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ACQUISITION OF CORPORATE CONTROL BY NUMEROUS PRIVATELY NEGOTIATED TRANSACTIONS: A PROPOSAL FOR THE RESOLUTION OF STREET SWEEPS

*Yedidia Z. Stern**

INTRODUCTION

Corporate control¹ may be acquired by means of special techniques regulated by law, such as a merger or tender offer, or it may be effected by means of negotiating regular contracts for the purchase of corporate shares from the owners. Within the framework of the latter method of purchasing corporate control, three scenarios may exist. In the first case, termed "private acquisition of control," control is acquired by means of a private transaction with a holder of controlling shares (or from a group that has control and acts in concert with an identity of interests). The second case, the "open market purchase of control," is the act of acquiring control by means of a series of anonymous purchases of corporate shares on a stock exchange. In the third case, the "street sweep" or "sweep,"² the purchase of control is

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¹ For the purposes of this Article, "control" is attributed to the person who owns such a sufficient quantity of voting rights as to impose his business policy on the corporation.

² In legal jargon, the use of the term "street sweep" is not uniform. There are those who use the term widely to describe open market purchases as well as privately negotiated transactions. To differentiate between the two situations, this Article refers to open market purchases as "market sweeps," and reserves the term "street sweeps" for private transactions not conducted on an exchange.

There are those, however, who use the term "street sweep" narrowly to describe a particular case of acquisition of control by way of private transactions off the exchange after the failure of a tender offer. In that case, the raider who failed to acquire control (usually as a result of defensive tactics adopted by the target corporation) can successfully acquire control by means of private transactions made with risk arbitrageurs and with a number of central shareholders in the corporation. See, e.g., Dale A. Oesterle, *The Rise and Fall of Street Sweep Takeovers*, 1989 DUKE L.J. 202; Michael Ryngaert et al., *Shareholder Welfare and Substantial Acquisition Outside of the Williams Act*, 1988 COLUM. BUS. L. REV. 505. In this Article, I free the term from the narrow interpretation and apply it to every case of acquisition of control by way of private, independent trans-

effected through a series of unrelated private transactions, concluded off the exchange, between the purchaser of control and a large number of shareholders who have not coordinated their positions and as a result, have not previously wielded control of the corporation. The focus of this Article is this third case of privately negotiated transactions for the acquisition of control.

In principle one may conceive of two factual situations in which a sweep may be conducted to acquire corporate control. In the first instance, the concentration of corporate share ownership before the sweep is such that no shareholder holds sufficient shares to allow him or her to secure control over the corporation. In this situation, the sweep process turns the uncontrolled corporation³ into a controlled one. In the second case, the corporation is controlled before the sweep by a minority shareholder who holds *de facto* control of the corporation because a majority of the shares are dispersed among a wide range of investors who have not coordinated their positions.⁴ In this situation, the aim of the sweep is to concentrate in the hands of the purchaser greater voting power than that held by the present controller so that control passes to the purchaser even without the cooperation of the current controller. However, acquisition of control by way of a sweep is not possible in a third factual situation: where a shareholder owns the majority of the voting power. In this case, the agreement of the majority shareholder to sell his shares is a necessary condition for the transfer of control to others.⁵

actions conducted off the exchange between the purchaser and a large number of shareholders.

³ Professional management guides the operations of the uncontrolled corporation. It is therefore accepted practice to classify control of such a corporation as "management control." See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 5, 84-90 (rev. ed. 1968).

⁴ In such a scenario, control is referred to as "minority control." See BERLE & MEANS, *supra* note 3, at 5, 84-90.

⁵ An exception is where the majority shareholder has no interest in running the corporation. Since this type of control is only potential and not actual, the corporation can be classified as uncontrolled. For example, one can imagine a corporation where the majority of shares are held by a trust, a mutual fund or a financial institution that does not participate directly in corporate governance. This phenomenon, known as institutional investor passivity, enables an interested party to concentrate actual control of the corporation by means of a sweep of shares from the community of minority shareholders. For an analysis of the rational apathy of institutional investors, see John C. Coffee Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor* (1991) (un-

This Article examines the two-pronged question of whether and how Congress should regulate a street sweep for acquisition of corporate control. There is little substantive discussion on sweeps in legal literature. Courts,⁶ the Securities Exchange Commission ("SEC")⁷ and scholars⁸ focus mainly on the question of the whether the federal tender offer regulation applies to street sweep deals. Generally, they are not concerned with acquisition of control by the sweep method itself.⁹ This Article attempts to fill the lacuna by means of a systematic and analytical examination of street sweeps as a method of acquiring corporate control.

Part I describes existing relevant law. Statutory law does not refer specifically to the subject of sweeps and, therefore, the appropriateness of regulation is a matter of dispute. The SEC supports subjecting sweeps to the statutory norms that regulate tender offers because of the similarities between the two. However, most courts have rejected the SEC approach and refused to apply tender offer regulations to street sweeps.¹⁰ Generally, courts see no cause for distinguishing between sweeps and regular purchases of shares on or off a stock exchange. In other words, there is nothing to stop corporate control from passing hand to hand or from its initial consolidation by way of a sweep of shares in private transactions not on the exchange under current law.

published working paper no. 55, Columbia U. School of Law).

⁶ See *infra* notes 42, 45 & 51 and accompanying text.

⁷ See *infra* notes 40, 44, 49 & 50 and accompanying text.

⁸ The sparseness of legal literature dealing with street sweeps is surprising. Even the limited writings on sweeps are directed primarily at the discussion of the mutual relations between the sweep and the tender offer. See Thomas J. Andre Jr., *Unconventional Offers Under the Williams Act: The Case for Judicial Restraint*, 11 J. CORP. L. 499 (1986); Lloyd R. Cohen, *Why Tender Offers? The Efficient Market Hypothesis, The Supply of Stock and Signaling*, 19 J. OF LEGAL STUD. 113 (1990); D. Roger Glenn, *Rethinking the Regulation of Open Market and Privately Negotiated Stock Transactions under the Securities Exchange Act of 1934*, 8 J. CORP. L. 41 (1983); Oesterle, *supra* note 2, at 202.

⁹ Not all of academia is oblivious to the special questions raised by the street sweep. See Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985); see also Edward F. Green & James S. Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647 (1985). These two articles, although they do not distinguish between market sweep and street sweep, pave the way for an understanding of certain aspects of the problems presented by a sweep. This Article follows that path and proposes a specific and wider analysis of the street sweep phenomenon.

¹⁰ See *infra* notes 20-21 and accompanying text.

Part II of this Article explores whether the absence of statutory regulation of sweeps is harmful. The answer to this question is yes for a number of reasons. First, the need to protect minority shareholders in sweeps and the different risks involved in sweeps makes it clear that a sweep, like the other forms of acquisition regulated by law, poses conditions that are potentially detrimental to the shareholders. Additionally, a sweep contains other special features that mandate statutory regulation. Second, the non-regulation of sweeps is liable to lead to economically inefficient deals. In sweeps, unlike all the other means of acquiring corporate control, the selling shareholders are not aware of the purchaser's aim to gain control of the corporation. This state of affairs is likely to lead them into inefficient transactions. Contrary to the position of courts, this Article argues that sweeps should be viewed as a particularly problematic form of seizing control and, therefore, should be regulated by law. Contrary to the position of the SEC, however, sweeps should not be regulated by tender offer regulations because of the substantive differences between these two forms of acquisition.

Part III proposes new regulations to prohibit the acquisition of corporate control by means of a sweep. The proposed regulations would forbid an investor who wishes to increase holdings in a corporation beyond a certain limit (which signifies control of the corporation) to do so by way of private transactions. Instead, the investor will be obliged to adopt one of the accepted means of acquisition regulated by law. This proposal ensures that all acquisitions of corporate control will be effected in accordance with the general statutory norms designed to achieve the goals of economic efficiency and fairness for the shareholders. The prohibition will reduce the menu of techniques for acquiring corporate control.

Finally, Part IV shows that this reduction is beneficial. The sweep is an inferior mode of acquisition relative to other modes: its cost is high and certainty of success questionable. The sweep is also superfluous because it does not allow the purchaser to achieve any legitimate goal that could not already be achieved through existing acquisition methods. The prime motive for preferring the sweep technique to acquire corporate control is the

purchaser's pursuit of negative advantages,¹¹ which the current law attempts to prevent under regulated forms of acquisition of control. Hence, transactions for transfer of control by means of sweeps should be prevented.

I. BACKGROUND

A. *The Problem*

The commercial situation discussed in this Article may be illustrated simply by means of the following hypothetical examples. Assume that corporations A and B are public corporations and their shares are traded on the stock exchange. The composition of ownership of the shares of corporation A is such that none of the shareholders has more than five percent of the voting shares. In corporation B, the composition of the shareholders is different. One person—the “controller”—controls the corporation with thirty percent of the voting shares, another person—the “contender”—has twenty-five percent of the voting shares, and the other voting shares are dispersed amongst the general public of investors.

The contender is interested in acquiring control of both corporations. To do so, he must purchase more than five percent of the voting shares in each of the two corporations. For the contender's own reasons (which we shall analyze at a later stage), he prefers neither to resort to the acquisition techniques of merger and tender offer nor to conduct negotiations for acquiring control from shareholders. Instead, the contender locates a number of shareholders, who, for example, each hold three tenths of one percent of the voting shares in one of the two corporations, and approaches them directly, conducting private negotiations with each for the purchase of their shares. The contender is not interested in disclosing his intention to acquire control of the corpo-

¹¹ Negative advantages of acquisition are those that have their source not in the creation of new economic assets, but in the transfer of existing economic assets from the shareholders of the target corporation to the purchaser. For example, the real motive for acquiring control is sometimes the desire to loot the acquired corporation or to exploit the mistakes of the market in assessing the value of the acquired company. See Reiner Kraakman, *Taking Discounts Seriously: The Implication of Discounted Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988). Other times the motive is to take advantage of manipulative accounting. See RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* ch. 12 (1986).

rations to any of the shareholders. Therefore, his approach to each is private and discrete. It is designed to remain hidden from the other shareholders, management, other potential buyers and, in the case of corporation B, the "controller" as well. The contender approaches these shareholders in personal meetings, by way of telephone, facsimile, and so on. The price paid for the shares in each of the transactions is not uniform. Rather, it is the result of the bargaining skill of each of the selling shareholders. After closing ten transactions in the shares of each of the corporations (*i.e.*, he owns three percent of corporation A and twenty-eight percent of corporation B), he is somewhat concerned about discovery of his secret plan. Therefore he hides his identity and continues his sweep of the shares through intermediaries. After completing an additional ten transactions in each corporation, the contender achieves his goal: he is the owner of six percent of the shares in corporation A and thirty-one percent of the shares in corporation B. He is therefore the controller of both corporations. In corporation A, he created the preliminary controlling block, whereas in corporation B, he succeeded in transferring to himself the control once held by the controller.

Is the means of acquiring control of the two corporations adopted by the contender legitimate? Neither transaction for acquiring the shares in either corporation is, in itself, problematic from a legal point of view. However, does the accumulation of the transactions and the fact that they form part of a strategic plan for acquiring control give rise to a normative defect in the entire process?

B. *Current Law*

The usual means for acquiring control of a corporation are mergers, tender offers and the private purchases of control from its holder. The law does not, however, limit the methods of seizing control to these three possibilities. The law places neither prohibitions nor express limitations on acquiring control of a corporation by any other means. Interestingly, whereas the law provides detailed and extensive treatment for mergers¹² and

¹² See, *e.g.*, DEL. CODE ANN. tit. 8 §§ 251-53 (1991); MODEL BUSINESS CORP. ACT §§ 71-77 (1984) [hereinafter MBCA]. The codes specify the procedure of the transaction, including the need for each company's board to adopt a merger plan and the need for

tender offers,¹³ and struggles with the question of what arrangements, if any, are necessary for dealing with private transactions for purchases of control,¹⁴ there is virtually no specific regulation on acquisition of control by a sweep.¹⁵

Does this mean that sweeps do not require statutory treatment and that there is no legal basis to stop control of a corporation from being purchased by means of private approaches to shareholders? The answer is in dispute. Some courts, as well as the SEC, hold that sweep transactions should be regulated by

approval of the plan by a certain majority of the shareholders. Additionally, the codes provide the content of the plan and describe the effect of the merger.

¹³ See The Williams Act, codified at §§ 13(d) (e), 14(d)-(f) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m (d)-(e), 78n (d)-(f) (1982).

¹⁴ For a survey, see Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248 (1985).

¹⁵ One of the regulations applicable to sweeps is section 13(d) of the Securities Exchange Act of 1934. Under that section, a person who, in the process of a sweep of shares, accumulates five percent or more of the shares of a corporation, must report the acquisition in a disclosure schedule filed with the SEC within ten days of the date on which the limit was exceeded. However, this disclosure obligation does not significantly interfere with completion of the acquisition process by means of a sweep. First, the purchaser has a fair amount of time to conduct a sweep secretly. Second, the disclosure duty imposed by this section does not apply to a purchaser who owns more than five percent of the shares of the corporation before he or she starts the sweep process. Third, Item 4 of Schedule 13D requires the purchaser to report his intentions to acquire any additional shares in the future, or any plan to change the board of directors or management. Nevertheless, in practice many of the disclosures filed under section 13(d) are vague and un-specific, and therefore do not help the shareholders make a calculated decision with respect to the offer to purchase their shares. Finally, even where section 13(d)'s disclosure requirements do not serve as a warning sign to the shareholders about the real intention of the purchaser, it might have a negative effect on the shareholders, which may distort their decisionmaking process. See *infra* note 61 and accompanying text.

Another piece of legislation relating to sweeps is the Hart-Scott-Rodino Antitrust Improvements Act of 1976, which provides, in section 18(a), that in cases where the acquisition of shares exceeds certain limits (relating to the acquired corporation and the extent of purchase) set by law, the purchaser must report the acquisition, before its execution, to the Federal Trade Commission ("FTC") and, in appropriate cases, must wait a certain period before completing the transaction. The FTC rules apply these arrangements to creeping acquisitions as well, which characterize many sweeps. See Regulations under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18(a) (1989); 16 C.F.R. § 801.13 (1988).

The sweep might also be affected by state law. Many states have legislated state antitakeover legislation, such as control-share statutes, fair price and business combination statutes and redemption statutes. See, e.g., Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635 (1988). Even though the goal of such legislation is, in general, to help the target corporation defend itself against a hostile takeover, it has clear ramifications on the ability to acquire control of the corporation by means of a sweep.

the tender offer provisions of the Williams Act ("Act"). The purpose of the Act is to protect investors from pressures, distortions and "pirate-like" conduct to which they are exposed during contests for corporate control. Accordingly, the Act contains provisions designed to offset the power of the purchaser and, to the extent possible, to bring about a balance of power between the purchaser and the selling shareholders.¹⁶ However, major provisions of the Act do not apply to every case of acquisition of control, but only to the case in which the acquisition is effected through a tender offer. Therefore, the application of the arrangements of the Williams Act to sweep transactions depends on the interpretation of the term "tender offer."

Despite the importance of the term "tender offer," Congress has consistently refrained from defining it. The absence of a clear definition may stem from the intention of Congress to apply the Williams Act to as many transactions as possible, including transactions that, at the time of its enactment, were uncommon and unforeseeable.¹⁷ On the one hand, this state of affairs allows courts and the SEC the flexibility to apply the provisions of the Act as they see fit in each case. On the other hand, Congress's failure to define "tender offer" also stirs the imagination of the planners of transactions, who view the absence of a definition as an opening for crafting takeover techniques that fall outside the legislative framework of tender offers.¹⁸

¹⁶ Thus, for example, section 14(d) of the Securities Exchange Act of 1934 imposes a broad duty of disclosure upon the purchaser. This section also provides a time-frame for the transaction, imposes a duty to pay an equal price for all the shares that are purchased, sets out rules governing the quantity of shares that will be purchased from each shareholder who wishes to sell his shares, and allows the shareholders who are selling to withdraw their acceptance of the offer. 15 U.S.C. § 78n(d) (1982).

¹⁷ This position is accepted by courts. *See, e.g.,* *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 56 (2d Cir. 1985). This position is also embraced by commentators. *See, e.g.,* EDWARD R. ARONOW ET AL., *DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL* 1 (1977). It is also adopted by the SEC. *See* *Tender Offers*, Exchange Act Release No. 12,676, 10 SEC Dock. 143, 145 (Aug. 2, 1976). Others argue that Congress intended to leave the task of defining a tender offer to courts and the SEC. *See Letter from Senators Proxmire, Williams and Sarbanes Requesting SEC Views on Tender Offer Laws* (July 3, 1979), reprinted in *Sec. Reg. & L. Rep.* (BNA) No. 542, at 3-4 (Special supp. Feb. 27, 1980) [hereinafter *Letter*].

¹⁸ In avoiding the application of the Williams Act, the purchaser benefits greatly by opening the way for control over the timetable of the execution of the transaction. *See* GILSON, *supra* note 11, at 991. The law deliberately slows down the process of acquisition to allow the solicited shareholders to collect information concerning the potential purchaser and to assess, in the absence of pressure, the nature of the offer. Similarly, the

In the convoluted game between the SEC and investors concerning application of the Williams Act, the possible regulation of share sweeps arises. In many cases purchasers have tried to purchase control through a sweep, thereby avoiding the application of section 14(d) of the Securities Exchange Act of 1934 to the transaction.¹⁹ The SEC has attempted to broaden the definition of "tender offer" to include a substantial portion of street sweep cases.²⁰ The SEC was apparently aware of the complex ramifications of the sweep process and the need to protect the interests of all those involved in the stock market. Therefore, in the absence of a specific statutory arrangement dealing with sweeps, the SEC attempted to deal with the sweep issue by applying an existing legal arrangement to the problem. As a result the regulation of sweeps under securities law is discussed in the context of the dispute concerning the proper definition of "tender offer."

Courts and scholars agree that the term "tender offer" should not be limited to the narrow dimensions of the classical tender offer, namely an offer to all shareholders, made through the media, for the purchase of a certain quantity of shares at a fixed price within a fixed time.²¹ Hence, it appears that sweeps should not be excluded from the Williams Act's coverage merely

postponement allows other elements in the market to evaluate the offer and to consider whether they want to make the shareholders a more generous offer. The Williams Act also allows the management of the target corporation to protect itself from the offer of purchase by adopting various defensive tactics. Accordingly, avoiding the legislative framework governing a tender offer allows a person acquiring control by way of a sweep to block objections or informed reactions to the offer, thereby preventing the possibility of an alternative tender for control of the corporation. Furthermore, the purchaser is not subject to other requirements imposed upon purchasers by virtue of the Williams Act, such as the requirement of pretransaction disclosure of extensive information, the requirement to purchase the shares *pro rata* from all those interested in selling and the requirement to respond to a right of withdrawal of the sellers. See § 14(d)5-7, 15 U.S.C. § 78n(d)(5)-(7) (1970); see also *supra* note 16.

¹⁹ See *infra* notes 22-23 and accompanying text.

²⁰ See, e.g., Herbert A. Einhorn & Terence I. Blackburn, *The Developing Concept of "Tender Offer": An Analysis of the Judicial and Administrative Interpretations of the Term*, 23 N.Y.L. SCH. L. REV. 379 (1978); Neal I. Korval, Note, *Defining Tender Offers: Resolving a Decade of Dilemma*, 54 ST. JOHN'S L. REV. 520, 531-33 (1980); Nathaniel B. Smith, Note, *Defining "Tender Offer" Under the Williams Act*, 53 BROOK. L. REV. 189 (1987).

²¹ See, e.g., Martin Lipton, *Open Market Purchases*, 32 BUS. LAW. 1321, 1321 (1977) ("[T]he Williams Act was not intended to be restricted to conventional tender offers but rather was meant to encompass all methods of takeovers sought to be achieved by a large-scale stock purchase program.").

because they do not mirror the traditional characteristics of tender offers.

Those discussing this question examined the rationale underlying the enactment of the Williams Act. As was mentioned above, the purpose of the Act is to protect shareholders from having to respond hastily to an offer, under pressure and without sufficient knowledge. Therefore, every transaction that places the shareholders in such a difficult position should require such protection, irrespective of the technique adopted by the purchaser.²² This rationale is likely, at times, to demonstrate the need for applying the Williams Act to a sweep transaction since the position of shareholders in private transactions can be at least as inferior as the position of the shareholders faced with a tender offer.²³

The SEC has displayed a preference for examining the substance of a transaction over its form. Accordingly, the SEC has referred to the term "tender offer" in the following broad manner: "The term is to be interpreted flexibly and applies to special bids . . . and any transaction where the conduct of the person seeking control causes pressures to be put on shareholders similar to those attendant to a conventional tender offer."²⁴

In the well-known case of *Cattlemen's Investment Co. v. Fears*²⁵ the district court invoked the rationale test of the Williams Act to decide whether the Act applied to sweep transac-

²² See Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1251 (1982). For dissenting views, compare *S-G Securities Inc. v. Fuqua Investment Co.*, 466 F. Supp. 1114 (D. Mass. 1978) (extending the term "tender offer" to include an event in which the purchaser announces his intention to acquire controlling shares of the corporation, and subsequently conducts a hurried purchase of shares by means of the open market and private transactions), with *S.E.C. v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985) (rejecting the broad interpretation of *S-G Securities*). From time to time the SEC has elucidated its position that under the Williams Act, the scope of the term "tender offer" goes "beyond the conventional tender offer to include acquisition programs that prevent the type of abuses that Congress intended to eliminate." SEC Proposed Rules on Acquisitions During and Following a Tender Offer, Exchange Act Release No. 24,976, 19 Sec. Reg. & L. Rep. (BNA) No. 40, at 1548 (Oct. 7, 1987).

²³ In a sweep there is a particular element that exerts pressure on the solicited shareholder—the purchaser's power of persuasion, which is applied directly to the specific shareholder. This element is absent in a tender offer and, therefore, the shareholder is in a preferable position.

²⁴ See Tender Offers, Exchange Act Release No. 12,676, 10 SEC Dock. 143, 145 (Aug. 2, 1976).

²⁵ 343 F. Supp. 1248 (W.D. Okla. 1972).

tions. In *Fears* the shareholder held less than five percent of the corporation's shares. Over a period of six weeks, the shareholder purchased a substantial number of shares by means of personal approaches (through meetings, telephone calls and personal letters) to a large number of shareholders. The *Fears* court ruled that this action constituted a tender offer: "The contracts utilized by the defendant seem even more designed than a general newspaper advertisement, the more conventional type of 'tender offer', to force a shareholder into making a hurried investment decision without access to information, in circumvention of the statutory purpose."²⁶

Other courts have refused to extend the application of the Act to private transactions, even if they were effected as part of a general scheme for a massive purchase of shares of the corporation.²⁷ Support for this view is found in the position of Senator Williams, the main sponsor of the Act. When the Act was introduced in Congress, the Senator was aware of the similarity between street sweeps and classic tender offers, particularly in terms of the public's need for protection. Nevertheless, Senator Williams explicitly argued against the inclusion of private transactions in the framework of the Williams Act.²⁸

²⁶ *Id.* at 1252. In another well-known case, *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), the court interpreted the term "privately negotiated purchase" extremely narrowly: every purchase of a significant number of shares would be considered a public purchase subject to the strictures of the Williams Act. *Id.* For an analysis of relevant cases, see Block & Schwarzfeld, *Curbing the Unregulated Tender Offer*, 6 SEC. REG. L.J. 133 (1978).

²⁷ See, e.g., *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985); *S.E.C. v. Carter Hawley Hale Stores Inc.*, 760 F.2d 945 (9th Cir. 1985); *Kennecott Copper Corp. v. Curtis Wright Corp.*, 584 F.2d 1195 (2d Cir. 1978); *Energy Ventures Inc. v. Appalachian Co.*, 587 F. Supp. 734 (D. Del. 1984); *University Bank & Trust Co. v. Gladstone*, 574 F. Supp. 1006 (D. Mass. 1983); *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773 (S.D.N.Y. 1979). Rejection of the SEC's position by courts is not the outcome of a judicial analysis on the merits concerning the need for protecting the different parties involved in the sweep transaction. Rather, it results from courts examining the sole question of whether tender offer rules apply to street sweeps. In other words, nothing in the cases indicate a position regarding the actual need to regulate sweeps.

²⁸ See 113 CONG. REC. 856 (1967). In Senator Williams's opinion, although it is possible in private transactions to acquire control without disclosing the identity or the intentions of the purchaser, the obligation of disclosure should not be imposed upon a purchaser before the purchase. Senator Williams believed that to subject the sweep to an obligation of advance disclosure under section 14(d) might be detrimental to the free and orderly operation of the market in the framework in which the parties to the transaction do not, as a rule, disclose their interests and the conditions of the private transactions they conduct.

Over the years, there have been a number of attempts to define the term "tender offer." The SEC resorted to objective numerical parameters to determine with certainty when an acquisition of shares would be subject to section 14(d). The SEC argued that it is possible to define a tender offer as an approach made to a certain minimum number of solicitees, within a set period of time, which results in the transfer to the purchaser of a certain minimum number of shares.²⁹ This definition would hold even if the approach to the shareholders was not public, the price was not uniform, the intention to acquire control was concealed, the price had no premium over market price, the sellers conducted negotiations over the price and the period of the offer was open.

Under one of the broadest definitions suggested by the SEC, a "tender offer" is a solicitation that fulfills the following condition: "It constitutes one or more offers to purchase . . . securities of a single class during any 45 day period, directed to more than 10 persons, and seeking the acquisition of more than five percent of the class of securities."³⁰ Seemingly, if this broad SEC definition had been adopted, a large proportion of sweeps would have fallen within the definition of tender offer and would have been subject to the requirements of the Williams Act.³¹

²⁹ See, e.g., *Letter*, *supra* note 17; Sec. Ex. Act Reg. § 392 (1968) (only a watered-down process of swap-up to term transactions in the space of a year- does not constitute a "tender offer").

³⁰ Proposed Rule 14d-1(b), Exchange Act Release No. 16,385 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,374 (Nov. 29, 1979). In one case, the court relied on the rule; however, the proposed rule never became binding. *E.H.I. of Florida, Inc. v. Insurance Co. of North America*, 652 F.2d 310 (3d Cir. 1981). The proposed rule was opposed because it blurred the distinction between the application of sections 13(d) and 14(d). See M. LIPTON & E. STEINBERGER, *TAKEOVERS AND FREEZEOUTS* § 2.15 (1984) (criticizing the proposed rule). The SEC, for its part, did not deny that its broad approach to applying the Williams Act deviated from the intention of Congress. To justify the deviation, the SEC relied on the changing times and needs of the securities markets. It argued that the rationale of the Williams Act applied to transactions, such as sweeps, since they were not common at the time of enactment of the Williams Act and because these transactions present difficulties the Act was designed to resolve. See GILSON, *supra* note 11, at 1015-16 (citing Memorandum of the Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs Proposing Amendments to the Williams Act).

³¹ The SEC recommended a legislative solution for the problem of the definition of the term "tender offer." The SEC proposed adopting the Tender Offer Improvements Act of 1980, in which the term "statutory offer" would refer to all offers to acquire the beneficial ownership of equity securities of a public issuer by a person who is the owner of more than 10 percent of the class. See SECURITIES EXCHANGE COMM'N, REPORT ON

The artificial³² and problematic³³ nature of the SEC-proposed definition has led to its rejection by the majority of courts. Most courts refuse to extend the Act to a sweep of shares by means of private transactions, whether effected by a street sweep or a market sweep.³⁴ The majority view is that arrangements intended to deal with a particular situation, i.e., tender offers, should not be extended to different situations, such as private transactions. Therefore, "[c]urrent law in the United States takes an atomistic view of formally separate transactions that cumulatively may shift control, so long as a formal tender offer is not made to the target's shareholders."³⁵

II. THE NEED FOR NEW LEGISLATIVE REGULATION

As explained above, current law deals with street sweeps by focusing on whether the Williams Act applies to them. This emphasis misses a more basic question: what are the important features of sweeps and what impact do sweeps have on corporate investors, on the competitive forces in the securities market and on the market for corporate control? In the end, existing law with its two current approaches—non-regulation or regulation by the Williams Act—is misconceived.

In examining whether legislative regulation of sweeps is needed, one must first analyze the consequences of an unregulated sweep from two perspectives: corporate fairness and economic efficiency.³⁶ To determine the corporate fairness of unregulated sweeps involves focusing on the ramifications of sweeps for the welfare of shareholders in the acquired corporation, in-

TENDER OFFER LAWS (1980).

³² The substantive provisions of the Williams Act not applicable to sweeps include those relating to withdrawal, best price rule, proration and the prohibition on purchase outside of a tender offer.

³³ According to the definition, a private sweep of shares is, contrary to the most fundamental and characteristic requirements of a tender offer, since the sweep is not proposed to all the shareholders and it does not offer all the solicitees an identical price.

³⁴ See *supra* note 27.

³⁵ See Deborah A. Demott, *Comparative Dimensions of Takeover Regulation*, 65 WASH. U. L.Q. 69, 117 (1987).

³⁶ An economic analysis of legal rules in the area of corporate law indicates that the central aim of the rules must be to achieve economic efficiency. This aim is achieved in a transaction between parties when the rules imposed on the parties lead them to allocate assets to the user who most values them. It is reasonable to assume that such a user makes optimum use of the assets, thereby attaining the desired efficiency.

cluding those who sold their shares in the street sweep and the minority who did not participate in the transactions and remained involved in the corporation.³⁷ Such shareholder welfare is derived from preserving: the original nature of the investment; the fundamental conditions of the contractual agreement; the commercial environment of the corporation; and basic equality amongst shareholders in the corporation. Economic efficiency concentrates on the ramifications of sweeps for the general welfare of the economy. It is derived from the ability to ensure that the acquisition of the corporation shall be effected by only those who can maximize the output of the corporation's resources. Both aspects of sweeps are important. If non-regulation of sweeps is detrimental to corporate fairness, it can lead to a crisis of investor confidence in the securities market and to difficulties in securing capital, including the cost of raising corporate financing. Similarly, if non-regulation of street sweeps allows for inefficient transactions, then it will cause an unjustified waste of economic resources. These two drawbacks are present in street sweeps. Without statutory regulation of this technique, market failure will ensue. This result will be detrimental to the welfare of both the shareholders in the corporation and the economy as a whole.

A. *Corporate Fairness*

1. Consolidation of Initial Control: A Comparison Between Street Sweeps and Private Acquisitions of Control³⁸

When control is acquired by acquisition of the controlling block of shares from the previous controller, the substantive position of shareholders who are not parties to the transaction does not change; both before the transaction and afterwards, they remain minority shareholders in a corporation that is controlled

³⁷ Shareholders shall be termed the "minority" when they do not have the capacity to dictate their business policy to the corporation (even if they hold more than 50 percent of the voting shares in the corporation) and the "majority" when they have actual control of the decision-making process (even if they hold less than 50 percent of the voting shares).

³⁸ While analyzing the considerations of corporate fairness which justify regulation of street sweeps, we will also indicate the special nature of street sweeps relative to alternative means of acquisition. In addition, we shall illustrate general aspects of corporate fairness that, although not exclusive to street sweeps, nevertheless justify legislative intervention to regulate cases of acquisition of corporate control by this means.

by others. On the other hand, when control is acquired by means of a gradual sweep of shares in a series of independent transactions from a community of investors who did not coordinate their positions when they invested in the corporation, the success of the sweep is likely to transform a corporation that is not controlled to one that is.³⁹ Before the street sweep and in the absence of cooperation among the various shareholders for the purpose of imposing their will on the corporation, the corporation is run by professional managers who are neither connected to nor appointed by a particular investor. Therefore they have no incentive, direct or indirect, to prefer the interest of any particular investor, legally or illegally, to the interests of the corporation. Under these circumstances, it may be assumed that there is a climate of equality of rights and of opportunity among all shareholders in the corporation. After the street sweep, however, the equality is shattered, since shareholders who did not sell their shares change from equal shareholders to part of a minority group that has inferior status in the corporation.

The change in shareholder status in a corporation that is not controlled before a street sweep has significant economic consequences. First, the street sweep forces upon the remaining investors the general and typical incapacity of a minority relative to the strength of the majority in any democratic regime. The majority can dictate the corporation's commercial manifesto as well as its ideological position on social, political and philosophical questions. Before the sweep, every shareholder could assume that the chances that his opinion would be accepted by the corporate body were equal to the chances that someone else's views would be accepted. After the sweep, however, the purchaser's control over the democratic process ensures that his opinion prevails in every case; he retains the right to veto and defeat any proposal that he does not like. As a result, when the minority shares are offered for sale, a potential buyer knows that they do not represent any measure of influence over the corporate policy, and such a buyer, therefore, is not prepared to pay the price that he would have paid for controlling shares.⁴⁰

Second, consolidation of control by the street sweep might

³⁹ See *supra* note 1 and accompanying text.

⁴⁰ See William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505, 526 (1965).

be misused by the buyer, who could use the corporation's resources for personal gain, thereby reducing the value of the assets of other investors.⁴¹ This concern over potential abuse of control by the controlling party is rooted in daily commercial practice. The inferiority of the minority is well-documented by courts as well as by the various proposals to create a system of behavioral standards for controlling parties and of remedies for the minority when these norms are breached.⁴²

Third, the rule of the majority in a corporation can determine not only the nature of investors' rights in the corporation as a whole, but their identity as well. Corporate law has developed effective legal techniques that enable the majority to divest the minority.⁴³ Fourth, the transformation of the corporation to one that is controlled affects the minority shareholders in that they lose the potential to trade their securities as an element of control. Finally, placing control in the hands of a particular entity in some cases immunizes the controller from the possibility of a hostile takeover of the corporation, which would lead to a change in the management appointed by the controller. From the perspective of the minority, this means that market forces will not be able to protect the minority from the controlling majority of the company.

This analysis confirms the empirical data, which reveal that with acquisition of control of the corporation, there is a marked drop in the value of unsold shares.⁴⁴ The data coupled with the list of economic consequences revive the assumption that the harm to the minority in the consolidation of initial control of the corporation is significantly different from the harm to the minority where, before the transaction, the same investors were in a minority position. Even though in both cases the minority is a non-participating third party *vis-a-vis* the transaction, in a street sweep (in the course of which the initial control of the

⁴¹ See Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free Rider Problem and the Theory of the Corporation*, 11 BELL J. OF ECON. 42 (1980).

⁴² See generally A.H. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

⁴³ A merger allows for a general meeting of shareholders to adopt a resolution that forces all the shareholders to sell their shares to a third party at a price determined in negotiations between the corporation and that third party. See *supra* note 12.

⁴⁴ See Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs, Exchange Act Release No. 21,079, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,637, (June 21, 1984).

corporation consolidates), the position of the minority suffers in a more direct and clear fashion than in a private acquisition of control. Accordingly, the need for legislative intervention to protect the minority in sweeps in non-controlled corporations is greater than in the case of private acquisitions of control.

2. Non-Uniformity: A Comparison Between Street Sweeps, Tender Offers and Mergers

A street sweep is a process that comprises a number of individual transactions. The common denominator to these transactions is that their preliminary conditions are equal: what is being sold is identical, the purchaser is the same (having a set financial capability and certain motivation for acquisition), and the transactions generally take place over a fairly short period of time. This short duration means that between making one deal and another, the basic financial conditions have not changed in the corporation, in the sector or in the market in which it operates. Nevertheless, despite the equal starting conditions, reality teaches that there is a lack of uniformity in the final conditions that are agreed upon between the parties to the various transactions made in the framework of a street sweep. The difference lies in the fact that the process of negotiations, which leads to the conclusion of each transaction, is secret and private and its results depend on the balance of personal forces between the parties involved. Furthermore, the gap between the conditions of the transactions must be attributed to the fact that the parties to the various transactions do not, as a rule, have the opportunity to compare notes with respect to the other transactions being negotiated during a sweep.

On the other hand, the basic principle guiding the legislative treatment of tender offer and merger is that of equality between all those involved in the transaction. The desired equality has several aspects. First, there is the equality of treatment received by each of the solicitees, *e.g.*, the consideration received by all shareholders who sell both in the merger and in the tender offer is equal and the duration of the offer period is uniform. Second, there is the equality of the opportunities offered to each of the solicitees in the tender offer and in the merger. In a merger, the offer is presented for the approval of the corporation so that each shareholder retains the right to vote on its acceptance. When the corporation has decided to approve the merger,

all the shares are acquired. A tender offer also is directed to all shareholders. Accordingly, if the supply of shares is greater than demand, the shares will be acquired on a *pro rata* basis from all the shareholders who responded to the offer. Finally, there is equality of information. The person proposing a merger or making a tender offer bears a heavy disclosure obligation and must make the information available to all the shareholders in the target company.

Consequently, the position of shareholders who are subjected to a tender offer or to a merger is quite different from that of shareholders in a corporation where shares are being swept. In a street sweep, the shareholders are all abandoned to their fate, with no means of ensuring the existence of any form of equality present in a tender offer or a merger.⁴⁵ For example, a purchaser conducting a street sweep may propose different prices and different conditions in the various sweep transactions, which violate the equality of treatment premise. Similarly, the purchaser is not obliged to approach all the shareholders with an offer to purchase. Instead, the purchaser may choose at will the seller with whom to deal, which violates the equality of opportunity assumption. Additionally, the purchaser owes no special disclosure obligation to any of the solicitees, such as his identity or his intention to acquire control. Additionally, the purchaser is not obliged to reveal identical information to all the solicitees, which results in a double breach of the principle of equality of information.

It is therefore somewhat odd that the law intervenes in the regulation of mergers and tender offers but refrains from regulating street sweeps, despite the dangerous potential to breach corporate fairness.

3. Control Premium Sharing

The commercial reality is that when partial control of a corporation is acquired, the price that the purchaser is prepared to pay for every share that constitutes part of the controlling block exceeds the market price of that share when it is not sold as part of the controlling block. The gap between these two prices is

⁴⁵ See *supra* note 16 and accompanying text.

called the control premium.⁴⁶ In the professional literature, the question of the identity of the parties entitled to benefit from the premium—the seller of the controlling shares or all the shareholders—is hotly debated.⁴⁷ According to advocates of the “all shareholders” position, the premium is an asset that belongs to the corporation (since it is the consideration that is paid for another asset of the corporation, namely control). Therefore, the person holding control who sells his shares should not be allowed to retain the premium, and must share it with all the other investors in the corporation.⁴⁸

However, since those same investors are not parties to the contracts of sale of the shares that represent control, they cannot ensure contractually the receipt of their share of the premium. Consequently, normative intervention is required to force upon the contracting parties a norm whereby all investors in the corporation would receive their proportional share of the premium⁴⁹ or one that would afford all shareholders an equal opportunity to sell their shares to the purchaser of control on the same conditions as those under which control has been acquired.⁵⁰ This argument, which is raised in the legal literature and in cases concerning private acquisition of control, is also valid in the context of acquisition of control by means of a street sweep where a control premium is paid.⁵¹

⁴⁶ See Alfred Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 936 (1957).

⁴⁷ For a survey of opinions, see F. Hodge O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9 (1976); Hamilton, *supra* note 14, at 248, 249.

⁴⁸ The argument can also be formulated in a different manner: the purchaser of control receives, in exchange for buying part of the shares in the corporation, the actual control of 100 percent of the assets and the resources of the corporation. In consideration of this benefit, the purchaser is prepared to pay a premium price. Since this benefit is derived from the use he makes of the property belonging to the whole body of shareholders of the corporation, the consideration for this benefit ought to accrue to the whole body of shareholders.

⁴⁹ See *Perlman v. Feldman*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

⁵⁰ For a classic article on this subject, see Andrews, *supra* note 39.

⁵¹ Even if acquisition of control by means of a sweep was effected without the payment of a premium (or upon payment of a negligible premium), consolidation of initial control by the “sweeper” denies the shareholders the commercial opportunity of receiving a premium that they would have been entitled to if the corporation had been acquired by other means:

[T]he acquisition of a control block by one person may also reduce the possibility that some other purchaser will attempt to assemble a competing control block . . . [I]n fact, if another purchaser had known that the first bidder was

Furthermore, even those who oppose normative intervention to establish a rule of equal distribution of the premium in a case of private acquisition of control would probably support intervention in the case of a street sweep. Easterbrook and Fischel developed an argument, which has gained widespread support in the legal-economic literature, by which the rule of equal distribution of the premium would not only fail to protect the minority, but it would adversely affect it.⁵² In their view, a rule of equal distribution of the premium would raise the cost of acquiring control for the purchaser. Therefore, the increased price might prevent the conclusion of the transaction, even in cases where the purchaser intends to utilize the resources of the corporation more efficiently. As a result, the minority shareholders would be denied a commercial opportunity that transfer of control in the corporation ought to bring them.⁵³ Easterbrook and Fischel base their analysis on the economic efficiency of the transaction. They argue that the interests of the minority are best secured when the market forces operate free from legislative intervention. Yet, as explained below, in the particular case of a street sweep an analysis of the efficiency of the transaction leads to the conclusion that legislative intervention is necessary to prevent non-optimal transactions.

4. Dramatic Change in the Corporation

Corporate fairness is liable to be prejudiced not only when a

seeking control in the market, he might have made a tender offer at a hefty premium, which all shareholders would have had an equal opportunity to share. The open market purchaser who obtains control deprives all shareholders of this opportunity.

Greene & Junewicz, *supra* note 9, at 660-61.

⁵² On laying the foundations for this argument, see Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

⁵³ This argument is not convincing; we believe that the mere possibility of benefits to the minority shareholders, without the realization of those benefits, does not justify the lack of intervention. It is not enough that purchases of control, on average, increase the functional efficiency of the acquired corporations. It must also be shown that the minority shareholders benefit from the improved efficiency. A condition for the benefits of transfer of control trickling down to the minority is the voluntary agreement of the new controlling person to share the new benefits created by his acquisition of control of the corporation with the minority or the ability of the minority to compel the controller to share these benefits with them. Reliance upon voluntary agreements, however, is not rational. Moreover, reliance upon the means of compulsion of the minority does not hold great promise.

street sweep consolidates initial control of an uncontrolled corporation,⁵⁴ but also when the objective of a sweep is to transfer control from one person to another. Transfer of corporate control may sometimes bring about a decisive change in the functioning of the corporation and it may have significant consequences for the future of the investments of its shareholders. Thus, for example, the purchaser of control may turn out to have less business experience than that of the seller or his skills or connections may be inferior, thereby harming the clear interest of other investors in the corporation. This scenario is bound to occur since the seller, who is able to check the identity of the purchaser of control, has no incentive to prefer a "suitable" purchaser who will bring in a profit for the corporation.⁵⁵ In contrast, the minority, who has a clear incentive to select the best purchaser, is not a party to the transaction and cannot, therefore, select the purchaser of control in a private transaction.

Moreover, the change that will be detrimental to the minority is not necessarily due to selection of an unqualified purchaser. Harm may also stem from a competent purchaser who has a different sensitivity to risk or a different commercial policy and investment plan from those of the seller of control. For example, a careful investor who purchases shares in a corporation under the control of a conservative financial institution is liable to find himself, after transfer of control, involved against his will in a corporation controlled by an aggressive and possibly even speculative body. The change in identity of the owner of corporate control is likely to bring about a change in wide areas of the corporate experience, including its spheres of operation, its business policy, the risks it takes as well as its policy of distributing dividends and issuing new securities.

Arguably, the shareholders are protected from some of these changes since corporate law outlines procedures for democratic decisionmaking in a corporation.⁵⁶ In practice, however, since

⁵⁴ See *supra* note 39 and accompanying text.

⁵⁵ Since the seller extricates himself from his investment in the corporation, his private interest does not correlate to the general interest of the corporation and its other shareholders.

⁵⁶ See, e.g., MODEL BUSINESS CORP. ACT § 10.03(e) (1984) (The procedure to amend Articles of Incorporation calls for the affirmative vote of the holders of a majority of the shares.); *id.* § 8.08(c) (removal of directors by vote of the holders of a majority of the shares).

the purchaser's control of the corporation also assures him control over the results of the democratic process, it becomes clear that the democratic process cannot insure the rights of minority shareholders against these potential dramatic changes.⁵⁷ Similarly, minority shareholders are not able to protect themselves against such changes by selling their shares on the open market, since the price they will receive for their shares after the change will reflect the lower value of the corporation as assessed by the market *after* the transfer of control. Without legal intervention, transfer of ownership may sometimes have an instantaneous adverse effect on the sale value of the corporate shares, thereby blocking the investor's avenue of escape from the consequences of the transfer of control. Thus, the dramatic change in the corporation resulting from the transfer of control by way of a sweep justifies the intervention of the law to protect shareholders who were not partners to the transactions. Accordingly, the transfer of control is akin to the creation of a new corporation, and the investors, therefore, should not be forced to remain in it.

B. *Economic Efficiency*

A transaction for the purchase of shares, which represents control of the corporation, is different from a transaction for the purchase of shares, which does not represent control. The latter involves only the transfer of one asset to the purchaser, *i.e.*, corporate shares, while in the former transaction, two assets are transferred: shares and control. As such, the objective of economic efficiency—to bring about the maximal utilization of assets by ensuring that they are transferred to a body that will maximize output⁵⁸—requires that the transaction for transfer of control by a street sweep be examined through a double prism: the market for corporate control and the share market.

⁵⁷ See RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* 88-94 (1970). The dependency of shareholders on the management appointed by the purchaser is almost total. Shareholders generally have no conduit to the actual commercial situation of the corporation and its economic environment other than the management. The shareholder meeting adopts resolutions on the basis of information that the management collects and selects for it and on the basis of professional assessments of the management. The investors dwell permanently in the Platonic cave and reality is revealed to them by means of shadows that the management chooses to present to them. See *id.* at 84-87.

⁵⁸ See *supra* note 36.

1. Efficiency in the Market for Corporate Control

Advocates of an economic analysis of legal rules argue that, in general, there should be minimal legislative intervention in private transactions between consenting parties.⁵⁹ Each of the parties is presumed to act to realize optimal interests in the assets constituting the object of the negotiations. Therefore, even without regulation, the parties will ensure that the asset will eventually be transferred to the optimal user. The question, then, is whether this logic also applies to transactions aimed at the acquisition of control by way of a sweep or does a sweep constitute an exception that requires legislative intervention? Is the policy goal, which requires that control be transferred to the user who will obtain the greatest output from it, achieved in a street sweep by exposing the transactions to the alignment of market forces? Or should there be concern that an unregulated street sweep is liable to prevent the achievement of such an objective as a result of some market failure and, therefore, the transactions ought to be governed by law?

In transactions for the acquisition of corporate control by means of acquisition other than a street sweep, the parties involved are aware that the purpose of the transaction is the transfer of control. In a merger, a tender offer and in the private acquisition of control, the seller of control (the corporation, the shareholders or a particular shareholder) knows that the objective of the transaction is not limited to the trade in corporate shares, but is also directed at bringing about the transfer of an additional asset—corporate control. Consequently, with respect to each of these methods, the negotiations conducted between the parties express their assessment of the value of control. Therefore, it may be assumed that market forces will ultimately cause control to be transferred to the most efficient user.⁶⁰ In a

⁵⁹ See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* ch. 1 (1991).

⁶⁰ For example, in the case of private acquisition of control, it is reasonable to assume that the reason the seller and purchaser agreed to the conditions of the transaction lies in the fact that the purchaser places greater value on control than does the seller. This state of affairs constitutes a good indication that the purchaser is the most productive user of the assets and that the transaction is "efficient." As such, there are those who hold that from considerations of economic efficiency, there should be no interference in the transaction and that the interests of the minority—which in their view are linked to the interests of the controlling factor—will not be harmed by transfer of control to a

street sweep, however, the situation is completely different. The sweep conceals from sellers vital information concerning the transaction, thereby stifling the competition that is necessary to ensure economic efficiency.

A street sweep comprises a number of independent individual transactions. On the surface, the negotiations, which are conducted between the purchaser and each of the shareholders, are independent for the purpose of selling a limited number of shares that do not amount to a transfer of control to the purchaser. The purchaser does not make any public or private declaration concerning the overall plan of acquisition. The investors who are being solicited and who have not coordinated positions are not usually aware of the existence of any such plan. Moreover, acquisition of corporate control by way of a street sweep is liable to conceal the buyer's real objective not only from the shareholders who are being solicited, but also from all others who are involved in the market for corporate control. The sellers and the market forces will believe that the purchaser in the sweep bought one asset (shares) and will not be aware that the success of the sweep delivers an additional asset—control. As a result of the general lack of awareness of the true economic significance of sweep transactions, negotiations related to these transactions may not reflect the parties' true assessment of the value of the assets involved. The purchaser who offers the shareholders a price that is acceptable to them creates a *prima facie* assumption that the purchaser is a more efficient user of the shares.⁶¹ However, this does not indicate whether he is also the most efficient user of control. Forces in the control-market will not engender competitors who will offer a better price for the shares. Since the market does not reflect that control is up for sale, the competition that is vital to ensure economic efficiency is not created.

Therefore, legislative intervention is necessary to establish standards that deny the parties to sweep transactions autonomy in determining the conditions of these transactions. Sweeps should be subject to regulations designed to assure the achievement of the efficiency objectives.

preferred user who will be chosen by the market forces. See Fischel & Easterbrook, *supra* note 58.

⁶¹ See *infra* note 62 and accompanying text.

2. Efficiency in the Market for Corporate Shares

Avoiding the consequences of the above economic analysis involves creating minimalist normative rules that will not affect the conditions of a street sweep transaction itself, but will impose a duty to disclose an intention to take control by means of a street sweep. Indeed, such rules exist in the Securities Exchange Act of 1934. They obligate a purchaser of shares that raises his holdings in the corporation—by whatever technique, including a street sweep—to more than five percent, to report this to the issuing corporation, to the exchange on which the shares are traded and to the SEC within a period of ten days from the purchase of the shares that raised his holdings above the five percent limit.⁶² The disclosure is designed to serve as a warning sign to the other shareholders and traders of the purchaser's motivation to secure a jumping-off point for acquiring control of the corporation. Is this modest requirement of reporting sufficient to ensure achievement of the objectives of economic efficiency in the case of a sweep of shares or is more substantive intervention of the law required in regulating the transaction?

An analysis of the practice of street sweeps reveals that they are likely to fail to engender efficient results not only when the purchaser conceals his intention to acquire control, but also when the shareholders who are being solicited and the market as a whole are aware of the purchaser's intention to takeover. Furthermore, discovery of such an intention not only fails to prevent the potential economic harm to the minority, but it is likely to increase it, thereby increasing the need for normative intervention in the transaction. The reporting of the intention to acquire control, on the one hand, clarifies the situation in the market for control and helps to create an open competition for control of the corporation. On the other hand, such reporting may distort the forces operating in the market for the corporate shares and bring about an allocation of shares to users who do not obtain optimal output.⁶³

⁶² Section 13(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(d) (1981 & Supp. 1992).

⁶³ The most productive user of a share is the user who is able to make optimum use of the array of rights linked to the share. Thus, goals of economic policy will be achieved if the voting right that the share grants to its holder—a right that delivers the capacity

In the case of the disclosure of takeover intentions in a street sweep, pressure is exerted on the shareholders. This may cause them to make a distorted choice and to agree to the proposed street sweep transaction, even though they do not think that its conditions are worthwhile. To elucidate the psycho-commercial dynamic that may bring about the said market failure, one can envision a set of considerations of the solicitee, who believes that the stock he is holding is more valuable than the price he has been offered by the purchaser. The solicitee may worry that despite his objection to the conditions of the transaction, the purchaser will acquire control of the corporation through other transactions, thereby making his shares inferior minority shares. Consequently, the shareholder might respond positively to an offer, even though it is not worthwhile. This process is liable to repeat itself with other shareholders and become a self-fulfilling prophecy. Theoretically, it is possible that none of the shareholders who are being solicited will assess that the conditions of the street sweep transaction are worthwhile for him and, nevertheless, the shares will be sold to the "sweeper." As such, the execution of street sweep transactions without regulation by an intervening, mandatory legal norm will lead to a transfer of shares and of control of the corporation to a purchaser who is not necessarily its best user, thereby frustrating the policy objective of economic efficiency.⁶⁴

to influence the decision-making process in the corporation—is transferred to a user who knows how to make the best use of it.

⁶⁴ Concern about a distorted choice on the part of shareholders when they are aware of the intention of takeover is not exclusive to a sweep; it exists in similar fashion to a tender offer. Therefore market failure, which results from the pressure to which the shareholders are subjected, justifies the intervention of the legislator to rescue the shareholders from their straits in the two situations. See Bebachuk, *supra* note 9, at 1693. In a tender offer, the pressure exerted on the shareholder who is selling is indirect and stems from his assessment of the commercial reality of the corporation. A street sweep, however, involves the added element of direct pressure stemming from the direct and personal dealings between the purchaser and the shareholder:

The fundamental problem with direct solicitation is the communication that normally accompanies face-to-face offers. An acquirer usually, if not always, tells each solicitee that it intends to stop purchasing once it acquires a set amount of target stock, and urges the solicitee to tender in order to participate in the acquisition and collect any part of the acquisition premium.

Oesterle, *supra* note 2, at 225. The additional force of personal pressure exerted on the shareholder in a sweep increases the potential for distortion of the decision he will make in relation to the offer to purchase.

C. *Structural Considerations Deriving from an Overall View of Corporate Control Transactions*

Another angle from which to examine whether street sweeps should be regulated is to compare street sweeps and the current arrangements pertaining to alternative modes of acquisition: merger, tender offer and private acquisition of control. Current law does not allow an entity that is interested in acquiring control in a corporation by means of one of these three techniques to do so without being overseen. Rather, the law intervenes in the execution of the transaction in each of these techniques through a detailed set of normative, binding rules.⁶⁵ The failure to regulate street sweeps by legislation will affect the application of the legislation that deals with these other means of acquisition, since the law's oblivion to the street sweep provides purchasers with an opening to evade the legislative requirements for attempting a merger, tender offer or private acquisition of control.

A purchaser will prefer conducting a street sweep rather than resorting to the other modes when he determines that he cannot obtain the desired commercial results other than by way of a sweep. A legal system that does not regulate street sweeps may allow a purchaser to take control of a corporation even in a situation where the transaction constitutes a violation of both corporate fairness and economic efficiency.⁶⁶ A significant portion of existing laws regulating mergers, tender offers and private acquisitions of control attempt to prevent acquisitions that are tainted by unfairness and inefficiency. Therefore, non-regulation of street sweeps allows for the execution of transactions that the law was designed to prevent: inefficient and unfair deals.

1. Considerations of Corporate Fairness

The central features of the legislation regulating the substantive and procedural conditions of mergers,⁶⁷ tender offers,⁶⁸

⁶⁵ For an illustration of some of the arrangements, see *infra* notes 68-77.

⁶⁶ See *supra* notes 39-42 & 57-59 and accompanying text.

⁶⁷ The substantive and procedural conditions of merger are typical of corporation law in various states. For the references for two of these Acts, see *supra* note 12.

⁶⁸ See The Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982); *supra* note 13.

and private acquisitions of control are considerations of corporate fairness.

a. *Substantive Conditions*

The statutory norms that regulate tender offers and mergers ensure equality of treatment, opportunity and information among all the shareholders in the target corporation.⁶⁹ Unlike the general approach of modern commercial law, which tends not to intervene in contracts reached by parties of their own free will, tender offer law tends to regulate various substantive details of transactions of acquisition, such as determining the level of consideration,⁷⁰ the number of shares to be acquired from each shareholder,⁷¹ the duration of the offer,⁷² the information that is to be disclosed⁷³ and the right of the parties to withdraw.⁷⁴ Unlike tender offers, in mergers the target (and not its shareholders) is the party to the contract. The basic principle is that the conditions of the transaction to which the corporation agreed apply equally to all shareholders. In the two cases—merger and tender offer—the law dictates a rule for the sharing of the control premium among shareholders.⁷⁵ The justification for the paternalism adopted by Congress regarding the status of the parties in transactions of merger and tender offer is the desire to protect the community of shareholders and to establish a regime of corporate fairness by preserving unity in the attitude of the purchaser toward the shareholders and by preserving the balance of power between the shareholders themselves.

In private acquisitions of control, scholars and courts are di-

⁶⁹ See *infra* notes 78-79 and accompanying text.

⁷⁰ See § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1982).

⁷¹ See Rule 14d-8, 17 C.F.R. § 240.14d-8 (1991).

⁷² See Rule 14e-1, 17 C.F.R. § 240.14e-1 (1991).

⁷³ See Rule 14d-6, 17 C.F.R. § 240.14d-6 (1991).

⁷⁴ See Rule 14d-7(a)(1), 17 C.F.R. § 240.14d-7 (1991).

⁷⁵ In a merger the target corporation ceases to exist. M.B.C.A. § 11.06 (1984). Therefore the premium is distributed among all the shareholders of the target corporation (equality of treatment). A tender offer is an offer aimed to purchase a certain amount of the target's shares. The offer is public and not directed to specific shareholders. This character of the tender offer assures that the premium is offered to all the shareholders (equality of opportunity). Section 14(d)(7) provides that all the sellers will receive the same price for their shares, even if some of them are tendered before an increase occurs in the offering price.

vided on the need for normative intervention. Some hold that the law must intervene to ensure sharing of the premium received by the seller among all the shareholders (equality of treatment). Others favor forcing the purchasing shareholder to make the offer made to the controlling shareholders to all other shareholders (equality of opportunity). Finally, some commentators contend that the law should not intervene in the question of the distribution of the premium at all.⁷⁶ Yet even those who deny the need for legislative intervention to assure equality agree that the law must provide special behavioral norms regarding a transaction in which control is sold. The case law has developed a whole system of special behavioral norms that bind the controlling shareholder who is interested in selling his controlling block. For example, the seller must refrain from selling control to a person who is liable to cause damage to the corporation. Additionally, he must refrain from effecting a transaction in a manner that would arouse concern that the consideration he received from the transaction is not only consideration for the shares sold, but also for his post as corporate officer. Similarly, he must ensure that he does not sell the business opportunities that belong to the corporation or to the whole community of shareholders.⁷⁷ These behavioral norms, which are all subsumed under the general heading of the fiduciary duties of the controlling shareholders, were designed to prevent a situation in which transfer of control is effected at the expense of the shareholding public, which is not a partner to the transaction, thereby constituting a violation of corporate fairness. The law chose to protect the community of shareholders by imposing behavioral norms not only on a person who has gained control, but also on the person selling control, even though the seller may have no interest in or intention of harming the shareholders.⁷⁸

A person who seeks to purchase controlling shares for unacceptable purposes, such as embezzlement, might sometimes come up against the refusal of the controlling block to cooperate

⁷⁶ See *supra* notes 51-52 and accompanying text.

⁷⁷ For a discussion of these rules and related cases, see ROBERT C CLARK, *CORPORATE LAW* § 11.4 (1986).

⁷⁸ Existing cases provide that the sale of control to a looter is a breach of fiduciary duty of the holder of control, even if the seller did not know of the purchaser's intention to loot, but ought to have known or deliberately ignored this possibility. See, e.g., *De Baun v. First Western Bank & Trust Co.*, 120 Cal. Rptr. 354 (Cal. App. Ct. 1975).

in light of the threat of the above legislative arrangements. In a system that permits street sweeps, a person interested in acquisition for illegitimate purposes will attempt to circumvent this whole array of norms by acquiring control by means of a street sweep. By this technique, control is acquired from the general public of investors, none of whom holds control of the corporation individually and the sellers are not, therefore, subject to the said behavioral obligations of the controlling shareholders. Similarly, in a street sweep, the sellers are sometimes unaware that the purchaser might be purchasing their shares as part of a take-over plan and they are not, therefore, subject to the said norms of conduct.

b. *Procedural Conditions*

In corporate mergers, the law stipulates that the transaction must be approved by a certain majority of the shareholders in a general meeting of the corporation as a condition of its execution.⁷⁹ In a tender offer, there has been a proposal to stipulate by law that a precondition of a transaction is the support of the majority of shareholders of the corporation, even though a tender offer is directed at the shareholders and not at the corporation.⁸⁰ Underlying such rules of play is the desire to prevent various types of detriment to corporate fairness. For example, the problems that arise following consolidation of initial control of the corporation and reduction of the shareholders to minority status are solved, at least partially, when the law avails the shareholders with the option of rejecting the proposal for consolidation of initial control. The affirmative vote of the shareholders supporting consolidation of the initial control means that the majority of shareholders in the corporation believe that the advantages they will gain from new management will outweigh the devaluation of their investment as a result of their minority status.

Therefore, corporate fairness is an important rationale underlying the statutory norms regulating the acquisition of control by means of a tender offer, merger and private acquisition of the controlling block.

⁷⁹ See, e.g., MBCA § 11.01 (1984).

⁸⁰ See Bechuk, *supra* note 9.

2. Considerations of Economic Efficiency

a. *Efficiency in the Sale of Corporate Control*

In a merger and a tender offer, it is clear that the object of the acquisition is to gain control of the corporation. The law issues a caution about the offer of the corporation for sale and the price tag attached to it by subjecting the transaction to the approval of the meeting of shareholders (merger)⁸¹ or by publicizing it to the public at large (tender offer). The requirement that the general meeting approve the transaction allows each of the shareholders to consider the conditions not as an offer to purchase the shares in his possession, but as an offer to purchase control (which he does not have). The requirement to publicize the offer means that if the purchaser does not maximize output, market forces will produce a better offer than that of the purchaser, there will be a tender for control and, at the end of the process, control will pass into the hands of the most efficient user.

b. *Efficiency in the Sale of Shares*

The proposal to stipulate by law that the condition for legitimization of the tender offer is approval by the majority of shareholders solicited is designed to solve the problem of the distortion of choice of these shareholders.⁸² However, since the same system of pressure exists in the context of a street sweep,⁸³ non-regulation of a sweep by statute allows the purchaser to impose upon the shareholders the distorted choice while avoiding the regulations governing tender offers.

Therefore, the statutory arrangements concerning the various modes of acquisition ultimately aims to prevent breaches of corporate fairness and to ensure the promotion of economic efficiency in transactions for acquisitions of control. Non-regulation of street sweeps will leave a serious lacuna in this system of regulation, threatening the very effectiveness in preventing violations in fairness and efficiency of transactions for acquisition of control in corporations through other methods. Accordingly, a

⁸¹ Section 11.01 of the MBCA provides that a plan of merger should be approved by each of the corporations taking part in the transaction in a shareholders' meeting.

⁸² See *supra* note 63 and accompanying text.

⁸³ See *supra* Part II.B.2.

structural view of the whole range of techniques for acquisition of control mandates legal intervention to prevent problematic sweep transactions and, in turn, to eliminate the possibility of unfair or inefficient transfers of corporate control.

III. THE PROPOSED LEGISLATIVE REGULATION

The simplest, albeit most rigid, form of intervention in sweep transactions is to impose a complete ban on such transactions in cases where a sweep will lead to a transfer of control to the purchaser. Even though in principle Congress should try to refrain from intervening in transactions between consenting parties, the concern for preventing a breach of corporate fairness and ensuring economic efficiency justifies imposing such a strict prohibition on sweeps.

A. *The Substance*

Different rules are required for sweeps in different factual situations. To distinguish between a permitted sweep and a prohibited sweep one must ascertain the number of shares held by the purchaser before and after the sweep.

First, the law will stipulate a rebuttable legal presumption, whereby possession of a certain proportion of the shares of the corporation gives the holder "control" of the corporation. Second, where both before and after the sweep the purchaser does not hold the proportion of shares set by the law as constituting control of the corporation, the law will not intervene in the sweep and will not place constraints upon the purchasing process. Third, where before the sweep the purchaser did not have control, but has acquired control by means of the sweep, the law will intervene and ban the sweep. The purpose of the prohibition is to limit the menu of techniques by which control may be acquired and to force the parties to use one of the regulated techniques established in the law—merger, tender offer or private acquisition of control. Finally, when before the sweep the purchaser held control of the corporation and the purpose of the sweep is to fortify his position, the law will allow the transaction, since it does not give rise to serious concerns about undermining corporate fairness or economic efficiency.

The following example illustrates the features of the proposed regulation. Assume that corporate "control" is defined by

law as ownership of twenty-five percent of the voting rights in the corporation. The holder of ten percent of the voting rights who is interested in acquiring another ten percent of the shares can do so by way of sweep, without any legislative intervention. However, if the shareholder wishes to purchase another twenty percent of the shares, he will not be able to approach the other shareholders privately, off the exchange, in an attempt to conduct private transactions by way of a sweep, since this would lead to the transfer of control into his hands by a prohibited method. Under the proposed regulation, the transfer of control could be effected only if the purchaser employs one of the techniques recognized and regulated by law. Recourse to each of these techniques will clarify to the parties of the transaction that the purpose of the transaction is not just a regular purchase of corporate shares, but transfer of control of the whole corporation. Removing the veil to expose the purpose and true nature of the transaction will ensure that corporate fairness is preserved and that the control is transferred to the optimal purchaser.

What happens when a person violates the prohibition and purchases controlling shares by way of a sweep? The proposed regulation does not advocate intervention in the freedom of the parties to transact in a sweep, even if it was accomplished in a prohibited manner; it therefore recognizes the validity of the transaction to transfer the property right in the shares on the level of relations between the seller and the purchaser. Instead, it is proposed that a purchaser who conducted a prohibited sweep will not be permitted to benefit from the fruit of his forbidden act. Therefore, even though the law recognizes his ownership of the purchased shares, it will not permit him to invoke the voting rights that these shares provided him.⁸⁴ Moreover, acquisition of control by way of a sweep will also lead to the expiration of other voting rights of the purchaser derived from the

⁸⁴ Cases have recognized the possibility of revoking voting rights acquired by illegal means. Thus, for example, in a case in which a share purchaser did not fulfill the disclosure obligation of section 13(d) of the Williams Act, the court examined the damage caused to the corporation, its employees and shareholders by non-disclosure and decided that it could not be restored. The court held that the most appropriate remedy in the circumstances was a declaration that the shares acquired by illegal means were "tainted" shares, carrying no voting rights. *Champion Parts Rebuilders, Inc. v. Cormier Corp.*, 661 F. Supp. 825, 851 (N.D. Ill. 1987).

shares he held on the eve of the sweep.⁸⁵ The purchaser will be able to resume invoking his voting rights with the shares that he held on the eve of the sweep if he makes amends by selling the shares that he acquired in the prohibited sweep to another person. He will then regain his former status of a person who does not have control over the corporation.

B. *The Mode of Operation*

The objective of the proposed regulation is to ensure that acquisition of control will be effected only in situations in which corporate fairness toward both the shareholders who are selling and the shareholders who refrained from selling is maintained, and only when the purchaser is the most efficient user of control. These goals will be achieved by various means.

1. Deterrence

A purchaser who is interested in circumventing the legislative regulation of the techniques of control designed to ensure corporate fairness and efficiency will be deterred from doing so by means of a sweep for fear of losing his voting rights. Even the ability to sell the shares he collected, should he be caught, will not lessen his reluctance to resort to the prohibited practice, since it is reasonable to expect that the price he will receive for the sale will be less than that he paid for the purchase.⁸⁶

⁸⁵ Taking away a voting right held by a person on the eve of the sweep is not a punitive result. Rather, its aim is to ensure that the sinner not be rewarded. The fear is that if the voting rights were not revoked, the purchaser is likely to become the controlling factor in the corporation, even without resorting to the quantity of shares acquired through the sweep. This is a result of the growth of the purchaser's relative share of the voting rights and the corresponding decrease in the total quantity of voting shares in the corporation.

⁸⁶ The acquisition is effected in a continuous process over time according to the laws of supply and demand. The continuous nature of the sweep is liable to bring about an increased demand and a rise in the price of the shares. The purchaser is prepared to pay the high price since his intention is to acquire another asset—control of the corporation—and the rise in value of the shares in the process of a sweep is justified, from his point of view, as the payment of a premium for this asset. On the other hand, the sale is effected due to the purchaser being forced, by the legal arrangement, to sell his shares. The intervention of the law creates an artificial supply of shares that is not consequent upon the market's assessment of the shares. As a result, it may be assumed that the price of the shares will fall. Furthermore, the purchasers do not expect to gain control of the corporation and the price that they are prepared to pay will most likely reflect this.

2. Economic Efficiency

Even where the deterrence inherent in the proposed regulation is not effective and the purchaser risks acquiring control by means of a sweep, the proposed regulation will attain the objective of economic efficiency since the regulation will force the purchaser to resell a part of his holdings and to forego his position as the controlling factor in the corporation. Thus, transfer of control to a person who does not maximize output will be negated and future transfer of control will be effected in an open manner by means of one of the set legal techniques, with disclosure of the conditions of the transaction and all relevant information for the market forces. Moreover, the regulation will also achieve economic efficiency regarding sale of the corporate shares. The source of the reduction in efficiency of the share market lies in the pressure applied to investors to sell their shares when they realize that the objective of the sweep is acquisition of control. However, under the proposed regulation, the shareholders' knowledge of the sweep's objective will enable them to prevent it. The proposed regulation, which forbids acquisition of control by a sweep, assures the shareholders that the sweep will not be effective in pushing them into a minority position. The goal of economic efficiency will be attained because the shareholders will be able to consider the offer in an undistorted manner.

3. Corporate Fairness

Examining the regulation through the prism of corporate fairness requires a separate discussion of the shareholders who sold their shares in the sweep and those who did not respond to the offer. The latter's concern about consolidation of initial control of the corporation and their resulting relegation to the minority will be dissipated with the implementation of the regulation. It will ensure that the former structure of ownership of the corporation's capital will be restored and that their status in the corporation will not change as a result of the prohibited sweep. On the other hand, the regulation will not serve as a means for shareholders who sold their shares to regain their property, since the proposal honors the legal force of the sweep between the parties to the transaction. Nevertheless, the regulation will ensure fair treatment of sellers as well, since the result of the regu-

lation—that control not be transferred by means of a sweep—turns into the reality that sellers perceived, *i.e.*, that the only asset being sold was the corporate share and not corporate control. The proposed regulation means that the transactions conducted by the sellers are not different in nature from other ordinary transactions for the sale of shares. Therefore there is no need to protect them and to grant them special advantages beyond the conditions to which they agreed when making the transaction.

The need to ensure the various types of equality (of treatment, of opportunity or of information) arises in situations where various transactions constitute part of a single, comprehensive purchase plan, aimed at the control of the corporation. However, since the proposed arrangement does not allow the acquisition of control by the sweep, it negates the common denominator of all the transactions in the sweep plan. Thus, it is not unfair if the terms of the various transactions are not equal.

C. *Flexibility in the Proposed Regulation*

1. The Exceptional Case

The proposed regulation suggests that the law will stipulate a presumption that the acquisition of shares, which transfers into the possession of the purchaser a quantity of shares exceeding a certain level, say twenty-five percent, will constitute control. What will happen in cases where it is clearly proved that, as a result of the structure of ownership of the corporate capital, the level set is not the appropriate determinant of ownership of control? For example, what justification is there for prohibiting a sweep in the case of a corporation in which a sweep of more than twenty-five percent of the voting rights is in progress, but in which there is a single shareholder (or one group of shareholders acting in concert) who holds more than fifty percent of the voting rights and who declares that it is not his intention to sell his shares to the person sweeping shares and who refuses to cooperate with him in the future? Furthermore, in the opposite case, what justification is there for allowing a sweep that does not reach the level set by law in a corporation where shares are so widely dispersed that control of the corporation can be acquired by purchase of a block of shares that amounts to less than twenty-five percent of the voting shares?

The potential gap between the proposed legal presumption—where there is a set level of holdings that grants the owners control—and reality necessitates including in the regulation a mechanism for addressing the exceptional cases.

One possible solution lies in establishing an administrative body that is empowered to deal with exceptional sweep cases. However, the justification for establishing special bodies exists only where the questions with which they must deal are specialized and require professional expertise. Here, this is unnecessary. The task of the body deciding the question of applying the sweep regulations in a given case is not complicated and, therefore, does not require professional expertise. All that is required is an examination of the way in which ownership of the corporate capital is distributed to determine whether the sweep changed the identity of the controlling person in the corporation. The SEC or the courts are able to conduct such an examination at low cost and with reasonable speed.

Consequently, the proposed regulation should stipulate that the shareholders of the corporation whose shares are being swept retain the right to apply to the courts or the SEC to examine whether the sweep process brought about a transfer of control. At the same time, a purchaser who plans a sweep exceeding the permitted limit may apply to the courts or the SEC to determine whether to allow the sweep; these bodies can grant the application if it is established that the sweep does not result in a transfer of corporate control.

2. Modification of the Terms of the Regulation

The enabling nature of the regulation should be univalent. A corporation will not be allowed to stipulate in its bylaws or in any other contract that it is permissible to sweep its shares beyond the limit set by law. It will, however, be permitted to make the standards tougher and to stipulate that acquisition of an even lower percentage of ownership will trigger the application of the proposed regulation. Seemingly, corporations will choose the latter option when they believe that it is possible to transfer corporate control from one to another by purchasing a small number of voting shares. Other corporations, which need not be concerned about transfer of control by means of a sweep of a lower percentage of shares than that set by law, will have no need to establish stricter requirements. An unnecessary preven-

tion of the free transfer of shares, when no transfer of control is involved, is liable to affect the negotiability of shares by lowering demand for them and reducing their value, without affording any advantages to the shareholders.⁸⁷

IV. THE COST OF THE LEGISLATIVE REGULATION

To justify such an invasive and comprehensive legislative regulation, it must be asked whether, as a rule, it is reasonable to anticipate that the benefits of including the sweep in the list of permitted control-acquisition techniques will outweigh its damage. Since the purchaser initiates the transaction and retains the ability to decide which means of acquisition will be employed, it is necessary to examine the question from the perspective of the purchaser of control. Therefore, what are the incentives for the purchaser to prefer a sweep over other forms of purchase? If the sum total of the array of incentives is likely to be positive, *i.e.*, acquisition by way of a sweep allows the purchaser to make efficient transactions in a manner that is not possible through the other modes of acquisition, then prevention of such transactions should be seen as a hefty cost of the proposed regulation. On the other hand, if the sum total of incentives is negative, *i.e.*, if the preference for the sweep lies in the desire to obtain an illegitimate advantage that cannot be obtained through the other modes of acquisition, then the law

⁸⁷ Providing an enabling nature to the regulation is liable to create an opening for abuse by the corporation management: the management will cause the corporation to adopt a voluntary arrangement, prohibiting a sweep of shares in the corporation beyond a ceiling that is lower than that set by the regulation, even if it is clear that possession of the said quantity of shares does not transfer an asset other than the shares themselves to the purchaser. Such a stipulation will serve the interests of the management, since it will make it difficult to purchase significant blocks of shares, thereby reducing the chances of a consolidation of power outside the management. Despite this, there is no reason to prohibit the said stipulation, since even under existing law, management may determine various voluntary arrangements that will strengthen its position at the expense of the interests of the corporation it is supposed to serve. The laws of corporations relate to them by various means, such as imposition of a fiduciary duty on managers, which is intended to limit the agency costs resulting from separation of control from ownership of the corporation. See, *e.g.*, MBCA § 860 (discussing directors' conflict of interest). These problems give rise to a similar, though not identical, question to that arising in the context of defensive tactics, which the managers are liable to adopt against a potential hostile tender offer. Scholars and courts express different views as to the position that the law ought to take on this subject, but such a discussion is beyond the scope of this Article.

ought to impose a general prohibition on sweeps.

A. *The Sweep: An Inferior Mode of Acquisition*

The best interest of the purchaser requires him to prefer any of the other modes—merger, tender offer or, in appropriate cases, private acquisition of control—over the street sweep. The technique of sweep, when examined from the purchaser's point of view, is unsophisticated. It requires the purchaser to: (1) seek out each of the shareholders (since the purchase takes place off the exchange); (2) conduct a long series of separate negotiations with each of the sellers; and (3) incur costs with respect to each of the separate transactions (checking the seller's ownership, drawing up a separate contract, various legal costs, and so on).

A more serious problem from the purchaser's point of view is that at the time when the purchaser is investing his resources in the purchase of corporate shares, he cannot be certain about two of the central parameters of the transaction: the accomplishment of his goal, *i.e.*, the acquisition of control, and its cost. A comparison with the position of a person who acquired control by means of a tender offer will illustrate this important point. From a contractual point of view, a tender offer is a transaction for the acquisition of control. In other words, the purchaser announces in advance to all the shareholders that his offer is dependent upon attaining control and that if there is insufficient response to his offer, the offer will be withdrawn. In a sweep, however, each transaction is independent and defined as a transaction for the acquisition of a certain number of shares held by the seller. Similarly, the various transactions in a tender offer take place simultaneously, while sweep transactions take place over a period of time. Thus, in a tender offer, it is possible to determine in advance whether or not the objective has been achieved. Since the offer is made for the purpose of acquiring control, the person making the offer can withdraw it if he finds that the objective has not been achieved. Moreover, since the offer is uniform regarding all the shareholders, it is clear to the purchaser in advance what the cost of control will be, should the transaction work out. In a sweep of shares, the purchaser cannot make the validity of each individual transaction conditional upon the execution of future transactions with other shareholders. In other words, the purchaser is liable to discover, after investing his money in purchasing a certain amount of shares, that

he cannot gain control through the sweep and that he cannot back out of the concluded transactions. Moreover, because the transactions are disparate and consecutive, the purchaser cannot know in advance what the overall cost will be of attaining control.

Why, then, should a person interested in control choose to forego the convenient and efficient option of a tender offer and prefer to take the bumpy road of a sweep? The true advantage of resorting to a sweep, from the purchaser's point of view, lies in his desire to escape the net of the legislative arrangements that restrict the other forms of acquisition. A purchaser will choose a sweep, despite the drawbacks, because he hopes that by the extra concern of maintaining the sweep, he will succeed in taking over the corporation without corporate fairness *vis-a-vis* all the shareholders in the corporation. Similarly, he gains control, despite the fact that he might not be the most efficient user.

If the buyer were to invoke other modes of acquisition, the legislative rules would force him to act fairly and efficiently and to compete on the share and control markets. Additionally, the regulations would insulate the shareholders from the pressure that the purchaser intends to place upon them through the sweep. Therefore the purchaser does not resort to these techniques.

Considering that the cost of the sweep is high and embraces an element of uncertainty, a rational purchaser would prefer the sweep technique only when he assumes that the illegitimate advantages he can obtain through it are large enough to offset these costs. The obvious conclusion from this analysis is that the advantages for the purchaser that ensue from preferring sweeps over the other modes of acquisition are illegitimate. Therefore, policymakers should take action to eliminate them.

B. *The Sweep: A Superfluous Mode of Acquisition*

It can be argued that a purchaser's decision to initiate a sweep lies in the paucity of viable acquisition options: the purchaser chooses the sweep—despite its faults—when he cannot achieve his legitimate objectives by any other means. To support this contention, it must be shown that the sweep presents an acquisition option that is essentially different from the others and that to exclude it from the menu of corporate control trans-

actions would limit the variety of options available to the purchaser whose motivation is positive.

The accepted modes of acquisition include merger, tender offer, private purchase of control and purchase of all assets. These can be classified according to two principles: legal technique or commercial outcome. In legal technique the mode of acquisition can be consensual or hostile. When consensual, the purchaser receives the blessings of the target corporation. When hostile, he circumvents management and approaches the shareholders behind the backs of the establishment (and often, against its will). In the commercial outcome the mode of acquisition can transfer to the purchaser total ownership of the target corporation (100 percent of its shares) or only partial ownership. The application of these two criteria to a sweep will classify it as a non-consensual form of acquisition, the commercial result of which is partial ownership of the corporation. In light of this characterization, there would appear to be no need to permit sweeps as an alternative mode of acquisition.

When the purchaser is able to acquire control of the corporation by a consensual method, he will generally prefer to do so.⁸⁸ Therefore, where the purchaser believes that his offer will be welcomed by the target corporation, he will resort to a consensual form of acquisition, like a merger. When the purchaser assesses that any approach to the establishment of the target corporation will be futile (or when his overtures have already been rejected), three means of acquisition are available to him: tender offer, private acquisition of the controlling block from the person holding control or a sweep. In all three cases, the commercial outcome of the technique will not change, since in each technique, complete control of the corporation cannot be achieved and, therefore, in the future, the buyer will need to consider the interests of the minority shareholders. Nor do the

⁸⁸ The chances of realizing a friendly transaction, such as a merger, are greater than the chances of conducting a takeover not welcomed by the management. More importantly, in a friendly acquisition the purchaser conducts negotiations with the management that is selling and, in the framework of these negotiations, the purchaser can demand access to inside information on the corporation to enable the purchaser to assess the benefits of the purchase from a position of knowledge. In a non-consensual acquisition, however, the purchaser has no access to the confidential data of the corporation and must base commercial decisions on public information and unsubstantiated commercial assessments.

three modes of acquisition differ in their treatment of the separate legal personality of the acquired corporation, in the consideration that will be paid to the shareholders, in the scope of the obligations that the purchaser assumes as a result of the acquisition, and in any of the other matters that customarily determine the choice of mode of acquisition in a given situation. Therefore, the sweep is superfluous, since it does not constitute a substantive alternative to the modes of acquisition already regulated by law.

CONCLUSION

The non-regulation of a street sweep under current law may lie in the belief that since what is involved is a series of generally small transactions that are governed by the principle of freedom of contract, concern about any harmful effects is unwarranted. This belief is misguided. A street sweep, like its more famous siblings—merger, tender offer and private acquisition of control—can bring about transfers of control that will be detrimental to corporate fairness and to economic efficiency.

A structural analysis of all the modes of acquisition of corporate control reveals that a purchaser's preference for a street sweep, rather than alternative modes, does not lie in any legitimate advantageous commercial outcome. From the purchaser's point of view, a sweep is an inferior and superfluous mode of acquisition. The advantage of resorting to a street sweep is that it allows the purchaser to acquire control without legislative interference. A purchaser will prefer a street sweep when he is interested in obtaining the commercial outcome that the merger, tender offer or private acquisition can afford him, but wishes to avoid the corresponding legislative responsibilities. The law should not encourage such evasion. These legislative arrangements have a great deal of internal logic designed to preserve the delicate balance between the different parties to an acquisition transaction and to ensure corporate fairness *vis-a-vis* the shareholders as well as the economic efficiency of the deal. Therefore, this Article proposes the adoption of regulations prohibiting acquisition of control by means of a sweep of shares.

The proposed prohibition on sweep acquisitions will force all those interested in acquiring control to do so by means of one of the techniques regulated by law to ensure that those involved in the transaction know about the buyer's intention to negotiate

control. Thus, the transaction will be disclosed to the forces of competition in the market and the transfer of control to the most efficient user will be assured. Similarly, removal of street sweeps from the menu of options of acquisition will contribute to the prevention of transactions made at the expense of the selling shareholders or transactions that are detrimental to the shareholders who remain a minority in the acquired corporation.

