices disagreed with Justice White’s conclusion.” As a result, the Court emphasized, “we are not bound by its reasoning.” The *CTS* Court nevertheless applied its understanding of Justice White’s approach in *MITE* for the sake of argument—and found that “the Indiana Act passes muster even under the broad interpretation of the Williams Act articulated by Justice White in *MITE*.” As a result, in rejecting the bidder’s preemption argument in *CTS*, the Court did not issue a definitive holding on the Williams Act’s overall preemptive scope.

Still, the Court’s opinion in *CTS* made a number of statements that made clear its skepticism about expansive Williams Act preemption—and in particular, its respect for the states’ historic and traditional prerogative in establishing principles of corporate law. “[I]f it were construed to pre-empt any state statute that may limit or delay the free exercise of power after a successful tender offer,” the Court observed, “the Williams Act would pre-empt a variety of state corporate laws of hitherto unquestioned validity.” As examples, the Court cited staggered boards and cumulative voting—both of which could serve to “delay ... the ability of offerors to gain untrammelled authority over the affairs of the target corporation.”

All of this strongly cut *against* preemption, in the Court’s view:

The longstanding prevalence of state regulation in this area suggests that, if Congress had intended to pre-empt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly. [Emphasis added.]

And, quite notably, the Court in *CTS* also observed that the Indiana statute was designed to protect shareholders against coercive tender offers in which stockholders are forced to tender for fear of receiving diminished value in a back-end, second-step transaction. That aim,

the Court noted, was quite consonant with, and not contrary to, the policies underlying the Williams Act:

The desire of the Indiana Legislature to protect shareholders of Indiana corporations from this type of coercive offer does not conflict with the Williams Act. Rather, it furthers the federal policy of investor protection. [Emphasis added.]

Williams Act Preemption After *CTS*:
the “Meaningful Opportunity” Test

Given the Supreme Court’s obvious misgivings about preemption of state corporate law, virtually all Williams Act preemption challenges to takeover statutes thereafter *failed*—other than those involving first-generation state takeover statutes, or state statutes imposing [disclosure obligations](#) that specifically “intrude[d] upon” the Williams Act’s scheme “for regulating disclosure” and thus created “an ‘actual conflict between federal and state law’” on “disclosure regulation.”

Most of the post-*CTS* cases involved challenges brought in 1988 and 1989 to “third generation” takeover statutes, such as Section 203 of the Delaware General Corporation Law. Generally speaking, these third-generation takeover statutes—also known as “business combination” laws—prohibit a would-be acquirer from engaging in a back-end merger with a target if the acquirer purchases a certain threshold percentage of the target’s stock without first obtaining the approval of the target’s board. These laws were consistently found to be consonant with the Williams Act and thus constitutional.

Some courts reached this conclusion by following the approach that the Supreme Court took in *CTS*: they assumed the validity of Justice White’s capacious view of the Williams Act, but found the preemption claims to be meritless anyway. Thus, for example, in a leading case addressing Delaware’s Section 203, [RP Acquisition Corp. v. Staley Continental, Inc.](#), the federal district court in Delaware applied Justice White’s “‘broad interpretation’” “for the sake of argument,” and, given its conclusion that “Section 203 survives [that] standard,” saw no need to “explore what narrower standard the *CTS* court might have approved.” *RP Acquisition*, and other district court cases like it, went on to apply a standard that Bebchuk and Jackson now argue should doom the poison pill—the “meaningful opportunity for success” test. The third-generation laws were not preempted by the Williams Act, these courts held, because hostile bidders still had a meaningful opportunity for success.

Judge Easterbrook’s Landmark Opinion in
Amanda Acquisition v. Universal Foods

But these cases, decided in 1988 and 1989, did not provide the final word on the question of Williams Act preemption. To the contrary, that word comes from two seminal court of appeals decisions that decisively *rejected* the “meaningful opportunity for success” test—and effectively put to rest Justice White’s erroneous view of the Williams Act. These appellate decisions leave no doubt today that state laws governing poison pills are entirely constitutional. Indeed, both of the decisions so stated, and one of the two expressly so held.

The first was the Seventh Circuit’s powerful decision in 1989 in [*Amanda Acquisition Corp. v. Universal Foods Corp.*](#)—a case that our Firm briefed, argued, and won. *Amanda Acquisition* rejected a bidder’s constitutional challenges to Wisconsin’s third-generation takeover law. Interestingly enough, the opinion’s author was none other than Judge Frank Easterbrook—a former University of Chicago law professor who, as a corporate law scholar, had published an [article](#) that directly attacked [our Firm’s views](#) on the role that directors should and must properly play in protecting companies from hostile takeover bids. Then-Professor Easterbrook’s article famously took the extreme position that directors’ fiduciary duties should prohibit any and all defensive tactics, and instead should require directors to be entirely passive in response to all hostile bids. Needless to say, he was no friend of takeover statutes, or of the pill. In fact, in *Amanda Acquisition* itself, as a matter of policy, he strongly criticized both.

But even Judge Easterbrook recognized that the Williams Act, and the Constitution, did nothing to preclude them. “Skepticism about the wisdom of a state’s law,” he wrote, “does not lead to the conclusion that the law is beyond the state’s power.” Reviewing *MITE* and *CTS*, he noted that “[p]reemption has not won easy acceptance among the Justices for several reasons.” Among these, he explained, was “the traditional reluctance of federal courts to infer preemption of ‘state law in areas traditionally regulated by the States.’” That reluctance was of particular significance here, he observed, because “[s]tates have regulated corporate affairs, including mergers and sales of assets, since before the beginning of the nation.”

As for the Williams Act, Judge Easterbrook’s opinion for the Seventh Circuit went on to observe that, “[t]o say Congress wanted to be neutral between bidder and target ... is not to say that it also forbade the states to favor one of these sides.” “Nothing in the Williams Act says that the federal compromise among bidders, targets’ managers, and investors is the only permissible one.” “Every law has a stopping point,” the court added, and the Williams Act’s stopping point was that it merely “regulates the *process* of tender offers: timing, disclosure, proration if tenders exceed what the bidder is willing to buy, best-price rules.” And that was why, Judge Easterbrook explained, the Supreme Court had upheld the Indiana second-generation vote-sterilization provision that was at issue in *CTS*: in the Williams Act, “Congress said nothing about the voting power of shares acquired in tender offers.”

Most importantly, the Seventh Circuit explained how *CTS* made clear that the Williams Act could not be deemed to preempt state laws “governing the internal affairs of corporations,” no matter what effect those laws might have on takeover bids:

CTS observed that laws affecting the voting power of acquired shares do not differ in principle from many other rules governing the internal affairs of corporations. Laws requiring staggered or classified boards of directors delay the transfer of control to the bidder; laws requiring [a] supermajority vote for a merger may make a transaction less attractive or impossible. Yet these are not preempted by the Williams Act, any more than state laws concerning the *effect* of investors’ votes are preempted by the portions of the Exchange Act regulating the process of soliciting proxies. Federal securities laws frequently regulate process while state corporate law regulates substance. Federal proxy rules demand that firms disclose many things, in order to promote informed voting. Yet states may permit or compel a supermajority rule (even

a unanimity rule) rendering it all but impossible for a particular side to prevail in the voting. Are the state laws therefore preempted?

The court went on to list other defensive practices and devices that were permissible under state law and simply could not “be thought [to be] preempted by the Williams Act or the proxy rules.” *The list included **poison pills**:*

How about state laws that allow many firms to organize without traded shares? Universities, hospitals, and other charities have self-perpetuating boards and cannot be acquired by tender offer. Insurance companies may be organized as mutuals, without traded shares; retailers often organize as co-operatives, without traded stock; some decently large companies (large enough to be “reporting companies” under the ‘34 Act) issue stock subject to buy-sell agreements under which the investors cannot sell to strangers without offering stock to the firm at a formula price; Ford Motor Co. issued non-voting stock to outside investors while reserving voting stock for the family, thus preventing outsiders from gaining control (dual-class stock is becoming more common); ***firms issue and state law enforces poison pills***. *All of these devices make tender offers unattractive (even impossible) and greatly diminish the power of proxy fights, success in which often depends on buying votes by acquiring the equity to which the vote is attached. **None of these devices could be thought preempted by the Williams Act or the proxy rules***. If they are not preempted, neither is [Wisconsin’s takeover law]. [Emphasis added.]

Judge Easterbrook concluded that “[o]nly if the Williams Act gives investors the right to be the beneficiary of offers could Wisconsin’s law run afoul of the federal rule.” But this interpretation was entirely a nonstarter: “No such entitlement can be mined out of the Williams Act.” Indeed:

Investors have no right to receive tender offers. More to the point ... the Williams Act does not create a right to profit from the business of making tender offers.

As a result, the court concluded that “events leading bidders to cease their quest do not conflict with the Williams Act any more than a state law leading a firm not to issue new securities could conflict with the Securities Act of 1933.” Because “Wisconsin leaves [the tender offer] process alone,” the Seventh Circuit concluded, “its law may co-exist with the Williams Act.” The bidder petitioned for certiorari in *Amanda Acquisition*, but the Supreme Court refused to hear the case.

The Fourth Circuit in *WLR Foods*: A Williams Act Challenge to the Pill Is Explicitly Rejected

When *Amanda Acquisition* came down, [we wrote to our clients](#) that *Amanda Acquisition* “should end constitutional doubts” about state takeover laws that addressed the internal governance of domestic corporations. That prediction turned out to be quite accurate. So trenchant was the Seventh Circuit’s analysis, that constitutional challenges to such takeover laws virtually ceased after *Amanda Acquisition*. Nonetheless, one of the very few post-*Amanda*

challenges actually resulted in another important court of appeals decision—one that explicitly addressed and rejected a preemption challenge to the poison pill.

That decision came from the Fourth Circuit in 1995. [*WLR Foods, Inc. v. Tyson Foods, Inc.*](#) presented a constitutional challenge to four Virginia statutes. According to the bidder, Tyson Foods, the four laws, operating together, “impermissibly restrict[ed] the ability of a bidder to effect a takeover of a Virginia corporation.” Two of the statutes were takeover laws—one, a second-generation vote-sterilization statute akin to the Indiana law upheld in *CTS*, and the other, a third-generation business-combination law resembling the Wisconsin statute affirmed in *Amanda Acquisition*.

The third challenged provision was Virginia’s “Poison Pill Statute,” [Va. Code Ann. § 13.1–646](#). That law explicitly authorizes Virginia corporations to create shareholder rights plans. It also provides that “[a]ny action or determination by the board of directors with respect to the issuance, the terms of or the redemption of [a rights plan] shall be subject to the provisions of § 13.1–690 and shall be valid if taken or determined in compliance therewith.” In turn, [Section 13.1–690](#), referred to in the pill statute, was the fourth provision challenged by Tyson. And it was none other than Virginia’s codification of the business judgment rule—not the modern Delaware version, but rather the traditional, historic, pre-*Unocal*, pure business-judgment rule, which protects directors from liability for *any* good faith business judgment, without regard to whether it involves matters of corporate control, and with no heightened scrutiny for those matters.

Thus, by challenging both Virginia’s statute authorizing pills and its no-heightened-scrutiny business-judgment rule as it applies to pills, Tyson brought the very challenge that Bebchuk and Jackson now erroneously say has never been brought: to borrow words from their article, the court in *WLR Foods v. Tyson Foods* “expressly considered a preemption challenge to the validity of state-law poison-pill rules.” What is more, the preemption challenge in *WLR Foods* could not have been made in a posture more favorable to Bebchuk and Jackson’s position: not only were the Virginia “state-law poison-pill rules” challenged in conjunction with two potent antitakeover laws, but those “state-law poison-pill rules” were also considerably more forgiving of directors than Delaware’s, as the Virginia regime commands the application of the pure, traditional, no-heightened-scrutiny business-judgment rule. No better test case for Bebchuk and Jackson’s thesis could possibly be found.

Yet both the district court and the court of appeals in *WLR Foods* rejected the preemption claim. And quite emphatically so. Quoting *Amanda Acquisition*, the Fourth Circuit held that “[n]othing in the Williams Act says that the federal compromise among bidders, targets’ managers, and investors is the only permissible one.” As a result,

Congress did not forbid the result that Virginia has achieved with the statutory scheme in the instant case. The fact that Congress, when it created the Williams Act, did not intend to create an advantage for target management in the takeover situation, does not necessarily mean that Congress meant to prevent the states from allowing management an advantage which is not unfair to investors.

And so the Fourth Circuit concluded that the Virginia statutory scheme was necessarily constitutional, because it did not interfere with the Congress's effort through the Williams Act to provide shareholders with additional disclosure:

The means by which the Williams Act achieves its purpose of protecting investors is by requiring disclosure of information in order to allow shareholders to make an informed decision and to prevent coercion in the tender offer context; Tyson has not shown that the Virginia statutes controvert the purpose of the Williams Act by removing protection from investors, for example, by keeping information from the shareholders. In fact, Tyson has not shown that the shareholders in this case were deprived of any relevant information. The goal of neutrality between bidder and target, emphasized by Tyson, is not so central to the purpose of the Williams Act that the Act should be held to preempt a group of state statutes that regulate the balance between a target and a bidder, but do not disadvantage the shareholders or prevent them from gaining access to pertinent information.

In so holding, the Fourth Circuit went on to disapprove the “meaningful opportunity for success” test that had been suggested by some earlier district-court decisions, and that, decades later, Bebchuk and Jackson now seek to exhume. The court of appeals cogently explained why this test lacked any foundation in the Williams Act:

We, like the district court, reject the meaningful opportunity for success test. As stated above, the purpose of the Williams Act is to protect independent investors from bidders and management by ensuring that the investors have access to information. The statute does not, however, have as an independent purpose the creation of an environment for bidders that is conducive to takeovers. Tyson attempts to use the “meaningful opportunity for success” test to shift the focus of the Williams Act from protection of investors to protection of bidders. However, the Williams Act is simply not designed to protect a company in Tyson’s position; “the Williams Act does not create a right to profit from the business of making tender offers.”

The four Virginia statutes may work to give target management an advantage in the tender offer context. The preemption question we address here, however, is whether Virginia’s decision to allow management access to a set of defensive mechanisms in the takeover situation frustrates the Williams Act’s goal of investor protection. We hold that it does not. [Emphasis added.]

And with that, the court of appeals dispensed with Tyson’s claim that Virginia’s director-friendly poison-pill rules were preempted by the Williams Act. As in *Amanda*, the bidder petitioned for certiorari—and once again, the Supreme Court refused to take the case.

Conclusion

Bebchuk and Jackson are wrong that to say that the pill has never been argued to violate the Supremacy Clause, and wrong to say that no court has ever addressed such a preemption challenge. But they are right that “commentators and practitioners” have devoted “little attention” to the question of the pill’s constitutionality. The reason for this is the same

reason that preemption challenges to state takeover laws virtually disappeared a quarter-century ago: those challenges are utterly meritless. They are meritless because the Williams Act governs procedure, not substance; disclosure, and not fiduciary duties; and because it evinces no Congressional intent, explicitly or implicitly, to supplant the states' historic authority to set rules governing the internal affairs of corporations that the states themselves have created. [As we argued in our brief in *Amanda* some 25 years ago](#), the “protection [of investors] is achieved in the Williams Act through *disclosure*, not through obliteration of the internal affairs doctrine or of the role of directors in corporate governance.” And at the end of the day, [as we explained almost 30 years ago in our brief in *Household*](#), the arguments for preemption prove too much—they would extensively “federalize matters traditionally committed to state law,” and “would render constitutionally suspect all of the judicial decisions upholding corporate steps [that] block takeover attempts.”

There has never been any doubt, and never will be: The pill, and the state-law doctrines permitting it, entirely comport with the Williams Act and the Constitution of the United States.

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October 29, 2015

The Delaware Courts and the Investment Banks

A doctrinal innovation in Delaware law that first appeared a year ago is threatening to mature into a full-on trend: through the tort of “aiding-and-abetting” fiduciary breach, the Delaware courts, accepting the invitation of the stockholder-plaintiffs’ bar, have begun to take on the task of regulating the M&A advisory function of investment banks. In October 2014, the Court of Chancery awarded stockholder plaintiffs \$76 million in damages against an investment bank for aiding and abetting breaches of the duty of care by the directors of Rural Metro, an ambulance company that was sold for a 37% premium in 2011 and was bankrupt by the time of trial. The novel theory of the decision was that conflicted bankers dispensed self-interested advice, which left Rural Metro’s directors uninformed and hence induced them to breach their duty of care in approving the sale. Although the directors were not liable for the breach (because they had settled and were exculpated at any rate), the court found that the bankers were.

Rural Metro initially appeared to be an outlier, driven by bad facts. But the Court of Chancery has recently applied the *Rural Metro* analysis in a variety of procedural and factual settings. In the course of these decisions, the court has suggested that certain banker conflicts may be unwaivable, even if independent directors believe that a waiver reflects sound business judgment, and that independent directors may breach their duty of care by failing to investigate a bank’s representation that it does not have a material conflict.

Among the difficult policy and doctrinal questions raised by this line of decisions: Can aiding-and-abetting, which is historically akin to civil conspiracy, fairly be extended to regulate banker conduct? Does imposing aiding-and-abetting liability based on exculpated director conduct undermine the Delaware legislature’s determination to authorize charter provisions that exculpate directors from liability for breaches of the duty of care and the stockholders’ vote to adopt such provisions? Does the use of tort principles to allow stockholder plaintiffs to directly challenge the work of bankers impair the ability of boards and financial advisors to privately order their affairs through contract? Does recognizing this new form of banker liability induce courts to find due care violations by directors that would seem unjustified were the reviewing court being asked to hold directors themselves personally liable? What are the unintended consequences—to duty-of-care doctrine, to litigation incentives, to the character and price of financial advice, to banker indemnification practices, to the role of other advisors—of this doctrinal departure?

The Delaware Supreme Court has now heard argument in *Rural Metro*, and its decision, expected in the coming months, will likely answer some of these questions. In the meanwhile, the cases suggest practical lessons for dealmakers. The first is that disclosure matters: under the Supreme Court’s recent [KKR Financial ruling](#), approval of a transaction by a fully informed stockholder electorate requires deferential judicial review and will likely lead to dismissal of aiding-and-abetting claims based on a breach of the duty of care. Directors should also consider more detailed inquiry into their investment banks’ dealings with potential transaction partners and more searching examination of their bankers’ advice. And banks must take account not only of the potential for exposure, and consider internal conflict processes to limit it, but also of the much greater likelihood, conflicts aside, that they and their work product will be targeted by the stockholder-plaintiffs’ bar in any case.

We hope that the Delaware Supreme Court’s decision will enable us to give definitive advice to boards of directors and their bankers and other advisors that will foreclose this type of litigation.

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December 3, 2015

The Delaware Supreme Court Speaks to Boards and the Investment Banks

The Delaware Supreme Court earlier this week issued its much anticipated decision in the *Rural Metro* appeal. [*RBC Capital Markets, LLC v. Jervis*, No. 140, 2015 \(Del. Nov. 30, 2015\)](#). The opinion canvasses many important areas of Delaware fiduciary duty doctrine applicable to directors and the aiding and abetting liability exposure of investment bankers advising on transactions. The Supreme Court's decision is its first statement on the subject of banker conflicts and conduct since a series of recent Court of Chancery opinions sparked a debate about whether, and how, Delaware is breaking new ground in examining and potentially regulating the conduct of bankers and their conflicts (see [*The Delaware Courts and the Investment Banks*](#), our memorandum of October 29, 2015).

The Supreme Court's opinion represents a carefully balanced intervention into that debate. The opinion contains clear messages for both boards and bankers.

To boards:

“[D]irectors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest. But, at the same time, a board is not required to perform searching and ongoing due diligence on its retained advisors in order to ensure that the advisors are not acting in contravention of the company's interests, thereby undermining the very process for which they have been retained. A board's consent to a conflict does not give the advisor a ‘free pass’ to act in its own self-interest and to the detriment of its client. Because the conflicted advisor may, alone, possess information relating to a conflict, the board should require disclosure of, on an ongoing basis, material information that might impact the board's process.”

“A board's consent to the conflicts of its financial advisor necessitates that the directors be especially diligent in overseeing the conflicted advisor's role in the sale process.”

“For instance, the board could, when faced with a conflicted advisor, as a contractual matter, treat the conflicted advisor at arm's-length, and insist on protections to ensure that conflicts that might impact the board's process are disclosed at the outset and throughout the sale process.”

To bankers:

“[W]e do not adopt the Court of Chancery’s description of the role of a financial advisor in M & A transactions. In particular, the trial court observed that ‘[d]irectors are not expected to have the expertise to determine a corporation’s value for themselves, or to have the time or ability to design and carryout a sale process. Financial advisors provide these expert services. In doing so, they function as gatekeepers.’ Although this language was *dictum*, it merits mention here. The trial court’s description does not adequately take into account the fact that the role of a financial advisor is primarily contractual in nature, is typically negotiated between sophisticated parties, and can vary based upon a myriad of factors. Rational and sophisticated parties dealing at arm’s-length shape their own contractual arrangements and it is for the board, in managing the business and affairs of the corporation, to determine what services, and on what terms, it will hire a financial advisor to perform in assisting the board in carrying out its oversight function. The engagement letter typically defines the parameters of the financial advisor’s relationship and responsibilities with its client. ... As became evident in the instant matter, the conflicted banker has an informational advantage when it comes to knowledge of its real or potential conflicts. ... Adhering to the trial court’s amorphous ‘gatekeeper’ language would inappropriately expand our narrow holding here by suggesting that any failure by a financial advisor to prevent directors from breaching their duty of care gives rise to an aiding and abetting claim against the advisor.”

This is a welcome opinion that offers important practical guidance to bankers and boards. The decision makes clear that informed boards of directors can, in the exercise of their business judgment, retain conflicted investment advisors and that, if appropriate procedures are followed, neither the board nor the bankers will face liability for breach of fiduciary duty. The decision also reaffirms that contractual arrangements between companies and financial advisors will generally be respected. The decision thus provides a constructive pathway for well-counseled companies and well-counseled advisors to work through the issues of potential conflict that from time to time inevitably arise in the M&A context.

Martin Lipton
Theodore N. Mirvis
William Savitt
Ryan A. McLeod

December 3, 2015

A Personal Reflection on Corporate Governance: Is 2015, like 1985, an Inflection Year?

In an October 2015 paper, I posed the question: [*Will a New Paradigm for Corporate Governance Bring Peace to the Thirty Years' War?*](#) As we approach the end of 2015, I thought it would be useful to note some of the most cogent recent developments on which the need, and hope, for a new paradigm is based. These developments include, among other things, the accumulation of a critical mass of academic research that discredits the notion that short-termism, activist attacks and shareholder-centric corporate governance tend to create rather than destroy long-term value.

In January a [*Report of the Commission on Inclusive Prosperity*](#), co-chaired by Lawrence Summers and Ed Balls, identified activism and short-termism as being a threat to the American economy and society. The report noted that reforming corporate governance and moving away from quarterly reporting are critical:

“An additional reason for the absence of inclusive prosperity [inequality] is the changing nature of corporate behavior. Business leaders, government officials, and academics have pointed out that corporations have shifted their traditional focus on long-term profit maximization to maximizing short-term stock-market valuations.

The effects of short-termism are damaging to the economy as a whole. A firm that invests for the long term will make more investments in future productivity, whether that's developing lifesaving medicine; building or buying newer, more efficient machinery; or paying for training for its workforce. All of these investments show up immediately as expenses on the balance sheet and reduce profits in the current quarter but raise future productivity of the firm. Incentivizing a continuing short-term focus lowers future output, reduces long-term competitiveness, and diminishes future worker productivity and the higher wages that it can bring.

To provide greater macroeconomic and financial stability and to raise productivity, it is essential that markets work in the public interest and for the long term rather than focusing only on short-term returns.”

At various times during the year, BlackRock, State Street and Vanguard (the major managers of index funds that together hold, on average, about 15% of the shares of most significant U.S. public companies) issued statements that they would support the long-term plans of companies against activist attacks and they would withhold support of activists who primarily seek to force companies into share buybacks and extraordinary distributions. In May, these three institutional investors supported DuPont in its proxy fight with Trian. See [*Winning a Proxy Fight – Lessons from the DuPont-Trian Vote*](#) and [*Some Lessons from BlackRock, Vanguard and DuPont—A New Paradigm for Governance*](#).

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During 2015, five important papers were published by prominent economists, law professors, a renowned jurist and The Conference Board, each of which points out serious flaws in the so-called empirical evidence and policy arguments being put forth to justify short-termism, attacks by activist hedge funds and shareholder-centric corporate governance.

Emiliano Catan and Marcel Kahan, [*The Law and Finance of Anti-Takeover Statutes*](#),

Yvan Allaire and François Dauphin, [*The Game of 'Activist' Hedge Funds: Cui bono?*](#)

John C. Coffee, Jr. and Darius Palia, [*The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*](#),

The Conference Board, [*Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?*](#)

Leo Strine, Jr., Chief Justice of the Supreme Court of Delaware, [*Securing Our Nation's Economic Future: A Sensible, Nonpartisan Agenda To Increase Long-Term Investment And Job Creation In The United States*](#)

For an earlier critique of the defects in the so-called empirical evidence, see [*The Bebchuk Syllogism*](#).

In addition, last month, K.J. Martijn Cremers, Erasmo Giambona, Simone M. Sepe, and Ye Wang published the results of an impressive econometric study, [*Hedge Fund Activism and Long-Term Firm Value*](#), that indicates that hedge fund activism more likely destroys long-term value rather than creates it. Their results show that prior studies—of the type Harvard Law School Professor Lucian Bebchuk relies on to validate his policy arguments in favor of unfettered attacks by activist hedge funds—do not warrant the credibility claimed for them.

The aforementioned studies and papers build on the growing body of academic and policy research focused on this critical issue, including many other insightful studies that seriously undermine the credibility of shareholder-centric governance and its concomitant short-termism and hedge fund activism.

In a paper I presented at an August meeting of the World Economic Forum, [*Is Activism Moving In-House*](#), I quoted Laurence Fink, Chairman and CEO of BlackRock:

“It is critical, however, to understand that corporate leaders’ duty of care and loyalty is not to every investor or trader who owns their companies’ shares at any moment in time, but to the company and its long-term owners. Successfully fulfilling that duty requires that corporate leaders engage with a company’s long-term providers of capital; that they resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, that they clearly and effectively articulate their strategy for sus-

tainable long-term growth. Corporate leaders and their companies who follow this model can expect our support.”

I concluded by expressing hope that activism would continue to move in-house at the major institutional investors and, as this new paradigm for corporate governance becomes pervasive, the influence of hedge fund activists and ISS and Glass Lewis will shrink and be replaced by the policies, evaluations and decisions of the major institutions. While this will be a welcome relief from the short-termism imposed by hedge fund activists, it raises a new fundamental question—how will the institutions use their power? In an article in *Fortune* discussing the ramifications of the outcome of the DuPont-Trian proxy fight, Ram Charan posed the following question:

“As the biggest asset managers gain more power and exercise it more freely, they bear a heavy responsibility. They may influence employment, national competitiveness, and economic policy for better or for worse. They can ensure a balance between short-term and long-term corporate goals, and between value creation and societal needs. They can keep succession planning near the top of every company’s agenda. How they will discharge their responsibility remains to be seen....”

I believe that the influence of the major institutional investors will be more favorable to the Nation’s economy and society than the current hedge fund activism and pressure for quarterly performance. Hopefully, the institutional investors will follow through on what they are saying about encouraging long-term investment and implement fully the new paradigm.

Martin Lipton

February 1, 2016

The New Paradigm for Corporate Governance

Since I first identified a nascent new paradigm for corporate governance with leading major institutional investors supporting long-term investment and value creation and reducing or eliminating outsourcing to ISS and activist hedge funds, there has been a steady stream of statements by major investors outlining the new paradigm. In addition, a number of these investors are significantly expanding their governance departments so that they have in-house capability to evaluate governance and strategy and there is no need to outsource to ISS and activist hedge funds. The following is a summary consolidation of what these investors are saying in various forums.

Clearly articulated plans are necessary to gain and keep the support of these investors. A company should not leave an opening for an activist with a more attractive long-term plan.

Board participation in the development and approval of strategy should be effectively communicated in letters to these investors, annual reports and proxy statements. The description should include the major issues debated by the board and how they were resolved.

A company should recognize that **ESG and CSR issues and how they are managed are important** to these investors.

A company should develop and communicate its procedures for **engagement by management and directors** with these investors. In addition, a company should **facilitate direct engagement** with directors by these investors who request it.

A company should **support national policies that are designed to achieve long-term value creation**. A company should support major investment by government in infrastructure, a rational tax policy that encourages long-term strategies and other policies that encourage and support long-term growth on both a company and a macro basis.

These investors **do not favor stock repurchases** at the expense of long-term investment.

These investors recognize that there is **no need for quarterly earnings guidance**, if a company has a clearly articulated long-term strategy. These investors also recognize that quarterly guidance is inconsistent with the long-term investment strategies that they are encouraging.

In addition to the statements by, and actions of, these leading institutional investors, similar views are being expressed by The Conference Board, The Brookings Institution, The Aspen Institute, Focusing Capital on the Long Term (an organization formed to promote long-term investment), the chief economist of the Bank of England and numerous others. In addition, recent academic research has revealed the methodological fallacies in the so-called “empirical evidence” use by the academics who have argued that unrestrained attacks by activist hedge funds create long-term value for the targets of their attacks, thereby strengthening the ability of these institutions to refuse to support activist attacks on portfolio companies. A [recent article](#) by Professor John Coffee of the Columbia Law School and the February 1, 2016 [Letter](#) from Larry Fink of BlackRock to the CEOs of the S&P 500 are must reads.

Martin Lipton

March 7, 2016

The New Paradigm for Corporate Governance

In my February 1, 2016 note, "[The New Paradigm for Corporate Governance](#)," I called attention to the growing evidence that the leading institutional investors were developing a new paradigm for corporate governance. In the new paradigm, these institutions would engage with a company and its independent directors to understand its long-term strategy and ascertain that the directors participated in the development of the strategy, were actively monitoring its progress and were overseeing its execution.

In a [February 26, 2016 letter to board members](#), State Street Global advisors said:

Unless we make independent long-term thinking and leadership the driving force behind a board's mission, no amount of change to management incentives, investor behavior or the like will be sufficient to ensure a focus on the long term. Boards need to look beyond the traditional measures of corporate success such as the quarterly earnings report and accomplishments since the last board meeting. Short-term performance matters, but it should be assessed in the context of a company's long-term goals. Given a company's stated objectives for the next 5, 10 or 20 years, did management execute as well as possible? Did the company meet its milestones and exceed its benchmarks?

We recognize that the role of a board has become more complex and demanding as the challenges companies face in a competitive global economy marked by technological disruption have intensified. Many boards lack the experience and expertise to engage effectively and critically with management with regard to a company's long-term planning. Board recruitment becomes an even more critical function when viewed through the lens of long-term focus. That is all the more reason that boards should continually self-assess the skills and experience of their board members and seek to continually enhance their capabilities by addressing any skill, experience or other gaps.

Martin Lipton

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June 2, 2016

Delaware Court of Chancery Appraises Fully-Shopped Company
at Nearly 30% Over Merger Price

In an appraisal decision issued this week, the Delaware Court of Chancery held that the fair value of Dell Inc. was \$17.62 per share—almost four dollars over and nearly 30% more than the price paid in the 2013 go-private merger. [*In re Appraisal of Dell Inc.*, C.A. No. 9322-VCL \(Del. Ch. May 31, 2016\)](#). The result reflects the remarkable view that “fair value” in Delaware represents a price far higher than any buyer would have been willing to pay and that the merger price derived from an admirable sales process should be accorded no weight.

In 2012 Michael Dell informed the company’s board that he wished to pursue a management-led buyout. In response, the board formed a special committee, which embarked on a year-long process culminating in the approval of a merger agreement under which Mr. Dell and a private equity firm paid \$13.75 per share—a 25% premium over the pre-announcement unaffected share price of \$10.88 and a 37% premium over the trailing 90-day average. Over the course of its pre-signing auction and very public post-signing go-shop, the committee contacted over 60 potential merger partners. In view of this robust sales process, the Court of Chancery previously refused to entertain the customary avalanche of fiduciary duty litigation challenging the deal. As this week’s opinion reiterated, the company’s careful process “would easily sail through [a fiduciary duty challenge] if reviewed under enhanced scrutiny.”

The court nevertheless accorded that process no deference in deciding that the company’s appraised “fair value” was billions more than the market price. Finding that the company’s investors were “focused on the short term,” the decision concluded that there was “a significant valuation gap between the market price of the Company’s common stock and the intrinsic value of the Company.” The merger market was likewise irrelevant in appraising the transaction, the court reasoned, because financial sponsors like private equity firms “determine[] whether and how much to bid by using an LBO [leveraged buyout] model, which solves for the range of prices that a financial sponsor can pay while still achieving particular IRRs,” or internal rates of return. While some aspects of the decision focused on the fact that the transaction was a management buyout, much of its reasoning appears to apply to financial buyers generally. The court thus concluded that “what the sponsor is willing to pay diverges from fair value because of (i) the financial sponsor’s need to achieve IRRs of 20% or more to satisfy its own investors and (ii) limits on the amount of leverage that the company can support and the sponsor can use to finance the deal.”

The decision may turn out to be an outlier, as other Chancery decisions have held that the merger price—including in [private equity deals](#)—is the most reliable indicator of fair value. In the meanwhile, however, proponents of [appraisal arbitrage](#) will tout the *Dell* result to encourage the flow of even greater funds into the practice.

For their part, private equity firms should be expected to ask whether they face routine appraisal exposure in Delaware, no matter how robust the auction, and therefore seek out alternative transaction structures to cap and price their risk (or exit the market entirely). Consider, for example, the acquisition of a Delaware company with 1 billion shares trading at \$12 per share, for a total valuation of \$12 billion, where a private equity buyer is willing to pay \$16 billion in total to acquire the target. Assume further that the buyer’s reserve price easily

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topped the competitors and the seller succeeds in extracting the full amount the buyer is willing to pay through a robust auction. A private equity buyer in this situation, concerned that a court will rely on the logic of *Dell* and award a 30% increase over the merger price to dissenting shares, is likely to consider transactional alternatives to mitigate the risk. To cap its appraisal exposure, the private equity buyer might insist on a provision in the merger agreement allowing it to walk away if a small fraction of the shares—1 or 2 percent—perfect appraisal rights. This approach is likely to be unpalatable to selling boards, however, and creates substantial risk that the buyer will exit the transaction when the appraisal cap is exceeded. Alternatively, a buyer might choose a higher appraisal cap of 10% of the shares, but augment that approach by reducing its offer to create a reserve for the eventual appraisal award for the 100 million dissenting shares. In this scenario, if the reserve is based on the *Dell* result, the buyer's top offer price would be only \$15.53 per share (instead of \$16), with the excess reserved for a payoff to the appraisal arbitrageurs of \$20.19 per share. This outcome would result in a wealth transfer of \$423 million from the public stockholders to the arbitrage firms.

Either way, however, there is a substantial risk that public stockholders lose out—whether by losing a value maximizing deal altogether or through value leakage to appraisal arbitrageurs. Accordingly, it is very much open to question whether the *Dell* dynamic will incentivize transactions that maximize value to stockholders and a market for corporate control that promotes managerial accountability.

Martin Lipton
Theodore N. Mirvis
William Savitt
Ryan A. McLeod

January 9, 2017

Corporate Governance: The New Paradigm

At the invitation of the International Business Council of the World Economic Forum, I prepared [*The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*](#). I presented The New Paradigm at the August 2016 meeting of the IBC and it was unanimously approved by those in attendance. The IBC is now seeking signatures from all participants in its January 2017 meeting to [*The Compact for Responsive and Responsible Leadership: A Roadmap for Sustainable Long-Term Growth and Opportunity*](#). The Compact includes key features of The New Paradigm. Endorsement and adherence by business corporations, institutional investors and asset managers to The Compact and The New Paradigm will substantially alleviate short-term pressures and will promote sustainable long-term investment and growth. I believe this is a unique opportunity to make a real difference. I recommend endorsement and adherence to The Compact and The New Paradigm, not just by those attending the IBC meeting, but by all corporations, institutional investors and asset managers.

Martin Lipton

January 31, 2017

Promoting Long-Term Value Creation – The Launch of the Investor Stewardship Group (ISG) and ISG’s Framework for U.S. Stewardship and Governance

A long-running, two-year effort by the senior corporate governance heads of major U.S. investors to develop the first stewardship code for the U.S. market culminated today in the launch of the [Investor Stewardship Group](#) (ISG) and ISG’s associated [Framework for U.S. Stewardship and Governance](#). Investor co-founders and signatories include U.S. Asset Managers (BlackRock; MFS; State Street Global Advisors; TIAA Investments; T. Rowe Price; Vanguard; ValueAct Capital; Wellington Management); U.S. Asset Owners (CalSTRS; Florida State Board of Administration (SBA); Washington State Investment Board); and non-U.S. Asset Owners/Managers (GIC Private Limited (Singapore’s Sovereign Wealth Fund); Legal and General Investment Management; MN Netherlands; PGGM; Royal Bank of Canada (Asset Management)).

Focused explicitly on combating short-termism, providing a “framework for promoting long-term value creation for U.S. companies and the broader U.S. economy” and promoting “responsible” engagement, the principles are designed to be independent of proxy advisory firm guidelines and may help disintermediate the proxy advisory firms, traditional activist hedge funds and short-term pressures from dictating corporate governance and corporate strategy.

Importantly, the ISG Framework would operate to hold investors, and not just public companies, to a higher standard, rejecting [the scorched-earth activist pressure tactics to which public companies have often been subject](#), and instead requiring investors to “address and attempt to resolve differences with companies in a constructive and pragmatic manner.” In addition, the ISG Framework emphasizes that asset managers and owners are responsible to their ultimate long-term beneficiaries, especially the millions of individual investors whose retirement and long-term savings are held by these funds, and that proxy voting and engagement guidelines of investors should be designed to protect the interests of these long-term clients and beneficiaries. The divergent needs and time horizons of these ultimate beneficiaries have long been emphasized by Chief Justice Leo Strine (see, for example, Justice Strine’s provocative article, *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*), and implicates the [new theory of corporate governance](#) espoused by Professors Zohar Goshen and Richard Squire. While the ISG Framework is not intended to be prescriptive or comprehensive in nature, with companies and investors being free to apply it in a manner they deem appropriate, it is intended to provide guidance and clarity as to the expectations that an increasingly large number of investors will have not only of public companies, but also of each other.

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Key highlights of the ISG Stewardship Framework for Institutional Investors and the ISG Corporate Governance Framework for U.S. Listed Companies are outlined below. The ISG has also supplemented each of these high-level principles with examples of illustrative implementation. Many of the principles in the ISG Frameworks will be familiar to those who have recognized the emergence of, and supported, [The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth](#)[New Paradigm for Corporate Governance](#), sought to [adapt their communication, engagement and governance practices](#) to reflect the New Paradigm and [tracked the heightened expectations and scrutiny placed on public company boards](#).

Stewardship Framework for Institutional Investors

- Principle A: Institutional investors are accountable to those whose money they invest.
- Principle B: Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.
- Principle C: Institutional investors should disclose, in general terms, how they manage potential conflicts of interest that may arise in their proxy voting and engagement activities.
- Principle D: Institutional investors are responsible for proxy voting decisions and should monitor the relevant activities and policies of third parties that advise them on those decisions.
- Principle E: Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.
- Principle F: Institutional investors should work together, where appropriate, to encourage the adoption and implementation of the Corporate Governance and Stewardship principles.

Corporate Governance Framework for U.S. Listed Companies

- Principle 1: Boards are accountable to shareholders.
- Principle 2: Shareholders should be entitled to voting rights in proportion to their economic interest.
- Principle 3: Boards should be responsive to shareholders and be proactive in order to understand their perspectives.

- Principle 4: Boards should have a strong, independent leadership structure, which may be evidenced by an independent chair or a lead independent director.
- Principle 5: Boards should adopt structures and practices that enhance their effectiveness.
- Principle 6: Boards should develop management incentive structures that are aligned with the long-term strategy of the company.

ISG's goals are ambitious, seeking to have "every institutional investor and asset management firm investing in the U.S." sign the framework and incorporate the stewardship principles in their proxy voting, engagement guidelines and practices. It should be noted that while the ISG guidelines emphasize the need for a framework to promote long-term value creation, the current version does not specifically commit investors to support long-term investment but does express the view that it "is the fiduciary responsibility of all asset managers to conduct themselves in accordance with the preconditions for responsible engagement in a manner that accrues to the best interests of stakeholders and society in general, and that in so doing they'll help build a framework for promoting long-term value creation on behalf of U.S. companies and the broader U.S. economy."

The Framework is intended to be effective January 1, 2018 and apply to the 2018 proxy season; nevertheless, as companies conduct off-season and in-season shareholder engagement and finalize their 2017 proxy statement disclosures and associated annual letters to shareholders from the Board and/or management, they may wish to incorporate into their communications some of the themes highlighted in the ISG Framework and benchmark their disclosures and practices against the Framework.

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April 18, 2017

Corporate Governance

In a brilliant must-read article in the May-June 2017 issue of the *Harvard Business Review*, Joseph L. Bower and Lynn S. Paine show the fallacies of the economic theories and statistical studies that have been used since 1970 to justify shareholder-centric corporate governance, short-termism and activist attacks on corporations. They demonstrate the pernicious effect of the agency theory promoted by Milton Friedman (1970) and Michael Jensen and William Meckling (1976), a theory still endorsed today by a majority of academic economists and lawyers who write about and teach corporate governance. The Bower and Paine rejection of hedge fund activism is telling.

The activists' claim of value creation is further clouded by indications that some of the value purportedly created for shareholders is actually value transferred from other parties or from the general public. Large-sample research on this question is limited, but one study suggests that the positive abnormal returns associated with the announcement of a hedge fund intervention are, in part, a transfer of wealth from workers to shareholders. The study found that workers' hours decreased and their wages stagnated in the three years after an intervention. Other studies have found that some of the gains for shareholders come at the expense of bondholders. Still other academic work links aggressive pay-for-stock-performance arrangements to various misdeeds involving harm to consumers, damage to the environment, and irregularities in accounting and financial reporting.

We are not aware of any studies that examine the total impact of hedge fund interventions on all stakeholders or society at large. Still, it appears self-evident that shareholders' gains are sometimes simply transfers from the public purse, such as when management improves earnings by shifting a company's tax domicile to a lower-tax jurisdiction—a move often favored by activists, and one of Valeant's proposals for Allergan. Similarly, budget cuts that eliminate exploratory research aimed at addressing some of society's most vexing challenges may enhance current earnings but at a cost to society as well as to the company's prospects for the future.

Hedge fund activism points to some of the risks inherent in giving too much power to unaccountable "owners." As our analysis of agency theory's premises suggests, the problem of moral hazard is real—and the consequences are serious. Yet practitioners

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continue to embrace the theory's doctrines; regulators continue to embed them in policy; boards and managers are under increasing pressure to deliver short-term returns; and legal experts forecast that the trend toward greater shareholder empowerment will persist. To us, the prospect that public companies will be run even more strictly according to the agency-based model is alarming. Rigid adherence to the model by companies uniformly across the economy could easily result in even more pressure for current earnings, less investment in R&D and in people, fewer transformational strategies and innovative business models, and further wealth flowing to sophisticated investors at the expense of ordinary investors and everyone else.

To counter short-termism and activism, Bower and Paine embrace the corporation-centric/constituency theory of governance. They argue that the corporation and its board of directors have a fiduciary duty not just to its shareholders, but to its employees, customers, suppliers and to the community. This is the theory I argued in *Takeover Bids in the Target's Boardroom* (1979) and regularly since in a lone series of articles and memoranda. While Bower and Paine say:

The new model has yet to be fully developed, but its conceptual foundations can be outlined. . . . [T]he company-centered model we envision tracks basic corporate law in holding that a corporation is an independent entity, that management's authority comes from the corporation's governing body and ultimately from the law, and that managers are fiduciaries (rather than agents) and are thus obliged to act in the best interests of the corporation and its shareholders (which is not the same as carrying out the wishes of even a majority of shareholders). This model recognizes the diversity of shareholders' goals and the varied roles played by corporations in society. We believe that it aligns better than the agency-based model does with the realities of managing a corporation for success over time and is thus more consistent with corporations' original purpose and unique potential as vehicles for projects involving large-scale, long-term investment.

in fact the corporation-centric theory—that the directors have a fiduciary duty to the corporation and all of its stakeholders—is reflected in a number of state corporation laws. Perhaps the most cogent example is the Pennsylvania Business Corporation Law which provides:

A director of a business corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care,

including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.

In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of the corporation, consider to the extent they deem appropriate:

The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.

The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.

All other pertinent factors.

While wider adoption and strengthening of laws like the Pennsylvania statute would provide some more ability to boards of directors to temper short-termism and resist attacks by activist hedge funds, voting control of corporations will remain in the hands of the major institutional investors and asset managers. To achieve a truly meaningful change and effectively promote long-term investment, corporations and institutional investors and asset managers will need to endorse and adhere to *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* (2016) promulgated by the World Economic Forum or *A Synthesized Paradigm for Corporate Governance, Investor Stewardship, and Engagement* (2017) based on it and on *The Principles of the Investor Stewardship Group* (2017). The alternative would be legislation, something that both corporations and investors should assiduously avoid.

Martin Lipton

June 30, 2017

The Classified Board Duels

Professor Lucian Bebchuk has engaged in two rounds of law-review-article duels with Professor Martijn Cremers and Professor Simone Sepe over classified boards. The weapons were statistics (and common sense). Cremers and Sepe wore the classified-board-stakeholder colors; Bebchuk, the agency-model-shareholder-democracy colors. Cremers' and Sepe's riposte was decisive.

The field for these duels was chosen by Bebchuk in 2011 when he chartered the Harvard Law School Shareholder Rights Project (the "Harvard Project"). Bebchuk described the Harvard Project as an academic program designed to "contribute to education, discourse, and research related to efforts by institutional investors to improve corporate governance arrangements at publicly traded firms." In practice, it worked to eliminate the classified-board moat protecting companies from short-termism and attacks by activist hedge funds. Over the course of three academic years from 2011 to 2014, the Harvard Project submitted declassification proposals to 129 companies, resulting in 102 declassifications.

Bebchuk's Harvard Project sparked sharp criticism. Former SEC Commissioner Daniel Gallagher's and Stanford Professor Joseph Grundfest's [*Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors \(2014\)*](#) argued that it "relie[d] on the categorical assertion that staggered boards are associated with inferior financial performance" and that the proposals omitted disclosure of significant, conflicting research.

Scholars with sharpened statistics followed suit. Cremers' and Sepe's [*The Shareholder Value of Empowered Boards \(2016\)*](#), as well as their follow-on piece [*Staggered Boards and Long-Term Firm Value, Revisited \(2017\)*](#) coauthored with Lubomir Litov, employed lengthy time-series studies showing that classification (declassification) is associated with an increase (decrease) in firm value. These studies exposed the limitations of prior cross-sectional studies: namely Bebchuk's [*The Costs of Entrenched Boards \(2005\)*](#), which succumbs to the reverse causality fallacy. They provided "no support for the entrenchment view." In light of their findings, the authors urged policy reform to make classification boards quasi-mandatory, exclude shareholder declassification proposals and impose a supermajority requirement on board declassification proposals. They believed this reform would "restore a board's ability to credibly commit shareholders to long-term value creation, which is in their own and society's best interests."

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Cremers and Sepe then turned to the Harvard Project. [*Board Declassification Activism: The Financial Value of the Shareholder Rights Project \(2017\)*](#) treated the Harvard Project as a “quasi-natural experiment” to again measure value implications of classifications. These data provided a source of exogenous variation, useful to avoid the flaws in prior cross-sectional studies, because the Harvard Project plausibly had “a direct, causal impact” on classification decisions. And the results remained the same. They found that Harvard Project targets that declassified declined in value, more so than non-Project targets, and that such declines appeared “directly attributable to . . . declassification.” Further, these results were especially strong for firms with large research and development investments. Consistent with recent studies, they concluded that “classified boards may serve a positive governance function in some companies, thus challenging the ‘one-size-fits-all’ approach to board declassification exemplified by the [Harvard Project] and, more generally, most activist investors and proxy advisory firms.”

In [*Recent Board Declassifications: A Response to Cremers and Sepe \(2017\)*](#), Bebchuk and Alma Cohen contend that, “appropriately interpreted,” Cremers’ and Sepe’s 2017 study contradicts their own 2016 study because it “provide[s] some significant evidence that declassifications are beneficial and no evidence that they are value-reducing.” Bebchuk and Cohen focus on non-Project declassifications, which they believe are more important than Project declassifications (reasoning that the Harvard Project was limited in time and scope), and claim that firm values did not decline after non-Project declassifications. They turn only briefly to Project declassifications, finding that the results do not “provide a basis for concluding that [such] declassifications reduced value.” Bebchuk and Cohen conclude that the results “fail to provide any basis for opposing declassifications,” which justifies the apparent retreat from the policy proposal in the 2016 article (*i.e.*, the relatively weaker language in the 2017 article).

In response to Bebchuk and Cohen, Cremers’ and Sepe’s [*Board Declassification Activism: Why Run Away from the Evidence? \(2017\)*](#) reiterates their findings and argues that Bebchuk’s and Cohen’s critique is unwarranted because, put simply, it ignores the evidence. That is, the critique essentially disregards the main result that firm values declined after Project declassifications; cherry-picks data, sidestepping or downplaying key results; draws conclusions on statistically and economically insignificant results, defying the “basic econometric precept that no inferences can be drawn when results lack statistical significance” and incorrectly focuses on non-Project declassifications while failing to interpret them in connection with Cremers’ and Sepe’s prior studies. Finally, Cremers and

Sepe show that their 2017 study reinforces, and not belies, their policy proposal with new data: a \$90 to \$149 billion decline in value associated with Project declassifications that their policy would have mitigated “if not altogether prevented.”

The costs of Bebchuk’s actions are real. He has exposed hundreds of major U.S. companies to short-term pressures and attacks by activist investors to the detriment of those companies, their shareholders and, more generally, the economy. With the growing recognition by major institutional investors, asset managers and academics that short-termism and activism are antithetical to the interests of all stakeholders, including shareholders, and society generally, one hopes that Bebchuk and his cohorts would cross the Charles River and join their Harvard Business School colleagues, Jay Lorsch, William George, Joseph Bower and Lynn Paine in supporting long-term investment and rational, not shareholder-only, governance. In a recent article, Bower and Paine sum up the damage done by one-size-fits-all, shareholder-centric governance:

To us, the prospect that public companies will be run even more strictly according to the agency-based model is alarming. Rigid adherence to the model by companies uniformly across the economy could easily result in even more pressure for current earnings, less investment in R&D and in people, fewer transformational strategies and innovative business models, and further wealth flowing to sophisticated investors at the expense of ordinary investors and everyone else.

Martin Lipton
Daniel Bulaevsky