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# Towards a More Balanced Treatment of Bidder and Target Shareholders

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# TOWARDS A MORE BALANCED TREATMENT OF BIDDER AND TARGET SHAREHOLDERS

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I. INTRODUCTION: THE COMEBACK OF MERGERS AND  
ACQUISITIONS

In recent years, a new wave of merger and acquisition activity has greeted the corporate world.<sup>1</sup> Unlike the hostile takeover wave of the 1980's, the current wave of takeovers is characterized by mergers and acquisitions initiated by large, publicly held companies such as IBM or Disney, as opposed to private LBO firms or corporate raiders like T. Boone Pickens or Carl Icahn. These "new" mergers often are completed under "friendly" circumstances and are justified by various potential synergies between bidder and target, such as economies of scale and scope and vertical integration. Unlike the ill-fated conglomerate mergers of the 1960's or the hostile buy-outs of the 1980's, the new wave of mergers and acquisitions promises to improve industrial production and generate substantial increases in shareholder wealth. Indeed, *The Economist* has recently observed: "Entailing true romance rather than shotgun weddings, tempting synergies rather than financial

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<sup>1</sup> According to several recent business articles the current merger wave may well dwarf that of the 1980s in volume and value of the deals. See Michael J. Mande! et al., *Land of the Giants*, BUS. WK., Sept. 11, 1995, at 34.

opportunism, no rash of mergers has seemed more benign, or better calculated to boost corporate profits."<sup>2</sup>

It is probably too soon to tell whether the current wave of merger activity is any different from former waves that have swept Wall Street. Whatever the case, target shareholders that confront such merger activity will not be lacking in legal protection from bidders offering too little stock or cash for the value of their stock. If target shareholders dislike an offer, they can use their voting power to block a bid.<sup>3</sup> In addition, legal mechanisms such as the Williams Act<sup>4</sup> prevent bidders from taking targets by surprise, reduce the coercive effect of tender offers, and arguably result in higher premium payments to target shareholders.<sup>5</sup> Legal mechanisms not only protect target shareholders from overreaching bidders, but they also protect them from overreaching managers as well. In Delaware, judges examine target managers' defensive actions according to a heightened standard of review as dictated by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*<sup>6</sup> Moreover, once the target is put up for sale, its managers must procure the highest premium possible for target shareholders — usually through an auction.<sup>7</sup> Finally, if the shareholder truly believes that a bidder's price fails to reflect the value of his stock, he can

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<sup>2</sup> *The Trouble with Mergers*, THE ECONOMIST, Sept. 10, 1994, at 1. The editorial proceeds to argue that the newest wave of mergers in fact may not turn out to be as beneficial as expected.

<sup>3</sup> See, e.g., DEL. CODE ANN. tit. 8, § 251 (1991). Discussed *infra*, Part III.A.

<sup>4</sup> A tender offer is an offer made by a bidder directly to the target's shareholders for their stock. For discussion of the Williams Act, see *infra*, Part III.C.

<sup>5</sup> In addition, state anti-takeover mechanisms and various defenses designed by lawyers, such as the "poison pill" arguably protect target shareholders from overreaching bidders by strengthening management's negotiating position when and if an offer is made to buy the company. See generally Martin Lipton, *Takeover Bids in the Target's Boardroom; An Update After One Year*, 36 BUS. LAW. 1017 (1981).

<sup>6</sup> 493 A.2d 946 (Del. 1985). Discussed *infra*, Part III.B.

<sup>7</sup> See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

ask for appraisal rights and opt out of the transaction altogether.<sup>8</sup>

Unlike target shareholders, the owners of acquiring firms do not enjoy legal protection for the value of their stock when their managers decide to acquire other firms. Indeed, as bidding firms increase their premium in order to win more competitive auctions, their shareholders are more likely to suffer a loss in the value of their stock rather than a gain. Despite the magnitude of loss they may suffer from overpriced and ill-fated acquisitions, bidder shareholders have no more legal protection from their ego-driven managers than the deferential standards of judicial review laid out by the business judgment rule.<sup>9</sup> In fact, the *only* way a shareholder can signal his displeasure with his company's impending acquisition is to take the "Wall Street walk": upon announcement of a pending acquisition, he can sell his stock.

The purpose of this paper is to determine whether bidder shareholders ought to have more options than the "Wall Street walk" when their managers propose acquisitions that threaten to destroy the value of their stock.<sup>10</sup> Ten years ago, one commentator observed that

[t]he reams of commentary on corporate mergers, acquisitions and tender offers have focused largely on protection of shareholders of acquired (or target) companies from both the depredations of acquiring (or raider) companies and the cupidity of their own managements in either negotiating the terms or obstructing the accomplishment of transactions. *Virtually no attention has been paid to the plight of*

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<sup>8</sup> See DEL. CODE ANN. tit. 8, § 262 (1991). Appraisal rights entitle the dissenting shareholder to sue for the fair value of his stock in court. A shareholder may not sue for appraisal rights if the merger in question entails an exchange of stock that is traded on a national stock market exchange. See discussion *infra*, Part III.D.

<sup>9</sup> The business judgment rule is a presumption employed by courts that the decisions of corporate management are unreviewable unless a breach of fiduciary duty is present. See Part III.B *supra*.

<sup>10</sup> My analysis is limited to shareholders of publicly held firms.

*shareholders of acquiring companies devastated by unwise acquisitions.*<sup>11</sup>

Today, the legal status of bidder shareholders is of greater importance, as more of the acquirers participating in the current era of takeovers are publicly held companies. When a takeover initiated by a publicly held corporation fails to deliver its promised riches, large numbers of shareholders suffer uncompensated losses on the value of their stock. In today's new wave of merger activity, the time has come to reassess the way in which the law treats bidder shareholders.

Increased legal protection of bidder shareholders can be justified on two broad grounds: first, the law should protect the bidder shareholder from losses wrongfully caused by the bidder's officers and directors, who owe a fiduciary duty of loyalty and care to the shareholders of the corporation, regardless of whether the corporation is a target or a bidder.<sup>12</sup> Second, the law should attempt to promote an efficient allocation of resources. Acquisitions are often criticized as wealth-reducing vehicles or mere wealth transfers between one group to another. If that is the case, legal mechanisms designed to deter this type of activity should be put in place to better ensure a more efficient allocation of resources. In the past, those legal mechanisms have taken the form of target defenses, such as the Williams Act or *Unocal* review. It is now time to reconsider whether or not those mechanisms should now take the form of bidder shareholder defenses, especially if the bidder shareholders are the parties with the most to lose.<sup>13</sup>

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<sup>11</sup> George W. Dent, *Unprofitable Mergers: Toward a Market-Based Legal Response*, 80 NW. U. L. REV. 777 (1986) (emphasis added).

<sup>12</sup> See Dent, *supra* note 11, at 779-80 (disputing argument that management owes duties to investing public as a whole and not individual investors, who presumably could diversify the risk of a poor acquisition by investing in different stocks).

<sup>13</sup> See 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, 1173-74 (1984).

In this paper, I construct the argument for increased legal protection of bidder shareholders by first looking at the comparatively large number of options open to the target shareholder, either when he is dissatisfied with an offer to buy the company, or when he is unhappy with his management's response to what appears to be a fair bid. Part III briefly surveys target shareholder protections, such as state mandated voting rights, judicial review of target defenses, federal regulation of the takeover process, and appraisal rights. The target shareholder clearly has several options when he feels that the value of his stock is threatened by a takeover or by management's defense against a takeover. In contrast, bidder shareholders enjoy few legal protections from losses of stock market value caused by acquisitions. So long as the bidder management engages in a reasonably deliberative process prior to engaging in the acquisition, courts will find that it has fulfilled Delaware's duty of care as defined by *Smith v. Van Gorkom*,<sup>14</sup> and they will accord management's decision deference under the business judgment rule.

Part IV discusses the common justifications for acquisitions, and considers whether or not the law's asymmetrical treatment of bidder and target shareholders is a reasonable policy. Various competing hypotheses attempt to explain the large premiums above market price that acquirers pay for targets. These theories fall into three general categories. The first group is based on the assumption that the stock market is not completely efficient. The theories in this category explain bidder premiums as the result of (a) "inside information," whereby the bidder possesses information allowing it to offer more than market price for control of the company; (b) "market discount theory," which assumes that the market is informationally efficient, but less efficient as a reflection of the true value of the corporation; and (c) the downward sloping demand hypothesis, which argues that the market

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<sup>14</sup> 488 A.2d 858 (Del. 1985).

for corporate control and the market for stock are completely separate markets.

The second category of theories explains and justifies bidder premiums as the result of transactions that will ultimately create wealth. The theories most often invoked under this heading are (a) "synergy," including economies of scope and scale, as well as vertical integration; and (b) "managerial discipline" whereby the target's stock price is lower than the bidder's offer because incumbent managers have wasted the corporation's assets.

Finally, a third group of theories explains bidder premiums as partial or full wealth transfers from bidder shareholders to target shareholders. Included within this group are (a) empire building, in which the bidding manager's rationale for offering the premium is largely fueled by his desire to expand the company, add to his prestige and perhaps raise his compensation; (b) hubris, in which the manager overestimates his ability to extract profits from the target; (c) winner's curse, in which the bidder pays too much for the target because of the nature of auction in which he purchased it; and finally, (d) the "agency/cash-flow" hypothesis, which attempts to explain the large premiums bidders pay to target shareholders as one of the agency costs of free cash flow. Michael Jensen initially set forth this theory in defense of takeovers and the market for corporate control, arguing that debt-producing leveraged buyouts would force managers to pay out excess cash flows to debt-holders and thus reduce management's proclivity to invest extra cash in negative net present value acquisitions.<sup>15</sup> Other commentators, however, have shown that under Jensen's theory, takeovers are not only a

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<sup>15</sup> Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, in KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER, (John C. Coffee Jr. et al. eds., 1988) [hereinafter Jensen, *Takeover Controversy* and KNIGHTS, RAIDERS, AND TARGETS]; Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV., May 1986, at 323. [hereinafter Jensen, *Agency Costs*].



"solution" to the cash flow problem but a symptom of the cash flow problem as well.<sup>16</sup>

Which account is correct? One way to answer this question (as well as the larger issue of whether bidder shareholders warrant legal protection at all) is to look at literature surveying bidder shareholder returns following acquisitions. The evidence within most articles seems to suggest that bidder shareholders almost never gain and often lose. If this is the case, then the hubris, empire building, winner's curse, and the agency/free cash flow hypotheses may well be correct — at least in some circumstances.

But so what? Certainly, the mere fact that one's managers are misinvesting funds does not, without more, warrant enhanced legal protection. Part V therefore explains why enhanced legal protection is necessary and further explores those legal mechanisms most likely to aid bidder shareholders without unduly complicating or destroying the takeover process. In addition, I argue that increased protection of bidder shareholders can be accomplished without undermining or repealing current protections of target shareholders already in place, such as the Williams Act.

## II. PROLOGUE: THE NEWEST WAVE OF M&A ACTIVITY

Before discussing the legal status of bidder shareholders in the merger and acquisition context, a few words need to be said about the newest wave of takeover and merger activity. Following the passage of state anti-takeover legislation,<sup>17</sup> and the onset of a credit crunch and federal indictment of junk bond financier Michael Milken, the

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<sup>16</sup> See Bernard S. Black, *Bidder Overpayment*, 41 STAN. L. REV. 597 (1989); Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372 (1990).

<sup>17</sup> Anti-takeover legislation had been passed in 41 states as of mid-1995. See *Mergers & Acquisitions Report*, INVESTMENT DEALER'S DIGEST, September 19, 1995. (Supplied by the Investor Responsibility Research Center).

hostile takeover market virtually collapsed in 1989.<sup>18</sup> Mergers and acquisition activity massively decreased in the early 1990s, prompting one scholar to quip, "The takeover wars are over. Management won."<sup>19</sup>

Since that time, mergers and acquisitions have returned with a vengeance. In 1995, merger and acquisition activity set new record levels in both price and number of deals.<sup>20</sup> In 1996, merger volume increased, while takeover premiums decreased somewhat.<sup>21</sup> Whether the decrease in premiums represents an aberration or permanent trend is a question that cannot be answered definitively at this time. In any event, the mergers of today, however, differ significantly from their earlier counterparts. First, they are (currently) friendly.<sup>22</sup>

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<sup>18</sup> Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 861-62 (1993).

<sup>19</sup> *Id.*

<sup>20</sup> According to Securities Data Inc., 9,150 domestic deals valued at \$519 billion were announced in 1995. Edward Adams, *M&A Volume in '96 Hits Record High*, N.Y. L. J., Jan. 2, 1997, at 5.

<sup>21</sup> In 1996, 10,210 domestic deals were announced valued at \$653 billion dollars. *Id.* Despite the continuing interest in mergers and acquisitions, premiums may be deflating on average. The Wall Street Journal has reported that data compiled by J.P. Morgan demonstrates that the premiums paid by acquirers to target corporations has shrunk by more than 50% since 1990. Steven Lipin, *Takeover Premiums Lose Some Luster*, WALL ST. J., Dec. 31, 1996, at 13; see also Lipin, *Merger Wave Gathers Force As Strategies Demand Buying or Being Bought*, WALL ST. J., February 26, 1997, at A1 (noting that premiums have eased from 57% to 28% of the target's pre-merger stock price in 1996). Since premiums were initially high to begin with (the median in 1990 was 56% according to J.P. Morgan's data), this information does not necessarily mean that takeover premiums are "just right." Moreover, J.P. Morgan's figures present the *average* premiums paid by acquirers, suggesting that some acquirers continue to present target shareholders with offers above and beyond the stock market's valuation of their stock.

<sup>22</sup> According to Salomon Brothers, unsolicited bids represented less than 5% of the total volume of announced deals in 1995. *Mergers and Acquisitions Report*, INVESTMENT DEALERS' DIGEST, Jan. 15, 1996, at 14. These bids, however, often started out hostile and became friendly only later in time (e.g. IBM's acquisition of Lotus). Moreover, some commentators have suggested that a trend towards hostile acquisitions

Second, they are considerably more expensive.<sup>23</sup> Third, they are executed by widely held public corporations seeking to increase overall size and thus compete globally, or to spur growth in a particular area.<sup>24</sup> Unlike corporate raiders of times past, the current group of corporate acquirers do not wish to break their newly targets into component parts and sell them off. Rather, they seek growth amidst a competitive global economy. Fourth, the new wave of mergers and acquisitions is funded mostly by stock, and not by cash or debt.<sup>25</sup> Finally, the newest wave of merger and acquisition activity raises questions of monopoly power and the efficacy of the federal government's enforcement of the antitrust laws, since many of the mergers currently taking place are between companies in the same or similar industries.

### III. TARGET SHAREHOLDER PROTECTIONS

Target shareholders enjoy several varieties of legal protections from losses due to mergers or acquisitions.<sup>26</sup>

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may be forming. See Steven Lipin, *1995 Year-End Review of Markets and Finance*, WALL ST. J., Jan. 2, 1996, at R8.

<sup>23</sup> The Wall Street Journal has dubbed 1995 the year of "megadeals." Lipin, *supra* note 21. Mergerstat reported that megadeals accounted for 60 percent of the mergers and acquisitions market. "There were 75 transactions of \$1 billion or more in 1995 — an increase of 60 percent from 47 such deals in 1994." Ronald E. Yates, *Outdoing the '80s Frenzy: Big Deals, and More of Them*, CHI. TRIB., Jan. 28, 1996, available in 1996 WL 2638072.

<sup>24</sup> When IBM bid for Lotus in June 1995, Business Week reported that the acquirer's top executives had concluded that the fastest way to increase IBM's network software presence was to buy Lotus. See Amy Cortese & Ira Sager, *Gerstner at the Gates*, BUS. WK., June 19, 1995, at 36.

<sup>25</sup> "In 1995, it was stock — not cash — that was king. Nearly 60% of all companies used stock as acquisition currency, up from earlier years, aided by a booming stock market that effectively made purchases cheaper." Lipin, *supra* note 21.

<sup>26</sup> "Fair value" is itself a loaded phrase. For those who accept the "strong form" efficient capital market hypothesis theory, any bid priced above the current stock market price is a premium for the target shareholder and is therefore *a priori* a fair price. For the purposes of this

Although some of these legal mechanisms have been criticized as providing target management with too much power to entrench itself, these mechanisms nevertheless protect the target shareholder from self-interested managers and overreaching bidders. The following is a brief summary of four of the most noteworthy legal mechanisms that protect target shareholders: voting rights, judicial review, federal takeover regulation, and the appraisal remedy.

### A. Voting Rights

Under Delaware<sup>27</sup> law, a majority of target shareholders entitled to vote must ratify a merger agreement at an annual or special meeting before the deal is completed.<sup>28</sup>

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section, however, I will assume that the strong form efficient market hypothesis does not exist, and further, that stock prices are regularly discounted by the market to take into account the incompetence or inefficiency of the target's incumbent management. See Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices As An Acquisition Motive*, 88 COLUM. L. REV. 891 (1988). Both of these concepts (the efficient capital market hypothesis and the discount theory) will be discussed in greater detail in Part IV below.

<sup>27</sup> Since Delaware remains the predominant locus of incorporation for most businesses, much of Part III focuses on the decisions of the Delaware courts and its statutory provisions. I do note, however, those aspects of takeover law in which Delaware's law diverges significantly from that of other jurisdictions.

<sup>28</sup> DEL. CODE ANN. tit. 8, § 251(c) (1991) states:

The agreement required by subsection (b) of this section shall be submitted to the stockholders of each constituent corporation at an annual or special meeting for the purpose of acting on the agreement. Due notice of the time, place and purpose of the meeting shall be mailed to each holder of stock . . . . The notice shall contain a copy of the agreement or a brief summary thereof, as the directors shall deem advisable. At the meeting, the agreement shall be considered and a vote taken for its adoption or rejection. If a majority of the outstanding stock of the corporation entitled to vote thereon shall be voted for the adoption of the agreement, that fact shall be certified on the agreement by the secretary or assistant secretary of the corporation.

Like other states, Delaware, in turn, provides the corporation's board of directors with the power to allocate voting power to various classes of stock within the corporation's charter.<sup>29</sup> Most public corporations adhere to a single class voting scheme, whereby common stock receives all the voting power, and preferred stock receives voting power contingent only on the corporation's failure to pay a dividend over a certain period of time.<sup>30</sup> Despite federal attempts to create one, no legal rule binds the corporation to a "one vote/one share" system among common stock.<sup>31</sup> Nevertheless, the New York Stock Exchange's refusal to list any corporation providing non-voting common stock encourages most public companies to adhere to the one-share/one-vote rule.<sup>32</sup>

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Shareholders also retain the right to vote for the corporation's sale of assets (known sometimes as a "de facto" merger). See DEL. CODE ANN. tit. 8, § 271 (1991).

<sup>29</sup> Under DEL. CODE ANN. tit. 8, § 151(a) (1991), the corporation's board of directors may issue nonvoting stock.

<sup>30</sup> "Most public corporations concentrate voting rights in a single, publicly traded class of common shares." Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia in Shareholder Voting Cases*, 79 IOWA L. REV. 485, 498 (1994). Corporations may, nonetheless, create a class of stock called "blank check preferred", whereby the board of directors reserves the right to allocate voting power to the class of stock at its discretion. Blank check preferred stock makes the target less attractive to a would-be acquirer because it increases the acquirer's difficulty in gaining control of the board of directors. See Melissa M. Kurp, *Corporate Takeover Defenses After QVC: Can Target Boards Prevent Hostile Tender Offers Without Breaching Their Fiduciary Duties?*, 26 LOY. U. CHI. L.J. 29, 50 (1994).

<sup>31</sup> In 1989, the SEC promulgated Rule 19c-4, which mandated single class offerings of stock to owners of common stock. This Rule did not survive judicial scrutiny. See *Business Roundtable v. Securities and Exchange Commission*, 905 F.2d 406 (D.C. Cir. 1990); Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565 (1991).

<sup>32</sup> NYSE has refused to list the stock of corporations that have issued non-voting common stock to the public. Facing competition from NASDAQ, the NYSE has considered dropping the "one-share/one-vote" rule for common stock. See discussion in Oesterle & Palmiter, *supra* note 30, at 498-99 n.63 (1994).

Shareholder voting protects target shareholders in two ways. First, if shareholders wish to block a bid because they think it is too low, they can vote against it. Second, if they wish to accept a bid — by redeeming a poison pill or accepting an acquisition pursuant to the procedures outlined by the state anti-takeover statutes — they can vote out the current board of directors and put in place new management to negotiate with the bidding corporation.

Despite the theoretical uses of a shareholder vote, its use as a tool of corporate democracy is undermined by the perception that widely dispersed shareholders lack the incentive or ability to cast an informed vote. According to the traditional Berle and Means concept of separation of ownership and control within the corporation, a collective action problem develops in widely held public corporations because the single shareholder's costs of acquiring information outweigh any potential gain as a consequence of his vote.<sup>33</sup> Thus, when a merger is proposed, the target shareholder will most likely sit back and wait for someone else to acquire the necessary information.<sup>34</sup> Despite the persuasiveness of this argument, empirical evidence suggests that it is less true than when Berle and Means wrote about the structure of the corporation in 1932. Institutional investors now own a significant percentage of stock; due to the size of their stake in public corporations, they have more incentive to gather information about stock than they do to sell it.<sup>35</sup> As one academic argues, "[i]ncreased concentration of shareholding makes shareholder activism more rational, making it easier for shareholders to surmount the classic collective action problem that forms the basis for much of corporate law,

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<sup>33</sup> See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

<sup>34</sup> This is commonly called the "free rider" problem. See Grundfest, *supra* note 18, at 908. Grundfest classifies the collective action problem further into three categories: free rider problems, communication among and coordination of shareholders, and rational apathy.

<sup>35</sup> See generally, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 566-75 (1989).

namely, the problem facing dispersed shareholders in disciplining management."<sup>36</sup> The phenomenon of relational investing<sup>37</sup> therefore increases the importance of the shareholder franchise.<sup>38</sup>

Unlike target shareholders, bidder shareholders are not uniformly assured voting rights when acquisitions are announced and completed. Instead, their right to register their dissent and prevent a wasteful transaction depends on the state in which their firm is incorporated. Under Delaware law, a bidder shareholder may cast a vote in favor of or against a merger only if the proposed transaction would result in the issuance of a certain number of new shares in excess of 20% of the ones already outstanding.<sup>39</sup>

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<sup>36</sup> Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452 (1991).

<sup>37</sup> Relational investors see themselves as long term owners of the firm, as opposed to short term investors. According to Professor Gordon, "[r]elational investing depends on the interrelation of three elements: substantial share ownership, a commitment to an extended holding period, and a reciprocal engagement with management over the business policy decisions of the firm." Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 129 (1994).

<sup>38</sup> For an interesting account of how relational investors can use voting power symbolically to loosen the incumbent management's grip on the top positions within the corporation, see Grundfest, *supra* note 18.

<sup>39</sup> See DEL. CODE ANN. tit. 8, §251(f)(1991): "Notwithstanding the requirements of subsection (c) [providing for target shareholder voting rights] of this section, unless required by its certificate of incorporation, no vote of stockholders of a constituent corporation surviving a merger shall be necessary to authorize a merger if . . . (3) securities or obligations convertible into such stock are to be issued or delivered under the plan of merger . . . do not exceed 20% of the shares of common stock of such constituent corporation outstanding immediately prior to the effective date of the merger." (emphasis added).

Of course, a corporation's charter can provide more extensive voting rights for its shareholders than the standard form rules provided by the state's corporation law. For example, in *American General Corp. v. Unitrin*, 1994 WL 698483 (Del. Ch. 1994), the corporation's charter provided that all mergers required the approval of seventy 75% of the shareholders. This supermajority requirement allowed a minority insider group of board members to take control of 28% of the company and thereby prevent any merger or acquisition that the Board did not like.

Unlike Delaware, Ohio offers bidder shareholders greater protection by giving them the right to vote on any transaction that would result in an issuance of stock equaling one-sixth the number of outstanding shares.<sup>40</sup> Once the Ohio provision is triggered, a supermajority<sup>41</sup> — two-thirds of the shareholders — must approve the transaction in question. Finally, New York treats all shareholders equally: with the exception of short form mergers, all shareholders of constituent corporations must ratify a proposed merger or acquisition by a two-thirds vote.<sup>42</sup> Even in states that provide bidder shareholders

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Thus, under this scheme, bidder or target shareholders would be forbidden from completing a transaction without the approval of an entrenched minority. Unitrin's shareholders effectively had no voting rights at all.

<sup>40</sup> See OHIO REV. CODE ANN. §1701.78(D) (Banks-Baldwin 1994):

In the case of a merger, the agreement shall also be adopted by the shareholders of the surviving corporation at a meeting held for the purpose, if one or more of the following conditions exist:

- (1) [the article of incorporation require such a vote]
- (2) The agreement conflicts with the articles or regulations of the surviving corporation then in effect, or changes the articles or regulations . . .
- (3) The merger involves the issuance or transfer by the surviving corporation to the shareholders of the other constituent corporation or corporations of such number of shares of the surviving corporation as will entitle the holders of the shares immediately after the consummation of the merger to exercise one-sixth or more of the voting power of that corporation in the election of directors.

<sup>41</sup> OHIO REV. CODE ANN. § 1701.78 (F)(Banks-Baldwin 1994). The shareholders can opt out of the two-thirds provision for any other provision that does not fall below majority vote by designation in the corporate charter.

<sup>42</sup> See, N.Y. BUS. CORP. LAW § 903 (McKinney 1986):

- (a) The board of each constituent corporation, upon adopting such plan of merger or consolidation, shall submit such plan to a vote of shareholders in accordance with the following:

...



with voting rights prior to completion of an acquisition, bidder managers still can avoid the voting requirement by structuring the acquisition as a purchase of the target's stock or assets.<sup>43</sup> Thus, bidder shareholders simply receive less voting rights protection than target shareholders when mergers and acquisitions are under consideration.

## B. Judicial Review

Perhaps the most important source of legal protection for the target shareholder is the ability to secure judicial review of target management's actions in response to a bid. "Judicial review" includes judicial intervention in the takeover process before the takeover has been completed (as in injunctive relief), and intervention to compel management's payment of damages to shareholders after the transaction has been completed (as in punitive or compensatory damages). In carrying out any business transaction, the officers and directors are expected to fulfill their fiduciary duties of loyalty and care to the corporation's shareholders.<sup>44</sup> Ordinarily, judges presume that directors and officers have fulfilled these duties and refuse to second-guess the business expertise of the managers of a firm. This presumption is known as the business judgment rule, and it

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(2) The plan of merger or consolidation shall be adopted at a meeting of shareholders by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon. . . .

<sup>43</sup> See Dent, *supra* note 11, at 786 n.51, citing W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 145-46 (1980) for the proposition that no approval of acquiring shareholders is necessary when a transaction is not a statutory merger. Dent notes, however, that this harsh rule is muted somewhat by the NYSE's regulations that require shareholder approval of any acquisition, "however structured, that will increase the acquirer's outstanding stock by 20%." *Id.*

<sup>44</sup> The directors formally trace their legal responsibility to run the corporation to the state corporation law statutes. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991).

applies whenever managers are independent, informed, and acting in good faith on behalf of the corporation.<sup>45</sup>

When corporate officers accept a takeover offer, their decision is reviewed according to the standard of care defined by *Smith v. Van Gorkom*.<sup>46</sup> Although *Van Gorkom* applied the business judgment rule to a decision to sell a corporation at a premium over the stock price, it modified the traditionally deferential test to require deliberation and procedural safeguards in takeover and merger situations. Despite the Pritzker offer's premium over the stock price, the *Van Gorkom* court held the directors of the Trans Union corporation personally liable to its shareholders for failing to properly value the company prior to selling it to the Pritzker family. Although the *Van Gorkom* opinion formally defined the duty of care in terms of "gross negligence", its actual decision ushered in a stricter definition of "care" than past decisions by requiring officers to set up an "appropriately deliberative" decision-making process before selling the company.<sup>47</sup>

Although the Delaware courts retained a modified version of the business judgment rule for situations in which the target's management accepted an offer, they unequivocally dispensed with the rule for situations in which the target rejected or sought to fight off an offer. In *Unocal Corp. v. Mesa Petroleum Co.*,<sup>48</sup> the Delaware Supreme Court substituted an enhanced scrutiny test for evaluating the propriety of defensive conduct of incumbent Board members in response to takeover bids. Prior to *Unocal*, the Delaware Supreme Court had held the business judgment rule generally applicable to takeovers.<sup>49</sup> Nevertheless, the Delaware Supreme Court now held, "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of

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<sup>45</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

<sup>46</sup> 488 A.2d 858 (Del. 1985).

<sup>47</sup> *AC Acquisitions v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986).

<sup>48</sup> 493 A.2d 946 (Del. 1985).

<sup>49</sup> See *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984).

the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.<sup>50</sup>

Whereas *Van Gorkom* was concerned with the officer and director's proper exercise of care, *Unocal* was written with a different fiduciary duty in mind: loyalty. Despite the absence of self-dealing or corporate opportunities in the strict doctrinal sense, the Delaware Supreme Court nevertheless worried that managers would place their own interests (entrenchment) over that of their shareholders when control of the company was at stake. At the same time, the *Unocal* court recognized that some target defenses were legitimate, even desirable, if bidders were able to coerce target shareholders into tendering their stock at unfair prices. The challenge was to adopt a screen that separated "good" defenses from the "bad" ones without overly engaging courts in second-guessing and matters of business judgment.

The *Unocal* court therefore adopted an "enhanced scrutiny" test. It would not be as deferential to the directors' and officers' expertise as the business judgment rule, but it would not be as detailed and questioning as the "entire fairness" test, which attached whenever self-dealing was present.<sup>51</sup> First, directors had to identify some threat to shareholder welfare justifying their defensive reaction.<sup>52</sup> Second, their response had to be proportional to the threat they were seeking to avert.<sup>53</sup>

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<sup>50</sup> *Unocal*, 493 A.2d at 954.

<sup>51</sup> Directors must demonstrate "utmost good faith and loyalty" whenever they possess a personal interest in the corporate transaction that will not be dispersed equally to all of the shareholders. The courts therefore apply an "entire fairness" test to these types of transactions, whereby the directors must show both fair price and fair dealing. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

<sup>52</sup> "[D]irectors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership." *Unocal*, 493 A.2d at 955.

<sup>53</sup> "If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed." *Id.*

In theory, *Unocal* should provide shareholders with the power to compel takeovers when they feel that management has unfairly blocked a bid; in fact, challenges brought under *Unocal*'s enhanced scrutiny standard often fail.<sup>54</sup> Generally, target managers can "just say no" when they wish to fight a tender offer or bid for the target's shares.<sup>55</sup> Once the corporation has been "put in play" however, and a change in corporate control is inevitable, the target managers' actions come under closer scrutiny. They cannot pick and choose between bidders based on personal preference or guarantees of a job following the takeover. Rather, they must ensure that target shareholders will receive the "best" price for the value of their stock. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>56</sup> the Delaware court held that when the breakup of a company becomes "inevitable," the directors' duties change "from the preservation [of the company] as a corporate entity to the maximization of the company's value at a sale for the stockholder's benefit."<sup>57</sup> Although directors still retain a considerable amount of latitude in deciding which bid is the "better" offer for shareholders,<sup>58</sup> they nevertheless are

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<sup>54</sup> The Delaware court approved of the board's exclusive share repurchase in *Unocal*. See also *Moran v. Household Int'l., Inc.*, 500 A.2d 1346 (Del. 1985) (approval of poison pill).

<sup>55</sup> The fact that target managers can adopt a "just say no" defense might undermine my argument that target shareholders receive judicial protection when they wish to compel target managers to let them tender their shares. Nevertheless, *Unocal* review does differ substantially from the business judgment rule by allowing shareholders to go to court and challenge the target management's defense tactics. Even if target managements normally win these challenges, they still must set aside corporate funds to defend themselves in court. At some point, the cost of defending their tactics will enter into the target management's decision whether or not to defend against a takeover. In this sense, shareholder litigation acts as a monitor over target management's response to would-be acquirers.

<sup>56</sup> 506 A.2d 173 (Del. 1986).

<sup>57</sup> *Id.* at 182.

<sup>58</sup> In assessing the bid:

expected to promote, "the highest values reasonably attainable for the stockholders' benefit."<sup>59</sup> Many scholars have since debated whether or not auctions actually protect target shareholders. Whereas Easterbrook and Fischel criticize auctions as making the takeover process more expensive and thus reducing the number of bids, several scholars have responded that bidders can protect themselves by buying some target stock prior to making the first bid.<sup>60</sup>

Much litigation has since followed concerning what activity "triggers" *Revlon* duties.<sup>61</sup> Although courts have

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[t]he board may under appropriate circumstances consider the inadequacy of the bid, the nature and timing of the offer, questions of illegality, the impact on constituencies other than shareholders, the risk of nonconsummation, and the basic stockholder interests at stake, including the past actions of the bidder and its affiliates in other takeover contests.

*Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341-42 (Del. 1987).

<sup>59</sup> *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1264 (Del. 1988).

<sup>60</sup> For general argument against auctions, see Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) (arguing that auctions make bidding more expensive, reduce number of bids, and thereby harm target shareholders by reducing managerial discipline). Easterbrook and Fischel's argument has met substantial resistance from academics and lawmakers. See Lucian Bebchuk, *The Case for Facilitating Tender Offers*, 95 HARV. L. REV. 1028 (1982) (arguing that coercive nature of tender offer demands that target shareholders receive protection provided by auction) and Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

<sup>61</sup> "The [Revlon] duty does not apply to all takeovers. Rather, it applies during the 'break-up' of a company or when the board facilitates a 'sale' or 'change in control' of a corporation." Alexander B. Johnson, *Is Revlon Only Cosmetic?: Structuring a Merger in the Mid-1990s*, 63 FORDHAM L. REV. 2271, 2282 (1995). In *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989), the Delaware Supreme Court held that a long-term business plan to complete a merger of "equals" between Time and Warner was not a "sale" and therefore did not trigger auction duties. "After Time-Warner, a change in control will not occur if

discussed the target directors' duty to uphold standards of fairness in maintaining an auction,<sup>62</sup> little has been said about when an auction must (or can) end.<sup>63</sup>

In contrast to target shareholders, bidder shareholders enjoy substantially less access to judicial review when acquisitions are about to be or have been completed by their managers. In part, this is because the Delaware judiciary has constructed its takeover doctrine with one and only one group in mind: target shareholders. *Van Gorkom*, *Unocal*, and *Revlon* are designed to minimize the agency costs between target shareholders and their managers by restraining management's discretion — in increasing degrees — when takeovers are imminent.

Sometimes the Delaware judiciary incidentally aids bidder shareholders by protecting targets. That certainly was the case with *Van Gorkom* and its definition of "care" in terms of process and deliberation. If target managers cannot sell the company without adequately informing themselves about the product they are about to sell, then by the same token, bidder managers cannot buy a company without engaging in the same type of process of deliberation.

Unfortunately, bidder shareholders have little protection in the courts beyond that provided by *Van Gorkom*. One of the few decisions addressing a string of "defensive"

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control remains vested in a widely dispersed public." Johnson, *supra* at 2292. The Delaware Supreme Court further clarified *Revlon*'s application in *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1993), in which it held that a transfer of control from dispersed public shareholders to a single shareholder constituted a "sale of control" and therefore triggered the *Revlon* duty to get the highest price for the shareholder's stock.

<sup>62</sup> *Mills*, 559 A.2d at 1264.

<sup>63</sup> For an interesting account of how supposedly "final" bids turned into a series of successive bids, see the account of bidding for control of RJR Nabisco in BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE* 472-503 (1990). The failure of the courts to specify when auctions "end" arguably contributes to uncertainty in bidding, higher bids, and ultimately, overpayment for target shares at the expense of the bidder shareholder.

acquisitions, *Panter v. Marshall Field*,<sup>64</sup> strongly rebuffed any suggestion that the management's acquisition should be reviewed according to anything other than the business judgment rule. *Panter* was decided several years before *Unocal* (and in the Seventh Circuit). Since *Unocal*, no court has addressed the continuing viability of *Panter*'s holding regarding defensive acquisitions. Even if courts held that defensive acquisitions do fall under *Unocal*'s heightened standard of review and thus require proportionality, one can easily imagine that managers would deny the "defensive" nature of the acquisitions and instead point to some imagined synergies between the two companies.<sup>65</sup> Whatever the case, bidder shareholders currently enjoy only the protection provided by *Van Gorkom*'s process-oriented definition of the directors' duty of care.<sup>66</sup> Provided the bidder's management conducts a reasonably deliberative process to evaluate the target's worth, its actions will not be questioned on judicial review.

### C. State and Federal Regulation of the Takeover Process

A third source of takeover protection for target shareholders is the regulation of takeovers effected by federal laws.<sup>67</sup> Of the federal legal protections, the Williams

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<sup>64</sup> 646 F.2d 271 (7th Cir. 1981). "The plaintiffs also contend that the 'defensive' acquisitions . . . were imprudent, and designed to make [Marshall] Field's less attractive as an acquisition as well as to exacerbate any antitrust problems created by the [proposed] merger. *It is precisely this sort of Monday-morning-quarterbacking that the business judgment rule was intended to prevent.*" *Id.* at 297 (emphasis added).

<sup>65</sup> Moreover, even if *Unocal* were to apply in this situation, the shareholder still would have no extra protection when the acquisition was the result of managerial hubris or mistaken judgment.

<sup>66</sup> "[C]ourts have treated acquisitions as involving no conflict of interest for the acquirer's managers and, accordingly, have applied the business judgment rule to such cases rather than the stricter standard that would apply to self-dealing." Dent, *supra* note 11, at 784.

<sup>67</sup> Anti-takeover laws within this discussion have been excluded because I think it is highly questionable that they protect shareholders

Act provides the best example of the asymmetrical treatment of target and bidder shareholders. The Williams Act<sup>68</sup> creates a de facto auction period by outlawing surprise tender offers, mandating disclosure by potential bidders, and setting limits on a tender offeror's ability to make coercive two tier offers.<sup>69</sup> This allows target shareholders the time and freedom necessary to make a rational decision about selling their shares. In particular, the Act requires would-be acquirers to disclose their intentions when they acquire more than five percent of a class of stock in the corporation.<sup>70</sup> In addition, § 14(d) requires any offeror who would own more than five percent of the stock once a tender offer were completed to disclose "the purpose of the tender offer and its plans or proposals for the target."<sup>71</sup> Finally, the Williams Act protects target shareholders by requiring a minimum offer period of twenty days,<sup>72</sup> by mandating a "best price rule" for offerors who increase the consideration of the tender offer such that the best price extends to all shareholders,<sup>73</sup> and by requiring that the tender offeror extend proration rights to all shareholders who tender stock when the stock exceeds the number of shares desired by the offeror.<sup>74</sup>

Although the Williams Act has been criticized as harming target shareholders by making bidding costs too

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from coercive bids. Rather, they tend to allow target managers to perpetuate themselves in office.

<sup>68</sup> 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1994).

<sup>69</sup> "Two-tier" offers, are offers in which the bidder offers a high price for a certain amount of stock, and then freezes out the remaining stockholders at a much lower price. This type of tender offer forces stockholders to tender their stock out of fear that they will be left in the second group. If the average price offered for the target is less than its actual worth, one can argue that target shareholders are unfairly coerced into transferring their wealth to the bidder. For a general overview and discussion of the Williams Act and literature about two-tier tender offers, see ROBERT CLARK, *CORPORATE LAW*, §§ 13.3, 13.4 (1986).

<sup>70</sup> 17 C.F.R. § 240.13d-1(a) (1993).

<sup>71</sup> CLARK, *supra* note 69, at 549.

<sup>72</sup> 17 C.F.R. § 240.14e-1 (1993).

<sup>73</sup> 17 C.F.R. § 240.14d-7 (1993).

<sup>74</sup> 17 C.F.R. § 240.14d-6 (1993).



expensive and thereby reducing takeover activity,<sup>75</sup> it is clear that the law at least attempts to clothe target shareholders with legal protection from overreaching bidders.<sup>76</sup>

#### D. Appraisal Rights

Appraisal rights provide the minority shareholder with a method of opting out of a merger even if all of the other shareholders conclude that the deal offered to them is fair. Appraisal rights do not prevent the merger from taking place; rather, they force the majority shareholders that favor the merger to pay the minority shareholders "fair value" in exchange for their shares.<sup>77</sup> Under Delaware law, the appraisal process provides the minority stockholder with judicial process to determine the fair value of his stock, provided he does not vote for the merger.<sup>78</sup>

The minority shareholder is entitled to a proportionate interest in the going-concern value of the target corporation as of the date of the merger.<sup>79</sup> Most commentators have

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<sup>75</sup> See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). See also Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613, 691 (1988) (criticizing Williams Act's "best price" rule).

<sup>76</sup> See note 59 *supra*.

<sup>77</sup> "Appraisal rights are a liability rule that allows the majority shareholders to accomplish a merger by compensating the dissenting minority with judicially-determined damages for the breach of a corporate contract right." Angie Woo, Note, *Appraisal Rights in Mergers of Publicly-Held Delaware Corporations: Something Old, Something New, Something Borrowed, and Something B.L.U.E.*, 68 S. CAL. L. REV. 719, 728 (1995).

<sup>78</sup> "Any stockholder of a corporation . . . who holds shares of stock on the date of the making of a demand pursuant to subsection (d) of this section . . . who continuously holds such shares through the effective date of the merger or consolidation . . . and who has neither voted in favor of the merger or consolidation nor consented thereto . . . shall be entitled to an appraisal by the Court of Chancery of the fair value of his shares of stock . . ." DEL. CODE ANN. tit. 8, § 262(a) (1991).

<sup>79</sup> See DEL. CODE ANN. tit. 8 § 262(h).

construed Delaware's appraisal statute as excluding from the minority shareholder's remedy any value created by the proposed merger.<sup>80</sup> Recently, however, the Delaware Supreme Court altered this assumption somewhat when it held that when the acquirer initiates a two-step transaction,<sup>81</sup> the minority shareholder is entitled to the value created by the acquirer's plans for the combined entity, provided that value is nonspeculative.<sup>82</sup> One commentator has praised this decision, and predicts that it might discourage acquirers from engaging in otherwise unworthy transactions.<sup>83</sup> Others have suggested, however,

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<sup>80</sup> See, e.g., CLARK, *supra* note 69, at 452-53.

<sup>81</sup> A two-step acquisition is one in which the acquirer first purchases a majority stake in the target and then later purchases the rest of the minority stock (commonly called a "freeze-out" transaction) at a later time. See generally Jesse A. Finklestein & Russell C. Siberglied, *Technicolor IV: Appraisal Valuation in a Two-Step Merger*, 52 BUS. LAW. 801 (1997). The two-step structure is considered desirable because it does not require immediate financing by the acquirer and allows the acquirer to gain access to nonpublic information about the target prior to making its bid for the minority shareholders' stake in the corporation. *Id.* at 807.

<sup>82</sup> See *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996). The *Cede* court rejected the contention that Delaware's appraisal statute excluded value generated by a planned acquisition when the merger had not yet taken place: "[V]alue added to the going concern by the 'majority acquiror,' during the transient period of a two-step merger, accrues to the benefit of all shareholders and must be included in the appraisal process on the date of the merger." *Id.* at 298-99. *Cede* in turn, was based on *Weinberger v. UOP, Inc.*, which provided that "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered." 457 A.2d 701, 713 (Del. 1983). In a two-step acquisition, "the date of the merger" apparently is construed to be the date of the completion of the second step, i.e., the day the acquirer purchases the minority shareholders' interest in the target.

<sup>83</sup> See Recent Cases, 110 HARV. L. REV. 1940, 1943-44 (1997). "A minority shareholder contributes to the investment cost required in a two-step takeover to the extent that the acquirer uses material, nonpublic information about the target, which is the property of all the shareholders, in formulating his business plan. When the acquirer's business plan remains valued or undeveloped until he obtains a controlling stake, which then gives him access to and use of proprietary information about the target, the value arising from the transaction is

that since an acquirer's plans for the target are usually less well defined (and therefore more likely to create only "speculative" value) in a one-step acquisition, the Delaware Supreme Court's decision may simply have the effect of encouraging all acquirers to abandon the two-step structure for future acquisitions.<sup>84</sup> In any event, target shareholders are benefited by the decision.

Appraisal rights do not apply in all mergers. Of special importance is the "stock market exception", which precludes use of the remedy if the target corporation is a widely held public corporation.<sup>85</sup> There are two exceptions to the stock market exception: (i) short form mergers<sup>86</sup>, and (ii) mergers in which the shareholder receives cash instead of the surviving corporation's stock as consideration.<sup>87</sup>

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less like prospective value directly attributable to the acquirer's efforts and more like the taking of a preexisting corporate opportunity . . . ."

<sup>84</sup> "[The Delaware Supreme Court's decision] diminishes the desirability of using a two-step acquisition structure because, in some cases, the acquirer might be forced to pay a substantially higher appraisal price after the second step merger than the acquirer would in a one-step transaction." Finklestein & Siberglied, *supra* note 81, at 807.

<sup>85</sup> See DEL. CODE ANN. tit. 8 § 262(b)(1)(1991). A widely held corporation is one that (i) is listed on a national securities exchange, or (ii) is held by more than 2000 stockholders.

<sup>86</sup> See DEL. CODE ANN. tit. 8 § 262(b)(3)(1991): "In the event all of the stock of a subsidiary Delaware corporation party to a [short form merger] is not owned by the parent corporation, immediately prior to the merger, appraisal rights shall be available for the shares of the subsidiary Delaware corporation." Under Delaware law, a short-form merger is a merger in which the acquiring corporation already owns ninety percent of the stock in the target corporation. Voting rights do not attach to target shareholders in the short-form merger scenario. Therefore, appraisal rights are considered necessary to protect minority shareholders from being cheated out of the value of their stock.

<sup>87</sup> See DEL. CODE ANN. tit. 8 § 262(b)(2)(1991) (stating that appraisal rights are available if the consideration for the shareholder's stock is cash). "[I]f the merger consideration is equity of the surviving firm, the minority shareholder does not have a self-dealing concern *ex post* because all shareholders are treated the same and retain an equity interest in the surviving corporation." Woo, *supra* note 77, at 736. On the other hand, if the consideration for the minority shareholders' shares is cash, there is more fear that they have indeed been "frozen out", based on a distrust of the efficient market hypothesis. See note 81, *supra*.

In the past, appraisal rights were justified as a method of ensuring liquidity for the minority shareholder wishing to exit a fundamentally changed enterprise, following a merger or takeover. Today, however, appraisal rights are justified as an efficient way of preventing self-dealing between majority shareholders and the corporation.<sup>88</sup> Without the appraisal process, a majority shareholder would have the ability to freeze out a minority shareholder for a portion of the fair value of the stock. The appraisal remedy, on the other hand, forces the majority shareholder (or the acquirer) to pay a "fair price" to the tendering shareholder for the value of his stock. Fair price, in turn, can be calculated according to "any valuation technique commonly accepted in the financial community."<sup>89</sup>

Since many of the mergers now taking place are stock for stock transactions, and many of the companies involved are publicly traded, it is questionable how important the appraisal remedy will be to dissenting target shareholders throughout the current wave of mergers and acquisitions. Nevertheless, it is yet another example of legal protection that protects target shareholders from coercive transfers of wealth to bidders.

## E. Conclusion

The legal mechanisms discussed above are not the only sources of legal protection for target shareholders, and they are not without their drawbacks. Nevertheless, voting rights, judicial review, the Williams Act, and the (concededly limited) opting-out rights provided by the appraisal remedy, provide target shareholders with a considerable amount of protection from self-interested

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<sup>88</sup> "Now the remedy serves as a check against opportunism by a majority shareholder in mergers and other transactions in which the majority forces minority shareholders out of the business and requires them to accept cash for their shares." Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 4 (1995). See also Woo, *supra* note 77, at 727-32.

<sup>89</sup> Weinberger, 457 A.2d at 712.

managers and bidders and ensure the target shareholder at least a portion of the difference between the stock market price and the "actual value" of the stock.

In contrast, none of the legal mechanisms discussed in this section attempt to protect bidder shareholders from the losses of value created by bad deals. Asymmetry in the legal treatment of target and bidder shareholders clearly exists. Of course, if most or all mergers are justified and provide gains to bidder shareholders, there is little reason to be concerned by this anomaly. The next section of this paper therefore examines some common justifications for takeover premiums and then reviews some of the most recent financial literature discussing the health of the bidder shareholder's investment *after* the merger has taken place.

#### IV. HOW ACQUISITIONS AFFECT BIDDER SHAREHOLDERS: THEORY AND FACTS

Part III demonstrated the ways in which bidder shareholders receive less legal protection than shareholders of target firms. This section examines whether that difference in legal protection is justified. First, I review the competing theories that attempt to explain why supposedly rational bidders offer such high premiums over market price for the target shareholders' stock. Depending on which theory is used to justify a merger or its attendant premium over the target's stock price, the bidder shareholder should either (i) remain indifferent, (ii) rejoice over his good fortune, or (iii) register strong disapproval and discontent when his corporation decides to proceed with an acquisition.

After discussing the competing theories, I then survey financial and economic literature examining the empirical effect of takeovers and mergers on the value of the bidder shareholder's stock. Although the evidence is not conclusive, it nevertheless suggests that bidder shareholders lose at least some of the time, and that these losses might be prevented (or perhaps compensated) by some type of legal reform.

## A. Justification for Mergers

Mergers, and the premium bidders pay for the target corporations' stock, are justified or explained by many competing theories.<sup>90</sup> Although these theories differ considerably, they can be classified in three general categories: stock market inefficiency, wealth creation, and wealth transfer.<sup>91</sup> The theories falling under the "stock market inefficiency" heading assume, for various reasons, that the stock market fails to convey to investors accurate information about the "true" value of the corporation. The "wealth creation" heading, on the other hand, assumes market efficiency and includes those theories most often used to justify merger premiums: synergy and managerial discipline. Finally, the "wealth transfer" heading includes those theories that suggest that the bidder corporation has engaged in overbidding, and by doing so, has harmed its shareholders.

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<sup>90</sup> In analyzing these theories, Professor Romano has noted, "[W]e do not have a comprehensive theory of takeovers. Different theories do well at explaining various subsets of acquisitions, but no theory satisfactorily explains all." Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. ON REG. 119, 120 (1992). Romano goes on to argue that "[t]he empirical evidence is most consistent with value-maximizing, efficiency-based explanations of takeovers." *Id.* The thesis of this section is that Romano's assessment is incorrect.

<sup>91</sup> Professor Romano has classified competing explanations into "value-maximizing" and "non-value-maximizing" explanations. *Id.* See also Kraakman, *supra* note 26, at 893: "Three possibilities might occur to an observer who first learned that acquirers routinely pay large premia over share price for the assets of target firms: (1) acquirers may be discovering more valuable uses for target assets; (2) share prices may 'underprice' these assets; or, finally (3) acquirers may simply be paying too much." (classifying theories into "traditional" gains hypotheses, discount hypotheses, and hypotheses based on the premise that the acquirer has overbid for the target).

## 1. Stock market inefficiency: Information, Discounts, and Cost of Gaining Control

The theories discussed under this heading assume that the stock market, on some level, fails to convey the true value of a corporation's assets and future cash flows to investors. The "inside information" hypothesis is premised on the belief that the stock market is inefficient because it fails to reflect certain inside information as part of the value of the stock. The Efficient Capital Market Hypothesis (ECMH) is premised on the belief that the stock market adequately reflects all available information about a given corporation and estimates the future cash flow of the corporation.<sup>92</sup> If the ECMH is correct, then any premium paid over the stock price should represent a real "gain" for target shareholders. Bidder shareholders, meanwhile, usually benefit in a world characterized by the ECMH only if the bidder managers run the combined entity more efficiently, or if the merger itself creates value-enhancing synergies.

Some commentators suggest that the huge premiums offered targets from bidders do not reflect potential synergy or increased managerial efficiency, but rather inside information that the market has undervalued the worth of the particular target firm in question.<sup>93</sup> The inside

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<sup>92</sup> See generally RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS*, Ch. 5 (1986) and Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). The ECMH exists in three forms. Strong form efficiency assumes that the market incorporates inside information and public information about the corporation into the price of the stock. The semi-strong form hypothesis assumes that the market incorporates all available public information. The weakest form assumes only that past sequences of share prices are incorporated into the shares of the stock.

<sup>93</sup> According to Professor Kraakman, the "private information" theory, "assumes that the market may be uninformed about the real value of target assets." Kraakman, *supra* note 26, at 895. Kraakman gives short shrift to the inside or private information theory in hostile takeover situations: "Short of hiring informers, hostile acquirers lack access to inside information about targets." *Id.* Many of the acquisitions taking place, today, however, are at least on the surface "friendly" acquisitions.

information hypothesis provides bidder managers with a justification for takeover premiums. They are not paying too much for targets; rather, they are either paying the "real" value of the firm, or they are paying less than the computed value of the target and getting a "bargain."<sup>94</sup> Professors Kraakman, Black and Romano, however, have pointed out that if the "inside information" theory were correct, target firm prices would not sink to pre-bid levels once an acquisition was blocked or abandoned by the bidder since the bidder's premium would itself convey information about the target's worth to previously uninformed traders.<sup>95</sup> Yet studies show that stock prices sink to pre-bid levels once the bidder disappears.<sup>96</sup> Inside information therefore does not appear to drive acquisitions, or explain the high premiums that bidders offer to targets.

Several other theories that seek to explain acquisition premiums assume that the stock market does not always efficiently predict the future cash flows of all corporations.<sup>97</sup>

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Therefore, the information thesis may be worth more than it was five years ago.

<sup>94</sup> Since the target shareholders do not receive any true gain, the bidder's return on investment "does not depend on any operating improvements or other changes to be undertaken by the bidder in the future" and the bidder corporation profits from buying a corporation at a lower price than its intrinsic value. Romano, *supra* note 90, at 143-44.

<sup>95</sup> See Romano, *supra* note 90, at 144; Black, *supra* note 16, at 607; Kraakman, *supra* note 26, at 895.

<sup>96</sup> See Romano, *supra* note 90, at 144 n.103 (citing studies); Kraakman, *supra* note 26, at 895 n.12 (also citing studies).

<sup>97</sup> Note that this type of inefficiency — the failure of the rational market hypothesis, that is of stock prices to reflect accurately the expected future cash flows of the corporation — is different from the type of inefficiency discussed in conventional ECMH discussions. The first type of inefficiency is labeled "allocative" inefficiency by Kraakman, whereas the second concerns the informational efficiency of the market. The discount theories set forth by Kraakman undermine only the first type of efficiency. "Note, however, that the distinction between informational and allocative efficiency is cogent only if the standard view, the rational market hypothesis, is suspect." Kraakman, *supra* note 26, at 898 n.22. "A growing body of work in financial economics now suggests, first, that informational efficiency - for which there is substantial empirical support - does not imply fundamental efficiency,



Professor Kraakman has argued that, at least in some circumstances, share prices diverge from the actual or "true" value of the corporation and result in a "discounted" price.<sup>98</sup> Kraakman identifies two explanations for the "discounting" of a corporation's shares. The first is known as the "misinvestment hypothesis," whereby the market discounts the corporation's shares to reflect the rational belief that the corporation's managers are likely to misinvest future cash flows.<sup>99</sup> This theory and its effect on acquisition choices and premiums are discussed later within Part IV, in conjunction with the managerial discipline hypothesis.

Professor Kraakman also identifies a second explanation for share discounts: the "market hypothesis," which asserts that the share prices themselves are an incorrect valuation of the corporation's net present value for reasons other than investors' distrust of managers.<sup>100</sup> The market hypothesis, in turn, breaks into two types of objections to the stock market's valuation of a company.<sup>101</sup> First, share prices may discount the true value of the corporation, "simply because

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and, second, that both the empirical and theoretical bases for the belief that markets are fundamentally efficient are suspect." Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 102 YALE L. J. 577, 615 (1992) (reviewing Frank Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991)) (citations omitted).

<sup>98</sup> Kraakman, *supra* note 26, at 909: "Large premia are easily explained if reliable appraisals of large firms can reveal the existence of market discounts. Under these circumstances, acquirers can calculate discounts with standard appraisal techniques and thereby learn, within the limits of appraisal error, whether the bulk of their premia costs are a simple purchase of assets at their existing values."

<sup>99</sup> "[T]he 'misinvestment' hypothesis holds that investors rationally expect managers of target firms to misinvest the future returns on corporate assets, and discount the value of these assets accordingly." *Id.* at 892. The misinvestment theory does not necessarily undermine the ECMH. Rather, the information it provides results in a discount of the stock that will be erased as soon as new management is put in place.

<sup>100</sup> "On this view, market prices simply fail to reflect informed estimates of likely cash flows generated by target firms." *Id.*

<sup>101</sup> *Id.* at 898-99.

assets and shares differ in ways that matter to traders."<sup>102</sup> According to Kraakman, traders might discount the target's stock because of the timing or taxation of distributions or liquidity concerns. Thus, if the bidder harbors preferences that differ from those of the trader, the bidder will value the target's shares more highly and pay more than market price for the stock. Although this prong of the discount theory may explain some premiums, it does not explain why bidders consistently offer premiums as high as 50% (or higher) over the target's actual stock price, unless one is willing to believe that *all* traders substantially discount their shares accordingly.

A second, and more prominent prong of the market hypothesis is that the stock market fails to adequately price corporate worth because of persistent biases that are introduced into the market by uninformed traders (so-called "noise trading").<sup>103</sup> Noise trading skews the stock market price by introducing price pressures that have little or nothing to do with the net present value of the corporation's future cash flows. Since noise can either depress or elevate shares, it presumably justifies only some premiums, while simultaneously undermining others.

On the surface, the first prong of the market hypothesis — that traders discount stock because of liquidity concerns — does not appear to explain the premiums offered to target shareholders in the current merger wave. Kraakman wrote about discounts in 1988, when most acquisitions were hostile and characterized by cash payments to target shareholders. That traders and investors would prefer cash to stock because of its liquidity makes sense under the

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<sup>102</sup> *Id.* at 899.

<sup>103</sup> "[T]here is a growing theoretical literature on 'mispricing' behavior, which argues that uninformed traders may introduce persistent biases or cumulative noise into share prices or that speculative trading might lead to positive or negative price 'bubbles.' Large-scale noise trading — arising from misconceived strategies, erroneous valuation assumptions, fashion and fads, or simple pleasure in trading — might distort share prices and generate discounts or premia through the sheer pressure of trading." *Id.* at 899-900.

discount theory.<sup>104</sup> Most recent mergers, however, have been stock for stock deals.<sup>105</sup> If the trader receives another stock in lieu of target stock, the market price or "discounts" should remain in place, since the trader will discount what he receives just as much as he discounts what he gives away in return. Premiums nevertheless remain a significant aspect of the typical deal, thus undermining this prong of Kraakman's discount theory.<sup>106</sup> At any rate, Kraakman admits that in order for an acquirer to find another corporation an attractive target, some other source of wealth must exist alongside the discount itself.<sup>107</sup> In sum, although it is highly plausible that discounts exist, they are only part of the story.

Finally, Professor Lynn Stout set forth a third theory that attempts to explain bidder premiums apart from overbidding or promises of future wealth creation.<sup>108</sup> According to Stout, stock market prices do not reflect the full value of target corporations; rather they reflect the marginal value of a particular share of stock.<sup>109</sup> On any

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<sup>104</sup> *Id.* at 914-20 (arguing that investors' behavior when shares are converted to equity supports the discount hypothesis).

<sup>105</sup> See *supra* notes 20-24 and accompanying text.

<sup>106</sup> *Id.* Premiums did, however, decrease in 1996. See *supra* note 21.

<sup>107</sup> "The most important way in which discounts can prompt takeovers is in combination with other sources of acquisition gains such as operating gains or private information." Kraakman, *supra* note 26, at 925. The need for an additional motive arises because the bidder often is forced to participate in an auction for the target, and by doing so, competes away much of the premium to the target shareholder. *Id.* at 925-27.

<sup>108</sup> Stout, *supra* note 75. See also Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990) [hereinafter Stout, *Takeover Premiums*]. See also, Richard A. Booth, *The Efficient Market, Portfolio Theory, and the Downward Sloping Demand Hypothesis*, 68 N.Y.U. L. REV. 1187 (1993).

<sup>109</sup> "In the public trading markets, price is set at that level at which a limited number of shares have changed hands between a willing buyer and willing seller in that day's trades. But the bidder who wants to buy the entire corporation must deal not only with the shareholders willing to sell at that day's market price, but with those unwilling to do so - the shareholders who, by declining to sell, have revealed their opinion that

given day, I may value my share of Capital Cities stock more highly than the current price that reflects existing demand. Once Disney decides to buy that stock, however, it must take as much stock as is available. Therefore, it must pay a higher price to obtain a threshold of control.<sup>110</sup> Like Kraakman, Stout assumes that stock market prices do not always reflect an informed calculation of the value of the target corporation's future cash flows.<sup>111</sup> Her theory, however, is not based on any "discounting" per se: the marginal price of a corporation's stock presumably always differs from the price it costs to control the entire entity. Although Stout's downward sloping demand theory has been strongly criticized by several scholars,<sup>112</sup> it offers a plausible explanation for the market for corporate control. Nevertheless, her theory of "price pressure" does not dispel the belief that bidders overpay for target stock, since Stout freely admits that stock price has little to do with the fundamental value of the corporation.

It is important to note that the policy implications of the inside information, discount, and payment for corporate control hypotheses are not all identical. If inside information fuels the bidder's premium, nothing need be done to protect the bidder shareholder, since it is unlikely that he will lose. Similarly, if the misinvestment discount has depressed the target's stock, then the takeover

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the value of their shares exceeds the valuation of the market." Stout, *supra* note 75, at 687-88.

<sup>110</sup> "If the bidder who buys a controlling block of shares in a target firm is 'cornering the market' in a unique good with a limited supply, it seems natural that buying larger and larger quantities of stock should inevitably bid up the market price." Stout, *Takeover Premiums*, *supra* note 108, at 1236.

<sup>111</sup> "While efficient markets may accurately measure the marginal value of a single share, they tell us little of what the price of a successful tender offer would be — except that it will likely be greater." Stout, *supra* note 75, at 689.

<sup>112</sup> See J. Gregory Sidak and Susan E. Woodward, *Takeover Premiums, Appraisal Rights and the Price Elasticity of a Firm's Publicly Traded Stock*, 25 GA. L. REV. 783 (1991) (arguing that Stout's thesis of downward sloping demand inelasticity of stock is incorrect).

premiums reflect the true value of the target corporation's future cash flows, and the acquirer need not increase the target's productivity following the completion of the takeover or merger.<sup>113</sup> On the other hand, if one explains bidder premiums as a result of price pressure or noise trading, then one cannot predict with certainty whether or not the bidder corporation is getting its money's worth. Already, bidder shareholders may have reason to voice concern.

Whatever the case, the inside information, discount and downward sloping demand hypotheses appear to be inadequate explanations for the size and frequency of takeover premiums offered above the target's stock market price. This is not to say that stock prices are perfect estimates of the future cash flows of target firms, but rather, that hypotheses based on stock market inefficiency fail to reflect the full extent of premiums paid to targets.<sup>114</sup> Thus, it is not surprising that most bidders justify their premiums with claims of synergy or better management.

## 2. Wealth Increasing Justifications

The most predominant wealth increasing justifications for acquisitions and takeover premiums in general are the managerial discipline hypothesis and synergy-based explanations.

The first type of value-maximizing theory that was often invoked throughout the last takeover wave is the

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<sup>113</sup> "[A]cquirers learn that their premia costs largely pay for assets that are worth the price if they merely continue to perform as they have in the past." Kraakman, *supra* note 26, at 909.

<sup>114</sup> This is supported, in part, by the observations of CEOs in a Law and Economics conference that took place at Columbia Law School some years ago. The CEOs "were unanimous in their belief that acquirers are paying inflated prices" to targets, and yet simultaneously argued "that prices in the stock market frequently fail to reflect a firm's long-term prospects under current management." Foreword, *KNIGHTS, RAIDERS & TARGETS*, *supra* note 15, at 3-4. According to this account, corporate managers believe stock market prices undervalue target firms, but not so much to justify such high premiums paid by bidders.

managerial discipline hypothesis. This too has several variants. At its lowest common denominator, it refers to the belief that the corporate market for control disciplines lazy or profligate managers by allowing raiders to buy the company and then draw profits by cutting fat from the company.<sup>115</sup> The profits pay for the acquisition and in turn scare other managers into doing a more efficient job. The market for corporate control argument is strengthened by the perception that shareholders lack the means and incentive to properly monitor their agents, the corporate officers. If internal controls break down, external controls such as the takeover mechanism ensure that management does not diverge from its job of protecting the shareholders' interests.<sup>116</sup> This market control hypothesis, however, makes most sense in a hostile world. Most mergers today, however, are "friendly" and sometimes keep the old CEOs in some variant of their positions.<sup>117</sup> It is hard to see, then, how friendly mergers can justify premiums on this hypothesis.<sup>118</sup>

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<sup>115</sup> "The theory of the 'market for corporate control' asserts that in an efficient market, hostile tender offers can direct control of the corporation from unprofitable management to more effective owners. . . . When a bidder offers to buy the corporation at a price *higher* than market price, the bidder must believe that under his control the corporation will have higher earnings than at present." Stout, *supra* note 75, at 685-86 (emphasis in original); see generally, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965).

<sup>116</sup> "The internal control mechanisms of corporations, which operate through the board of directors, generally work well. On occasion, however, they break down. One important source of protection for investors in these situations is the takeover market." Michael C. Jensen, *Takeover Controversy*, *supra* note 15, at 318.

<sup>117</sup> Following Disney's acquisition of Capital Cities/ABC, Cap Cities' Chairman, Thomas Murphy, joined Disney's Board of Directors and its CEO, Robert Iger, signed a five-year contract to be president of the Capital Cities/ABC subsidiary of Disney. See Laura Landro & Elizabeth Jensen, *All Ears: Disney's Deal for ABC Makes Show Business A Whole New World*, WALL ST. J., Aug. 1, 1995, at A1. Such was not the case with IBM's acquisition of Lotus, which eventually resulted in the departure of Lotus' CEO, Jim Manzi.

<sup>118</sup> "Only in the context of a hostile offer can stock price 'discipline' management." See Stout, *supra* note 75, at 685 n.361.

A second variant of the managerial discipline hypothesis is suggested by Kraakman in his exposition of the discount effect on share prices discussed above. According to Kraakman, one type of discount is the misinvestment hypothesis, whereby shareholders rationally discount the value of the stock based on the belief that managers will misinvest funds in wasteful projects. Unlike the first variant of the managerial discipline justification, Kraakman's misinvestment hypothesis does not require the acquirer to do a better job with the firm to justify the takeover premium; rather, the discount itself disappears because the shareholders' expectations about the old managers no longer figure in the calculations of the corporation's internal worth.<sup>119</sup>

The misinvestment hypothesis is in fact closely related to the third variant of the managerial discipline justification, Michael Jensen's free-cash flow theory.<sup>120</sup> According to Jensen, excess cash flow — cash flow in excess of money needed to fund all positive net present value projects for the company — creates an agency problem between manager and shareholder. Although the manager should return the cash to the shareholders, he nevertheless declines to do so since any return of cash would necessarily restrict future flexibility.<sup>121</sup> Instead, management places excess cash in negative net present value projects and so reduces the value of the firm.

Jensen sees acquisitions as a possible solution to the agency cost of free cash flow because he believes the market

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<sup>119</sup> "Although the misinvestment hypothesis is conceptually related to traditional accounts of acquisition gains arising from improvements in the operational management of target firms, there is an important difference. Ongoing mismanagement of targets' assets reduces their cash flows. Thus, low share prices may accurately mirror the value of mismanaged target assets; there may be no discounts. By contrast, under the misinvestment hypothesis, discounts can arise even though targets' assets are put to their best uses." Kraakman, *supra* note 26, at 898.

<sup>120</sup> "Free cash flow is cash flow in excess of that required to fund all projects that positive net present values when discounted at the relevant cost of capital." Jensen, *Takeover Controversy*, *supra* note 15, at 321.

<sup>121</sup> *Id.*

for corporate control encourages managers to disgorge the cash to shareholders rather than waste it on negative net present value projects. The key element of the motivational mechanism, however, is debt. By using debt to take over an entity, the acquiring firm is locked into a relationship with its creditors that forces it to be efficient and disgorge excess cash flow to its rightful owners (now the creditors).<sup>122</sup>

Jensen's theory of excess cash flow as a justification for takeovers is especially inapt in the current wave of mergers and acquisitions. First, stock, not excess cash, funded many of the mergers in 1995. Jensen himself notes the difference between stock for stock and cash for stock transactions.<sup>123</sup> Moreover, debt no longer plays the role it once did in leveraged buyouts. Thus, the agency theory of free cash flow does not function well as a justification for today's takeover activity.<sup>124</sup>

The second type of value-maximizing explanation voiced as a justification for mergers or takeovers is the synergy explanation. "Synergy" is a generic term used by managers to describe the increased wealth that results from the unique combination of two firms: in other words, the sum equals more than its parts. Since fewer deals are hostile in the current merger and acquisition wave, synergy has emerged as the primary justification issued by corporate managers for acquisitions and their ever larger premiums.

The most traditional synergy explanations are traditional economy of scale and scope theories. One large entity, corporate managers assume, can more easily and more cheaply produce and distribute a product than two

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<sup>122</sup> See generally Jensen, *Agency Costs*, *supra* note 15, for discussion of value of debt in reducing agency and monitoring costs.

<sup>123</sup> "Stock acquisitions tend to be different from debt or cash acquisitions and are more likely to be associated with growth opportunities and a shortage of free cash flow. They therefore represent a fundamentally different phenomenon from the nongrowth - or exit - motivated acquisitions that have been occurring in the 1980's." Jensen, *Takeover Controversy*, *supra* note 15, at 335-36.

<sup>124</sup> The free cash flow theory, however, does work quite well as an explanation of premiums as wealth transfers. See discussion *infra*.



smaller ones.<sup>125</sup> The economy of scope idea is slightly different: one large corporation can market and distribute two related products more cheaply than two smaller firms.<sup>126</sup> Lately, synergy explanations have focused on the benefits of vertical integration,<sup>127</sup> size for competition in a global market,<sup>128</sup> and one of the newest explanations, growth through acquisition.<sup>129</sup> "Synergy" can have a coercive effect on whole industries; indeed, once several corporations within an industry begin to merge, remaining corporations feel the need to join together to be able to compete with their new and larger competitors. Finally, "synergy" may well be a more euphemistic term for "monopoly," as rival firms combine with little or no comment from federal

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<sup>125</sup> This type of thinking has in part motivated consolidation within the financial services industry, where the goal "is to squeeze out costs and earn economies of scale." Mandel, *supra* note 1.

<sup>126</sup> This type of thinking drove Anheuser Busch's acquisition of Eagle Foods, a snack concern, 18 years ago. Busch assumed that beer and snacks could be distributed and marketed in the same manner, since consumers usually eat snacks with their beer. Unfortunately for Busch, the expected synergies did not materialize because snack foods and beer are placed in different parts of convenience stores and therefore are not so easily distributed and marketed together as one would think. Recently, Busch announced that due to its inability to make a profit out of Eagle, it was abandoning — not even selling — the snack business, salvaging only \$135 million from a sale of four plants to competitor Frito-Lay. Richard A. Melcher & Greg Burns, *How Eagle Became Extinct*, BUS. WK., March 4, 1996, at 68.

<sup>127</sup> Vertical integration is the combination of two firms within a related field to ensure the acquiring firm access to markets through owning its own distribution channels. A particularly good example of the vertical integration motive is present in Disney's acquisition of ABC/Capital Cities, as well as Viacom's (overpriced) acquisition of Paramount. The vertical integration explanation is especially salient in the entertainment industry because of changing technology. See *The Price of Mogulmania*, ECONOMIST, Jan. 29, 1994, at 16.

<sup>128</sup> Examples of such types of synergy abound in the banking industry, where Chemical Bank and Chase Manhattan recently announced their billion dollar merger to compete globally with other banks. See Mandel, *supra* note 1, at 34.

<sup>129</sup> IBM reportedly bought Lotus because it was the fastest way it could shore up its sagging software division. See discussion at note 24, *supra*.

regulators, increase market share, and then expropriate wealth from consumers through significantly higher prices.

Although synergy (minus its monopolistic implication) is an attractive thesis from a social welfare standpoint, the problem is that it is too often and easily invoked by bidder corporations. Despite every manager's best intentions, some synergies never surface in quite the way or scope imagined prior to the merger. Moreover, synergies can be competed away by similar bidders if the target holds an auction for sale of the company. Finally, some synergies, such as those created by vertical integration, can be outweighed by their costs, such as limited flexibility in distribution of product.<sup>130</sup>

### 3. Wealth Transfers

The final group of theories seeking to explain motivations for acquisitions and their accompanying premiums assume the worst; namely, that the acquisitions represent wealth transfers from bidder shareholders to target shareholders. Several theories fall under this heading.<sup>131</sup>

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<sup>130</sup> One business professor criticized Disney's acquisition of ABC and other acquisitions motivated by vertical integration as short-sided and likely to cause inefficiency in the future. "The notion of a captive (i.e., in-house) customer of a captive supplier is a dangerous one because it often leads to uneconomic decision-making and can seriously hurt the competitiveness of the integrated company. . . . Moreover, it has the almost immediate impact of inspiring counter-alliances from rivals, negating many of its supposed benefits." Rajendra S. Sisodia, *A Goofy Deal*, WALL ST. J., Aug. 4, 1995, at A8.

<sup>131</sup> Some academics argue that acquisition premiums represent involuntary wealth transfers from other groups, such as employees, bondholders, consumers or taxpayers, to the target shareholders. This group of "expropriation" theories has been rejected by most observers of merger activity. See Black, *supra* note 16, at 611 (discussing and dismissing most theories of wealth transfers from other groups). See also Romano, *supra* note 90, at 133-43 (same). Although the monopoly-driven view of acquisitions may have more bite in the current merger and acquisition wave, it is outside of the scope of this paper and probably too early to decide whether or not antitrust policy needs to change to protect against excessive consolidation of firms within the same industry.

The most widely voiced objection to acquisitions is that they are constructed solely for the benefit of ego-driven managers and not for the true welfare of shareholders. According to the empire-building hypothesis, corporate managers seek acquisitions in order to increase the size of the corporation and to enjoy corresponding increases in prestige and compensation.<sup>132</sup> Several studies suggest that management's stock ownership in the firm affects the value of its acquisitions.<sup>133</sup> Other studies appear to lend support to the "empire building" hypothesis that managers initiate acquisitions as a result of desires to improve status, compensation and prestige.<sup>134</sup>

Another "managerialist" explanation for acquisitions is the so-called "hubris" hypothesis. Related in part to the concept of "empire building," the hubris hypothesis holds

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<sup>132</sup> See Dent, *supra* note 11, at 781: "Corporate managers may seek growth of firm size rather than maximization of share price in order to justify better compensation and perquisites, to increase prestige, to expand opportunities for promotion, and perhaps most importantly to protect themselves from the discipline of the market. In short, they often engage in empire building."

<sup>133</sup> See Romano, *supra* note 90, at 148-49 (citing studies illustrating positive relationship between management's ownership of stock and acquiring shareholders' stock returns).

<sup>134</sup> Coffee identifies several motivations that might fuel management's desire for growth over profitability and shareholder welfare. "Several plausible reasons explain why management would pursue growth through acquisitions and pay an economically unjustified premium to achieve increased size: (1) executive compensation and associated perquisites tend to be a function of firm size; (2) increased size in turn implies increased immunity from a hostile takeover; (3) acquisitions dilute the stockholdings of existing large shareholders and thereby confer increased autonomy on the management of the bidder; and (4) expansion both provides an opportunity for advancement within the corporate hierarchy for younger managers and justifies the continued employment of those who are acquisition specialists." Coffee, *supra* note 13, at 1224. Coffee cites (early) data supporting this hypothesis, and concludes, "Much empirical data suggest that these wealth transfers occur frequently, but it is considerably more difficult to argue that they predominate. Nonetheless, the Empire Building Hypothesis suggests that the most important conflict of interests in corporate control contests may be on the bidder's side of the transaction — between the interests of the bidder's management and those of its own shareholders." *Id.* at 1168.

that managers overpay for targets because they overestimate their ability to extract value from the targets. A recent Columbia Business school study conducted by Mathew Hayward and Professor Donald Hambrick suggests that this theory might be correct in some instances.<sup>135</sup> According to the business school study, which examined 106 publicly traded American companies involved in acquisitions that cost more than 100 million dollars in two years (1989 and 1992), three factors predispose managers towards engaging in acquisition activity and paying high premiums for targets. First, recent instances of corporate success provide CEOs with "an inflated notion of their organizational genius, as well as a pile of cash with which to foist that genius on the wider world."<sup>136</sup> The second factor is the gap between the managers' salaries and those held by second highest paid executive within the company. "In our study, the higher the salary ratio [between CEO and his less well paid colleagues], the higher the acquisition premium."<sup>137</sup> Finally, the third factor determining whether managers engage in high-premium acquisitions is the

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<sup>135</sup> The study was performed as a doctoral dissertation by Mathew Hayward and a business professor, Donald Hambrick. The results of their study was presented in August, 1995 at the Academy of Management in Vancouver. Mathew L. Hayward & Donald C. Hambrick, *Michael Eisner's Tragic Flaw: Excerpt from 'Explaining Premiums Paid for Large Acquisitions: Evidence of CEO Hubris,'* HARPER'S MAGAZINE, Oct. 1995, at 24. See also *Acquisitive Egos: Managers and Shareholders*, ECONOMIST, Aug. 12, 1995, at 52. See also Dent, *supra* note 11, at 781 n.20 (citing less recent studies for proposition that executive ego fuels merger decisions).

<sup>136</sup> *Acquisitive Egos*, *supra* note 135. "CEOs tend to attribute their company's success to managerial excellence rather than to market trends or other external causes; as a result, CEOs of successful companies believe that their company is primed for entirely new challenges." Hayward & Hambrick, *supra* note 135.

<sup>137</sup> According to Hayward and Hambrick, the CEOs' confidence and belief in oneself, "plays a role in their strategic choices, including the premiums they pay in large acquisitions. Our measure of [CEO] self-importance was the ratio of the CEO's pay to that of the second-highest-paid executive in the firm, which we took to be a telling indicator of the CEO's sense of potency and self-esteem." Hayward & Hambrick, *supra* note 135.

amount of (good) media attention the manager has received prior to the announcement of the acquisition.<sup>138</sup> All of these motives support the inference that acquisition premiums represent wealth transfers from bidder shareholders to target shareholders, and furthermore undermine the argument that takeovers and mergers are socially beneficial and should be encouraged through policy.

Hambrick and Hayward's conclusions were only recently released. They are not the first academics, however, to suggest managerial (over)expectations as an acquisition motive. In 1986, Richard Roll suggested that hubris, the manager's expectation that he can do more with a target firm than is actually possible, fuels many acquisitions.<sup>139</sup> According to Roll, an important component of the acquirer's decision to buy a target is the valuation of the target's worth plus synergy or increased managerial efficiency. The "hubris hypothesis" assumes that the manager's valuation of the firm is too high because the manager has an inflated opinion of how much he can improve the target following completion of the acquisition. According to Roll, the manager need not consciously wish to harm his shareholders; rather, he deludes himself into thinking that he is improving the company with each new acquisition.<sup>140</sup>

In addition to hubris, another motivation that might fuel management's acquisition is the desire to protect itself from being a target in the future. Although "defensive

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<sup>138</sup> "In our sample, each highly favorable article about the CEO resulted, on average, in a 5.4 percent increase in a premium paid." *Id.*

<sup>139</sup> Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. Bus. L. 197, 198 (1986):

The mechanism by which takeover attempts are initiated and consummated suggests that at least part of the large price increases observed in target firm shares might represent a simple transfer from the bidding firm, that is, that the observed takeover premium . . . overstates the increase in economic value of the corporate combination.

<sup>140</sup> "Management intentions may be fully consistent with honorable stewardship of corporate assets, but actions need not always turn out to be right." Roll, *supra* note 139, at 214.

acquisitions" clearly exist,<sup>141</sup> it is difficult to calculate their number with precision since management's defensive motives may be well hidden at the time of the announcement of the acquisition. For example, when Novell announced in 1994 that it would buy WordPerfect, it had already been approached two years earlier by Microsoft in secret negotiations to buy it for 10 billion dollars. Due to culture clashes and the failure of synergies to materialize, Novell lost much of its value and announced that it would sell the WordPerfect division — for much less than the price it paid to acquire it.<sup>142</sup>

Sometimes, the bidder may have chosen a target that offers real synergies but then destroys these potential sources by falling prey to the "winner's curse." Unlike the hubris or empire-building hypotheses, the "winner's curse" hypothesis does not criticize the bidder's initial valuation of the target. Rather, the winner's curse theory is tied to the manager's inability to adjust his bid downward when participating in an auction. When a bidder enters an auction and he is uncertain about the value of the target, he should rationally adjust his bid downward as the number of participants in the auction increases. The inclination of bidders, however, is to do just the opposite and adjust his bid upward in order to win the auction.<sup>143</sup> "Winner's curse

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<sup>141</sup> See *Panther v. Marshall Field*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (refusing to review Marshall Field's decision to acquire the Galleria and several other purchases in order to create more antitrust problems for the would-be buyer).

<sup>142</sup> Don Clark, *Novel Nouveau: Software Firm Fights to Remake Business After Ill-Fated Merger*, WALL ST. J., Jan. 12, 1996, at A1.

<sup>143</sup> See generally, RICHARD H. THALER, *THE WINNER'S CURSE, PARADOXES AND ANOMALIES OF ECONOMIC LIFE*, Ch. 5 (1992). Thaler writes that Roll's data concerning the hubris hypothesis are consistent with the winner's curse theory as well. Professor Romano also provides a helpful explanation of the winner's curse phenomenon: "When the value to the bidders of the auctioned item is uncertain, the person who has overestimated the value the most will be the winner. This is because a positive evaluation error produces a winning bid, but a negative error does not. The intuition is that the winning bidder pays too much — that is why he is the winner. Winning is bad news (a "curse") because it signifies that all other bidders' estimates were lower. That is, the winner

theory dictates that bidders must offer substantially less than they think an asset is worth, and be prepared to have only a fraction of their bids succeed."<sup>144</sup> Most bidders, unfortunately, do just the opposite. Despite their advisor's presumed knowledge of the phenomenon, they are too interested in completing a deal to tell the managers to bid low.<sup>145</sup> Moreover, managers do not necessarily always learn from mistakes such as these since they are not always able to attribute later failures to the overbidding for target stock.<sup>146</sup>

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had the highest positive evaluation error." Romano, *supra* note 90, at 150-51.

<sup>144</sup> Black, *supra* note 16, at 625. Roll sees a connection between hubris-fueled bids and auction theory:

Rational bidders will realize that valuations are subject to error and that negative errors are truncated in repeated bids. They will take this into account when making a bid. Takeover attempts are thus analogous to the auctions discussed in bidding theory wherein the competing bidders make public offers. In the takeover situation, the initial bidder is the market, and the initial public offer is the current price.

Roll, *supra* note 139, at 200.

<sup>145</sup> "I know of no evidence that the investment bankers who advise managers on takeover bids, let alone corporate managers themselves, know anything about winner's curse theory. My personal experience as a takeover lawyer is that they do not." Black, *supra* note 16, at 625. See also Romano, *supra* note 90, at 151-52 "In any specific transaction, the [financial] intermediary's incentive structure works against counseling a downward revision, as intermediaries are paid more when their client wins the auction." Romano further notes, however, that over the long run, intermediaries who fail to warn clients about the winner's curse eventually suffer reputational harm, assuming bad bidders attribute their later failures to overbidding. "Over the long run we would expect this effect to occur, and any problem of overbidding in the corporate takeover market should be self-correcting." *Id.*

<sup>146</sup> Evidence is mixed concerning whether bidders learn from past mistakes. Roll is particularly negative on this point:

There is little reason to expect that a particular individual bidder will refrain from bidding because he has learned from his own past errors. Although some firms engage in

Despite the persuasiveness of the winner's curse theory, it is dependent on a world in which bidders are similar. In the takeover world, however, bidders may well have unique synergy potential with targets. Insofar as a bidder is unique and offers particular synergy potential for a combination with a target, it should not fall prey to the winner's curse.<sup>147</sup> Nevertheless, empirical evidence seems to suggest that, to some extent, it exists.<sup>148</sup>

Another explanation for acquisitions that falls under the "wealth transfer" heading is the Jensen cash flow hypothesis that was described earlier in this paper. According to several articles, the Jensen hypothesis of free cash flow/agency problems applies not only to targets, but to bidders as well. In this light, acquisitions and mergers are not only "solutions" to the free cash flow phenomenon, but they are part of the problem as well.<sup>149</sup> The fact that

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many acquisitions, the average individual bidder/manager has the opportunity to make only a few takeover offers during his career. He may convince himself that the valuation is right and that the market does not reflect the full economic value of the combined firm.

Roll, *supra* note 139, at 199-200. Black is about as negative on this subject as Roll, and adds that it may take many years before a manager learns for sure that he has overpaid for a target, giving him more time to engage in further wasteful acquisitions. "[L]earning from past overpayment is, at best, a weak cure for future overpayment." Black, *supra* note 16, at 626.

<sup>147</sup> "[A] bidder who has unique synergy with a target faces a winner's curse only to the extent of the target's value to other bidders." Black, *supra* note 16, at 625.

<sup>148</sup> See Romano, *supra* note 90 at 151 (citing studies). At the same time, Romano cites other studies suggesting that bidders do often adjust their bids downward in response to the winner's curse. *Id.* at 150-151.

<sup>149</sup> See Mitchell & Lehn, *supra* note 16. Mitchell and Lehn found that targets of takeovers were more likely to have participated in value-reducing acquisitions than non-targets and that most of these "bad" acquisitions were eventually divested through "bust-up" takeovers. Mitchell and Lehn were looking at mergers and acquisitions that took place in the 1980's. Today's mergers and acquisitions are similar in that many current acquirers have free cash (or market-inflated stock) to invest in targets. "As the economy purrs along, many companies have surplus cash flow, but few promising places in which to invest it. To put



today's acquirers experience positive returns prior to the announcement of the acquisition supports this theory.<sup>150</sup>

Finally, another variant of the wealth-transfer argument is the overpayment hypothesis, which has been most thoroughly described by Professor Black.<sup>151</sup> Black's overpayment hypothesis is in part an extension of Jensen's free cash flow hypothesis to bidders, with the further twist that bidder share prices do not drop as much as they should because the bidder shareholders already expect their managers to misinvest excess cash in wasteful projects.<sup>152</sup>

Black's theory is a combination of Kraakman's misinvestment hypothesis and Jensen's free cash flow theory. He assumes that some, but not all, bidders overpay for targets.<sup>153</sup> The overpayment hypothesis is extremely provocative because it suggests that "bad" (or wasteful) managers can outbid their "good" counterparts. For example, in an auction for a target, Bidder X, whose shareholders already expect him to misinvest several billion dollars can bid that amount, plus the expected value of any synergies that might evolve from the deal. Bidder Y, on the other hand, does not waste cash and his shareholders do not hold any expectations that he will do so; therefore, Y can bid only so much as synergy or other value-maximizing gains will allow him to do so. Assuming X and Y are similar companies and can expect the same synergies from the target, X will win the auction.<sup>154</sup> Clearly, this is not an

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the capital to use, they are searching for appropriate takeover targets." Gregory Zuckerman, *One for the Books*, Mergers and Acquisitions Report, INVESTMENT DEALERS' DIGEST, Jan. 15, 1996, at 14.

<sup>150</sup> See Romano, *supra* note 90, at 150: "takeovers are both the epitome of the agency problem and its solution."

<sup>151</sup> Black, *supra* note 16.

<sup>152</sup> "In this paper, I advance the hypothesis . . . that, for many takeovers, target shareholders gain partly because the bidder pays too much. These overpayments don't cause bidder stock prices to drop because investors already expect the bidder to waste the money, one way or another." *Id.* at 599.

<sup>153</sup> *Id.* at 605.

<sup>154</sup> *Id.* at 615-616. Applied to a series of acquisitions financed by cash, Black writes:

efficient allocation of resources if it exists. Like Lehn and Mitchell, however, Black assumes that eventually bidder X will use up his misinvestment allowance and that eventually X will trade at such a point below its true asset value that X eventually will become a target of a takeover.<sup>155</sup>

For Black's theory to be correct, two conditions must be met: the bidder must "overpay" for the target, and the investor must already expect the manager to misinvest company funds. The first condition, that bidders overpay for targets, is supported by economic and accounting literature suggesting that most acquisitions lead to losses in productivity of the combined entity.<sup>156</sup> The second condition, that bidder shareholders already expect their managers to misinvest, is harder to prove.

The overpayment hypothesis is different from the hubris or free cash flow/agency hypotheses because it does not purport to identify the motivation for managers who engage in overbidding. Rather, it allows for one or a combination of all theories. Hubris or "winner's curse" or even a combination of either one with the synergy theory might explain why the bidder decides to pay too much for the target, but the overpayment theory explains why the stock price does not significantly drop in contemplation of that acquisition.

It is clear that the wealth-transfer theories demand a closer look at the way the law treats bidder shareholders following the announcement of potentially destructive

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[t]here will be positive or negative incremental effects on stock price from various combinations of (i) unexpectedly profitable or unprofitable investments, which are (ii) unexpectedly high or low risk (and thus have unexpectedly high or low expected return), and are made by (iii) bidders who were previously expected to make positive or negative net present value investments.

*Id.* at 620.

<sup>155</sup> *Id.* at 622.

<sup>156</sup> *Id.* at 605-606 (citing studies).

acquisitions. Before these theories (or any legal reform) can be embraced, however, an analysis of the empirical evidence measuring the wealth effects of acquisitions is warranted.

## B. Empirical Evidence: How Mergers Affect Bidder Shareholders

In evaluating returns to target and bidder shareholders, five sets of findings and conclusions are possible. First, one might find that takeovers increase both bidder and target shareholder value. Were this the case, takeovers would be *prima facie* socially beneficial and I would have nothing to write about. A second possibility is that one might find that takeovers produce gains for target shareholders, but produce net zero returns for the bidder shareholders. In this case, wealth maximization has taken place, but all of the wealth has landed completely in the laps of the target shareholders. A third possibility is that while targets have registered gains, bidder shareholders have suffered losses that are less than the target's gains, but significant nonetheless. In such a case, a partial wealth transfer has taken place between bidder and target shareholder. A fourth possibility is that the target's gain is exactly commensurate with the bidder's loss. Excluding takeover costs, no net social gain or loss has occurred. Rather, the takeover represents a full wealth transfer between bidder and target. The fifth (and final) possibility is that the target's gain has been outweighed by the bidder's loss. In such a case, an aggregate loss in wealth has occurred.

All scholars agree that if takeovers produce overall losses in wealth (possibility number five), takeovers should be discouraged. Because of the costs of takeovers, most scholars further agree that wealth transfers (possibility number four) and partial wealth transfers (possibility number three) should be discouraged.<sup>157</sup> Moreover, if the

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<sup>157</sup> Professor Coffee persuasively argues that wealth transfers should be discouraged:

reason behind the partial or full wealth transfer is that the bidder managers acted because of hubris or ego at the expense of their shareholders, then those same shareholders should have some claim against their managers for having expropriated their wealth and transferred it to an entirely different group of shareholders, in violation of their fiduciary duties.

According to most financial and economic literature, acquisitions generate wealth for target shareholders.<sup>158</sup> The literature is less conclusive with regard to bidder shareholders. Part of the conclusion comes from the methodology used by those seeking to measure post-acquisition return to bidder shareholders. Romano has noted that gains to bidder shareholders are not easily measured, since the bidder is normally larger than the target, its bid may itself reveal information that skews the stock price effect, and the acquirer's gain from the merger may already have been anticipated in the stock price if it had been engaged in a series of acquisitions.<sup>159</sup>

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Public policy should seek to discourage mere wealth transfers between bidder and target shareholders (in either direction), both because there are no redistributive goals to be served in this context and because wealth-transferring takeovers are likely to involve an element of coercion, which means that these transfers are not voluntary in the usual sense of the term. Indeed, *even where the winner's gains clearly exceed the loser's losses it does not follow that society is entitled on efficiency grounds to disregard the fact that uncompensated losses to some group are foreseeable.*

Coffee, *supra* note 13, at 1173-74 (emphasis added).

<sup>158</sup> Romano, *supra* note 90, at 122. "All studies find that target firms experience statistically significant positive stock price responses to the announcement of takeover attempts or merger agreements." *Id.*

<sup>159</sup> "There are, however, theoretically plausible reasons for not finding positive abnormal returns to bidders even when acquisitions are value-maximizing transactions. First, acquiring firms are typically much larger than target firms, making it more difficult to measure abnormal returns. Second, a bid may reveal information about the bidding firm unrelated to the particular acquisition confounding the stock price effect. Third, if the takeover market is competitive then bidders will earn only normal returns, as abnormal profits are competed away." *Id.* at 123-124.

Generally, two types of studies exist. "Event studies," which are the most common in the finance literature, measure the acquisition's effect on shareholder wealth by looking at the acquirer's stock price in the months preceding and following the announcement and completion of the transaction in question. The "window" or amount of time before and after the merger announcement used for computing bidder shareholder returns has a great effect on the results. Professor Black summarizes that, depending on the window period used, most older studies show, "that since 1975, takeover bidders have earned at best a zero, and perhaps a slightly negative, net-of-market return."<sup>160</sup> If bidders are earning a zero or non-negative return and targets are earning positive returns, some scholars argue, then takeovers create a net social gain in society and should be encouraged.<sup>161</sup> Black's overbidding hypothesis, however, undermines this conclusion by suggesting that stock price declines are muted by investor expectations that their managers will misinvest excess cash. Moreover, other

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<sup>160</sup> Black, *supra* note 16, at 602. See also Roll, *supra* note 139, at 204-206 (citing studies): In 1983, Malatesta found that although mergers were positive events for target shareholders, their impact was "larger in absolute value and negative for acquiring firms." Peter H. Malatesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155 (1983). Varaiya found that the larger the premium paid to the target, the greater the acquirer's loss. Nikhil Varaiya, "A Test of Roll's Hubris Hypothesis of Corporate Takeovers," Working Paper, Southern Methodist University School of Business, cited in Roll, *supra* note 139. But see Jensen and Ruback, *The Market for Corporate Control*, 11 J. FIN. ECON. 5 (1983) (arguing that acquiring firm shareholders actually register gains).

<sup>161</sup> Those who make this argument usually explain away the bidder shareholder's net zero return as a result of competition between bidders for synergistic and efficiency gains. See, e.g., Sidak & Woodward, *supra* note 112, at 796-800. This explanation is limited by the fact that bidders are not "fungible" and thus should not be competing away potential synergies that no other bidder can match. See Black, *supra* note 16, at 603.

studies from the time period suggest that the bidder's losses are, in fact, significant.<sup>162</sup>

Other types of studies measure the productivity of the combined firm following the acquisition. Since these studies do not rely on stock market returns, they offer more concrete evidence about the accuracy of Black's overpayment hypothesis. The most famous of these studies was written by Caves, who concluded that mergers and acquisitions did not produce the expected gains following completion of the transaction.<sup>163</sup> Caves' study was followed by several others that backed up his conclusion. A few studies reported opposite effects, but most did not deal directly with acquisitions by public companies.<sup>164</sup> Whatever the case, most scholars conclude that the effect on post-merger productivity is, at best, inconclusive.

Some might argue that because the studies quoted above examine the wealth effects of what were mostly conglomerate mergers or bust-up takeovers, they are not applicable to the current merger wave. Newer studies of acquirers' post-merger stock performance, however,

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<sup>162</sup> See Ellen Magenheimer & Dennis Mueller, *Are Acquiring-Firm Shareholders Better Off After an Acquisition?* in KNIGHTS, RAIDERS & TARGETS, *supra* note 15, at 171.

<sup>163</sup> Citing various studies examining post-merger profitability, productivity and market share, Caves concludes, "[e]x post, recent studies [indicate] that mergers not merely fail to warrant acquisition premia, but actually reduce the real profitability of acquired business units, increase the intraindustry dispersion of plants' productivity levels, and shrivel the acquiree's market share." Richard E. Caves, *Mergers, Takeovers, and Economic Efficiency*, 7 INT'L J. IND. ORG. 151, 167 (1989). Caves supports Jensen's free cash flow theory of acquisition motivation on the part of the bidders. *Id.* at 169. See also Edward S. Herman & Louis Lowenstein, *The Efficiency Effects of Hostile Takeovers*, in KNIGHTS, RAIDERS & TARGETS, *supra* note 15, at 211.

<sup>164</sup> Studies cited in Sidak & Woodward, *supra* note 112, at 799 n.52 measure the effects of management buyouts and leveraged buy-outs on the firm's operating performance. Since MBOs and LBOs are fueled by debt, however, they are different from acquisitions by public companies since creditors may be able to exercise greater control over managers ex post. In addition, Romano cites two unpublished studies arguing that corporate performance does in fact improve post-merger. See Romano, *supra* note 90, at 125 n.17.

strongly suggest that overpayment or other hypotheses falling within the wealth-transfer category may be accurate. Recently, *Business Week* reported the results of a study it conducted with Mercer Consulting of 150 deals valued at 500 million dollars or more and completed between 1990 and July 31, 1995. Of the deals analyzed, 50% of them resulted in shareholder losses to the acquiring corporation, judged in relation to Standard & Poor's industrial indexes.<sup>165</sup> Moreover, the Business Week study found that nonacquirers were more likely to outperform their peers than those firms that engaged in substantial amounts of acquisition activity.<sup>166</sup>

### C. Conclusion

The latest empirical evidence on mergers and acquisitions suggests that bidders lose, and that they lose because of some combination of the wealth-transfer theories stated above. The overpayment, hubris, free cash flow hypotheses best explain why combined entities, as a whole, fail to lead to increased productivity and why bidder shareholder returns are, depending on the window period used, negative. Even in a purely competitive world, bidder shareholder returns should never fall below zero.<sup>167</sup> The synergy and managerial discipline theories simply do not provide explanations for negative bidder shareholder returns; the wealth-transfer theories must therefore have

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<sup>165</sup> *The Case Against Mergers*, BUS. WK., Oct. 30, 1995, at 123. 30% of the deals "substantially eroded" shareholder returns, while 20% simply "eroded some" shareholder returns. Business Week's "window" extended from three months before and up to three years after the announcement of the deal. Again, since the negative returns to bidders are not compared with the positive gains enjoyed by target shareholders in the same period, it is difficult to determine whether this period of merger and acquisition activity was socially inefficient.

<sup>166</sup> Between January 1, 1990 and July 31, 1995, 69% of nonacquiring companies (companies making no acquisitions larger than 5 million dollars) outperformed their Standard & Poor's industry indexes. 58% of acquirers outperformed their respective Standard & Poor's indexes.

<sup>167</sup> "Competition can drive stock price returns to zero, but not beyond." Black, *supra* note 16, at 604.

some bite, given the statistical data and anecdotal evidence of mergers and acquisitions gone awry.<sup>168</sup> Legal policy-makers therefore should re-evaluate a system that allows management to claim "synergy" so easily when it makes potentially devastating acquisitions.

## V. WHAT SHOULD BE DONE FOR BIDDER SHAREHOLDERS?

The previous sections of this paper analyzed the ways in which bidder shareholders are treated differently from target shareholders by legal mechanisms. In terms of voting rights, judicial review, state and federal legislation and appraisal remedies, bidder shareholders receive substantially less legal protection than their target counterparts. Obviously, there is nothing wrong with such asymmetrical treatment if bidder shareholders generally benefit from mergers and acquisitions. Unfortunately, most accounting and finance studies suggest that this is not the case. If bidder shareholders are registering significant losses, then part of the gain accruing to target shareholders may represent a wealth transfer, involuntarily exchanged by the bidder's management either for a larger empire or simply as a way of investing excess cash. For years, legal mechanisms regulating mergers and takeovers have been constructed and vigorously debated with target shareholders in mind. Now, we might re-evaluate the ways in which the law treats their apparently poorer counterparts, the bidder shareholders.

In the following section, I will first consider — and reject — the argument that no legal reform is desirable or

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<sup>168</sup> A possible argument to this may be that merger losses are not caused by mis-valuation or overpayment of the target, but rather by a failure to adequately integrate the two companies and their cultures following the completion of the deal. Nevertheless, the costs of carrying out the deal should be considered by the managers and integrated into the premium *before* the manager undertakes the acquisition. Therefore, post-merger explanations of negative bidder returns are reconcilable with wealth-transfer theories such as hubris and overpayment.



necessary. In addition, I will argue that legal reform and increased protection of bidder shareholders can be achieved without necessarily repealing key target protections, such as the Williams Act or state anti-takeover legislation. Then, I shall set forth several potential areas of reform, including expanded voting rights, judicial review, and auction reform.

I do not claim to know which is the mechanism most likely to protect bidder shareholders without unnecessarily precluding "good" acquisitions, and thus an efficient allocation of resources. Nevertheless, I do think any optimal system of bidder shareholder protection will contain some combination of all of these mechanisms. At the very least, the suggestions contained herein should provide fodder for further inquiry.

### A. The Argument Against Doing Nothing

Even if one accepts the argument that acquisitions ordinarily harm bidder shareholders, one still can argue that no regulation is necessary since "bad" bidders eventually become targets themselves and an efficient allocation of resources eventually occurs.<sup>169</sup> In the interim, however, bidder shareholders must suffer the losses caused by inefficient managers. If the bidder shareholders' losses (plus transaction costs) outweigh the target's gains, then society suffers under this delayed action regime as well, since the CEO may make several "bad" buys before someone finally takes over the company. In addition, our current legal system protects target managements from hostile bidders. Thus, managers can easily make bad bids and then entrench themselves in office with various defenses once they become targets. This is hardly an efficient system.

A stronger argument against bidder shareholder protections is made by those who support the contractarian theory of corporate law.<sup>170</sup> The empirical data reviewed in

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<sup>169</sup> See Mitchell & Lehn, *supra* note 16.

<sup>170</sup> The contractual theory of corporate law views corporate charters as standard term contracts that best approximate the terms that would

Part IV confirms the notion that bidder shareholders lose; it does not, however, prove that these losses outweigh target gains. Thus, we might say that the acquisition increases social welfare overall, yet harms bidder shareholders more often than not. Where only a partial wealth transfer has occurred, such that the target's gains outweigh the bidder's losses plus transaction costs, some have argued against legal protection for bidder shareholders since the bidder shareholder can easily protect himself by diversifying his investments.<sup>171</sup> Under the contract theory of the corporation, moreover, one might argue that the bidder shareholder contractually "agrees" to a system that allows the corporation's managers wide discretion in making acquisitions and rationally integrates this knowledge into the price of the stock.<sup>172</sup> Since the (well-informed) shareholder may have some idea whether he will be a target or a bidder in the future, he is in a sense betting on a particular outcome and can improve that outcome by holding a portfolio of diversified stocks.

The contractarian/diversification argument is supported, in part, by Kraakman's misinvestment hypothesis and by Black's use of Jensen's free cash flow theory: if the

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have been negotiated between shareholder and management if contracting costs were lower. In this sense, state corporation laws reduce transaction costs of contracting between shareholder and management and thus make stock cheaper. In addition, background terms reduce agency costs between the shareholder and manager. See Daines & Hanson, *supra* note 97, at 581-82, n.20. For a general debate of the contractarian theory of corporate law, see Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

<sup>171</sup> See Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698, 711-14 (1982). Easterbrook and Fischel assume that the corporation is equally likely to be a target or bidder. Bebchuk disputes this assumption. See Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989). Mitchell and Lehn's work appears to undermine Easterbrook and Fischel's contention as well. See Mitchell & Lehn, *supra* note 16.

<sup>172</sup> According to this view of corporate law, management's transfer of wealth from the bidder to the target shareholder is "voluntary". But see Coffee, *supra* note 13, at 1173-74.

shareholder already expects his manager to make a "bad" investment (and discounts the price of the stock accordingly), why should the law treat the manager's investment in a wasteful acquisition any differently from an investment in wasteful research and development or other types of negative present value projects?

Despite its internal coherence, the contract theory is flawed in several ways. First, it is questionable whether shareholders truly "agree" to give up wealth simply to stroke the bidder management's ego when they initially buy a share of stock. Corporate charters and state corporation laws are not individually negotiated; they are (arguably) adhesion contracts.<sup>173</sup> It is difficult, then, to attribute "choice" to shareholders in a normative or descriptive sense.<sup>174</sup> Second, inefficient contractual agreements between bidder shareholders and managers may affect third parties, such as employees and bondholders. Third party externalities therefore provide a second reason for promulgating mandatory rules that prevent value-reducing acquisitions.<sup>175</sup> Finally, even the contractarian must admit

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<sup>173</sup> Adhesion contracts are agreements in which one party lacks the ability to haggle over the individual terms of the contract. They are often called "take it or leave it" contracts. According to the contractarian theory of corporate law, shareholders "haggle" over the terms of the corporate contract by choosing between competitive corporate charters and state corporation laws. Corporate charters, however, often contain inefficient terms and states continue to adopt inefficient anti-takeover laws. These inefficiencies produce doubt as to whether shareholders have power to dictate the terms of their contracts with corporate managers. The "race for the bottom" mentality, whereby states compete for corporate business by tailoring default rules to meet the needs of *managers*, further undermines the contractarian's contention that shareholders can protect themselves in a competitive contractual market. "[S]tate antitakeover laws are strong evidence that the efficiency of corporate law is, at best, limited." Daines & Hanson, *supra* note 97, at 588.

<sup>174</sup> Those who object to the contractarian view of corporate law often speak in terms of the shareholders' imperfect information when they "accept" a particular term in the charter. See Bebchuk, *supra* note 171, at 1825 (discussing difference between contracting for initial corporate charter and opting-out of mandatory rules "midstream").

<sup>175</sup> Cf. Daines & Hanson, *supra* note 97, at 598.

that corporate managers are bound by fiduciary duties of loyalty and care *regardless* of whether the stock price includes shareholders' expectations about future managerial misconduct. It is currently standard corporate fare to expect managers to obey fiduciary duties of loyalty and care. Hubris and empire-building arguably qualify as violations of the latter duty. Surely, legal mechanisms protecting *target shareholders* rely on fiduciary duty and protection against loss, and not contract theory.<sup>176</sup>

"So," the contractarian might respond, "repeal the target shareholder protections and then we will have equality." Scholars have debated for years the efficiency and wealth effects of legislation such as the Williams Act and state anti-takeover legislation statutes. Although repeal of these protections might make the takeover process more conducive to bidders and thus reduce costs associated with the takeover process itself, it would not prevent managers from making wealth-reducing acquisitions based on inflated egos or desires for empire-building. In addition, any attempt to remove target protections would be met with extreme opposition from incumbent target managers. Something else is needed.

## B. Five Potential Areas of Reform

Increased legal protection of bidder shareholders can be accomplished through at least three areas of corporate law: voting rights, judicial review, and auction reform. Voting rights and auction reform are mechanisms that attempt to prevent harm to bidder shareholders before the transaction has been completed. Judicial review, on the other hand, can provide for compensation of unhappy shareholders

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<sup>176</sup> In other words, since lawmakers and judges have completely rejected Easterbrook and Fischel's arguments concerning how the law should treat target shareholders (see, e.g., Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981)), lawmakers should similarly reject their view of how bidder shareholders should be treated, since bidder shareholders arguably are in a worse position than their target counterparts.

following the merger by holding managers (board members and officers) personally liable for shareholder losses. In doing so, judicial review may inaugurate general deterrence among officers and directors who change their behavior in response to the threat of future litigation. Finally, injunctive relief allows shareholders to prevent particular transactions by bringing litigation before sympathetic courts.

### 1. Expanded Voting Rights

The least radical of the three areas of reform is the expansion of voting rights to bidder shareholders in all takeover situations.<sup>177</sup> Professor Coffee and several others have argued that expanded voting rights can protect shareholders from managers who make wasteful acquisitions based on a desire to engage in empire-building.<sup>178</sup> Coffee would have shareholders vote on the transaction after it had been announced, but before its completion. That way, "bidder shareholders would be voting on a transaction with the market's judgment largely in front of them and would understand that a rejection would restore the discount in share value which an adverse market reaction had already subtracted from their shares."<sup>179</sup> Unlike other shareholder voting mechanisms, this one would not be burdened by the collective action problem since bidder shareholders presumably would have cheap and instantaneous access to information concerning the value of the acquisition by noting the drop (or rise) in stock price. Moreover, management would have to expend costs to issue a proxy statement explaining the details and specific terms of the offer. Thus, the costs of acquiring information about the acquisition and of acting on that information would be relatively low. According to Coffee,

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<sup>177</sup> This would entail the provision of voting rights for all acquisitions of corporations, regardless of the form in which they are accomplished. See *supra* notes 38-42 and accompanying text.

<sup>178</sup> Coffee, *supra* note 13, at 1269 nn.378, 379 (citing authorities).

<sup>179</sup> *Id.*

shareholders presumably would vote against mergers whose announcements have been greeted with decreases in stock price. Finally, Coffee concludes, mandatory voting rights would, at the very least, provide arbitrageurs and institutional shareholders with a mechanism in which to signal their displeasure with the proposed acquisition and thereby derail its completion.<sup>180</sup>

Coffee's thesis suffers several flaws. First, even when shareholders have cheap access to information, they still may act against their best interest if they believe that their vote will have very little impact on the overall outcome.<sup>181</sup> Second, Coffee's voting mechanism depends heavily on the market to portray correct information about the value of a particular acquisition following announcement. If, as Kraakman and Black have hypothesized, shareholders already expect bidder managers to misinvest corporate funds, the stock price may not decline following announcement of the acquisition, or if it does, it will not decline as much in value as it should, given the destructive

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<sup>180</sup> *Id.* at 1269-70: "In such a context, the usual obstacles to shareholder activism would be minimized, and indeed one could expect arbitrageurs and institutional investors to seek to organize shareholder resistance to a pending takeover that the market perceived as unpromising for the bidder."

<sup>181</sup> See Grundfest, *supra* note 18, at 857:

If individual shareholders rationally calculate that their own participation in the decision process has only a small likelihood of affecting corporate action - either because they hold a very small percentage of the corporation's shares or because they expect that collective action problems will prevent an effective group response - then those shareholders may rationally decide not to participate in the process at all.

In addition, shareholders with heterogeneous interests may have a difficult time coordinating their response to a proposed acquisition. This might be the case if one group of shareholders disliked all aspects of a proposed acquisition, whereas another group objected only to a limited number of terms within the offer.

potential effects of the proposed acquisition. Shareholders therefore might not react by voting against the offer.<sup>182</sup>

Finally, the question remains whether institutional shareholders can (or wish to) influence the voting process as much as they have influenced the hiring and firing of CEOs in the corporate governance context. Institutional shareholders are legally restricted from owning a significant percent of stock in any one corporation. Their power is grounded in the ability to send a symbolic message to unopposed incumbent managers by withholding their authority on proxy statements at annual shareholder meetings.<sup>183</sup> It is simply an open question whether a voting strategy based largely on the power of a symbolic message would be of any worth in the mergers and acquisitions context.

One way to solve the shareholder collective action problem would be to require a supermajority ratification of all proposed acquisitions.<sup>184</sup> This requirement would give institutional shareholders veto power over wasteful acquisitions, reduce coordination costs, and overcome the rational apathy phenomenon. At the same time, the supermajority requirement might create new problems, especially if targets used the voting mechanism as a "back door" defense by buying up some stock and then voting

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<sup>182</sup> A possible response to this argument is that if shareholders *know* that they have discounted the stock in expectation of managerial misinvestment, the fact that the stock price remains constant will itself be a source of information, and shareholders will rationally veto the proposed transaction if the price fails to improve following announcement of the transaction. On the other hand, the fact that the price improves in this context does not necessarily mean that the acquisition is value-producing; rather, it simply means that it is not as bad as shareholders expected of the managers. In that case, shareholders might ratify a value-reducing acquisition. Thus, the inability to separate out the discount from the extra (good or bad) marginal effect of the acquisition prevents shareholders from using the market to accurately guide their voting decisions.

<sup>183</sup> See Grundfest, *supra* note 18, at 905 (explaining that the "just vote no" mechanism is a "purely symbolic device that allows shareholders to cast a vote of no confidence in management").

<sup>184</sup> But see *supra* note 39 (discussion of *Unitrin*).

against the transaction.<sup>185</sup> Where targets had advance warning prior to the announcement of a hostile bid, this concern would be quite real and substantial.

Even if the collective action and market information problems can be overcome, the voting rights mechanism still presents further practical difficulties in its application. Presumably, management would be expected to issue proxy statements providing information about the terms of the proposed acquisition. If shareholders rejected the acquisition, that would be the end of the matter. If, on the other hand, shareholders accepted the deal, further complications would arise if another corporation offered the target a higher bid. Should management be forced to re-issue proxy statements every time it raises its bid? An affirmative answer would entail a significant increase in the cost of bidding and presumably a reduction in the number of bids. To some extent, this is a good result; after all, one way to prevent bad bids is to make the bidding more expensive. Of course, the problem here is that *all* bidders would be affected by the voting rights mechanism. "Good" bidders might abandon bids because of the added expense of administering a potentially complicated voting process.<sup>186</sup>

The trick then is to provide voting rights protection to bidder shareholders in an inexpensive fashion, especially when other bidders present counteroffers to the target. Coffee suggests that shareholders extend to managers the authority to make counteroffers when registering their initial vote on the specific terms of the acquisition. "If the bidder were required to secure shareholder approval of a proposed offer, and also permitted at the same time to obtain ratification of a right to increase a bid in response to any counter-bid made by a rival bidder, the necessity of multiple resolicitation would fade."<sup>187</sup> Although the need for

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<sup>185</sup> Coffee, *supra* note 13, at 1270.

<sup>186</sup> "By increasing the already considerable costs of consummating acquisitions the requirement would tend to discourage acquisitions generally, both profitable and unprofitable." Dent, *supra* note 11, at 788.

<sup>187</sup> Coffee, *supra* note 13, at 1270.



"multiple resolicitation" might fade under this system, so too would the protection against overpayment by bidders taken in by the winner's curse during heated auctions.<sup>188</sup> Another solution is to allow shareholders to authorize the offer and then set an agreed upon ceiling above which bidder management would not be permitted to bid. Coffee persuasively argues that this solution is also flawed because it opens bidders up to the claim by targets that they have not paid an adequate price for stock. The problem of counteroffers simply defies an easy solution.

Finally, perhaps the most persuasive argument against expanded voting rights protection is the prediction that its adoption is not likely. Professor Dent argues that Coffee's expanded voting rights proposal lacks political feasibility and economic desirability. He questions whether states or stock exchanges competing for corporate fees would act against their own self-interest by placing constraints on managers who wish to use the acquisition as a defensive tool against future hostile tender offers.<sup>189</sup>

In sum, voting rights protection is not a panacea. Nevertheless, some sort of voting mechanism might serve as a useful tool for preventing particularly destructive acquisitions. Moreover, it might allow shareholders of target firms to prevent managers from derailing a potentially lucrative takeover by defensively acquiring other companies. The fact that some bidders already have the right to vote under certain corporate charters or state laws, moreover, proves that mechanical difficulties can be

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<sup>188</sup> Dent concludes that the problems caused by repeated bidding and resolicitation of proxies make expanded voting rights proposals impracticable. *Id.* at 786-89.

<sup>189</sup> *Id.* at 787. Dent also concludes that Congress is not likely to legislate expanded voting protection because "Congress traditionally has regulated only corporate disclosure and has left substantive corporate regulation to the states." *Id.* In light of the "substantive" regulation supplied by the Williams Act, Dent's observation appears to be weak with regard to Congressional motivation.

overcome without necessarily burdening the takeover process.<sup>190</sup>

## 2. Expanded Judicial Review

Currently, target shareholders may seek relief under *Unocal* when they feel that their managers are not behaving in their best interests in defending the corporation against a hostile takeover. As discussed in Part III, *Unocal* provides intermediate scrutiny of managerial action of target defenses adopted in response to takeover bids. No such scrutiny applies to managerial action in acquiring companies, despite many of the same concerns that fueled the *Unocal* decision. Like the target managers in *Unocal*, managers of acquiring firms often put their own interests before that of their shareholders. It is not unreasonable then, to request heightened review of transactions likely to cause bidder shareholders negative returns on the value of their stock.<sup>191</sup>

Expanded judicial review is easier said than done. What standard should courts apply to proposed and contested transactions?<sup>192</sup> Should courts abandon the business judgment rule for an intermediate standard of scrutiny like *Unocal*, or should they adopt a more detailed and searching inquiry like the "entire fairness" test? Clearly, if courts are to avoid the cost and inefficiency of examining each transaction in its entirety while providing bidder shareholders greater protection than the deferential

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<sup>190</sup> I have found no research on the value of shareholder voting rights to bidder shareholders when acquisitions are under consideration. Nevertheless, Black agrees that Coffee's voting proposal is "worth exploring" and further notes that the British currently use such a system. Black, *supra* note 16, at 652. Clearly, further research concerning the use and success of this rule in Great Britain is warranted.

<sup>191</sup> Dent suggests the following rule: "[A] court should enjoin as corporate waste or a breach of fiduciary duty any acquisition the disclosure of which causes a material decline in the price of the proposed buyer's common stock." Dent, *supra* note 11, at 794.

<sup>192</sup> In using the word "contested", I refer to those transactions that have already been completed and have caused shareholder losses.

business judgment rule, they must create some form of screening mechanism like *Unocal*'s proportionality test.

What should this intermediate standard of scrutiny look like in the context of bidder shareholders and when should it apply? The mere fact that an acquisition threatens to reduce the value of the bidder's stock, without more, does not make the best case for increased judicial interference in corporate affairs.<sup>193</sup> This is especially so if bidder losses plus transaction costs are outweighed by target gains. What fuels *Unocal* review is the fear that the target managers have been motivated by self interest and not shareholder welfare. It is a weaker variant of the duty of loyalty problems that accompany self-dealing and corporate opportunity doctrines. Thus, bidder overpayment hypotheses based on either hubris or empire building fit squarely within *Unocal*'s justification for heightened review.<sup>194</sup>

Unlike other theories that attempt to explain overbidding, the free cash flow theory may undermine the argument for increased judicial review of acquisitions because it applies to all transactions (for example, investments in assets) financed with excess cash, as it is premised on the basic agency problem between shareholders and managers. Thus, if judicial review applies to acquisitions, one might argue, it should apply to *all* potentially destructive transactions financed with excess cash flow.<sup>195</sup> Such a regime, however, would destroy the

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<sup>193</sup> See Dent, *supra* note 11, at 780 ("If unprofitable acquisitions resulted from mere mistakes of judgment, perhaps the law could tolerate them as it does other mistakes of business judgment.")

<sup>194</sup> Included in this group are "defensive" acquisitions, wherein the bidder management is in fact evading an offer from another company. In this situation, *Unocal* should apply in full force, and it is unclear whether it already does just that. *Panter*, which applied the business judgment rule to defensive acquisitions, was decided prior to the Delaware Supreme Court's decision in *Unocal*. Nevertheless, it was cited by the Delaware Supreme Court with approval subsequent to its *Unocal* decision in *Moran*, 500 A.2d at 1350.

<sup>195</sup> If anything, one could argue that excess cash-fueled investments in assets are *more* deserving of judicial review than overpayments for target

business judgment rule and leave shareholders with a less efficient system than the one they already have. Assuming the business judgment rule is generally a legitimate and useful doctrine, those who seek to protect bidder shareholders must find some way of distinguishing worthless acquisitions from other equally worthless investments. Professors Dent and Black both respond that acquisitions can be distinguished from other wealth reducing transactions because they are "major events" and more likely to be riddled by winner's curse or overbidding problems.<sup>196</sup> Neither author offers much empirical evidence to prove the salience of this distinction. One can easily imagine that some investments in research and development qualify as "major events" in the life of the corporation as much as any acquisition. Moreover, winner's curse problems may easily apply in situations where auctions occur for acquisitions of oil fields or factory lots, as opposed to auctions for other companies.

Without proof of even a weak variant of managerial breach of loyalty, it simply is difficult to justify expanded judicial review without gutting the business judgment rule

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corporations since the first type of agency problem involves a complete destruction of wealth whereas the second ordinarily involves a full or partial transfer of wealth to target shareholders. "Overpayment in a takeover differs in a critical respect from overinvestment in real assets. Externalities aside, overinvestment in real assets involves net social loss because better alternative investments are forgone. In contrast, transaction costs aside, overpayment in a takeovers is merely a wealth transfer from the bidder's shareholders to the target's shareholders." Black, *supra* note 16, at 647.

<sup>196</sup> According to Dent, "[a]cquisitions are unusual, major events that often dramatically affect stock prices. Most other corporate activities do not influence stock prices to such an extent . . . . Acquisitions also deserve special treatment because they generate losses more often than other activities." Dent, *supra* note 11, at 805. Black distinguishes mergers from other value-reducing investments by focusing on the process in which they are completed, noting that winner's curse problems more likely affect takeovers as compared with other investments. Black, *supra* note 16, at 647. My argument is different from those put forth by Dent and Black in that it focuses on violations of fiduciary duty and not merely on the nature of acquisitions or the losses they cause.

entirely.<sup>197</sup> Fiduciary duties are normative rules that guarantee loyalty and care (and good faith), not shareholder maximization of wealth. Plaintiff shareholders therefore should have to plead a *prima facie* case of managerial self-interest in order to get courts to review the terms of the transaction.<sup>198</sup> Thus, my suggested intermediate standard of scrutiny would require the plaintiffs to plead a *prima facie* case that managerial self-interest was a primary motivation behind the proposed or completed merger or acquisition, which was in conflict with management's loyalty to shareholders.<sup>199</sup> If the plaintiff cleared this hurdle, managers would be expected to respond with evidence that the acquisition would in fact produce the synergistic or efficiency gains promised in press releases. If managers failed to fulfill this burden, courts could enjoin the proposed acquisition if not yet completed, or they could compensate shareholders *ex ante* if the transaction had been completed and shareholders could show loss resulting from the acquisition.

Administering this form of judicial review admittedly would not be very easy. First, discounts and other market inefficiencies may make it difficult for shareholders to show past or potential loss when challenging acquisitions. In addition, almost all bidder managers would be able to point to some potential synergy between target and acquirer that

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<sup>197</sup> Black argues the same point, concluding, "I would not change judges' reluctance, embodied in the business judgment rule, to second-guess takeover bids and other investment decisions. The costs of litigation are too high, and the business acumen of judges too meager, to make it likely that the benefits of greater judicial scrutiny will outweigh the costs." Black, *supra* note 16, at 651.

<sup>198</sup> This seems to me to be more of a problem in theory rather than in practice. Plaintiffs simply would plead hubris, empire-building, or defense from being acquired by another firm as a motive for the acquisition when challenging bids that are too high because of the winner's curse or too wasteful because of the extra cash in management's hands.

<sup>199</sup> I would define "self-interest" as any managerial motivation that seeks to maintain, expand or increase the managers' wealth, prestige, or position, at the expense of corporate profitability or shareholder welfare.

they believed would materialize in the future. How then, would judges be able to tell the difference between "good" bidders and "bad" bidders? Indeed, on the target side, judges have not been terribly keen in choosing between loyal and disloyal target managers.<sup>200</sup> One might wonder then, why judges would do such a better job ferreting out "good" from "bad" bidder managements. In sum, would judicial error be so great as to make judicial review's costs outweigh its benefits?

Professor Dent tries to avoid the problems discussed above by offering a different form of judicial review, in which he limits all relief to *ex ante* injunctions. Labeling his solution a market-based approach, Professor Dent argues that courts should enjoin all transactions that cause "material" declines in the price of the stock upon announcement.<sup>201</sup> According to Dent, injunctions are less problematic than other types of relief because they do not involve complicated inquiries about damages.<sup>202</sup>

Despite this concededly simple solution, Dent's proposal still has its flaws. Like Coffee's voting proposal, the market based approach is problematic on several levels. First, it assumes that information about the wealth effects of the proposed transaction is readily and immediately available. Second, it assumes that the stock market perfectly reflects this information and that judges will be able to distinguish material declines from temporary noise in the stock markets.<sup>203</sup> Third, it fails to take into account Kraakman

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<sup>200</sup> "The tremendous deference that Delaware courts have given target managements seems based not on confidence in the managements' loyalty but on distrust in judges' ability to distinguish loyal from disloyal managements." Daines & Hanson, *supra* note 97, at 604.

<sup>201</sup> "[A] court should enjoin as corporate waste or a breach of fiduciary duty any acquisition the disclosure of which causes as material decline in the price of the proposed buyer's common stock." Dent, *supra* note 11, at 794. Dent further specifies that plaintiffs would bear the burden of proving a material decline in stock price. *Id.* at 795.

<sup>202</sup> *Id.* at 796.

<sup>203</sup> According to Dent, defendants would bear the burden of proving that the decline was not caused by announcement of the imminent merger. *Id.* at 795.

and Black's discount hypotheses. If shareholders already expect their managers to make bad investments, the stock price may not suffer a material decline.<sup>204</sup> Finally, it suffers from a legal feedback problem: once stockholders knew that they could get injunctive relief from courts, they would incorporate this knowledge into the price of the stock, thus failing to trigger the injunctive relief in the first place.

Dent recognizes the feedback problem, but discounts its existence in practice. According to Dent, the market would *also* incorporate the knowledge that a feedback reaction would preclude judicial protection:

If the stock market were functioning perfectly it still would react to the unwise merger. Recognizing that a court would not enjoin the merger if the buyer's stock price did not fall, owners of the stock would sell. If the price fell to the point at which a court certainly would enjoin the merger, investors would bid the price up. Equilibrium would be the price at which the market could not predict either a grant or a denial of an injunction — that is, the borderline between a material and an immaterial decline in price. If we assume an unbiased market, approximately half of these unwise mergers would be enjoined.<sup>205</sup>

Even if Dent is correct (and one would need empirical evidence to test both his hypothesis and the general theory of the legal feedback effect on stock price), only half of the mergers that *should* be enjoined *will* be enjoined. This hardly seems efficient, much less optimal.

A final form of judicial review might be connected with the expanded voting rights protection described in the preceding section. Under this third variant of protection, shareholders would first vote for or against the transaction. If they ratified the transaction, and the acquisition later

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<sup>204</sup> In fact, price might even experience a slight *rise* if the acquisition is less wasteful than the level of wasteful expenditure already expected by the shareholders and incorporated into the discounted price of the stock. See discussion *infra*.

<sup>205</sup> Dent, *supra* note 11, at 803.

proved to be financially destructive, shareholders would have the option of suing managers for putting out false or misleading proxy statements when ratification was solicited. Coffee sees this as a problem.<sup>206</sup> I, however, think it could provide a nice solution to some of the problems detailed above. Managers would be penalized only when they put out false or misleading information. The threat of litigation would force them to minimize costs following the acquisition and would likely dampen their hubris and likelihood of falling prey to the winner's curse before they initiated or completed the transaction. Thus, the voting rights protection provided above would allow shareholders to *prevent* uneconomic bidder acquisitions, and if they ratified the acquisition, they would be able to seek *compensation* if they could show falsity or misleading behavior on the part of over-eager bidder managers and economic loss caused by the acquisition.<sup>207</sup> Undoubtedly, this system would not *eliminate* overbidding or ego-driven acquisitions, but it certainly might reduce their number and detrimental effects on bidder shareholders.

I have described in this section three ways in which judicial review could be expanded to protect bidder shareholders. The first would be based on the plaintiff shareholder's *prima facie* showing of managerial ego or hubris driving the acquisition. The second, Dent's proposal, is based on market decreases in share price following announcement of the takeover. The last, based on false and misleading proxy statements, works in conjunction with the voting rights protections described above to allow for compensation whenever management has misled or falsified information pertaining to the terms of the acquisition. Each of these mechanisms carries with it costs

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<sup>206</sup> See Coffee, *supra* note 13, at 1270.

<sup>207</sup> Of course, this is a bit question begging, since I have argued consistently throughout this paper that "loss" cannot always be measured by the market's valuation of shareholder stock. I would respond that shareholders should have the option of illustrating "loss" through reduced productivity and market share in addition to depressed stock price.



and benefits. Similarly, each mechanism requires further examination and refinement before it is employed by courts. (Indeed, I have not even begun to ponder the possible effect of frivolous suits on this discussion). Nevertheless, the three versions of judicial review set forth above illustrate that expanded protection of bidder shareholders by courts certainly is a possibility.

### 3. Liability Rule Protection

For those who have little faith in judges and substantial reservations about shareholder ability to overcome the collective action problem in the voting rights context, it might be useful to consider a "liability rule" regime similar to that proposed by Professor Hanson and Robert Daines in the target context.<sup>208</sup> Daines and Hanson consider the potential losses to target shareholders caused by target managers' adoption of defensive tactics. Because courts often are unable to distinguish between fair and unfair takeover bids *ex ante*, Daines and Hanson argue for "liability rule" protection for target shareholders, whereby "managers could resist a takeover . . . so long as shareholders were compensated *ex post* for having to forego a takeover premium."<sup>209</sup> According to this liability rule, target management may defend against a tender offer so long as it bonds itself to pay target shareholders later what they would have gained had they not been prevented from tendering their shares. If management is correct in stating that the true price of the stock is greater than that offered by the bidder, it gets back its bond at some later date; if not, management gives it up to shareholders.<sup>210</sup> Daines and

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<sup>208</sup> Daines & Hanson, *supra* note 97, at 605.

<sup>209</sup> *Id.* at 605.

<sup>210</sup> For the liability rule to work, management must have access to the funds needed to bond themselves to paying out what is owed to the shareholders later. According to Daines and Hanson, a market for bonding would emerge in which third parties would agree to bond loyal managers and refuse to bond disloyal ones. Daines & Hanson, *supra* note 97, at 607. The third-party resistance bonder, presumably, would keep management in line because his money was on the line. According to

Hanson recognize that their liability rule is potentially undermined by its dependency on market prices. If markets are informationally, but not allocationally efficient,<sup>211</sup> they will reflect the shareholders' knowledge that they can get their money back by way of a liability rule, thus creating the so-called legal feedback loop discussed with regard to Dent's proposal for injunctive relief.<sup>212</sup> Thus, the market price will not differ much (if at all) from the bid price. Daines and Hanson attempt to solve this problem by requiring resistance bonders to pay into an escrow account until the stock price increases from its market position following the takeover defense up until it reaches an amount higher than the bid price. Once the stock price rises above the bid price, the authors argue, the shareholders and management will know the difference between the true value of the stock at a given time in the future and the bidder's premium that was foregone by shareholders.<sup>213</sup>

Daines and Hanson originally designed their liability rule to apply to agency problems between target managements and shareholders.<sup>214</sup> There is no reason, however, that their analysis could not be expanded to problems on the acquirer's side of mergers and transactions. Thus, instead of "resistance bonding," we would have acquisition bonding. According to Daines and Hanson, the liability rule should guarantee that the

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Hanson and Daines, the liability rule's third party bonding market, "insures that the bonder's decision is in sync with shareholders' interest by tying the bond to the share price and by requiring that the bond be as substantial as shareholders' potential loss from unbonded resistance." *Id.* at 628. In this sense, Hanson and Daine's reliance on market institutions to monitor managers in the takeover context is very similar to Jensen's argument that debt has a good monitoring effect on managers in the context of leveraged buyouts. See Jensen, *Agency Costs*, *supra* note 15.

<sup>211</sup> See discussion *supra* at note 90 and accompanying text.

<sup>212</sup> Daines & Hanson, *supra* note 97, at 622.

<sup>213</sup> Hanson has referred to this mechanism in his classes as "topping off."

<sup>214</sup> They state that, initially, the rule might be mandatory, but later on would be voluntarily contracted for in the corporation's articles of incorporation. See Daines & Hanson, *supra* note 97, at 623 n.216.

shareholder is no worse off than if the transaction never took place. Therefore, stockholders should have at least as much stock value *after* an acquisition than before it took place. As applied to the bidder context, the Daines and Hanson liability rule might require<sup>215</sup> the bidder's management to pay into an escrow account following the acquisition an amount of money up to the point necessary to make the stock move above the price it was trading at prior to announcement of the merger or acquisition.<sup>216</sup> That way, shareholders are assured that they will be no worse off than before the announcement of the acquisition.

Although the Daines and Hanson liability rule mitigates problems caused by the legal feedback loop, it does not do the same for problems caused by the market discounts identified by Kraakman and Black. The legal feedback loop causes the stock price to be inflated over its "true" price because of investor expectations. The misinvestment discount, on the other hand, causes the stock price to *deflate* below its "true" price.

Although it is possible to remove the legal feedback loop by requiring managers to put money into an escrow account until the price of the stock moves above the market price, no such liability rule will remove the discount effect. Imagine at  $T_1$ , prior to announcement of an acquisition, Bidder's stock is trading at  $D$ , the discounted market price of the stock. At  $T_2$ , Bidder's management announces an acquisition. Four scenarios may result. First, if the acquisition is truly an example of wealth creation, the stock price will rise above its "true" price. Second, if the acquisition is as wasteful as what shareholders already expected of Bidder's management, the stock price will stay constant. Third, if the acquisition is worse than investors

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<sup>215</sup> This rule could be made mandatory through state corporation laws and/or stock exchange rules. It may not be as politically infeasible as the reforms suggested above because it doesn't facially prevent any particular acquisition.

<sup>216</sup> There are, however, some problems that would need to be worked out because of the nature of the acquisition itself, which might result in the creation of more stock shares.

already expected, the market price will move downward to reflect this information. Finally, if the acquisition is wasteful, but not *as* wasteful as shareholders expected of Bidder's managers, the stock price will rise, but not above its true price. Thus, a wasteful acquisition could trigger an increase in stock prices, *as well as* a decrease, or result in the prices remaining the same. Because of the discount effect, the liability rule, as defined by Daines and Hanson, is therefore unable to properly distinguish between "good" and "bad" acquisitions.

It is important to note that unlike the judicial intervention advocated by Dent and discussed in the last section, the liability rule advocated by Daines and Hanson expressly eschews legal intervention in the takeover process. I criticized Dent's market based proposal because the "trigger," a decline in stock market prices, would be hidden by the legal feedback loop. Daines and Hanson's liability rule solves that problem — so well in fact, that it obviates the need for judicial intervention in the first place. Unfortunately, the discount effect identified by Kraakman and Black undermine even this type of protection for bidder shareholders. Nevertheless, its application in the bidder/acquisition context should be seriously considered in the future, since it would, at the very least, ensure shareholder protection where announced acquisitions *exceeded* shareholder expectations of managerial misinvestment.

#### 4. Auction Reform

Another source of protection for bidder shareholders is auction reform. In the past, vigorous debate about the wealth effects of auctions focused almost exclusively on target shareholder welfare. Auctions, however, affect bidders — and their shareholders — significantly. As was discussed in Part IV, one of the reasons bidders overpay is that they fall prey to the "winner's curse," whereby they overbid for the target because of the nature of the auction process. If that is the case, the auction process might be

altered in such a way to prevent bidder overpayment without creating target shareholder underpayment. One possible way of combating the winner's curse is to limit the number of auction participants, since bidders often fail to properly adjust bids downward as the number of auction participants increases. The problem with this suggestion, however, is that it treats all bidders as fungible, and fails to recognize that each bidder may have unique synergies with the target. If that is the case, then a rule limiting the number of auction participants will lead to an inefficient allocation of resources, since the bidder with the greatest synergies with the target may be left out of the takeover process.

A less drastic way of mitigating the winner's curse may be achieved by altering the financial advisers' incentive structure. If investment bankers' fees were tied to shareholder welfare and not the completion of a particular deal, they might have more encouragement to warn bidder managements about the winner's curse. In addition, auctions might be altered by eliminating sealed bids. According to Romano, the winner's curse is, in part caused by uncertainty about the value of the target.<sup>217</sup> If sealed bids are eliminated, would-be acquirers will not overestimate the amount necessary to "beat" their opponents.<sup>218</sup> The targets' assets would still go to the highest valuing bidder. Targets, however, would undoubtedly complain that the new system would deny them full realization of the value of their stock. Policymakers could respond, however, that the extra amount bidders add to bids to "beat" their opponents has little to do with the value of the target and much more to do with the problem of overbidding.

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<sup>217</sup> "When the value to the bidders of the auctioned item is uncertain, the person who has overestimated the value the most will be the winner." Romano, *supra* note 90, at 150-51.

<sup>218</sup> For an interesting account of how sealed bidding affected opponent bidders and their decisions on what to bid for a "target", see BURROUGH & HELYAR, *supra* note 63, at 450-54.

## 5. Encourage Management to Return Cash to Shareholders

One of the explanations for bidder overpayment discussed in Part IV was Michael Jensen's free cash flow theory applied to bidders: managers with excess cash go on spending sprees that include value-reducing acquisitions of other companies. If acquisitions and bidder overpayment are part of a larger problem of controlling agency costs between shareholder and managers, one way to prevent them is to encourage (or force) managers to remit excess cash back to the shareholders. Caves supports such a reform, concluding "[i]f a useful solution lies in the realm of public policy, it probably involves increasing the incentives for managers to return to shareholders cash that could otherwise be used for low-value investments - whether mergers or other outlays."<sup>219</sup> Caves does not go on define the specifics of such an incentive. In his original statement of the free cash flow theory, Jensen argued that replacement of cash with debt would produce the desired reduction of agency costs between managers and shareholders.<sup>220</sup> Of course, this could be achieved only by eliminating the public shareholder altogether and replacing him with bondholders and banks via the leveraged buy-out.<sup>221</sup>

Professor Black suggests altering the present corporate tax to "reduce managers' incentives to hoard, and sooner or later to spend, excess cash."<sup>222</sup> According to Black, removing the taxation on corporate profits at the point of distribution (or providing it with an offsetting deduction) would encourage managers to return cash to shareholders, as would a tax on shareholders on undistributed corporate

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<sup>219</sup> Caves, *supra* note 163, at 171-72.

<sup>220</sup> Jensen, *Agency Costs*, *supra* note 15.

<sup>221</sup> Similarly, Black concludes, "[F]rom the perspective of the Overpayment Hypothesis, raiders may be among the *best* bidders, despite their unsavory reputation in Congress." Black, *supra* note 16, at 650.

<sup>222</sup> *Id.* at 651.

profits.<sup>223</sup> Clearly, the benefits of these reforms would have to be measured against the federal government's corresponding loss in revenue.

## VI. CONCLUSION

I have tried to show in this paper that the law treats bidder shareholders differently from the way it treats target shareholders. While target shareholders enjoy the protections of voting rights, *Unocal* review, protective state and federal legislation, and even appraisal rights, bidder shareholders retain only the limited protection provided by the business judgment rule. It is clear that the law treats bidder and target shareholders asymmetrically.

Unfortunately, it is even more clear that such asymmetrical treatment is unwarranted. The fact that bidder shareholders often earn a negative return proves that the wealth-reducing theories (free cash flow, winner's curse, hubris, etc.) are accurate at least in part. Losses to bidder shareholders may outweigh gains to target shareholders. Even if they do not, at least a portion of the premium to target shareholders represents a wealth transfer. These wealth transfers are involuntary and represent violations of management's fiduciary duty to shareholders. They are a form of agency costs and therefore should be discouraged. If voluntary contracting costs are too high, then mandatory rules should be put in place to protect shareholders.

Arguing for protection is one thing. Crafting legal rules which achieve that level of protection without destroying the takeover process is quite another. I have set forth several possible areas of legal reform with the background

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<sup>223</sup> In this vein, see Zohar Goshen's suggestion for a mandatory rule providing shareholders with the option of selecting their yearly dividend (pro rata) in stock or cash at fixed rates. In conjunction with this mandatory rule, Goshen would remove tax rules that encourage managers to hoard corporate profits rather than distribute them to shareholders. Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L. J. 881 (1995).

assumption that it is not likely that the Williams Act or state anti-takeover legislation will be repealed. (Even if these mechanisms were repealed, they would make bidding less expensive; they would not prevent bidder managers from making destructive acquisitions, especially friendly ones). Some combination of the reforms discussed in the preceding section offers the best possibility for future protection of bidder shareholders, but each needs further research, refinement and testing. Nevertheless, it is time to start thinking seriously about the bidder shareholder.



