RE-EXAMINING THE HOSTILE TAKEOVER

by

KE REN

LL.B., The University of International Business and Economics, 1988

A THESIS SUBMITTED IN PARTIAL FULFILMENT OF
THE REQUIREMENTS FOR THE DEGREE OF

MASTER OF LAWS

in

THE FACULTY OF GRADUATE STUDIES

(Faculty of Law)

We accept this thesis as conforming
to the required standard

THE UNIVERSITY OF BRITISH COLUMBIA

December 1998

In presenting this thesis in partial fulfilment of the requirements for an advanced degree at the University of British Columbia, I agree that the Library shall make it freely available for reference and study. I further agree that permission for extensive copying of this thesis for scholarly purposes may be granted by the head of my department or by his or her representatives. It is understood that copying or publication of this thesis for financial gain shall not be allowed without my written permission.

Department of Law

The University of British Columbia
Vancouver, Canada

Date Dec. 1st, 1998

DE-6 (2/88)

ABSTRACT

The thesis purports to examine the phenomenon of hostile takeovers in the United States and Canada. The thesis starts with a review of history of takeover waves in the United States and the various theories attempting to explain the hostile takeover and customise the role of target management in this context. The author argues that the hostile takeover is a heterogeneous phenomenon. The heterogeneity of the hostile takeover demands a differential approach of regulation that encourages wealth-creating takeovers, and chills wealth-transferring takeovers.

The hostile takeover may serve as a crucible to the soundness of a corporate governance structure. The thesis surveys the different approaches the courts of United States (mainly the Delaware courts) and Canada employ to tackle the issue of directors' duties in the context of hostile takeover bids. The author argues that the Delaware "Business Judgement Rule" approach is comparatively more coherent and effective in addressing the issue than the Canadian approach of proper purpose test.

The author further reviews the regulatory regimes regarding takeovers in the United States and Canada. The author argues that generally both regimes have successfully fulfilled the goal of full and fair disclosure of information in hostile takeover bids, and a level playing field for acquirers and target companies. However, new regulatory development represented by the state antitakeover statutes purporting to eliminate the hostile takeover has begun to change the landscape of takeover regulation in the United States. The author argues that the elimination of hostile takeovers should be considered premature unless alternative mechanisms of corporate accountability are available.

Are there any alternative schemes of corporate accountability available to replace hostile takeovers? Are there efficiencies made possible in the absence of hostile takeovers? The thesis strives to answer these questions by reviewing evidence from Japan, Germany and the United Kingdom. Two leading alternative schemes of corporate accountability - Gilson and Kraakman's independent directors and the Cadbury Report's Code of Best Practice - are also discussed. Finally, the author concludes that there are viable alternative schemes of corporate monitoring available for the United States and Canada to adopt, which may effectively render hostile takeovers obsolete as wasteful and controversial corporate monitors. There are also tangible movements toward the establishment of such alternative mechanisms in the North America. Hostile takeovers, a heterogeneous and controversial phenomenon that has enthralled academia and the business world for decades, will eventually fade into the history.

TABLE OF CONTENTS

ACKNOWLEDGEMENT

I owe a great debt of gratitude to my supervisor, Dr. B. V. Slutsky who patiently read many draft versions of the thesis and provided many helpful comments. He has been very helpful in formulating the main idea and building the structure of the thesis.

I owe many thanks to the graduate student class of 1997 and Dr. Wesley Pue who provided an ideal locality very much conducive to the development of the thesis. I also want to express my appreciation to Dr. Obiora Okafor, Sara Ramshaw, Lillian Ong and Deanna Clark for their help throughout the study.

The consummation of my gradate study at UBC is but the peak of a huge pyramid, which could not have been built without the support of many people on the other side of the Pacific Ocean. My gratitude to my parents, my wife, my teachers, and my friends whose love and support constitute the solid base of the pyramid, is beyond words.

Although my graduate study at UBC will not be the final destination of my academic pursuit, it is beyond doubt one of the most fruitful phases. Although there is still a long way to go, I am certain that the valuable experience at UBC has equipped me with adequate inner resources to face any challenge to come.

DEDICATION

TO MY PARENTS, MY WIFE AND MY FRIENDS

INTRODUCTION

A hostile takeover is an effort to gain control of a target company usually through a takeover bid (tender offer). Such a takeover usually happens without the approval of the management and board of the target company. It seems to have developed as a phenomenon in the United Kingdom in the 1950s.[1] Although the hostile takeover spread to the United States slightly later, it gained more momentum and became perhaps the most dramatic and controversial event in the corporate world in the U.S.A.[2] The takeover activity reached its climax in the U.S. in the 1980s when over 30,000 takeovers took place with an aggregate value of 1.3 trillion.[3] Canada has not witnessed as many hostile takeovers as the U.S., though the mergers and acquisition business has been as active in Canada as in the U.S..[4]

The rise of corporate takeovers brought about the development of regulatory regimes in the U.S. and Canada. In the U.S., federal securities law and regulations laid out the landscape of the regulatory environment. In Canada, provincial securities laws and

---

[1] *See* L. Loss, *Fundamentals of Securities Regulation* (Boston, Little, Brown & Co., 1983), at 568.

[2] *Ibid.*

[3] *See infra* note 9, and accompanying text. However, it should be noted that hostile takeovers only accounted for a small portion of all takeover transactions in the 1980s, for example, there was only 40 out of 3,300 takeovers in the U.S. in 1986 were hostile tender offers. *See* Michael Jensen, *Takeovers: Their Causes and Consequences*, 2 J. Econ. Perspectives, 21, 22 (1988).

[4] Deborah DeMott notes that "from 1980-1985, the value of Canadian mergers was two-and-a-half times as learge as the comparable value for the U.S." *See* D. DeMott, *Comparative Dimensions of Takeover Regulation*, 65 Wash. U. L. Q. 69, 73 (1987)

policy statements of securities administrators have played pivotal role in regulating takeover activity.

Initially, economic opinion was uniformly favourable to hostile takeovers. The most compelling argument in favour of hostile takeovers is that they serve as an important disciplinary mechanism on the management of potential target companies. However, as the takeover frenzy of the 1980s churned out numerous unfavourable side-effects, concern was expressed about the excessive leverage of corporations and the short-term management outlook in the U.S. which were supposedly caused by an over-heated takeover market. Controversies arose with regard to both the virtues and vices of hostile takeovers. Influenced by the public concerns over the fallout of hostile takeovers, the regulatory environment has begun to turn antagonistic toward takeover activity since late '80s. For example, state anti-takeover statutes purporting to eliminate hostile takeovers have considerably changed the regulatory environment of the U.S..

What is the essence of the controversial phenomenon known as hostile takeover? How should we most optimally regulate it? Is the hostile takeover, as a disciplinary control on corporate management, really indispensable to the health of economy? Can we do without it?

This thesis tries to answer the above questions. Chapter One reviews the history of takeovers in the U. S. where tender offers evolved into highly dramatic and controversial events in corporate world. This chapter further probes various theories and hypotheses that attempt to explain and evaluate hostile takeovers. Finally, based on the survey of all relevant theories, the chapter concludes that hostile takeover is a heterogeneous phenomenon that should not be encouraged or chilled in the aggregate. Instead, differential regulation should be devised to encourage takeovers that promote efficiency and create wealth, discourage those involving misapplication of resources and wasteful transfer of wealth. The survey also shows that due to the myopic outlook of shareholders of public corporations caused by an extremely liquid stock market conducive to short-term profits, it is inappropriate for target shareholders to decide the fate of the company. Target directors should be allowed to play an active role in the face of a hostile takeover, provided that their decision-making process is closely scrutinised to eliminate any self-dealing.

Chapter Two examines the regulation of hostile takeovers from the perspective of corporate governance. One event that is usually evident in hostile takeovers is the struggle between acquirers and target directors. Martin Lipton likens hostile takeover battles to the feudal wars of the Middle Ages.[5] The frenzied takeover market of the 1980s nurtured a wide range of takeover tactics such as "street-sweep", "greenmail" and "bear hugs", as well as the use of coercive strategies such as "two-tier, front-end loaded bid."[6] Correspondingly, target management also devised a variety of defensive tactics purporting to fend off or deter hostile takeovers in the name of protecting the interests of the target company and its

[5] Lipton & Steinberger, *Prologue* to *Takeovers and Freezeouts* (Law Journal Seminars - Press, 1991) at v.

[6] For a general review of takeover approaches and tactics, *see* Lipton & Steinberger, *id*, at §1.06, 1.08.

shareholders.[7] Although target directors are usually justified in mounting defences against a takeover attempt, it is still questionable that their decision-making process is adequately scrutinised to minimise self-dealing. The Chapter first reviews the general principle of directors' duties and its application in the context of hostile takeover battles, then concentrates on the examination of the business judgement rule established by U.S. Delaware courts, as well as the primary purpose test commonly applied by Canadian courts. A number of leading cases will also be discussed. Finally, the Chapter concludes that the U.S. cases have gone the furthest in seeking to articulate the business judgement rule in relation to the duties of directors of a target company in a hostile bid. In comparison, the primary purpose test espoused by Canadian courts is inadequate in the context of a hostile takeover to assess the observance of directors' fiduciary duties.

Chapter Three surveys the regulatory regimes of the U.S. and Canada. The federal securities laws and regulations, anti-trust laws and state anti-takeover statutes that have sculpted the landscape of the regulatory environment of the U.S. will be discussed. The leading provincial securities law of Canada - Ontario Securities Law - and two influential policy statements issued by Canadian securities administrators, as well as Competition Act of Canada will also be examined.

It is the opinion of the author that the regulatory climate of North America has become increasingly antagonistic toward hostile takeovers. The recent state anti-takeover

---

[7] For a general review of defensive tactics, *see ibid*, at chapter six.

statutes of the U.S. which have been endorsed by the U.S. Supreme Court, even purport to eliminate hostile takeovers. Is such a trend justified? Are there, perhaps, economic efficiencies made possible in the absence of hostile takeovers? Are there any alternative schemes that could provide effective corporate monitoring and justify the elimination of hostile takeovers as a means of wasteful corporate disciplinary apparatus? Chapter Four purports to answer these questions. The chapter first examines the evidence from Japan, Germany and the United Kingdom, then probes into the probable schemes of corporate accountability that could be provided by institutional shareholder activism and a reformed board of directors. Finally, the chapter reaches the conclusion that the internal monitoring provided by the bank-based system of Japan and Germany may not be easily emulated in North America. However, there is indeed great potential for institutional shareholders in the U.S. and Canada to play an active role in corporate monitoring. A more practical alternative scheme involving less fundamental change in legal structure is the reform of unitary board system pioneered by the Cadbury Report of the U.K.. It is the opinion of the author that a combination of institutional shareholder activism and unitary board reform will provide the most satisfactory result in seeking the alternative corporate monitoring mechanisms.

Finally, this thesis concludes in Chapter Five that it is premature for the time being to eliminate hostile takeovers. Hostile takeovers will still serve as an effective corporate monitor and discipline apparatus until an alternative mechanism of corporate accountability is established through institutional shareholder monitoring and board-level monitoring. Due to the distinction in underlying theories of the firm between the unitary board system and the dual board system, it seems an insurmountable barrier to expect American and Canadian corporate law to adopt the idea of a two-tier structure in the unitary board structure. However, evidence suggests that there is a tangible movement in Anglo-American legal system heading toward the institutional view of the firm, which is the rationale of the dual board system. It should not be overly optimistic to expect that along with the establishment of alternative corporate monitoring mechanisms, the hostile takeover, a phenomenon that has enthralled both academia and business world for decades, will eventually fade into history.

Chapter One

Theoretical Review of Corporate Takeovers

Before examining the controversial phenomenon known as the hostile takeover bid or tender offer, we should know the essence of the phenomenon. This chapter will review briefly the history of takeover waves in the United States, the various hypotheses attempting to explain takeovers, and discuss the three major theories purporting to analyse the merit of takeovers and customise the role of target management in the face of a tender offer. Finally, the author will attempt to formulate a general principled approach in respect of regulating the hostile takeovers.

I. The Takeover Wave of 1980s: Flow and Ebb

The hallmarks of the 1980s were "[m]egadeals . . . [,] hostile takeovers, leveraged and management buyouts, corporate restructuring, deregulation, bust-up deals, relaxed antitrust policies, competitive bidding, evolving industries, junk bonds, the Mergers & Acquisitions service infrastructure, globalisation, and foreign acquisitions in the U.S."[8] By one estimate, 31,105 mergers and acquisitions were made during the 1980s in the U.S., with

[8] Martin Sikora, *The M&A Bonanza of the '80s . . . And Its Legacy ("M&A Bonanza")*, Mergers & Acquisitions 90-91 (Mar./Apr. 1990).

an aggregate value of $1.34 trillion. Of the 500 largest industrial corporations in the United States in 1980 (Fortune 500), at least 143 or 28% had been acquired by 1989.[9]

1. Takeover Waves: Past History

The takeover wave of the 1980s was the fourth to have occurred in the United States in the last 100 years. The first and the largest takeover wave occurred around the turn of 20th century. As a response to the Sherman Antitrust Act of 1890 which precluded collusive agreements between firms but allowed the creation of virtual monopolies with a 50 to 90 per cent market share, many industries merged into monopolies overnight.[10] The U.S. Steel Corporation was formed controlling 65% of the steel-making industry. American Tobacco had a 90% market share. The wave was stopped by the Clayton Antitrust Act[11] of 1914.

The second wave came up in the late 1920s. Like the first wave, most deals were mergers of firms in the same industry. Although American law did not allow a monopoly, the formation of oligopolies - concentrated industries dominated by a few firms - was still allowed. Allied Chemical and Bethlehem Steel are products of this wave. The second wave was stopped by the Great Depression and the collapse of the stock market.

---

[9] *Ibid.*

[10] G.S. Stigler, Am. Econ. Rev. 40, 23 (1950).

[11] 15 U.S.C.A. § 18.

The third wave came up in the late 1960s. While antitrust policy turned fiercely against mergers between firms in the same industry, firms switched to the course of diversification and bought companies outside their industries, leading to the formation of the so-called conglomerates. At the outset, conglomerates were expected to improve the efficiency of U.S. industries. It was argued that conglomerates create an internal capital market where the central office can reallocate investment funds from slowly growing subsidiaries to fast growing sectors more cheaply and efficiently than the banks or the securities market; conglomerates also can better monitor individual businesses by subjecting them to the quantitative evaluations of the central office.[12]

The alleged superior efficiency of conglomerates probably disguises the true motivation for their creation. It was more likely that firms wanted to grow and had access to cheap internal and external funds. When blocked by aggressive antitrust policies, the growth-oriented managers took another way around by a path of diversification. Some well-known literature on the economies of the firm supports the view that management seeks to maximise size instead of profits, even when it is contrary to the shareholders' best interests. The "managerial literature" of the firm includes writings by such economists as William Baumol, John Kenneth Galtraith, Oliver Williamson, Robin Marris, Harvey Leibenstein and the Nobel Prize winner Herbert Simon.[13] The common elements of their

[12] For a general review of these studies, *see* D.C. Mueller, *The Effects of Conglomerate Mergers*, J. Bank Financ. 1, 315 (1977).

[13] For their relevant works, see, e.g. W. Baumol, *Business Behavior, Value and Growth* (Macmillan, rev.ed. 1967); J. Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1967); O. Williamson, *Markets*

model is: (1) managers prefer a tendency for growth maximisation over profit maximisation, (2) managers enjoy substantial opportunities for managerial discretion, including the discretion to consume perquisites, (3) managers normally display a desire to expand staff, and a failure to pursue cost minimisation strategies, except in times of severe financial constraint. The corporate diversification and the formation of conglomerates might only be an expedient means of satisfying management's harmful cravings for empire building.

Nonetheless, recent evidence shows that conglomerate mergers typically failed in promoting efficiency. Some studies found that the earnings performance of conglomerates deteriorated. Following the wave of conglomerate mergers was the massive divestiture of the unrelated assets acquired by conglomerates in '60s and '70s.[14] An explanation for the failure is that when conglomerates diversified their businesses, they ran against the economic principle that specialisation raises productivity. Managers running central offices often knew little about the business of subsidiaries thus could not efficiently allocate funds and monitor operations. As the empire of the conglomerate grew, divisions were insulated from market forces. They could afford to lose money, as losses in one sector could be subsidised by other divisions. Competition in product market, capital market and managerial competition were largely weakened. In some respects, conglomerates resembled state-owned enterprises in centrally planned economies. It seemed that the takeover wave

---

and Hierarchies: Analysis and Antitrust implications (New York, Free Press, 1975), R. Marris, *The Economic Theory of "Managerial" Capitalism* (London: Macmillan, 1964), Leibenstein, *Allocative Efficiency vs. "X-Efficiency,"* 56 Am. Econ. Rev. 392 (1966).

[14] *See supra* note 12. See also D.J. Ravenscraft & F.M. Scherer, *Mergers, Sell-offs, and Economic Efficiency* (Washington D.C.: Brookings Institution, 1987).

of the 1980s was to a large extent a response to the disappointment with conglomerates.

In the 1980s, the U.S. Justice Department revised the Merger Guidelines to subject fewer related-firm acquisitions to antitrust scrutiny.[15] Deregulation by the Reagan Administration enabled many business combinations to succeed, which might not have survived scrutiny in previous eras. The easy availability of internal and external funds for investment coupled with the negative experience of the diversification of the 1960s and the first laissez faire antitrust policy in decades shaped the takeover wave of the 1980s.[16]

2. Features of 1980s' Takeover Wave

A variety of economic factors contributed to the high volume of takeover transactions in the 1980s. First, during the 1980s, there was a wide discrepancy between market valuation and the intrinsic values of many publicly held corporations. This was in part due to the fact that the non-core subsidiaries of conglomerates were operated so poorly by their headquarters that their values were not fully recognised in their share prices. Acquirers believed that in buying the undervalued companies, they could profit immediately from the difference between acquisition price and the company's intrinsic worth.[17] Second, easy access to acquisition financing in the 1980s also contributed to the active market of

[15] Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 177 (1992).

[16] Martin Sikora, *supra* note 8, at p. 90, 93.

[17] Block, Levin and Mansky, *Current Trends in the Market for Corporate Control*, in *Contests for Corporate Control* (Practicing Law Institute, 1995) at 13.

corporate transactions. Drexel Burnham Lambert and Michael Milken created the institutional market for high-yield debt - "junk" bonds - which rose to prominence in merger and acquisition transactions. Drexel financed many of the largest transactions in the 1980s, including $27.4 billion takeover of RJR Nabisco by Kohlberg, Kravis, Roberts & Co. ("KKR"), the $3.2 billion sale of A. H. Robins Co. to American Home Products Corp., and MacAndrews & Forbes' $1.7 billion acquisitions of Revlon, Inc.[18] Commercial bankers also eagerly sought to provide senior acquisition financing because of the attractive interest rates and transaction fees of takeover transactions.

Several features characterised the merger and acquisition activity in the 1980s. A notable feature was the prominence of financial buyers who sought control of firms for short-term financial gain.[19] In the 1980s takeover wave, the so-called "corporate raiders"[20] and many leveraged buyout (LBO) specialists[21] played the critical role of brokers. They acquired conglomerates, broke them up, and sold off most business segments to large corporations in the same business. An example might well illustrate this feature. In 1985,

[18] *See Wall Street's Shooting Star*, Mergers & Acquisitions, May/June 1990, at 23.

[19] Financial buyers in acquisitions refer to someone who is buying a company for financial reasons, not to run the business over the long term, but for the hope of making a profit, usually by reselling the company in parts or in stock flotation. *See* Herzel & Shepro, *Bidders & Targets: Mergers and Acquisitions in the U.S.* (1990) at 489.

[20] Corporate raiders are individual financiers who believed that the market price of a target was significantly undervalued and that they could make a short-term profit - often by dismembering the acquired company by selling off different business units - even after paying a substantial takeover premium. *See* Block, Levin and Mansky, *supra* note 17, at 18.

[21] Leveraged buyout means the acquisition of a corporation or division where a very high percentage of the purchase price is obtained by borrowing. A number of financial service companies such as KKR and Forstmann Little & Co., focused their practices on financial acquisitions through leveraged buyouts. *See ibid.*

the cosmetics giant Revlon was acquired by raider Ronald Perelman after a fierce hostile takeover bid at the price of $2.3 billion. Before the takeover, Revlon acquired many non-cosmetic businesses especially in health care, with a hope that health care might offer more growth opportunities than cosmetics. After the takeover, Perelman sold off $2.06 billion of Revlon's health care and other non-cosmetics businesses. He even received but turned down an offer to buy the Revlon's cosmetics business for $905 million, which, combined with $2.06 billion, shows how profitable the bust-up transactions are. Finally, about 60% of Revlon's assets were sold off to other companies in the same field. After sell-offs, Revlon substantially revamped the cosmetics business and tripled its advertising budget, and as a result, its profits increased considerably.[22]

The motivation of these financial buyers was largely one of the profiteers. They in effect facilitated the process of de-conglomeration of American business, which represented a comeback to specialised firms after years of diversification. From the point of view that the ends justify means, these leveraged buyout transactions may be considered socially beneficial at least to a certain extent. However, Michael Jensen, a professor at Harvard Business School, went so far as to argue that takeovers by raiders and by leveraged buyout specialists move us toward a "new incentive-infused organisational form that will permanently deliver shareholders from the wasteful ways of public corporations."[23] The evidence proved that his view was largely over-optimistic. In the 1980s, most takeovers did

[22] *See* Shleifer & Vishny,*The Takeover Wave of The 1980s*, in *The Law of Mergers, Acquisitions and Reorganisations* (American Casebook Series 1990) at p. 6.

[23] M.C. Jensen, *Eclipse of the Public Corporation*, Harv. Bus. Rev. 61 (Sept. -Oct. 1989) at 67.

not involve raiders or LBO funds, and many raiders and LBO-controlled organisations were temporary, designed to exist only as long as it took to sell off the segments of the acquired firm to other public corporations.[24]

The fact that takeovers sometimes lead to the dismantling of conglomerates and allocation of divisions to specialists creates a presumption that performance and efficiency should improve. Although no statistics are available to directly substantiate this presumption, there is plenty of circumstantial evidence to show that divisions are more productive when they are part of less diversified companies.[25] Overall, there is justification for cautious optimism about the efficiency of takeovers in the 1980s.

Another feature of 1980s takeover wave was the strategic transaction.[26] Despite the public fanfare of corporate raiders and LBOs, strategic considerations drove most of the merger and acquisition activity of the 1980s. Firms merged for the sake of more market power or synergistic gains. For example, the Time-Warner merger of 1989, one of the most publicised deals of the period, served the clear strategic purpose of developing Time's entertainment sector.

---

[24] *See* Shleifer & Vishny, *supra* note 22, at 5.

[25] *Ibid*, at p. 7.

[26] Strategic transaction refers to acquisition or merger transactions with long term strategic purposes. In a strategic acquisition, the acquirer regards the transaction as an opportunity to strategically supplement or complement the acquirer's existing operations. The target is often in the same or similar industry as the acquirer or is in a business that would allow a vertical integration of acquirer and target and gain long-term benefits. *See* Block, Levine and Mansky, supra note 17, at 10.

The1980s also saw more hostile takeovers. Up to 25% of all deals during the 1980s were hostile.[27] Foreign entities also played an eye-catching role in the wave. A few high-profiled transactions involved foreign players. Examples include British Petroleum and Standard Oil, Sony and CBS and Columbia Pictures, Beazer's takeover of Koppers, and Hanson's takeover of SCM etc.[28]

3. The Ebb of the Takeover Wave

In the early 1990s, merger and acquisition activity slowed down dramatically. Several factors contributed to the standstill. Efforts were made in late 1980s to discourage take-overs through the U.S. federal income tax laws.[29] The October 17, 1987 crash of the stock market affected the market for stocks and junk bonds and contributed to the collapse of the savings-and-loan industry.[30] The stalled economy made bankruptcy and restructuring activity prevalent in business operations. The 1990 bankruptcy of Drexel Burnham Lambert brought about the collapse of junk bond market and eliminated the financing mechanism for leveraged buyouts. LBO activity plummeted from a value of $76.1 billion in 1989 to $17.9 billion in 1990, and $7.4 billion in 1991.[31]

---

[27] Larry Zuckerman, *Shades of the Go-Go '80s: Takeovers Are Making A Comeback*, N.Y. Times, Nov. 3, 1994, at A1.

[28] Martin Sikora, *supra* note 8, at 90, 91.

[29] *See* Romano, *supra* note 15, at 173-175.

[30] *See* Mitchell and Netter, *Triggering the 1987 Stock Market Crash: Anti-takeover Provisions in the Proposed House Ways and Means Bill?* 24 Fin. Econ. 37 (1989).

[31] *See The Junk Bond Fizzle*, Mergers & Acquisitions, May/June 1990, at 21,22.

Following the resurrection of the U. S. economy in 1993 - 1994, mergers and acquisitions experienced a comeback. In the first 10 months of 1994, takeover deals were valued at $284.4 billion, which was close to the aggregate value of all deals made in 1989 ($292.2 billion). The resurgence, however, came about with a different landscape. Strategic transactions dominated the market for corporate control. Four industries have experienced the most active markets for strategic combinations -- health care, defence, media and banking and finance.[32] New methods and sources of financing have taken shape. The contingent value rights (CVRs), a form of derivative securities, have become very significant in certain recent deals -- Paramount's merger with Viacom and Viacom's merger with Blockbuster.[33] In contrast to the takeover wave of 1980s, many deals in the current market wound up as negotiated transactions. In 1994, less than 8% of takeovers were hostile.[34]

In view of today's robust American economy and bullish stock market, strategic transactions should continue to dominate the merger and acquisition market, while financial buyers may have to remain relatively quiet. However, if corporate control transactions continue to grow at a fast pace, more hostile and unsolicited takeovers should follow. If the number of hostile bids increases, so should the amount of litigation. The courts and policy

---

[32] Block, Levin and Mansky, *supra* note 17, at 32.

[33] *The Financing Devices*, Corp. Control Alert, Mar. 1994, at 20-21.

[34] *Go-Go '80s*, N. Y. Times, Nov. 3, 1994, at A1.

makers may have to face yet another wave of takeover-related problems and controversies.

II. Theories of Takeovers - Attempts to Explain Hostile Takeovers

Those who have attempted to explain the phenomenon of the hostile takeover have usually begun with a striking fact: bidders have been willing to pay extraordinarily high premiums (around 50% on average[35]) for the stock of target corporations. Why are such lucrative premiums paid?

There are two classes of explanations for a takeover transaction: wealth creating and wealth transferring. Wealth-creating explanations postulate that takeovers create wealth in the form of higher stock prices, which gains are shared by bidder and target shareholders.[36] Wealth-transferring explanations see the takeover as a mechanism that transfers wealth between different groups of shareholders and other constituencies.[37] Under the two headings, a number of hypotheses serve to explain the takeover one way or the other.

1. Wealth-creating Explanations

---

[35] *See* Bradley, Desai & Kim, *Synergistic Gains For Corporate Acquisitions and Their Division Between the Stockholders of Targets and Acquiring Firms*, 21 J. Fin. Econ. 3 (1988).

[36] Some scholars argued that the stock market frequently made valuation mistakes, and the possibility that the stock market was overly enthusiastic about the takeovers of the 1980s should not be dismissed. *See* Shleifer & Vishny, *supra* note 22, at 7.

[37] See J.C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Columbia L. R.1145, at 1173. (1984)

1.1. Synergy Hypothesis

One motivation of a takeover is to achieve synergistic gains: the value of the combined firm is greater than the value of the two firms (target and acquirer) separately. Such synergistic gains may result from a variety of factors: unique product complementarity between the two companies, specialised resources possessed by the target, economies of scale, cost reductions, lower borrowing costs, or the capital market's response to the combined enterprise.[38] There is certain empirical evidence that supports this hypothesis. One study shows that bidder and target stock returns in product-extension mergers combining managerial skills or resources, as well as financial synergy[39], which are likely to produce economies of scale, display significant growth.[40] Due to reallocation of target assets to related acquirers, acquisitions of firms in related businesses, where gains from economies of scale and scope are most likely, are so profitable as to allow a significant portion of the gains from hostile takeovers to be paid to target shareholders.[41] However, other studies seem more ambiguous. Tarasofsky and Corvari looked at the performance of more than 100 Canadian companies acquired from 1963 to 1983 and concluded that

---

[38] For a general review of the synergies in acquisitions, *see* Alberts, *The Profitability of Growth by Merger, The Corporate Merger* 247, 247-262 (1982).

[39] Financial synergy means that to the extent that the acquired firms' business cycle offsets downturns in the bidder's business cycle, the combining of the two co-variant earnings streams would produce a steadier, less volatile earnings stream. The reduced risk of bankruptcy may result in lower borrowing costs and a higher stock market capitalisation. *See ibid.*

[40] Weston, Chung and Hoag, *Mergers, Restructuring and Corporate Control* (1990) at 267-278.

[41] Bhagat, Shleifer and Vishny, *Hostile Takeovers in the 1980s: The Return to Corporate Specialisation*, Brookings Papers on Economic Activity: Microeconomics 1990, 1, 55.

although some 42% became more profitable after they were acquired, 43% showed a decrease in profit, and the remaining 15% were essentially unchanged.[42]

1.2. Disciplinary Hypothesis

The disciplinary hypothesis derives from the classic article by Henry Manne, written more than 30 years ago, which identified the "market for corporate control" as a major disciplinary force on managerial discretion and inefficiency.[43] The role of the hostile takeover is to replace inefficient management. The bidder pays a premium over the market price because it believes that the target's assets have not been optimally utilised and that under superior management they would earn a higher return, thereby justifying the takeover premium. Since the publication of Manne's seminal article, his ideas have been extended and formalised by a host of subsequent writers in the "law and economics" regime to the point that it is now commonplace within this literature to describe the hostile takeover as the principal mechanism of corporate accountability.[44] Under this hypothesis, the hostile takeover appears a benign and socially beneficially phenomenon, which benefits both the bidder and the target's stockholders, who simply divide among themselves the value that the incumbent management's inefficiency denied them.

---

[42] *See* Tarasofsky & Corvari, *Corporate Mergers and Acquisitions: Evidence on Profitability* (Ottawa Economic Council, 1991).

[43] H. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965).

[44] *See, e.g.* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819 (1981) at 841 ("Indeed, . . . the market for corporate control may be the only potentially serious force for limiting management discretion.").

1.3. Free Cash Flow Hypothesis

Another explanation that views takeovers as a mechanism for reducing agency costs and creating wealth is Michael Jensen's "free cash flow" theory.[45] Jensen contends that a source of waste in the public corporation is the conflict between shareholders and managers over the payout of free cash flow - that is, cash flow in excess of that is required to fund all investment projects with positive net present values. If these funds are paid out to shareholders, managers will have fewer resources under their control, and will thus be unable to squander cash by investing in wasteful projects. Additionally, eliminating free cash flow subjects managers to capital market monitoring when they need to finance new projects, further constraining their ability to undertake sub-optimal transactions. Shareholders are at a great advantage in a situation where companies distribute excess cash to shareholders and then must convince the capital markets to fund sound economic projects. Consequently, their investment plans are subject to enhanced monitoring by the capital markets.[46]

Managers have incentives to retain cash. Cash reserves increase their autonomy vis-à-vis the capital markets. Retaining cash also increases the size of the companies, and

---

[45] Michael Jensen, *The Takeover Controversy: Analysis and Evidence, in* Knights, Raiders & Targets: The Impact of the Hostile Takeover (1988) at 314. Also see Jensen, *Eclipse of the Public Corporation,* Harv. Bus. Rev. 61 (Sept. - Oct. 1989).

[46] Jensen, *Eclipse of the Public Corporation, ibid,* at 65-66.

managers have many incentives to expand company size beyond that which maximises shareholder wealth.[47] Corporate growth in size increases corporate compensation, enhances the social prominence, public prestige, and political power of senior executives. The so-called "empire-building" mentality reflects the megalomania of most top business executives. Managers also have justification to retain cash. Common law has long recognised that ". . . [t]he power to pay dividends is an integral component of the broad grant of managerial power for directors,"[48] and ". . . [t]he directors are always entitled in the honest exercise of their powers, to set up a reserve before declaring a dividend."[49] Corporate managers generally do not disgorge cash unless they are forced to do so.[50] In 1988, the 1,000 largest public companies (by sales) generated total funds of $1.6 trillion. Yet they distributed only $108 billion as dividends and another $51 billion through share repurchases.[51]

In essence, the free cash flow theory of takeovers is a elaboration of only one of the various results that the hostile takeover would produce under the disciplinary hypothesis by displacing the inefficient management. It also provides an explanation for the increased leverage of corporations upon an acquisition. Debt restricts future free cash flows in that unlike dividends on stock, which corporate managers have full discretion as to how much

---

[47] *See* "managerial literature", *supra* note 13.

[48] *The Queen v. McClurg*, [1990] 3 S.C.R. 1020, [1990] D.L.R. (4th) 217, at 226.

[49] *Devall v. Wainwright Gas Co.* Ltd., [1932] 1 W.W.R. 281, 26 Alta. L.R. 274 (S.C. App. Div.) at 276.

[50] *See Dodge v. Ford Motor Co.*, 170 N.W. 668 (1919).

[51] Jensen, *supra* note 46, at 66.

they would like to declare, interests on debt must be paid to avoid default or the bankruptcy trigger. The leveraged acquisitions increase the firms' value by mitigating agency cost from the misuse of excess cash.

2. Wealth-transferring Explanations

2.1. Expropriation Hypothesis

The expropriation hypothesis of takeovers focuses on five distinct groups: shareholders, taxpayers, bondholders, employees and consumers.

Expropriation of shareholders encompasses two different scenarios. In a two-tier takeover bid, a high premium is paid in a partial bid for the target's stock (usually 50%), and then a squeeze-out merger is eventually made at a price below the tender offer price, with a result that the average price received amounts to a net loss for target's shareholders in aggregate. Another and a more popular form of the exploitation thesis argues that bidders exploit temporary underpricing of the target's stock in order to seize control of the target in a bargain purchase.[52] The thesis views the high rate of takeover activity of 1980s as the product of systematic undervaluation on the part of the stock market which capitalised corporations at levels well below their intrinsic values. The rational bidder will exploit these opportunities to make a bargain purchase, rather than commit large

[52] *See* generally, Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 Colum. L. Rev. 249 (1983).

investments to develop equivalent plants. In both foregoing cases, takeover premiums are only a portion of the wealth transferred from the target's shareholders to the acquirers.

Tax benefits provide another wealth-transferring explanation for takeovers. Because interest is deductible, the increased debt load incurred in leveraged acquisitions shelters more income. Besides, a firm may have tax attributes, such as favourable deductions, investment tax credits, depreciation allowances, net operating losses, that it cannot use because it has too little income, leading the firm to seek to merge with another firm that has income to capture the value of the tax benefit. Thus the acquirer can shield its income from taxes so as to increase its real cash flows, and the target can realise the value of its deductions which it could not do on its own.[53] Under the tax expropriation thesis, the takeover premiums represent a part of the wealth transferred from public revenue to shareholders.

Leveraged acquisitions may be mechanisms for expropriating the wealth of bondholders, rather than taxpayers. When a firm increases its leverage, it also increases the risk for all bondholders. Since the firm's cash flow may not cover the new debt load, the value of pre-existing debt decreases because it is now a riskier investment for previous bondholders. As the bondholders are not compensated for this increased risk, the takeover redistributes wealth to the shareholders.[54]

[53] Romano, *supra* note 15, at 134.

[54] *Ibid*, at 136.

The expropriation explanation of takeovers that attracts public attention involves labour as the victim. It has been argued that hostile takeovers represent a breach of employees' trust in transferring wealth from employees to shareholders through wage reductions and employment cuts.[55] One example of a labour expropriation involves overfunded pension fund assets. Firms often fund cost-of-living adjustments that are not required by their pension contract with the excess assets in a plan. A takeover in which a pension plan is terminated and excess assets reverted to the firm for non-plan uses might be characterised as a redistribution of wealth from labour to shareholders.[56]

Finally, a traditional explanation for takeovers that falls in the expropriation category is that takeovers increase market power, thereby allowing the merged firm to reduce competition and gain from the higher price they could charge. In this case, takeover gains represent a transfer of wealth from consumers to shareholders. However, it stretches the credibility of the thesis when it has to explain the acquisitions of unrelated businesses in conglomerate mergers.

2.2. Empire-Building Hypothesis

[55] Shleifer & Summers, *Breach of Trust in Hostile Takeovers,* in *Corporate Takeovers: Causes and Consequences* (Univ. of Chicago Press 1988) at 33-68.

[56] *See* Pontiff, Shleifer & Weisbach, *Reversions of Excess Pension Assets After Takeovers*, 21 Rand J. Econ. 600 (1990).

The managerialist perspective on the firm dictates that the motivation for an acquisition is the maximisation of the manager's utility rather than of the shareholders' wealth, or more simply put, empire-building. The conglomerate mergers of 1960s were a manifestation of this empire-building mentality. Under the empire-building thesis, the takeover premiums are less an indication of the potential value latent in the target's assets than of an overly optimistic assessment by the bidder of its own capabilities as a manager. From this perspective, the takeover process may result not in creating wealth or improving efficiency, but only in a net transfer of wealth from the bidder's shareholders to those of the target.[57]

There are studies that provide some support for the thesis. For example, Lewellen, Loderer and Rosenfeld find that there is a positive relation between acquirers' abnormal returns and management's stock ownership. This indicates that managerialist motives prevail when management's incentives to act in the shareholders' interest evaporate due to low stock ownership of management.[58] The study supports Manne's disciplinary thesis, as well as managerialism, for they indicate that at least some acquisitions are profoundly misconceived.

2.3. Hubris/Winner's Curse Hypothesis

---

[57] For a concise statement of this thesis, *see* Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 Yale L. J. 1238 (1979). at 1238.

[58] Lewellen, Loderer & Rosenfeld, *Merger Decisions and Executive Stock Ownership in Acquiring Firms*, 7 J. Acct. & Econ. 209 (1985).

Another managerialist explanation that is closely related to empire building thesis is "hubris" hypothesis expounded by Richard Roll.[59] In his view, managers seek to make value-creating acquisitions, but they simply misjudge the situation. When the acquirer's stock price falls upon the announcement of a bid, the managers do not heed this warning of their impending mistake. Rather, they are obsessed with pride and persist in the belief that their valuation is correct and the market is wrong. Their hubris prevents them from recognising their mistake and calling off the deal, and they end up overpaying the target firm. The transaction is a wealth transfer from the acquirer's shareholders to the target's shareholders.

Roll's thesis is partly demonstrated in the phenomenon of the "winner's curse" in the auction situation. When the value of the auctioned target to the bidders is uncertain, and all bidders have approximately the same information regarding the target, the arithmetic mean of the bids should be the best estimate of the real value of the target. It would appear then that a wining bid much over the mean must be over-optimistic and that the winner had the highest positive evaluation error, which is so-called the "winner's curse."[60] Varalya has found that the difference between the bid premium (abnormal return) and the combined market value of bidder and target is positive and significant, which shows that there is an

---

[59] Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. Bus. 197 (1986).

[60] *See* Nikhil P. Varalya, *The "Winner's Curse" Hypothesis and Corporate Takeover*, 9 Managerial & Decision Econ. 209 (1988).

overpayment.[61]

The hubris/winner's curse hypothesis should not be a long-run explanation because we expect bidders to learn from their experience and adjust their bids downward to avoid the winner's curse. However, the market feature may work against the bidding adjustment. Many bidders engage in only one transaction, and it is possible that they could not learn something from their experience. Their advisers, such as investment bankers, are indeed experienced players, and should be able to transmit the requisite knowledge to a new client. But the market mechanism is such that the financial intermediaries have a bias to be over-optimistic since they are usually paid much more when bids are successful, which they are more likely to be if the offers are high.[62]

One might expect that after a decade of frenzied takeover activities in 1980s, there must have been sufficient knowledge being built up in the market that would enable the future bidders to be aware of the winner's curse and deliberately avoid it. However, the intense competition in the takeover market fostered by legal rules forces acquirers to pay top price. The haste imposed by competition increases the risk of mistakes for acquirers. The winner's curse as a trap set up by the auction market for corporate control may still remain a notable phenomenon in the foreseeable years to come.

---

[61] *Ibid.*

[62] *See* Herzel & Shepro, *Bidders & Targets: Mergers and Acquisitions in the U.S.* (1990). at 122.

III. Economic Analysis of Target Management's Role

In addition to the high premiums that are frequently paid in tender offers, other striking features about hostile takeovers are the spectacular aggressive tactics and litigation battles engaged in by potential acquirers and resisting target management alike. Many concerns arise out of management's response to a takeover threat, which may be sparked by self-interest rather than the best interest of shareholders.[63] Diverse opinions have been developed about the proper role of management in responding to threats of takeovers. Judge Posner once commented on the controversy in following terms:

> [T]he whole issue of permissible defensive tactics in the face of a tender offer is immensely contentious. . . . There are two polar positions in the debate. One views hostile takeovers as a bad thing, on a variety of grounds such as that they make managers of companies that are potential targets of takeover bids worry too much about short-term financial results and that they promote absentee ownership and control. . . .
>
> The other pole is that all resistance to takeover attempts is bad. The market price of publicly traded stock impounds all available information about the value of the stock, and anyone who offers a higher price . . . thereby offers an unequivocal benefit to the shareholders of the target firm, which management if it is really a fiduciary of the shareholders should embrace rather than oppose.[64]

Therefore, a basic understanding of the leading economic theories that analyse the proper role of management in the takeover context will be helpful in assessing the value of

---

[63] This conflict of interest is widely acknowledged, e.g. "A tender offer creates an obvious and inherent conflict of interest between managers and shareholders. The offer presents shareholders with the opportunity to receive a substantial premium over market price, while managers face the very real prospect of losing their jobs if the offer succeeds." Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 Va. L. R. 1257, 1263 (1985).

[64] *Dynamics Corp. of America v. CTS Corp.* 749 F. 2d 250, 253 (7th Cir. 1986).

hostile takeovers. There are three leading theories: the Lipton Theory; the Easterbrook and Fischel Theory of Efficient Capital Market; and Gilson's Structural Theory.

1. The Lipton Theory

In a series of articles that could be characterised as pro-management,[65] Martin Lipton asserted that the defeat of tender offers by management benefits both society and target shareholders, and therefore the target directors should be allowed to use their business discretion to resolve a takeover decision just like any other major business decision.[66]

The first premise of the Lipton theory is that corporations contribute benefits not only to their shareholders, but also to the entire society.[67] These benefits derive form the expanded role of the board of directors in the current corporate system to embrace social concerns.[68] Society will realise these benefits only if the law permits the directors to focus on the long-run interests of the corporation and not compel them to sacrifice these interests

---

[65] Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101 (1979) (hereinafter cited as Lipton I); *Takeover Bids in the Target's Boardroom: An Update After One year*, 36 Bus. Law. 1017 (1980)(hereinafter cited as Lipton II); *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel,* 55 N.Y.U.L.Rev. 1231 (1980)(hereinafter cited as Lipton III).

[66] *Ibid*, Lipton I, at 120.

[67] *Ibid,* at 105-106.

[68] *Ibid*, at 105 ("Efforts to broaden the concerns of directors to include employees, consumers, the community, the environment and the national welfare have reached full fruition only during the last 20 years.").

to satisfy the short-term interests of arbitrageurs and professional investors.[69] He says that those complaining about management are primarily arbitrageurs and professional investors whose short-run interests are inconsistent with the long-run interests of the corporation and its shareholders.[70] In his view, the central issue of public policy is "whether the long-term interests of the nation's corporate system and economy should be jeopardised in order to benefit speculators interested not in the vitality and continued existence of the business enterprise in which they have bought shares, but only in a quick profit on the sale of those shares?"[71]

The second premise of the Lipton theory is that target shareholders actually benefit from rejecting a takeover bid.[72] To support this view, Lipton presents evidence that, between 1974 and 1979, the shares of corporations that rejected or defeated a tender offer later reached a higher market price or were acquired in another tender offer at a higher price.[73] Lipton concludes that "the shareholders of more than 50% of the targets are better off today than if the defeated tender offer had succeeded."[74]

---

[69] *Ibid*, at 104.

[70] *Id*. Lipton asserts that this group of disgruntled investors "do not share the concern of corporate management with the need for long-term planning in a high technology economy . . .the overall health of the economy should not in the slightest degree be made subservient to the interests of certain shareholders in realising a profit on a takeover." *Id*.

[71] *Ibid*.

[72] *Id*, at 109.

[73] *Id*, at 106.

[74] *Id*, at 107.

Lipton likens requiring acceptance of any takeover bid that represents a considerable premium over the market price to mandating a periodic decision to sell or liquidate the company.[75] The fallacy of a requirement for annual assessment by the directors as to whether the company should be sold or liquidated is threefold. First, it defies common sense and ordinary business practices;[76] second, it incurs disruptive business activity that impacts other corporate constituencies and favour the short term at the expense of long-term planning;[77] third, the experience with mandated annual life or death assessment is no different from that with rejection of hostile tender offers.[78]

Lipton believes that a shareholder referendum is not the answer.[79] Due to the coercive nature of tender offers, shareholders will always be compelled to accept the offer, and "any uncoerced decision against acceptance of a tender offer can only be made at the board of directors level."[80] Besides, a change has taken place in composition of shareholders over the last thirty years. Individual investors do not hold a majority of a company's stock. Rather, 20-50% of the stock of many large public corporations is in the hands of professional investors.[81] The only interest of the arbitrageurs is in a quick sale at a

---

[75] *Id*, at 109.

[76] *Id.*

[77] *Id,* at 110

[78] *Id.*

[79] *Id*, at 113.

[80] *Id*, at 114.

[81] *Id.*

profit, and the professional investors are interested in retaining liquidity.[82] Thus, the shareholder referendum involves a majority of shareholder votes cast by a large and vocal constituency of professional investors and arbitrageurs whose interests are inconsistent with the interests of long-term individual investors.[83]

Lipton points out that the corporate mechanism does not leave disgruntled shareholders defenceless. If the shareholders are dissatisfied with the management decision in response to the takeover bid, they always have the right to topple the directors through the corporate voting mechanism.[84]

Lipton put forward a plan of managerial action that would fulfil management's fiduciary responsibilities. Management should keep the board fully informed of all factors relevant to the issue;[85] the directors should seek the opinions of independent investment banks and legal counsel regarding sufficiency of offering prices, antitrust and other legal issues, especially "whether the directors have received adequate information on which to base a reasonable decision;"[86] the directors also should appoint a committee of independent directors if the presence of inside directors creates a self-interest.[87] The next step involves

[82] *Id.*

[83] *Id.* at 114-115.

[84] *Id.* at 116.

[85] *Id*, at 121-22.

[86] *Id*, at 122.

[87] *Id.*

the directors considering all of these factors and deciding whether to reject or accept a takeover bid. "Once the directors have properly determined that a takeover should be rejected they may take any reasonable action to accomplish this purpose."[88]

Lipton concludes that a company need not have a perpetual "for sale" sign on its front lawn; the directors are not required when facing a takeover bid to declare an auction and seek to sell the company to the highest bidder; a company may make arrangements to protect the employees or other constituencies in the event of a takeover; and a company is entitled to discourage takeovers through such tactics as relevant charter amendments and lobbies for takeover laws.[89]

2. Easterbrook and Fischel: The Efficient Capital Market Theory

The basis of Easterbrook and Fischel's theory is the existence of a efficient capital market, which means that the prices of all securities in the capital market "accurately and promptly reflect the securities' intrinsic value relative to all publicly available information."[90] Under this theory, a trader who gathers and analyses public information about publicly-held companies in an attempt to determine which stocks are underpriced and profit from buying low and selling high will certainly fail,[91] because the process of hunting the underpriced

[88] *Id*, at 123.

[89] *Id*, at 112-113.

[90] Feschel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 Tex. l. Rev. 1, 1 (1978).

[91] *Id*, at 2-5.

stocks injects the information into the marketplace and, correspondingly, into the price of securities.[92] The fact that an efficient capital market reflects and adjusts to all available information determines that hunting and profiting from underpriced stocks will fail, since there is no way to "beat the market."[93]

Another basis of Easterbrook and Fischel's theory is Manne's "market for corporate control" thesis. The market for corporate control is the "correlative benefit of the efficient market theory", because the efficient capital market creates signals in stock prices which invite changes in control that maximize shareholder welfare.[94] Tender offers operate in the market for corporate control as a "mechanism whereby control shifts from less capable managers to others who can manage corporate assets more profitably."[95] Since the price of stocks reflects all relevant information, a poorly managed company's stock price will reflect the poor management. The corporation with inefficient management and corresponding low stock price necessarily attracts acquirers, as they hope to replace the inefficient management and turn the corporation around.[96]

---

[92] *Id.*

[93] *Id.*

[94] Harrington, *If It Ain't Broke, Don't Fix It: The Legal Propriety of Defences Against Hostile Takeover Bids,* 34 Syracuse L. Rev. 977, 1026 (1983).

[95] Fischel, *supra* note 90, at 5.

[96] For a discussion of characteristics of target companies which make them vulnerable to takeover, see *id*, at 7.

Easterbrook and Fischel argue that in a modern publicly held company, ownership and control are separate - the shareholders own and the managers control.[97] The divergence of interests between shareholders and managers dictates that managers cannot be expected to maximize the welfare of shareholders at their own expense.[98] The losses borne by shareholders due to sub-optimal management are known as "agency costs,"[99] which are equal to the difference between shareholder wealth under optimal management and that under the incumbent management.[100] Therefore, tender offers can be considered socially beneficial by reducing agency costs.

Under Easterbrook & Fischel's theory, allowing corporations to erect barriers against tender offers by employing defensive tactics defeats the whole process of allowing the market to monitor managerial effectiveness and replace management when necessary.[101] There is also little or no justification for government regulation on tender offers.[102] Disclosure requirements work against the market for corporate control by forcing an acquirer to make public the information that is privately produced with costs by researching. "Failure to recognise a property right in privately produced information, will decrease the

---

[97] *Id*, at 8.

[98] Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1170(1981) (hereinafter Easterbrook & Fischel I); see also Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 Bus. law. 1733, 1735 (1981)(hereinafter Easterbrook & Fischel II).

[99] *Id*, Easterbrook & Fischel II, at 1735.

[100] Easterbrook & Fischel I, *supra* note 98, at 1170.

[101] Fischel, *supra* note 90, at 5.

[102] *Id*.

incentives to produce this information," and lead to decreased information and entrenchment of inefficient management.[103] State takeover statutes are viewed as an even worse evil than the federal regulation, in that they tend to go so far beyond the federal laws as to intrude into the market. They eliminate the element of surprise so that management has more time to erect barriers against the offer. These statutes "pose a powerful threat to the operation of the market for corporate control."[104]

According to Easterbrook & Fischel's theory, "any strategy designed to prevent tender offers reduces welfare."[105] Shareholders lose the opportunity to sell their shares at a premium when a tender offer is defeated by defensive tactics, and the lost premium represents the shareholder's entitlement in the company under optimal management.[106] Finally, Easterbrook and Fischel conclude that target management can serve the best interests of shareholders by taking a position of passivity in the face of a tender offer.[107] "Management should be able to take action that has the effect of preserving its control only if there is an overriding or compelling corporate purpose to justify the conduct at that time."[108]

---

[103] *Id*, at 14.

[104] Id, at 28.

[105] Easterbrook & Fischel I, at 1174.

[106] *Id*, at 1174-75.

[107] Id, at 1201-04.

[108] Fischel, *supra* note 90, at 43.

3. Gilson: The Structural Theory

Gilson developed his theory, known as the "structural approach,"[109] through an analysis of the structure of corporation and the theory of the firm.[110] He begins by examining principles derived from the separation of ownership and control. The separation of ownership and control has made the allocation of resources more efficient. The advantages of centralised, specialised management, however, are not without cost.. "Management, acting as agents of the shareholders, can be expected, if otherwise unconstrained, to maximize their own welfare rather than the shareholders'."[111] The divergence of interests between shareholders and management, together with the expectations that the management tends to pursue its own welfare at the expense of shareholders lead to the generation of agency costs which are naturally derived from the separation of ownership of control in modern public companies.[112]

Market forces, however, can be expected to decrease somewhat the divergence between management and shareholder interests.[113] First of all, the market for product will

---

[109] Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819 (1981).

[110] *Id*, at 833.

[111] *Id*, at 836. The costs resulting from delegating the monitoring responsibility to professional management have been more precisely developed by Jensen and Meckling. *See* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

[112] Jensen & Meckling, *id*, at 327.

[113] Gilson, *supra* note 109, at 836.

penalise a company with inefficient management, because company's failure to meet ever-changing market demand due to management inefficiency in product development, marketing and distribution, will result in a loss of management jobs. Therefore, managers have an incentive to promote corporate performance in the product market.[114]

The second market constraint is the market for managerial talent. "The corporation's performance is commonly treated as a measure of a manager's skills, and hence is a central determinant of the future value of the manager's service."[115] Thus, managers have the incentive to improve their performance since their future marketability depends on their contribution to corporate performance.[116]

The third market constraint is the capital market. Because managerial inefficiency will be reflected by the stock market with a lowered stock price, which creates opportunity for acquirers to step in and replace inefficient management.[117] Thus, this is a motivating factor for managers to improve their performance.

The product, employment and capital markets, when combined with the judicially enforced fiduciary duty of directors, work efficiently to monitor and minimise managerial inefficiency, and "one would not expect a different part of that structure to provide

---

[114] *Id*, at 837.

[115] *Id*, at 838.

[116] *Id*.

[117] *Id*. *See* also the "Disciplinary Hypothesis", supra note 40 - 42 and the accompanying text.

redundant controls."[118] However, these market constraints are not as effective in monitoring and minimising managerial self-dealing.[119] Gilson finds that the market for corporate control provides an mechanism to fill this gap:[120]

> The theory of a corporate control market posits that a decrease in corporate profits, whether because of inefficient management or because efficient but self-dealing management has diverted too much income to itself, causes the price of the corporation's stock to decline to a level consistent with the corporation's reduced profitability. This creates an opportunity for entrepreneurial profit. If shares representing control can be purchased at a price which, together with the associated transaction costs, is less than the shares' value following displacement of existing management, then everyone - other than the management to be displaced - benefits from the transaction. Selling shareholders receive more for their stock than its value under previous management; new management receives an entrepreneurial reward through the increased value of acquired shares; and society benefits form more efficiently used resources.[121]

Gilson reviewed four mechanisms for displacing incumbent management, namely a merger, a sale of substantially all of the corporation's assets, a proxy fight, and a tender offer.[122] He finds that under most corporation statutes, merger or sale of assets is impossible without incumbent management's co-operation.[123] A proxy fight is economically unattractive to potential challengers due to the cost and free rider problem.[124]

---

[118] *Id*, at 839-840.

[119] *Id.*

[120] *Id*, at 841-842.

[121] *Id*, at 842.

[122] *Id.*

[123] *Id*, at 843.

[124] *Id*. For a general discussion of "free rider" problem, see Clark, *Vote Buying and Corporate Law*, 29 Case W. Res. L. Rev. 776, 788 (1979)

Therefore, "The market for corporate control is the principal constraint on management self-dealing in important situations, and the tender offer is the only displacement mechanism which has the potential to effectuate that constraint."[125] Gilson posits that if management is allowed to use defensive tactics to obtain certain degree of control over tender offers similar to that over mergers and sales of assets, it means that the corporate structure in essence grants management effective monopoly power over corporate control.[126] Therefore, he concludes that defensive tactics are improper because they seriously compromise the efficacy of the mechanism by which the corporate structure constrains managerial discretion.[127]

Gilson set up the general principle that target management should be encouraged to communicate with their shareholders to provide the information necessary to decide whether to tender their shares.[128] Gilson also advocates that target management assume a "bargaining role" when confronted with a tender offer, to actively solicit offers from other potential acquirers to get the highest price for its shareholders.[129] Shareholder and management interests are in harmony when the corporation is auctioned because both groups seek to obtain the maximum offering price.[130]

---

[125] *Id*, at 844.

[126] *Id*, at 846.

[127] *Id*.

[128] *Id*, at 865-67.

[129] *Id*, at 969-75.

[130] *Id*, at 870.

Gilson formulates a rule of guidance to simplify his structural theory, which summarises the proper role of target management in the face of a hostile takeover:

> During the period commencing with the date on which target management has reason to believe that a tender offer may be made for part or all of a target company's equity securities, and ending at such time thereafter that the offeror shall have had a reasonable period in which to present the offer to target shareholders, no action shall be taken by the target company which could interfere with the success of the offer or result in the shareholders of the target company being denied the opportunity to tender their shares, except that the target company (1) may disclose to the public or its shareholders information bearing on the value or the attractiveness of the offer, and (2) may seek out alternative transactions which it believes may be more favourable to target shareholders.[131]

IV. Conclusion: An Eclectic Approach

A review of the foregoing theories and hypotheses seeking to explain takeovers and customise the role of target management in tender offers may only serve to substantiate the view of Roberta Romano that ". . . [w]e do not have a comprehensive theory of takeovers. Different theories do well at explaining various subsets of acquisitions, but no theory satisfactorily explains all."[132] Perhaps the ideal resolution of this problem lies in following principled eclecticism - selecting the best of each.

1. A Case Against Deregulation of Hostile Takeovers

---

[131] *Id*, at 878-79.

[132] Roberta Romano, *supra* note 9, at 120.

Most of the economic and legal literature regarding takeovers are centred around one theme: whether takeovers are socially beneficial or harmful.[133] They invariably assume that the hostile takeover is a homogeneous phenomenon that is either improving efficiency or inhibiting it, and should either be encouraged or chilled in the aggregate. This premise ignores the fact that takeover activity, as a corporate phenomenon, is rather heterogeneous, and may have varied and even offsetting effects. Some takeovers may optimise the allocation of economic resources and thus promote efficiency, some may cause misapplication of resources and thus decrease efficiency; and there may be others which are neutral in terms of economic efficiency, but involve substantial wealth transfers between the participating classes. Therefore, the critical question of public policy is not whether hostile takeovers should be encouraged or chilled in the aggregate, but how to best adjust the balance between efficient and inefficient transfers of control and encourage acquisitions deemed desirable and discourage those considered undesirable.

Apart from its heterogeneity, hostile takeovers share a common characteristic: a relatively drastic nature compared to other forms of corporate transactions. In Judge Friendly's metaphor,[134] the hostile takeover represents the corporate guillotine: "its sharp blade achieves reform through a traumatic amputation of one senior management staff and

---

[133] *See* Dale A. Oesterle, *The Policy Debate,* in *The Law of Mergers, Acquisitions, and Reorganisations*, 29 (American Casebook Series, 1990)

[134] Judge Friendly characterised the takeover bid as "the sharpest blade for the improvement of corporate management." See Friendly, *Make Haste Slowly*, in *Commentaries on Corporate Structure and Government* 525, 532 (1979)

the substitution of another."[135] Just like capital punishment which is a necessary evil to cure specific social diseases, the hostile takeover, when serving as a corporate disciplinary mechanism, must be regarded as the last resort, which is allowed to take place only when any milder prescription would be inadequate.

Whatever its alleged merits, the hostile takeover is a costly transaction, which may bring about considerable diseconomies if left unbridled. John C. Coffee believes that there are three general types of diseconomies that might result from a policy aiming at maximising the frequency of takeovers.[136] First, frequent takeovers will encourage empire-building activity, which may increase inefficient transfers of control.[137] Second, a high frequency of takeovers would have an adverse impact both on the labour market for executive services and on employee performance generally.[138] Finally, an increased frequency of hostile takeovers may induce a substantial shift in both bidder and target managerial behaviour in the direction of risk preference and in particular towards an increased degree of leverage in

[135] Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Columbia L. Rev. 1145, 1159 (1984).

[136] *Id*, at 1222-23.

[137] *Id*, at 1224-34. Coffee argues that a higher frequency of takeovers and a low takeover premiums enhance the likelihood of erroneous business decisions when "[a] bidder, acting on information relatively inferior to that possessed by the target's management, is enabled to obtain working control of a corporation and reverse existing policies. Put more simply, low takeover premiums invite the bidder to undertake a "crapshoot", despite its inferior knowledge of the nature of the gamble, while high take-over premiums, such as those a competitive auction market ensures, require the bidder to be more certain that its judgement is superior to that of the target's management." *Id*, at 1157.

[138] *Id*, at 1234-43. Coffee believes that "as the threat of a hostile takeover increases, logic suggests both that increased executive compensation will be necessary to compensate managers for their increased risk and that the mobility of executive talent will be reduced, as marginal firms find it more difficult to attract executives who are risk-averse about the prospect of dismissal in the aftermath of a takeover." *Id*, at 1223.

corporate financial structures.[139]

Additionally, the hostile takeover also has inherent sins, which are coercive in nature. There are two types of coercive activity that can be identified with the hostile takeover. The first is the two-tier bid.[140] A two-tier bid is a 100% share acquisition effected in two stages. The bidder initially makes a partial bid for sufficient shares to get control of the firm. After having obtained control, the bidder then forces out the remaining shareholders by a second step amalgamation or similar transaction. The second stage cashout price is lower than that offered shareholders on the first step takeover bid.[141] The second form of coercion is said to be a partial bid for less than all the shares of the corporation. After the conclusion of the bid, a partial bid creates a condition of illiquidity in the market for those shares remaining in the hands of shareholders by reducing the public float of shares available for trading. A partial bid thus creates a compulsion similar to a two-bier bid.[142] In addition, some scholars argue that given the fact that the offer price must

[139] *Id*, at 1243-50. Coffee posits that "on the target's side, the pervasive threat of a takeover may cause potential target management to take riskier gambles to preserve their independence. . . . On the bidders' side, because leveraged takeovers can be sued as a means by which shareholders of the acquirer transfer value from debt holders in their corporation to themselves, bidders will have an incentive under a low premium policy to execute higher risk takeovers. The cost of these wealth transfers may be a potentially undesirable increase in risk that will not be penalised by the stock market." *Id*, at 1223.

[140] The American courts have accepted the argument that two-tier offers are coercive. *See, e.g., Unocal v. Mesa Petroleum*, 493 A. 2d 946 (Del. Sup. Ct. 1985) at P. 956; *Moran v. Household International, Inc.*, 500 A. 2d 1346 (Del. Sup. Ct., 1985). at 1357.

[141] For a discussion of the coercive nature of a two tier tender offer *see e.g.* Finkelstein, *Antitakeover Protection Against Two Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 Sec. Reg. L. J. 291, 293 (1984).

[142] For a strong statement of this view, *see* Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv. L. Rev. 1693, 1717-35 (1985).

exceed the "back-end" second stage merger price,[143] an element of potential coercion lurks in all bids except those that promises the same price on a second step transaction as on the first.[144] Thus, all takeover bids are 'structurally' coercive, any-or-all, partial and two-tier offers differ only in the degree of coercion they present to shareholders.[145] Due to the coercive nature of takeover bids, target shareholders are unable to make a careful appraisal of the merits or demerits of an offer. The coercive characteristic of tender offers calls for regulation of takeover bids. Unless the takeover bid is exorcised of its coercive feature, "any uncoerced decision against acceptance of a tender offer can only be made at the board of directors level."[146]

Another argument for the regulation of takeovers is based on the belief that takeovers may contribute to an excessive, harmful focus in the short run by companies.[147] If managers know that their companies are vulnerable to hostile takeovers and they are likely to lose their job if a hostile takeover succeeds, they will try to manage their companies in a way so as to boost stock prices immediately and deter potential acquirers. To compound the problem, a significant portion of top management compensation is tied to

---

[143] *See* Bradley, Desai and Kim, *Synergistic Gains From Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. Fin. Econ.

[144] *See, e.g.,* Bebchuk, *supra* note 142, at 17-35.

[145] See Securities Exchange Commission, Office of the Chief Economist, *The Economics of Any-or-All, Partial, and Two-Tier Offers* (April 19, 1985), at pp. 12-13.

[146] Lipton, *supra* note 65, at 114.

[147] Coffee's proposition of three types of diseconomies associated with takeovers substantiates this view. *See supra* note 137-139 and accompanying text.

stock prices or short-term profits through options and similar devices. The Massachusetts Institute of Technology Commission on Industrial Productivity espoused the view that "the wave of hostile takeovers and leveraged buyouts encourages or enforces an excessive and dangerous overvaluation of short-term profitability."[148]

Proponents of takeovers argue that based on the "efficient capital market hypothesis (ECMH)," the stock market is supposed to fully value the long-term planning of firms as well as the current value maximisation activities, so there should not be a distinction between the long-term and short-term.[149] The ECMH is far from a widely accepted theory among economic and legal academia.[150] The "boom and bust" drama that has been repeatedly put in play in the stock market, which showes that market valuation is sometimes rather erratic and irrational, stretches the credibility of the theory. The faith of the courts and academia in the efficient market was shaken considerably by the October 1987 stock market crash, when the stock market should have predicted such a plummet if the ECMH held good. In acknowledging the distinction between managing for current value

---

[148] Dertouzos, Lester and Solow, *Made in America* (1989), p. 144. One of the three authors, Robert Solow, was the 1987 Nobel laureate in economics. The MITCIP included a host of other distinguished economists, engineers and scientists associated with MIT.

[149] *See, e.g.*, Jensen, *The Takeover Controversy: Analysis and Evidence*, IV Midland Corporate Finance Journal 6, 11 (1986).

[150] For example, Professor Martin Shubik at Yale University is not a true believer in efficient markets: "The lawyers may talk about a premium for control. But to a true believer of efficient markets, there cannot be a premium for control. If, in contradistinction to the adherents of the single, efficient market, we suggest that there are several more or less imperfect markets involving the market for a few shares, the market for control, the market for going-business assets, and the market for assets in liquidation, then we have a structure for interpreting what is going on in terms of arbitrage among these different markets." Shubik, *Corporate Control, Efficient Markets, and the Public Good*, in *Knights, Raiders & Targets: The Impact of the Hostile Takeover* (1988).

maximization and managing for long-term value creation, Judge Allen of the Court of Chancery, Delaware epitomised the judiciary's reserved recognition of ECMH:

> It may be that in a well-developed stock market, there is no discount for long-term profit maximising behaviour except that reflected in the discount for the time value of money. . . . Perhaps wise social policy and sound business decisions ought to be premised upon the assumptions that underlie that view. But just as the Constitution does not enshrine Mr. Herbert Spencer's social statics, neither does the common law of directors' duties elevate the theory of a single, efficient capital market to the dignity of a sacred text.
>
> On the level of legal doctrine, it is clear that under Delaware law, directors are under no obligation to act so as to maximize the immediate value of the corporation or its shares, . . . Delaware law does recognise that directors, when acting deliberately, in an informed way, and in the good faith pursuit of corporate interests, may follow a course designed to achieve long-term value even at the cost of immediate value maximization.[151]

By and large, the foregoing discussion suggests that arguments for the deregulation of takeovers are inappropriate. Due to its drastic nature, coerciveness, potential diseconomies and inclination to promote myopic management, the hostile takeover should be carefully regulated so that its coerciveness be exorcised and its adverse impact on national economy and social welfare be minimised, but meanwhile its wealth-creating and efficiency-promoting effects be preserved and maximised.

2. A Case for an Active Role of Target Management

The coercive nature of hostile takeovers and the myopic outlook of shareholders,

[151] *Paramount Communications, Inc. v. Time, Inc.*, 1989 Fed. Sec. L. Rep. 94, 514, at p. 528.

institutional as well as individual, justify an active role which target directors and management are supposed to play in the face of a hostile takeover. As expounded by Martin Lipton, they should consider all relevant factors concerning the takeover bid, especially the long-term interests of the company.[152] The myopic outlook of shareholders also substantiates Lipton's opinion that in the face of a takeover, shareholder referendum is not the right answer.[153]

The pathogeny of shareholder myopia lurks in the short-run outlook of investing. In as early as 1935, John Maynard Keynes voiced his concern during the Great Depression that "Investment based on genuine long-term expectation is so difficult today as to be scarcely practicable."[154] Keynes believes that the reason lies in the extremely liquid stock market. Liquidity allows the possibility of large short-run profits for individual investors, and because of the possibility of those profits, institutional investment managers come under great pressure to realise them by investing for the short run only. Since 1935 the situation has worsened. Markets have become much more liquid, and pressure for short-run results has intensified because of the enormous growth in institutional investment. The short-run performance of money managers is closely monitored and encouraged by their clients, and the fierce competition among institutional investors has only exacerbated the situation.[155]

---

[152] *See supra* note 67-71 and accompanying text.

[153] *See supra* note 79 and accompanying text.

[154] Keynes, *The General Theory of Employment, Interest and Money* (1936), P. 157.

[155] The MIT study concludes that "although some fund managers invest for the long term, most turn over their stock holdings rapidly in an effort to maximize the current value of their investment portfolio, since this is the main criterion against which their own performance is judged." *supra* note 148, at p. 63.

Individual shareholders also cannot be immune from the myopic outlook. In modern public corporations in which shareholding is largely dispersed, individual shareholders rationally hold a passive attitude toward the monitoring of management. Due to the "rational shareholder apathy", shareholders respond to takeover bids solely on the basis of their assessments of financial values, and usually these assessments turn out to be based upon very short-term considerations.[156] Shareholders should not be expected to exhibit qualities such as loyalty and commitment to the business they invest in or to the communities in which the business operates, as the highly liquid capital market provides little incentive to do so.

Another feature substantiating shareholders' myopia is the wide-spread speculative mentality of modern investors. Keynes enunciated the "castle-in-the-air" theory of investing lucidly in 1936.[157] He opined that professional investors prefer to devote their energies not to estimating intrinsic values, but rather to analysing how the crowd of investors is likely to behave in the future and how during periods of optimism they tend to build their hopes into castles in the air. The successful investor tries to beat the market by estimating what investment situations are most susceptible to public castle-building and then buying before the crowd.[158] Keynes noted that no one knows for sure what will influence future earnings

---

[156] Herzel & Sheppro, *supra* note 62, at 24.

[157] Keynes, *supra* note 149.

[158] *Id. See* also Burton G. Malkiel, *A Random Walk Down Wall Street*, 30-31 (1990)

prospects and dividend payments. As a result, Keynes said, most persons are "largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public."[159]

Numerous "boom and bust" events taking place throughout the history substantiate Keynes' theory. "Greed run amok has been an essential feature of every spectacular boom in history. In their frenzy for money, market participants throw over firm foundations of value for the dubious but thrilling assumption that they too can make a killing by building castles in the air."[160] Although dramatic events such as the "tulip-bulb craze" and the "South Sea bubble" could be dismissed as ancient history, the spectacular boom of the late 1920s and the subsequent crash in the stock market which triggered the most devastating depression in the history should not be a memory too remote to recollect. Even in the more recent era when institutions and other professional investors are supposed to know the market and can be trusted to act prudently rule over the market, similar mistakes are still repeated. "Throughout the past thirty years of institutional domination of the market, prices often gyrated more rapidly and by much greater amounts than could plausibly be explained by apparent changes in their anticipated intrinsic values."[161] For an example, in the "new issue craze" of 1980s, Diasonics, a promising new technology stock, was traded in the

---

[159] *Id.*

[160] Malkiel, *supra* note 158, at 34.

[161] *Id*, at 52. For a general review of speculative movements in history such as the tulip-bulb craze, south sea bubble etc., *see id* 35-52.

stock market with a value 10 times the company's total sales for the previous year and 100 times the previous year's earnings. Only a year later, Diasonics' stock plummeted from the peak of $27.50 to $1.87, down 93%.[162]

Keynes was not the only one disturbed by the rational apathy, the myopic outlook and the speculative mentality of the shareholders of modern public corporation. In their book *The Modern Corporation and Private Property*, A. A. Berle and G. C. Means asserted that stockholders of the modern corporation think of themselves as passive investors, like bondholders, and not as owners. Most of them have no intention of participating in the affairs of corporate management.[163] Berle argued that shareholders' interests should not be the exclusive concern of management. His premise was that true ownership involves not only risk but active participation in management. A passive investor who abdicates management responsibility has no justifiable claim to the full fruits of the enterprise.[164]

The foregoing theories and empirical evidence all point to one conclusion. In addition to the divergence of interests between shareholders and management caused by the separation of ownership and control in modern public companies, the existence of a liquid capital market conducive to short-run profits also generate another divergence of interests

[162] *Id*, at 75.

[163] A.A. Berle & G.C. Means, *The Modern Corporation and Private Property* (New York: Harcourt, Brace, 1932).

[164] Berle, *The 20th Century Capitalist Revolution* 180 (1954).

between shareholders who are preoccupied with the short-run profit, and the company which at times must pursue long-term goals at the expense of the short-term profits.[165]

It is beyond the scope of this thesis to discuss whether shareholders should be the exclusive beneficiaries of corporate fiduciary duties. The foregoing survey of opinions at least serves to substantiate the position that in the context of a hostile takeover bid, it is inappropriate for the management to abdicate their decision-making to a referendum of shareholders who frequently can be characterised as apathetic, myopic and speculation-prone, and whose rationality may be easily over-ridden by the frenzy for making a quick profit.

Easterbrook and Fischel's highly glorified account of tender offers can hardly be accepted as a touchstone for public policy. They overestimate the disciplinary function of tender offers[166] and underestimate or even disregard the negative effects of tender offers. In addition, the weight of their theory naturally begins to evaporate when its foundation, the Efficient Capital Market Hypothesis, is increasingly called into question.

The most valuable merit of Gilson's structural theory is his auction theory, which serendipitously provides the key to refine the hostile takeover. His theory's major weakness,

[165] *See, e.g.,* Judge Allen's statement in *Time*, *supra* note 151.

[166] See, e.g., Coffee, *supra* note 135, at 1153 ("the discipline generated by the market for corporate control is sufficiently limited that it can serve only as a remedy of last resort for massive managerial failures and not as the principal enforcer of corporate accountability.")

however, lies in its reliance on the decision of shareholders. As the foregoing discussion reveals, unless shareholders' myopia and irrationality are completely cured, it remains highly questionable whether shareholders could live up to the task of determining the fate of a company.

The foregoing discussion necessarily leads to the conclusion that Lipton's pro-management theory deserves more credit. Although the divergence of interests of transient shareholders and the company justifies an active role for management to play, as Gilson points out, the divergence of interests between shareholders and managers also generates the possibility that managers maximize their own interests at the expense of shareholders.[167] In the context of a hostile takeover when target management is confronted with the threat of displacement, this conflict of interests is aggrandised. Before target management is allowed to play the active role, a mechanism must be erected to insure that their decision is made in the best interest of the company and shareholders.

3. A Principled Eclectic Approach Toward Hostile Takeovers

A principle takes shape after a survey of the explanatory hypotheses discussed in Section II. Takeovers may be explained as either wealth-creating or wealth-transferring. The Disciplinary Hypothesis, the Synergy Hypothesis and the Free Cash Flow Hypothesis

[167] Gilson, *supra* note 109, at 834-36.

all postulate that takeovers create wealth in the form of higher stock prices and bidder and target shareholders share the gains. The Empire-building Hypothesis, the Exploitation Hypothesis and Hubris Hypothesis see takeovers as a mechanism which frequently transfers wealth between different groups of shareholders and other constituencies. The Empire-building Hypothesis and Hubris Hypothesis see a transfer of wealth from bidder shareholders to target shareholders. Exploitation Hypothesis posits a transfer of wealth from target shareholders to bidder shareholders, or target shareholders profit at the expense of other tax-payers, bondholders, employees and general consumers.

From a public policy perspective, wealth creation should be encouraged, but wealth transfer discouraged. Highly valuable human resources are held up in the takeover business. If takeovers do not promote efficiency or create wealth, the tremendous amount of time and effort expended by top executives, investment bankers, commercial bankers and lawyers is squandered. Society would be much better served if these talented, ambitious people were producing better goods or other services. In view of the cost and social impact caused by takeovers, mere wealth transfers between bidder and target shareholders in either direction, or between shareholders and other stakeholders, represent uncompensated losses to society as a whole and create a "foreseeable class of losers,"[168] and therefore can be considered generally inefficient. As a result, the empire building, exploitation and hubris motives of the takeover must be chilled.

---

[168] *Id*, at 1174.

The auction theory expounded by Gilson may serve to fulfil this goal.[169] Under the auction theory, the target directors are supposed to assume the bargaining role and actively solicit offers from others bidders to get the highest price for the shareholders. The mechanism of an auction market for corporate control works against takeovers motivated by empire building, exploitation and hubris, because the high price bid up by auction decreases the gains anticipated by these bidders and chills their enthusiasm - after all, there have already been enough lessons of Winner's Curse in the market. On the other hand, more efficient bidders who in theory are willing to pay the highest prices, will not be discouraged by bid-up prices and ultimately triumph over inefficient empire builders.[170] Thus, auctions seem likely to minimise inefficient wealth transfers and refine the hostile takeover.

Again, a blanket rule advocating auctions runs the risk of over-generalisation. Cramton and Schwartz suggest that there are two prototypes of auction: common value and independent values. In a common value auction, the target's value is same to all bidders, whereas in an independent values auction, each bidder values the object differently.[171] Different explanations for takeovers mesh with different auction types. When a takeover bid is made under the Disciplinary Hypothesis and Synergy Hypothesis, the auction setting is one of independent values because each bidder views the value of the target differently, as

[169] *See* Gilson's "structural theory", *supra* note 109-131 and accompanying text.

[170] *See* Coffee, *supra* note 135, at 1232-34.

[171] *See* Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J. L. Econ. & Org. 27 (1991).

different bidders can achieve different synergistic gains or run the target's business with different levels of efficiency. When a takeover bid is motivated by empire building and exploitation, the auction setting is more like one of common value, because each bidder will be able to obtain the same value from the target.[172]

According to Cramton and Schwartz, common value auction should be discouraged.[173] Assuming bidding costs are fixed, as the number of bidders increases, a bidder's possibility of wining decreases. To achieve the anticipated gain, the bidder must reduce its bid. Additionally, winner's curse may be another deterrent for bidders to adjust their bid price downward. Therefore, a target company should be better off not to hold an auction and negotiate with one bidder in the case of a common value situation. On the other hand, an independent value auction is desirable and should be encouraged in that it really achieves the goal of maximization of the target shareholders' wealth.[174] As there are far more common value auctions than independent values auctions in the market for corporate control, Cramton and Schwartz propose a new regulatory approach: an auction ban.[175]

Cramton and Schwartz's theory may not deserve the full credit, as evidence shows that most of the merger and acquisition activity in 1980s and 1990s are strategic

---

[172] *Id*, at 47-49.

[173] *Id*, at 36.

[174] *Id*.

[175] *Id*, at 45.

transactions seeking synergy gains.[176] However, their theory does demonstrate a need for a discretionary policy to distinguish between common value and independent values auctions. The proposal that shareholders should decide whether a takeover auction is necessary[177] is not the right answer either, since shareholders are not in a better position than the management to decide the nature of the incoming takeover bid - a business judgement as complex as any others, and they are also inflicted with such chronicle diseases as apathy, myopia and speculative mentality. The responsibility seems to fall inevitably on the shoulders of the target directors, though their decisions should live up to the fiduciary standard and be subject to strict judicial scrutiny.

In sum, the heterogeneity of takeovers calls for a principled eclectic policy. A takeover auction may be an effective mechanism to minimise the inefficient wealth-transferring takeovers. In view of the diversity of the takeover auction itself, a discretionary policy is necessary and the target board of directors should bear the responsibility of deciding if an auction is in the best interest of the company and shareholders, provided that their decision-making be subject to high fiduciary standard and strict judicial scrutiny.

---

[176] *1994 M &A Activity Booming*! Corp. Growth Rep., Oct. 17, 1994, at 7456, 7506.

[177] *See* Romano, *supra* note 9, at 165.

Chapter Two

Corporate Governance in the Context of Hostile Takeovers

The role of corporate governance is to ensure that directors are subject to their duties, obligations and responsibilities to act in the best interests of their company, to give direction and to remain accountable to their shareholders and other beneficiaries.[178] The hostile takeover bid serves as a crucible for the soundness of current corporate governance structures.

As discussed in Chapter One, the coerciveness of the hostile takeover and the various abusive practices associated with it, as well as the myopic outlook of shareholders, warrant that target directors and management, in the face of an unsolicited tender offer, be allowed to take an active role in order to protect the interests of the company as well as its shareholders. However, the separation of ownership and control generates a divergence of interests between management and shareholders. The threat of displacement posed by a hostile takeover bid exacerbates this conflict and gives directors and managers extra incentive to pursue their own interests at the expense of shareholders. Therefore, one of the tasks facing current corporate governance structure is how to insure that directors and managers would live up to their fiduciary standards and not abuse their discretion.

---

[178] Saleem Sheikh and William Rees, *Introduction* to *Corporate Governance & Corporate Control* (London: Cavendish, 1995).

However, a survey of the various theories of takeovers reveals that the takeover bid is heterogeneous, which means that it may in some occasions create wealth and promote efficiency, but in others only cause inefficient wealth transfers. How to best adjust the balance between efficient and inefficient transfers of control and encourage acquisitions deemed desirable and discourage those undesirable, is another formidable task facing corporate governance.

This chapter will survey the different approaches the American and Canadian courts employ to tackle the issue. Then, an assessment will be presented according to the eclectic principle of takeover regulation established in Chapter one.

I. Director's Fiduciary Duties

The fundamental structure of corporate governance divides management powers between shareholders, officers and a board of directors.[179] Shareholders own the company.[180] However, their power to participate in corporate management and control is limited to decisions affecting the corporation's "ultimate destiny."[181] These types of

[179] *Norline Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 258 (2d Cir. 1984). *See also* generally H. Henn & J. Alexander, *Laws of Corporations and Other Business Enterprises* (West Publishing Co., 1983).

[180] H. Henn & J. Alexander, *ibid.*

[181] *Norlin*, *supra* note 179, at 258 ("[D]ecisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.").

decisions include the power to (1) approve or remove directors,[182] (2) make amendments to articles of incorporation or corporate bylaws, and (3) approve or disapprove fundamental corporate changes not in the regular course of business.[183]

Directors, who are normally elected by shareholders at the general meeting, are supposed to manage the business and affairs of a corporation[184], and owe fiduciary duties to the corporation they serve. The similar provisions can be seen in most company acts of the U.S. and Canada:

> A director shall discharge his duties as a director (1) act honestly and in good faith with a view to the best interests of the corporation and (2) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. [185]

The duties of directors can be discussed under two heads: (1) fiduciary duties of loyalty and good faith, and (2) duties of care and skill.[186] In the simplest terms, the duty of care and skill requires that directors exercise the care that an ordinarily prudent person would exercise under similar circumstances; the duty of loyalty prohibits faithlessness and self-dealing.[187]

---

[182] Buckley, Gillen and Yalden, *Corporations -Principles and Policies* (3rd ed., 1995).

[183] *See e.g., Re Vanalta Resources Ltd.* B.C.S.C. Unreported Decision No. A760559/76 Dec. 17, 1976; *85956 Holdings Ltd. v. Fayerman Brothers Ltd.* 38 Sask. R. 64 (Q.B.).

[184] Section 102, Canada Business Corporation Act(CBCA).

[185] *See, e.g.*, Section 122, CBCA; § 8.30(a), Model Business Corporation Act.

[186] Gower, *Principles of modern Company Law* (5th ed.), P.551.

[187] *See, e.g., Norline Corp. v. Rooney, Pace Inc.*, 744 F. 2d 255, 264(2d Cir. 1984); Model Business Corp. Act §8.30.

Some corollary issues regarding directors' duties necessarily fall within the scope of this chapter. The first one is "do directors directly owe fiduciary duties to shareholders?"

The traditional common law view is that the above-mentioned duties are owed to the company and to the company alone. In general, the directors owe no duties to the individual members.[188] However, it does not mean that directors can never stand in a fiduciary relationship to the shareholders. For example, in the face of a hostile takeover bid, directors may owe fiduciary duties to shareholders if they are authorised by the latter to negotiate with the acquirer on their behalf.[189]

In the United States, it has long been the view of courts that directors owe fiduciary duties to all shareholders, and must act fairly and in good faith towards them and for their common benefit.[190] In the context of board's exercise of corporate power to forestall a takeover bid, directors have a fiduciary duty to act in the best interests of the corporation's stockholders.[191] There has also been recent development in Commonwealth corporate laws. In Canada, the Saskatchewan Court of Appeal ruled in the landmark case of *Producers Pipelines* that "[a]lthough the duties of the directors are stated to be to the corporation, the

---

[188] *Percival v. Wright* (1902) 2 Ch. 421.

[189] *Briess v. Woolley* (1954) A.C. 333, H.L.

[190] *Jones v. HF Ahmanson & Co* (1969) 460 P 2d 464; *Remillard Brick Co. v. Remillard-Dandini Co.* (1962) 241 P 2d 66.

[191] *Guth v. Loft, Inc.*, Del.Supr., 5 A.2d 503, (1939).

authorities say that the corporation cannot be considered as an entity separate from its shareholders. The directors must act in the best interests of the corporation and all of its shareholders."[192]

The second relevant issue is "do directors owe fiduciary duties to corporate constituencies other than shareholders?"

Several states in the United States have added provisions to their statutes which allow corporations to take the interests of non-shareholder interests into account. For example, the Illinois statute provides as follows:

> **Directors and Officers - Considering Best Interests of Corporation**. In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best interests of the corporation, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices of other establishments of the corporation are located and all other pertinent factors.[193]

Corporate constituency statutes in the United States generally do not make it mandatory that directors of the corporation consider the various interests of non-shareholder constituents. Instead, like the Illinois provision cited above, they typically provide that the directors "may" take the interests of non-shareholder constituents into account. Non-shareholder constituents also do not have a legal right of action against the directors of a corporation for failing to consider their interests. These constraints on

[192] *347883 Alberta Ltd. v. Producers Pipelines Inc.* (1991) 4 W.W.R. 577, at p. 588.

[193] Illinois Ann. Stat. ch.32, para. 8.85.

constituency statutes have led commentators to suggest that these statutes are created not to protect non-shareholder interest groups, but rather to add an extra weapon in the arsenal of corporate managers to defend themselves against the charges of a breach of fiduciary duties when they engage in defensive tactics against hostile takeover bids.[194]

In Canada, directors are generally said to owe their duties to the company. However, there are some dicta in support of a broader approach to the fiduciary duties of directors. In *Teck Corp. v. Millar*, a case involving management's defensive tactics to a take-over bid, Berger J. stated:

> If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders.
>
> I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees: *Parke v. Daily News Ltd.* ... But if they observe a decent respect for other interests lying beyond those of the company's shareholders in a strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.[195]

In spite of the general legal position, many directors appear to view themselves as having broader fiduciary duties. According to the Conference Board's 1977 Report,

---

[194] *See, e.g.*, ABA Committee on Corporate Law, *Other Constituencies Statutes: Potential For Confusion,* 45 Bus. Lawyer 2253 (1990).

[195] *Teck Corp.* v. *Millar* (1972), 33 D.L.R. (3d) 228 (B.C.) at 314.

directors of Canadian public corporations believe that "they ought not to represent ... shareholders at the expense of employees, customers, local communities and the company at large," instead, "the board should regard the balancing of these interests and the provision of wider and longer term perspectives as integral parts of their tasks."[196] However, like the United States, there is no statutory provisions in Canada mandating that directors of the corporation take the various non-shareholder interests into account.

II. Business judgement rule

1. Origins, Rationale and Premises

The development of the business judgement rule as a common law principle of American jurisprudence can be traced back at least 160 years to *Percy v. Millaudon*[197], an 1829 decision by the Louisiana Supreme Court. In the decision the Court recognised that "...the test of responsibility, therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the directors is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it."[198] As the Rhode Island Supreme Court put it in 1853: "We think a board of directors acting in good faith and with reasonable care and diligence, who nevertheless fell

---

[196] The Conference Board, *Canadian directorship Practices: A Critical Self-Examination* ix, 94-109 (1977).

[197] 8 Mart. (n.s.) 68 (La. 1829).

[198] *Id.* at 77-78.

into a mistake, either as to law or fact, are not liable for the consequences of such mistake."[199]

The business judgement rule was initially recognised nearly a century ago by the Supreme Court of the United States in *Briggs v. Spaulding.*[200] The rationale underlying the rule is three-fold. First, the business judgement rule recognises human fallibility and encourages competent individuals to assume directorships.[201] Courts appreciate the part-time nature of outside directorships[202] and the necessity of relying on corporate officers and outside professionals in making efficient and effective board decisions.[203]

Second, the rule recognises that business decisions frequently entail risk, and thus provides directors with the broad discretion they need to formulate dynamic and effective company policy without a fear of judicial second-guessing.[204] As anticipated risk is often commensurate with anticipated return on investment, shareholders generally accept the fact

[199] *Hodges* v. *New England Screw Co.*, 3 R.I. 9, 18 (1853).

[200] 141 U.S. 132 (1891). In *Briggs*, the Court ruled to protect directors from personal liability because the directors acted without bad faith or corrupt motive.

[201] *See, e.g., Briggs v. Spaulding*, 141 U.S. 132,149 (1891); *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250,256 (7th Cir. 1986); *Wess v. Temporary Investment Fund, Inc.*, 692 F.2d 928, 941 (3d Cir. 1982); *Percy v. Millaudon*, 8 Mart. (n.s.)68,78 (La. 1829).

[202] D. Block, N. Barton & S. Radin, *The Business Judgement Rule: Fiduciary Duties of Corporate Directors and Officers*, 36 (1988) (citing a study which concluded that outside directors spend an average of two hours per week conducting their directorial duties).

[203] Manning, *The Business judgement rule and the Directors' Duty of Attention: Time for Reality*, 39 Bus. Law. 1477, 1492-98(1984).

[204] *See, e.g., Cramer v. General Telephone & Electronics Corp.*, 582 f. 2d 259, 274 (3d Cir. 1978).

that directors will assume certain risks on their behalf.[205] The rule "recognises that shareholders to a very real degree voluntarily undertake the risk of bad business judgement; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgement by corporate officers."[206] Without the protection of the business judgement rule, competent individuals might decline to serve as directors due to risk-aversion,[207] and those individuals who do agree to serve as directors might be overly cautious.[208] Because overly cautious decision-making diminishes the likelihood of high returns, shareholders accept and expect risk-taking by company directors.[209]

Third, the rule keeps courts from being entangled in complex corporate decision-making, a task which they are admittedly ill-equipped to handle.[210] Consequently, courts are reluctant to impose their hindsight on decisions made by well-informed business professionals.[211] As the Second Circuit of the U.S. observed in *Joy v. North*[212]:

> [A]fter-the-fact litigation is a most imperfect device to evaluate corporate

[205] *Joy v. North*, 692 F.2d 880, 885-86(2d Cir. 1982) ("It is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions...").

[206] *Frances T. v. Village Green Owners Association*, 42 Cal. 3d 490, 507 n.14, 229 Cal. Rptr. 456, 465 n.14, 723 P.2d 573,582 n.14 (1986), quoting 18B Am. Jur. 2d *Corporations* § 170, at 557 (1985).

[207] Arsht, *The Business Judgement Rule Revisited*, 8 Hofstra L. Rev. 93, 97 (1979) ("The business judgement rule grew principally from the judicial concern that persons of reason, intellect, and integrity would not otherwise serve as directors....").

[208] *Joy v. North*, *supra* note 205, at 886.

[209] *Id.* ("A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.").

[210] *See, e.g., GAF Corp. v. Union Carbide Corp.*, 624 F. Supp. 1016, 1918 (S.D.N.Y. 1985).

[211] *See Solash v. Telex Corp.*, Fed. Sec. L. Rep. (CCH) 93,608, at 97,727 (Del. Ch. 1988).

[212] *Id.* note 27.

> business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less then perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge. [213]

The courts have frequently described the business judgement rule as a presumption of regularity. The Delaware Supreme Court has reaffirmed this long-standing presumption in a string of recent cases. First in *Aronson v. Lewis*,[214] and subsequently in *Smith v. Van Gorkom*,[215] *Unocal Corp. v. Mesa Petroleum Co.*,[216] *Moran v. Household International. Inc.*,[217] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[218] *Polk v. Good*,[219] *Ivanhoe Partners v. Newmont Mining Corp.*,[220] *Grobow v. Perot*,[221] *Mill Acquisition Co. v. Macmillan, Inc.*,[222] *Paramount Communications, Inc. v. Time Inc.*,[223] and *Paramount*

---

[213] *Id.* at 886. The Court noted that "[B]ecause businessmen and women are correctly perceived as possessing skills, information and judgement not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith."

[214] 473 A.2d 805 (Del. 1984).

[215] 488 A.2d 858 (Del. 1985).

[216] 493 A.2d 946 (Del. 1985).

[217] 500 A.2d 1346 (Del. 1985).

[218] 506 A.2d 173 (Del. 1986).

[219] 507 A.2d 531 (Del. 1986).

[220] 535 A.2d 1334 (Del. 1987).

[221] 539 A.2d 180 (Del. 1988).

[222] 559 A.2d 1261 (Del. 1988).

[223] 571 A.2d 1140 (Del. 1989).

Communications Inc. v. QVC Network Inc..[224] Many of these cases concerned the duties of a board of directors in the face of a hostile takeover bid. The Court has emphasised that the rule "is a presumption that in making a business decision the directors of a corporation [have] acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[225] The rule has likewise been stated in terms of a presumption by courts applying the law of other states.[226]

2. Elements of the Business Judgement Rule

The business judgement rule shields corporate decision-makers and their decisions from judicial second-guessing when the five elements of the rule are satisfied.[227] These elements embody specific requirements of directors' fiduciary obligations.

First, directors must affirmatively act or make a conscious decision not to act.[228]

---

[224] 637 A.2d 34 (Del. 1994).

[225] *Aronson*, 437 A.2d at 812, *See also Sinclair Oil Corp. v. Levien*, 280 A. 2d 717, 720 (Del. 1971): "[A] board of directors enjoys a presumption of sound business judgement, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgement."

[226] See, e.g., *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d (2d Cir. 1980)(New York); *Plaza Securities co. v. Fruehauf Corp.*, 643 F. Supp. (E. D. Mich.)(Michigan); *Keyser v. Commonwealth National Financial Corp.* 675 F. Supp. 238, 257 n.22 & 258 (M. D. Pa. 1987)(Pennsylvania), etc.

[227] D. Block, N. Barton & S. Radin, *The Business Judgement Rule: Fiduciary Duties of Corporate Directors and Officers* 1 (1988).

[228] *Id.* (directorial action is protected, whereas inaction is not protected "unless it is the result of a conscious decision not to act"). *See also Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984).

No judicial deference can be paid to director inaction resulting from ignorance[229] or abdication of duties.[230] This requirement derives from the principle that directors, by virtue of their expertise, are better suited than judges to make business decisions.[231] Directors' superior expertise in business affairs is the ground for judicial deference, and if directors fail to utilise their superior expertise in making conscious decisions, the ground for judicial deference disappears.

Second, directors must be free from any conflict of interests in exercising their business judgement.[232] This requirement of disinterestedness embodies the directors' general duty of loyalty.[233] The judicial deference under business judgement rule is inappropriate when any conflict of interest affects the director's ability to exercise his or her business judgement.[234]

Third, directors must satisfy their duty of care, which requires that directors make a reasonable effort to consider all relevant information.[235] Directors' efforts to obtain and consider relevant information have come under increasing judicial scrutiny in cases

---

[229] *Rabin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 973 (Del. 1986).

[230] *Aronson*, 473 A.2d at 813 & n.7.

[231] *Solash*, note 211.

[232] Block, Barton & Radin, *Supra* Note 227.

[233] *Norlin, supra* note 187 (applying Delaware law).

[234] *See, e.g., Van Gorkom, supra* note 215 (business judgement rule protects only informed decisions).

[235] See *Smith v. Van Corkom, Supra* note 215 ("[A] director's duty to exercise an informed business judgement is in the nature of a duty of care, as distinguished from a duty of loyalty.") .

involving hostile takeover bids.[236]

Fourth, directors must act in good faith.[237] A director may also lose the protection of the business judgement rule if he or she acts without believing in good faith that his/her business judgement is in the best interests of the corporation. Good faith involves all aspects of honesty and integrity, and presupposes no personal financial interest or self-dealing.[238] The good faith requirement, like disinterestedness, is embodied within the directors' general duty of loyalty.

Finally, a director's business judgement will only be respected by the courts absent an abuse of discretion.[239] One example of abuse of discretion may be a conspicuous waste of corporate assets.[240] The courts' intent here is not to second-guess business decisions reasonably made, but to ferret out those decisions which are so egregious and preposterous that they constitute an abuse of discretion.

3. Business Judgement Rule Applied to the Corporate Control Contest.

---

[236] *See, e.g., Smith v. Van Gorkom*, 488 A. 2d 858 (1985) (introducing a constraint on rapid responses by target management to a takeover bid).

[237] D. Block, N. Barton & S. Radin, *supra* note 227, at 19.

[238] *Id.* at 19.

[239] D. Block, N. Barton & S. Radin, *supra* note 227, at 19-22. This element reflects the principle underlying the business judgement rule, which allows for errors of judgement but not for unconscionable and unreasonable acts.

[240] *See Growbow v. Perot*, 539 A.2d 180, 189-92 (Del. 1988) (repurchase of company's stock at premium over market from dissident shareholder was not "so egregious" as to eliminate presumption of business judgement protection).

The business judgement rule has been for over a century and a half the primary means by which the courts have reviewed directorial decisions concerning ordinary business transaction. In the 1980s, however, the business judgement rule has become the centre of rapid development and controversy in the corporate world as the courts struggled to tailor the rule to transactions involving corporate control.

3.1. Harmful Takeover Threat

To allow business judgement rule protection of its decisions, the board must satisfy each of these five elements. The business judgement rule may apply to protect director decisions to implement "defensive tactics" designed to thwart unwanted takeover attempts.[241] Ideally, the business judgement rule should only protect directors' decisions to defend against harmful takeovers.[242]

A proposed takeover may be harmful if it is either structurally coercive or substantively unfair to target company and its shareholders.[243]

---

[241] *Pogostin v. Rice*, 480 A.2d 619 (Del. 1984).

[242] Carol Seidler, *Assessing The Wisdom of The Business Judgement Rule in Corporate Control Contests: Is It Time to Make Shareholders' Interests Paramount?* 23 Loyola of Los Angeles L. Rev. (1990) at p.933.

[243] *City Capital Assocs. Ltd. Partnership v. Interco Inc.*, 551 A.2d 787, 797 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988). The Delaware Supreme Court has refused to limit threats directors are empowered to defend against to just structural and substantive threats. In *Paramount Communications, Inc. v. Time Inc., supra* note 223, the Court noted "that directors may consider, when evaluating the threat posed by a takeover bid, the inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on contingencies other than shareholders, the risk of nonconsummation and the quality of securities being offered in the exchange."

Structural coercion typically results from two-tier front-loaded bids.[244] Shareholders are "coerced because they must act independently to assess whether the tender offer will be successful."[245] Shareholders who think the bidder will be successful will tender their shares at the front end.[246] By tendering immediately, shareholders eliminate the risk of losing their chance to obtain the premium offered, but those shareholders also sacrifice the possibility of receiving a higher premium from a subsequent bidder.[247]

Substantive unfairness to shareholders can result from inadequate bids, which are not procedurally coercive.[248] Bid may be inadequate either because the price itself is too low[249] or because the quality of the consideration offered is unacceptable.[250] Such bids are arguably less valuable to tendering shareholders than all-cash offers. Moreover, shareholders who tender in a non-cash tender offer do not receive immediate value for their

---

[244] *City Capital, ibid. See* also *supra* note 140 and accompanying text.

[245] Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 Corp. L. Rev. 107, 111 (1980). This situation is sometimes called the "prisoner's dilemma" because like a prisoner, a shareholder can optimize his or her strategy only if he or she knows and can control what the other shareholders will do.

[246] Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger*? 28 J. L. & Econ. 151, 156 (1985).

[247] *Id.* An individual shareholder is assured some tender premium, which otherwise may be sacrificed if other shareholders tender their shares first.

[248] *City Capital, supra note* 243.

[249] *Id.* (threat might be posed if price is inadequate).

[250] *See, e.g., Unocal, supra* note 216 ("junk bonds" worth far less than face value of $54 consideration offered).

shares as do shareholders who tender in a cash bid. The value of the debt or equity consideration accepted in response to a non-cash offer depends on the future operation of the now highly leveraged surviving company, managed by the successful bidder. In addition, some scholars argue that given the fact that the offer price must exceed the "back-end" second stage merger price,[251] an element of potential coercion inheres in all bids except those that promise the same price on a second step transaction as on the first.[252] Thus, "all takeover bids are 'structurally' coercive; any-or-all, partial and two-tier offers differ only in the degree of coercion they present to shareholders."[253]

3.2. Justification of Defensive Action

Unsolicited offers consisting of either structural coercion or substantive unfairness may justify defensive action by corporate directors.[254] Directors of a corporation have an obligation to protect the corporation and its shareholders from harm,[255] and possess the power to defeat or effectively preclude an attempted takeover.[256]

---

[251] *See* Bradley, Desai and Kim, *Synergistic Gains From Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. Fin. Econ.

[252] *See, e.g.*, Bebchuk, *supra* note 142, at 17-35.

[253] See Securities Exchange Commission, Office of the Chief Economist, *The Economics of Any-or-All, Partial, and Two-Tier Offers* (April 19, 1985), at pp. 12-13.

[254] *See, e.g.*, *Unocal*, *supra* note 216 (quality inadequate); *Time*, *supra* note 223 (price inadequate).

[255] *Unocal*, *supra* note 216 ("[T]he board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm....").

[256] *See, e.g.*, *Time*, *supra* note 223.

In the first wave of takeover litigation, the courts held that board action in opposition to a takeover bid was protected by the business judgement rule.[257] Pursuant to this standard, a party challenging directorial action had to demonstrate fraud, bad faith, or gross overreaching.[258] The board would prevail whenever it could articulate a rational, unselfish business purpose for its action.[259] Thus, the business judgement rule was a formidable standard for any plaintiff to overcome.[260]

The chief alternative to the business judgement rule is the intrinsic fairness test. This standard applies whenever directors have a direct financial stake in action taken by the board.[261] Where the intrinsic fairness test applies, the directors must prove the substantive fairness of the transaction by an objective standard.[262] The U.S. courts rejected the intrinsic fairness test in the takeover defence context for several reasons. First, directors do not necessarily have a direct financial stake in the success or failure of a tender offer.[263] Second, the courts consider the board, not judiciary, the proper party to make business

[257] *See Panter v. Marshall Field & Co.*, 646 F.2d 271, 293-94 (7th Cir.); *Buffalo Forge Co. v. Ogden Corp.*, 555 f. Supp. 892, 904 (W.D.NY.).

[258] *See, e.g., Panter, ibid; Warshaw v. Calhoun*, 221 A. 2d 487, 492-93 (Del. 1966).

[259] *See Johnson v. Trueblood,* 629 F.wd 287, 292 (3rd Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del 1971).

[260] *See, e.g.*, Earnest L. Folk, *The Delaware General Corporation law* 75-81 (1972).

[261] *See* Robert c. Clark, *Corporate Law* 138, 166-167 (1986).

[262] *E.g.*, Del. Code. Ann. iti. 8, §144(a)(3) (1991); N.Y.Bus. Corp. Law §713 (b) (McKinney 1986); Norwood P. Beveridge , Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction,* 41 DePaul L. Rev. 655 (1992).

[263] *See City Capital, supra note* 77.

decisions.[264] Finally, the courts have noted that application of the stringent intrinsic fairness test would invalidate most defensive tactics due to the omnipresent conflict of interests between directors and shareholders in the context of a hostile takeover.[265]

Nevertheless, target company directors face a conflict of interest when adopting defensive tactics that have the effect, if not the goal, of perpetuating the directors' control. The divergence of interests between shareholders and management, as pointed out by Gilson, is magnified in the context of a hostile takeover.[266] Directors who act to entrench themselves may be subject to personal liability, and their decisions may be enjoined.[267] The difficulty in determining when a proposed hostile takeover bid poses a genuine threat to target company and its shareholders, and in assessing the disinterestedness of directors' motivations, creates a unique setting in which to apply the business judgement rule:

> The business judgement rule has a long history and for decades has served a legitimate purpose in shielding directors from liability for their conduct in running the day-to-day business of a corporation for the benefit of its shareholders. However, the application of the rule may be inappropriate in the context of a contested takeover attempts or other situations involving a threatened change in control of a corporation. In such situations, corporate managers often have a clear interest in maintaining their jobs, and this interest may conflict with both the long-term interests of the company and the interests of shareholders in selling their shares to the highest bidder or in gaining new management for the corporation.[268]

[264] *See Unocal, supra* note 216 (noting that takeover defence "decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgement").

[265] *See, e.g., AC Acquisitions Corp. v. Anderson, Clayton & Co*, 519 A.2d 103, 111 (Del. Ch. 1986).

[266] *See* Gilson, *supra* note 109 and accompanying text.

[267] *See Revlon, supra* note 218 (directors' decision enjoined because its "principal benefit went to directors").

[268] H. R. Rep. No. 1028, 98th Cong., 2d Sess. 1, 15.

The business judgement rule, like the intrinsic fairness test, is usually outcome determinative.[269] The Delaware Supreme Court recognised that the traditional standard for judicial review of takeover defences was too lenient, and created an intermediate standard of review between the traditional business judgement rule and the intrinsic fairness rule in the landmark case of *Unocal Corp. v. Mesa Petroleum Co.*.[270]

III. Delaware Approach to the Business Judgement Rule

The Delaware courts have played an important role in constructing director's duties in corporate control contests. It has been argued that the Delaware approach is founded on the business judgement rule.[271] In a string of cases the Delaware Supreme Court has established a series of rules concerning the application of the business judgement rule to defensive tactics adopted by Delaware corporations.[272]

1. The *Unocal* Rule - Proportionality Test

---

[269] *See* Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review*?, 44 Bus. Law. 247, 247-48 (1989).

[270] *See Unocal, supra note* 39. *See also* Gilson & Kraaman, *ibid.* at 249-51 (noting that academic and political pressures likely contributed to the formulation in *Unocal* of the intermediate standard of review for defensive measures used by target companies in response to tender offers).

[271] Michael Jensen, *Takeover, Their Causes and Consequences* (1988), 2 J. Econ. Perspectives 21 at p.22.

[272] *See. e.g. Unocal, supra* note 216; *Moran, supra* note 217; *Revlon, supra* note 218; *Time, supra* note 223; *QVC, supra* note 224.

In *Unocal Corp. v. Mesa Petroleum Co.*,[273] Mesa Petroleum, an entity controlled by T. Boone Pickens,[274] owned thirteen percent of *Unocal* stock.[275] Mesa made a hostile tender offer[276] for approximately thirty-seven percent of Unocal's outstanding shares at a cash price of $54 per share.[277] Mesa planned to complete its two-tier "front-loaded"[278] cash offer with "junk bonds" purportedly worth $54 per share.[279]

Facing the hostile takeover bid, Unocal's thirteen board members, including eight outside directors,[280] consulted with two reputable investment bankers regarding the merits of Mesa's offer.[281] Based on the these consultations, Unocal's board unanimously passed a resolution to reject Mesa's "grossly inadequate" offer.[282] To defend against Mesa's takeover threat, Unocal made a competing discriminatory self-tender offer which consisted

[273] *Ibid.*

[274] T. Boone Pickens is a well-known corporate raider who is also chairman of United Shareholders Association, a shareholder advocacy group. *See* Saiwen, *Ruling by Sec May Threaten Parachute Plans*, Wall St. J., Jan. 18. 1990, at A3, col. 4.

[275] *Unocal*, 493 A.2d at 949.

[276] *Ibid.*

[277] *Ibid.*

[278] *See supra notes* 78-80 and accompanying text for a discussion of the coercive nature of two-tier bids.

[279] *Unocal*, 493 a.wd at 949.

[280] An outside director is one who is not also employed within the corporation as are, for example, the CEO or CFO. *See* generally Simpson, *The Emerging Role of the Special Committee - Ensuring Business Judgement Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 Bus. Law. 665 (1988) for a discussion of how outside directors enhance the procedural integrity of the corporate decision-making process.

[281] *Unocal*, 493 A.2d at 950.

[282] *Ibid*

of debt securities valued at $72 per share.[283] This offer was open to all Unocal shareholders, except Mesa.[284]

Mesa filed suit to enjoin its exclusion from Unocal's self-tender offer.[285] Unocal's directors argued that their decision was justified and resulted from their reasonable belief that the self-tender served a valid corporate purpose.[286] In upholding Unocal's action, the Supreme Court of Delaware accepted the board's conclusion that Mesa's bid was inadequate.[287] The Court was concerned, however, with the conflict of interests of directors in takeover contests, and cautioned that directors did "not have unbridled discretion to defeat any perceived threat by any Draconian means available."[288] In the words of the Court:

> When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgement. See also *Johnson v. Trueblood,* 629 F.2d 287, 292-293 (3d Cir. 1980). There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent spectre that a board may be acting

[283] *Id* at 951.

[284] *Id.* Subsequent to this case, the SEC enacted the "all-holders rule" which proscribes exclusionary offers. 17 C.F.R. §240.14d-10(a)(1987). The all-holders rule provides that a bidder's tender offer must be open to "all security holders of the class of securities subject to the tender offer." *Id. See also Polaroid Corp. v. Disney*, 862 F.2d 987, 991-95 (3rd Cir. 1988) for a discussion of the purpose of the all-holders rule and the SEC's enactment authority.

[285] *Unocal*, 493 A.2d at 951.

[286] *Id.* at 953. Unocal argued that its directors acted properly to protect the company and its shareholders from harm. *Id.*

[287] *Id.* at 956 (acknowledging coercive effect of offer by nationally known greenmailer).

[288] *Id.* at 955.

> primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protection of the business judgement rule may be conferred.[289]

The enhanced business judgement rule mentioned by the *Unocal* court involved a two-part "proportionality" test to govern whether the business judgement rule protects takeover defensive actions.[290] Directors must show:

(1) they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed. To satisfy this burden, directors must show that they exercised good faith and performed a reasonable investigation.[291] This demonstration, the Court stated, would be "materially enhanced" when outside directors support board decisions.[292]

(2) the defensive measure was "reasonable in relation to the threat posed."[293] Under this prong, directors may consider the nature and timing of the takeover offer, the quality of the securities offered and the predicted effect of a change of control on the corporate enterprise.[294] Directors may also consider the predicted effect of a takeover on non-shareholder constituencies including employees, creditors, customers "and perhaps even the

---

[289] *Id.* at 954.

[290] *Id.*

[291] *Id.* A reasonable investigation assumes that it commences on a timely basis. *See Smith v. Van Gorkom*, *supra* note 215 ("determination of whether a business judgement is an informed one turns on whether the directors have informed themselves 'prior to making a business decision'...").

[292] *Unocal*, *supra* note 216 at 955. Courts upholding defensive measures are increasingly focusing on whether the outside directors of the target company supported the board decision.

[293] *Id.*

[294] *Id.* The Delaware Supreme Court later clarified these considerations, noting that "[a] board may have regard for various [non-shareholder] constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders." *Revlon*, supra note 218, at 182 (Del. 1986].

community generally."[295]

In applying this test, the *Unocal* Court concluded that T. Boone Pickens, a nationally known "greenmailer," reasonably posed a threat to company policy.[296] The Court also concluded that Unocal's discriminatory self-tender offer was commensurate with the threat posed by Pickens.[297]

Unocal's two-pronged test was designed to provide a safeguard against abuses potentially arising from a conflict of interest.[298] After *Unocal,* courts were left to decide whether *Unocal* or some other standard of review should apply under different factual situations involving corporate control contests.

The Delaware Supreme Court reiterated the *Unocal* rule in the case *Moran v. Household International, Inc* one year later, in which the Court affirmed the Chancery Court's decision to uphold a shareholder rights plan.[299] In *Moran*, the plaintiff challenged the shareholder rights plan adopted by Household's board and argued that it would entrench

---

[295] *Unocal, id,* at 956. Cases subsequent to *Unocal* have expanded the scope of non-shareholder considerations. *See, e.g., Paramount Communications, Inc. v. Time Inc., supra note* 47 (considering target company's long-term strategic plan).

[296] *Unocal, id,* at 956.

[297] *Id.*

[298] *Id.* at 954-55.

[299] *Moran*, *supra* note 217, at 1083. Shareholder rights plan, or poison pill, is one of the defensive tactics available to the target management facing a hostile takeover. It is designed to cause a massive dilution of acquirer's share and make the takeover prohibitively expensive. For an elaboration of how a typical shareholder rights plan works, *see* Gordon Coleman, *Poison Pills in Canada*, 15 Can. Bus. L. J. 1 (1988).

management and deny the shareholders the opportunity to obtain a takeover premium.[300] Household's board argued that their decision to adopt the takeover defence is entitled to the judicial deference under the business judgement rule, especially because the Household board contained a majority of outside directors.[301]

The Delaware Supreme Court determined that the Household board's shareholder rights plan was meant to resist potential two-tiered and bust-up takeover offers, which constituted threats to the target company under the *Unocal* standard.[302] The Court concluded that the plan was a reasonable response under the *Unocal*'s second prong, and it was not lethal to all tender offers but only to two-tiered and bust-up offers.[303] In making its ruling, the Court suggested that more deference to a company's board may be appropriate when the board acts under no immediate threat, as opposed to when it acts in response to a specific threat.[304] The Court reasoned that when directors have more time to deliberate, their business expertise is more likely to be utilised.[305]

2. *Revlon*'s Auction Duties Test

---

[300] *Id.* at 1067.

[301] *Id.* at 1074-75.

[302] *Id.* at 1351-55.

[303] Id. at 1356-57.

[304] *Id.* at 1350.

[305] *Id.*

In cases subsequent to *Unocal* and *Moran*, the Delaware Supreme Court applied the *Unocal* standard in a more rigorous manner. As a result, corporate management and directors became alarmed and confused as to what standard they would be held to when they respond to hostile takeover bids.[306]

In *Revlon, Inc. v. MacAndrews & Forbes Holdings*,[307] the Delaware Court limited the *Unical* proportionality test to circumstances where a target company had undertaken measures to preserve the company's independence and avoid a change in management control.[308] The *Revlon* court announced that a stricter test would be applied when a change in control became inevitable.[309]

In this case, control of Revlon was pursued by two bidders - Pantry Pride, an unwanted tender offeror, and Forstmann, Little, a "white knight."[310] Revlon entered into an agreement with Forstmann committing itself to: (1) a lock-up option;[311] (2) a no-shop

[306] Melissa M. Kurp, *Corporate Takeover Defences After QVC: Can Target Boards Prevent Hostile tender Offers Without Breaching their Fiduciary Duties*? 26 Loyola U. Chicago L. J. 29, 38 (1994).

[307] 506 A.2d (Del 1986).

[308] *Id.* at 182.

[309] *Id.* (". . . [R]ecognition that the company was for sale .. significantly altered the board's responsibilities under the Unocal standards.").

[310] *Id.* at 184. A "white knight" is a 'friendly" bidder which acquires control of the target company in order to prevent a hostile bidder from taking control. *See Responsibilities of Corporate Officers & Directors Under Federal Securities Laws*, Fed. Sec. L. Rep. (CCH) No. 1291, at 78 (June 22, 1988).

[311] *Revlon,* 506 A.2d at 178. The option allowed Forstmann to purchase certain Revlon subsidiaries at a signficant discount from their fair market values in the event that another bidder purchased 40% of Revlon shares. *Id.*

provision;[312] and (3) a $25 million cancellation fee payable to Forstmann if another buyer were purchase more than 19.9% of Revlon stock.[313] Apart from committing to this agreement, Revlon favoured Forstmann by providing it with confidential financial data unavailable to Pantry Pride.[314] Revlon shareholders and Pantry Pride sought to enjoin the Revlon-Forstmann agreement and to require "a level playing field" in which Revlon could not favour one bidder over another.[315] Revlon directors asserted that their actions satisfied the *Unocal* proportionality test and were protected by the business judgement rule.[316]

The *Revlon* court disagreed with Revlon's directors, and rejected the proposed application of *Unocal*'s proportionality test.[317] The Court distinguished the circumstances of this case from those in *Unocal* and established the *Revlon* Rule:

> [T]he Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the Unocal standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequately bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

---

[312] *Id.* A no-shop provision precludes the target company from negotiating with any other suitors. *Id.* at 184.

[313] *Id.* at 178.

[314] *Id.* at 184.

[315] *Id.* at 175.

[316] *Id.* at 182.

[317] *Id.* ("there are fundamental limitations upon [Unocal's] prerogative" permitting non-shareholder considerations).

> [F]avoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the later's offer adversely affects the company shareholder interests, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfil their enhanced *Unocal* duties by playing favourites with the contending factions. Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity.[318]

One of the most difficult issues that a board of directors and its advisers may have to consider in the face of a hostile takeover bid is when, if ever, it will be open to the board to "just say no," refusing altogether to entertain the bid. This position is widely known as "Nancy Reagan Defence."[319] While many targets may respond to a hostile takeover attempt asserting that the bid is inadequate and under no circumstances the company is for sale, *Revlon* makes it clear: "the critical question is whether there comes a point past which a board is no longer entitled to adopt this position."[320]

3. *Paramount v. Time*

In *Paramount Communications, Inc. v. Time Inc.*,[321] the Delaware Supreme Court shifted back to the lenient application of *Unocal* rule which was exemplified in *Moran*.[322]

---

[318] *Id.* at 187-88

[319] *See*, Gorden Coleman, *Poison Pills In Canada*, 15 Ca. Bus. L. J. 1 (1988).

[320] *See*, Buckley, Gillon and Yalden, *Corporations, Principles and Policies*, 3rd ed. (1995) at 1116.

[321] 571 A.2d 1140 (Del. 1990).

[322] *See supra.*note 302-305 and accompanying text.

Time, which had long been looking for a merger partner to develop its entertainment business, eventually negotiated a deal with Warner Brothers.[323] As a result, Time's stock, which had been trading at about $107 the week the merger was singed, increased by more than twenty-five percent upon public disclosure of the deal. Thereafter, Paramount made a cash offer of $175 per share for 100 percent of Time's stock.[324] Time's board believed that the long-term value of Time, coupled with a control premium, would raise the intrinsic value of Time's stock to greater than $ 175 per share.[325] After consulting its investment bankers, Time's board rejected Paramount's offer.[326] In response to Paramount's offer, Time's board revised its merger plans with Warner. Rather than proceed with a merger plan which would have required shareholder approval, Time's board made a cash tender offer for fifty-one percent of Warner's stock.[327] This revised Warner transaction, financed with $12 billion in high-yield debt, was completed quickly and without a shareholder vote.[328] Paramount then increased its offer to $200 per share, which Time's board again rejected as inadequate.[329]

Time shareholders and Paramount sought an injunction to stop Time's acquisition of

---

[323] *Time*, *supra* note 223, at 1147.

[324] *Id.* at 1147.

[325] *Id.*

[326] *Id.* at 1147-48.

[327] *Id.* at 1148.

[328] *Time*, 571 A.2d at 1148.

[329] *Id.* at 1149.

Warner,[330] alleging that Time's directors failed to maximize shareholder wealth as required by *Revlon*.[331] The plaintiffs argued that the Delaware court should apply the *Revlon* analysis and not the more lenient *Uocal* standard of review.[332]

First, the plaintiffs argued that the original Time-Warner merger agreement was a decision by Time's board to transfer control to the Warner shareholders.[333] The plaintiffs reasoned that transferring sixty-two percent of voting ownership constituted a "change in control" triggering *Revlon* duties.[334] The Delaware Supreme Court, however, rejected this argument, noting that Time never intended to be sold.[335]

Second, the plaintiffs argued that *Revlon* should apply because the $30 billion market value of Time-Warner made any future takeover attempt impossible to succeed, thus preventing shareholders from ever obtaining a future control premium.[336] The Delaware Supreme Court, and the Chancery Court before it, however, were not convinced that the combined Time-Warner company would 'legally preclude or impede a later sale" and

---

[330] *Id.* at 1143.

[331] *Id.* at 1144-45.

[332] *Id.* at 1147.

[333] Id. at 1146.

[334] *Id.*

[335] *Id.* at 1146-47. The Court restricted application of *Revlon* to circumstances in which a board puts the company on the 'auction block" or when the company "abandons its long-term strategy and seeks an alternative transaction also involving the break-up of the company." *Id.*

[336] *Id.*

concluded that *Revlon* did not apply.[337]

Third, the plaintiffs alleged that even if *Unocal* applied, rather than *Revlon*, Paramount's "fully-negotiable" and fairly-priced bid did not reasonably pose a threat to Time or its shareholders.[338] Paramount's bid offered cash for all of Time's outstanding shares, and the bid was bank financed.[339] The plaintiffs reasoned that under these circumstances, the defensive tactics employed by Time board against Paramount's takeover bid which did not amount to any threat to target company and its shareholders, were totally unjustifiable.[340]

The Delaware Supreme Court strongly rejected any "misconceptions" that all-cash, all-shares offers are non-coercive,[341] and refused to confine application of the business judgement rule under *Unocal* to circumstances where an identifiable substantive or structural threat exists.[342] The Court did not examine in detail whether the Time board's action was reasonable in response to the Paramount threat.[343] Rather, it held that revising

---

337 *Id.* at 1148-49.

338 *Id.* at 1142.

339 *Id.* The plaintiffs cited authority for the proposition that when faced with an all-cash, all-shares offer, the only potential threat was to the price offered shareholders. *Id.* (Citing *City Capital*, 551 A.2d 787 (Del. Ch.).

340 *Time*, 571 A.2d at 1149.

341 *Id.*

342 *Id.* Before *Time*, courts allowing the business judgement rule to protect board decisions under *Unocal* required a reasonably perceived substantive or procedural threat to the company or its shareholders. *See, e.g., City Capital*, 551 A.2d at 797.

343 *Id*, at 1153.

the form of the transaction to preclude Paramount's bid was a reasonable response because it protected the Time-Warner transaction.[344] The Court concluded that that Time's directors had reasonably perceived threat to: (1) Time's strategic plan of global expansion to be effected through a combination with Warner;[345] and (2) "company policy and effectiveness."[346]

Recognising that Time's strategic plan to combine with Warner was a legally cognisable interest, and that Paramount's bid threatened that interest, the Court held that Time's decision to recast the Time-Warner agreement was reasonable.[347] The Court concluded that the Time directors had satisfied the requirements of *Unocal* and that the business judgement rule protected the directors from personal liability and protected their decision from judicial second-guessing.[348] Without expressly overruling or precisely redefining the requirements of *Unocal* and *Revlon*, the *Time* court significantly broadened director discretion in takeover situations.

4. *Paramount v. QVC*

---

[344] *Id*, at 1154-55.

[345] *Id.* at 1144.

[346] *Id.* at 1149.

[347] *Id.* at 1150.

[348] *Id.*

Although many legal issues remained unresolved from the takeover frenzy of the 1980s, one unresolved issue of particular significance was under what circumstances target directors can use takeover defences to resist a hostile takeover.[349] *Paramount Communications, Inc. v. QVC Network Inc.*[350] demonstrated an attempt by the Delaware Supreme Court to clarify these issues.

A. The Facts

The facts of *QVC* had a apparent resemblance with those of *Time*. The case concerned a takeover contest between QVC Network Inc. and Viacom Inc. in Paramount Communications Inc.. [351] Like Time, Paramount had looked long and hard for a suitable partner in the entertainment industry. After four years of negotiations, Viacom Network Inc. and Paramount entered into a friendly merger agreement (the "Merger Agreement") and a stock option agreement (the "Stock Option Agreement") worth $9.2 billion in aggregate.[352] According to the Merger Agreement, the Paramount board had to amend its poison pill rights plan to prevent it from triggering upon the closing of the Merger Agreement.[353] The Stock Option Agreement created a lock-up stock option, which

[349] *See,* Levin, *Raiding the Establishment: New Perspectives on Takeover Law*, 26 U. Rich. L. Rev. 5067, 511 (1992).

[350] 635 A.2d 1245 (Del. Ch. 1993).

[351] Id. at 1250-51.

[352] *Id.*

[353] *Id.*

permitted Viacom to purchase 19.9% of Paramount's common stock at $69.14 per share or to put the option to Paramount and receive 16.7% of the bidding price from a competitor.[354] In effect, the Merger Agreement and Stock Option Agreement would shift the voting control of Paramount from the public Paramount shareholders to Mr. Sumner Redstone ("Redstone"), who was the majority shareholder of Viacom.[355]

A week later, QVC made a takeover offer of approximately $9.5 billion to Paramount.[356] On the same day, Viacom and Paramount made a public announcement saying that Viacom's offer provided the best option for Paramount in the long run, but that the Paramount board would consider QVC's offer.[357]

On October 11, the Paramount board authorised negotiations with QVC.[358] But Paramount board delayed negotiations. Several days later, QVC filed suit and made a hostile tender offer for Paramount.[359] In response to QVC's bid, the Paramount board revised the Merger Agreement with Viacom. The Paramount board reviewed one-page summaries of the QVC and Viacom proposals and comparisons of the transactions.[360]

---

[354] *Id.*

[355] *Id.*

[356] *Id.* at 1252.

[357] *Id.*

[358] *Id.* at 1253.

[359] QVC offered to pay $80 per share in cash for 51 percent of Paramount's outstanding shares and a stock-for-stock exchange for the remaining shares (second-step merger). *Id.*

[360] *Id.*

Thereafter, the Paramount board approved the Viacom transaction.[361] Meanwhile, QVC and Viacom raised their bids, and the Paramount board continued to reject QVC's advances. Although QVC's bids were higher than Viacom's, the Paramount board determined that QVC's offers were highly contingent and not the best alternative in the long run.[362]

B. The Court Battles

QVC and certain Paramount shareholders took the QVC-Viacom battle to the Delaware courts and sought, *inter alia*: (1) to invalidate the lock-up and break-up fee provisions agreed upon by Paramount and Viacom; (2) to enjoin Viacom's tender offer until the lock-up and poison pill agreements were invalidated; and (3) to require Paramount's board to remove all other defences to QVC's hostile bid.[363]

On November 24, the Delaware Chancery court preliminarily enjoined the Paramount defendants from amending or modifying the Paramount stockholder rights plan, from taking any other action to facilitate the Viacom tender offer, or taking action to consummate the Merger Agreement or the Amended Merger Agreement, and then enjoined the Paramount defendants and Viacom from taking any action to exercise any part of the

---

[361] *Id.* at 1256.

[362] *Id.* at 1255-56

[363] *Id.* at 1246.

Stock Option Agreement.[364] The Chancery Court, however, refused to enjoin the termination fee.[365] Thereafter, the Paramount defendants and Viacom appealed to the Delaware Supreme Court.[366]

C. The Decision

On December 9, 1993, the Delaware Supreme Court affirmed the lower court's decision to enjoin certain takeover defences adopted by the Paramount board.[367] After reviewing the facts of the case, the Delaware Supreme Court stated that the enhanced business judgement rule is the appropriate standard in analysing the Paramount board's actions, because this was one of the "rare situations which mandates that a court take a more direct and active role in overseeing the decisions made and actions taken by directors."[368] The Court set forth a two-step analysis to apply enhanced scrutiny.[369] First, a court must determine whether the directors observed their duty of care by making an informed decision.[370] Second, a court must determine if the board's actions were reasonable.[371]

---

[364] *Id.*

[365] *Id.* at 1271.

[366] *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

[367] *Id.* The Delaware Supreme Court issued its final opinion on Feb. 4, 1994.

[368] *Id.* at 42.

[369] *Id.* at 43-46

[370] *Id.* at 44-45.

[371] *Id.*

The Court concluded that in the case at bar, two events required the Court to apply enhanced scrutiny: (1) the approval of a transaction resulting in a sale of control, and (2) the adoption of defensive measures in response to a threat to the corporate control.[372] Accordingly, because the Paramount-Viacom transaction triggered *Revlon*,[373] the Paramount board had the following obligations. First, the Paramount board needed to diligently and vigilantly examine the QVC offers and the Viacom-Paramount transactions.[374] Second, the Paramount board must have acted in good faith.[375] Third, the Paramount board had to obtain, and act with due care on, all material information reasonably available to determine which alternative provided the best value reasonably available to the shareholders.[376] Fourth, the Paramount board was required to negotiate actively and in good faith with both suitors to that end.[377] The Delaware Supreme Court concluded that the Paramount board failed in these duties because its process was unreasonable and its actions were not taken to maximize shareholder value.[378] Specifically, the Paramount

---

[372] *Id.* at 42.

[373] Because the Merger Agreement would have caused the majority ownership interest to change from the public Paramount shareholders to Redstone, the Delaware Supreme Court determined that *Revlon* was triggered at the time Paramount entered into the merger agreement with Viacom. *Id.* at 42, 48.

[374] *Id.* at 48.

[375] *Id.*

[376] *Id.* The Court emphasized that the Paramount board needed to critically evaluate the reasonableness of each defensive measure individual. *Id.*

[377] *Id.*

[378] *Id.* at 49.

board failed to "give sufficient attention to the potential consequences of the defensive measures demanded by Viacom."[379] Furthermore, the Paramount board failed to adequately consider the QVC's offer, in other words, the Paramount board members "chose to wall themselves off from material information . . . and to hide behind the defensive measures" rather than to obtain the best value for the Paramount shareholders.[380]

The Delaware Supreme Court concluded that a court must be satisfied that in the context of a sale of control the course of action taken by the directors was reasonably orchestrated to secure the best value available to the shareholders.[381] The Court addressed the defensive actions taken by Paramount board and determined that these measures were designed to impede potential competing bidders and, thus, were unreasonable.[382] Consequently, the Paramount board breached its fiduciary duties and the Delaware Supreme Court invalidated all of the defensive measures.[383]

The Delaware Supreme Court's decision in *QVC* indicated that the trend in the 1990s is for courts to uphold reasonable takeover defences that target boards implement to further viable business plans unless a particular defence interferes with the decision-making

---

[379] *Id.* at 49.

[380] *Id.* at 51.

[381] *Id.* at 44.

[382] *Id.* at 50-51.

[383] *Id.* The Court also noted that under Delaware law, directors of a corporation are not bound by any agreement that violates their fiduciary duties to shareholders. *Id.* at 51.

power of shareholders.[384] As exemplified by *QVC*, courts will find that a takeover defence interferes with shareholders' decision-making power when a target board adopts such a defence after *Revlon* has been triggered.[385]

5. The Summary of Delaware Approach

By February of 1994, the Delaware Supreme Court had handed down six decisions regarding directors' duties when facing a hostile takeover bid. The Delaware decisions follow an apparently balanced pattern. The Court ruled in favour of the target directors in the first case *Unocal* ;[386] the third *Ivanhoe Partners vl Newmont Mining Corp.*;[387] and the fifth *Paramount Communications, Inc v. Time Inc.*.[388] It ruled in favour of the hostile offeror in the second, *Revlon*,[389] the fourth, *Mills Acquisition Co. v. Macmillan*[390], Inc., and the last, *Paramount Communications Inc. v. QVC Network Inc.*[391]. The apparent balance of decisions has not necessarily appealed to commentators.[392]

---

[384] Under the laws of many states, fundamental corporate changes are subject to approval by shareholder vote, including mergers, elections of directors, and so forth. *See, e.g.*, Del. Code Ann. tit. 8, §251 (1991).

[385] *See, QVC* 637 A,2d at 47-48.

[386] 493 A.2d 946 (Del. 1985).

[387] 535 A.2d 1334 (Del. 1987).

[388] 571 A.2d 1140 (Del. 1989).

[389] 506 A.2d 173 (Del. 1986).

[390] 559 A.2d. 1261 (Del. 1988).

[391] 637 A.2d 34 (Del. 1994).

[392] *For example*, Robert A. Ragazzo criticized Delaware opinions for drawing distinctions without foundation, *see* Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35

Although the Delaware Supreme Court has never fully articulated its theory in a single case (although it did summarise its theory to some extent in *QVC*), a survey of all relevant cases offers some clues to an understanding of the Delaware approach from a holistic perspective.

Any rules applicable to the duties of a target board facing a pending hostile takeover should be established in terms of the allocation of powers between directors, shareholders and courts.[393] The business judgement rule enables directors to manage corporate affairs including dealing with hostile takeover bids free from judicial scrutiny unless they failed to live up to the five requirements of the rule.[394] When directors are in a conflict of interest when dealing with a hostile takeover bid, and thereby fail to comply with the disinterestedness requirement of the rule, the locus of power to reject a hostile bid shifts to the independent directors, as stated in *Unocal*.[395]

The ultimate rationale here is that directors are elected by shareholders to manage

---

Ariz. L. Rev. 989, 990(1993); Peter Blackman stated that QVC had muddied up legal standards, *see* Blackman, *Move Over Delaware! Makeing New York Incorporation Friendly*, N.Y.L.J., Dec. 16, 1993, at 5; Jeffrey N. Gordon noted that the *Time* decision represents "collapse of . . . five-year old effort" to create intermediate standard of review, *see* Gordon, *Corporations, Markets, and Courts*, 91 Colum. L. Rev. 1931, 1944-45(1991) etc.

[393] Marcel Kahan, *Paramount or Paradox: The Delaware supreme Court's Takeover Jurisprudence*, J. Corp. L. 583, 589 (spring 1994).

[394] See *supra* note 227-240 and accompanying text.

[395] *Unocal*, 493 A.2d *946 (Del. 1985). See* also Marcel Kahan, *supra* note 232, at 589.

the company. As long as they are incumbent, they are entitled to serve in a way which may not be approved by shareholders. If shareholders are dissatisfied with the way the directors manage the company, the proper solution is not for shareholders to manage or for courts to interfere, but for shareholders to displace the incumbent directors through the appropriate corporate mechanism and reconstitute the board.[396]

This rationale is clearly expressed in *Moran,* where the Court upheld a poison pill.[397] The Court noted that under the *Unocal* standard directors must comply with their fiduciary duties before they can reach any decision to reject a tender offer. Additionally, the Court referred to several ways in which a tender offer might succeed despite board opposition. In particular, one could "tender and solicit consents to remove the board" or one could "solicit proxies for consents to remove the board" and redeem the poison pill.[398] Thus, the premise of *Moran* is that the shareholders retain the power to override the board through the voting process. The contingent power allocation to independent directors adopted by the Delaware Supreme Court considerably reconciled the fear of director self-entrenchment, court intrusion, and ignorant and rushed shareholder decisions.

The issue of what triggers *Revlon* then follows directly from the rationale for the

[396] *See* Kahan, *supra* note, at 590.

[397] Poison pill or shareholder rights plan is a kind of defensive tactics which the company grants to shareholders certain contractual rights to purchase additional securities of the company, upon certain triggering events (usually the commencement of a takeover bid). The rights allow shareholders to buy securities of the company at a discounted price, which will cause the massive dilution of takeover bid offeror's shareholding, and make the takeover prohibitively expensive.

[398] *Moran*, *supra* note, at 1354.

deference paid to independent directors under *Unocal*. Under *Unocal*, a Court does not engage in a substantive view of the decision by independent directors to reject a tender offer because this decision is ultimately reversible by the shareholders themselves. If, however, shareholders are deprived of the ability to override the judgement of the independent directors, a principal rationale for the deferential review standard has evaporated.

Corporation transactions that involve a change of control most clearly deprive shareholders of the ability to reverse the decision of independent directorsto reject a tender offer. In a change of control, shareholders may retain their shares and voting rights, but voting control is transferred to a party chosen by the present board and the current shareholders are usually reduced to minority, thus losing the ability to exercise their votes to elect different directors. In such instances, the courts subject decisions of the board to the more stringent *Revlon* review.

In sum, the theory of Delaware Supreme Court is based on two fundamental precepts: first, the directors, not courts, should make business decisions; and second, shareholders, not courts, should voice their disagreement with the board decisions by electing different directors.[399]

In view of the importance of hostile tender offers, and the "omnipresent spectre"[400]

[399] *See* Kahan, *supra* note, at 606.

[400] See *Unocal*, *supra* note 223, at 960.

that directors may be acting primarily in their own interests, rather than those of the corporation and shareholders in deciding to reject a tender offer, the Delaware courts have adopted a two-track approach.

First, the Court has tried to maintain the disinterestedness of board decision by giving the ultimate decision-making power to the outside directors, and subjecting directors to an enhanced duty of care which requires onerous information-gathering and consulting.

Second, the Court has tried to preserve the last resort of shareholders - their voting power to override the decision of a target board to reject a tender offer.[401] This is demonstrated in the triggering of *Revlon* duty when such events as a sale of control take place which will deprive shareholders of this right. On the other hand, if the target directors decide that the company is not for sale and prefer to maintain the independence or pursue the pre-existing business plan, their actions are only subject to *Unocal* review.[402]

In principle, the Delaware approach adopts Lipton's theory, while in the *Revlon* mode, it encompasses the quintessence of Gilson's structural theory. The contingent allocation of decision-making power from inside directors to independent directors considerably reduces the possibility of self-dealing. The enhanced due care requirements insure that the board decisions are made "in a cool, dispassionate, and thorough fashion."[403]

---

[401] *Id.*

[402] *Id.*

[403] See *Dynamics Corp. v. CTS Corp.*, 794 F. 2d 250 (7th Cir. 1986).

The auction duty of target directors dictated by "*Revlon* mode" serves to chill wasteful wealth-transferring takeover attempts.[404] Delaware's intermediate approach - a middle course between a "hands-free" traditional business judgement rule and the stringent intrinsic fairness test - provides a viable solution within the current corporate governance structure to tackle the situation of hostile takeovers.

IV. Canadian Approach - Proper Purpose Rule

1. The Primary Purpose Rule

Although the company laws of the Commonwealth pay some attention to the business judgement rule, it has not been worked out comprehensively in connection with takeovers. The courts generally prefer to talk about proper purpose although there has been a tendency in recent cases to formulate more specific rules.[405]

The leading Commonwealth cases dealing with hostile takeovers were two English cases, *Hogg v. Cramphorn*,[406] and *Howard Smith Ltd. v. Ampol Petroleum Ltd.*[407] In *Hogg* the company was the target of a hostile takeover bid for its ordinary and preferred shares.

---

[404] *See supra* note 169-170 and accompanying text.

[405] John H. Farrar, *Business Judgement and Defensive Tactics in Hostile Takeover Bids*, 15 Ca. Bus. L. J. 15 (1989).

[406] 1 Ch. 254 (1967).

[407] A.C. 821 (1974).

The board responded by setting up a trust for the benefit of employees with themselves designated as trustees and issuing to the trust a large block of authorised but unissued preference shares carrying 10 votes per share. The Court held that this exercise of the directors' power to allot shares was for an improper purpose. In reaching its decision, directors' good faith and their belief that their decision was in the best interests of the shareholders and employees were regarded as irrelevant. The Court found that the directors had acted simply to retain their control and this was an improper purpose.[408] *Hogg* decision reflects the earlier trend of English cases which were strict and interventionist.

In *Howard Smith ltd. v. Ampol Petroleum Ltd.*,[409] the Privy Council tacked a middle course. In *Howard Smith*, the litigation arose out of a struggle for the takeover and control of R. W. Millers (Holding) Ltd., the rival parties to which were Ampol on one side and Howard Smith on the other. Ampol and its associate Bulkships Ltd. together already owned 55 percent issued shares of Millers. Before the takeover contest, there had been discussions between Howard Smith and Millers' management involving the possible acquisitions by Howard Smith of two tankers of Millers. When the takeover contest broke off, the position was that it would be useless for the outside shareholders to accept the Howard Smith offer since Ampol and its associates already owned the control block of outstanding shares. In order to enable Howard Smith to proceed with its offer, Millers' management decided to issue 4,5000,000 shares to Howard Smith so as to convert Ampol

[408] *Hogg, supra* note 243, at 265-71.

[409] *supra,* at note 244.

and Bulkships together into minority shareholders.[410]

The issue before the Court was "whether the primary purpose of the majority of directors was to satisfy Millers' need for capital or whether their primary purpose was to destroy the majority holding of Ampol and Bulkships."[411] Lord Wilberforce said:

> . . . it is, in their Lordships opinion, too narrow an approach to say that the only valid purpose for which shares may be issued is to raise capital for the company. The discretion is not in terms limited in this way: the law should mot impose such a limitation on directors' powers. To define in advance exact limits beyond which directors must not pass is, in their Lordships' view, impossible. This clearly cannot be done by enumeration, since the variety of situations facing directors of different types of company in different situations cannot be anticipated. . . .
>
> In their Lordships' opinion it is necessary to start with a consideration of the power whose exercise is in question, in this case a power to issue shares. Having ascertained, on a fair view, the nature of this power, and having defined as can best be done in the light of modern conditions the, or some, limits within which it may be exercised, it is then necessary for the Court, if a particular exercise of it is challenged, to examine the substantial purpose for which it was exercised, and to reach a conclusion whether that purpose was proper or not. In doing so it will necessarily give credit to the bona fide opinion of the directors, if such is found to exist, and will respect their judgement as to matters of management; having done this, the ultimate conclusion has to be as to the side of a fairly broad line on which the case falls.[412]

Although the Court relaxed notably the strict rule established by *Hogg*, it still adhered to the traditional English position favouring judicial intervention. Lord Wilberforce later referred to the constitutional rights of shareholders and said:

---

[410] *Id*, at 832.

[411] *Id.*at 833.

[412] *Id.* at 835.

> The constitution of a limited company normally provides for directors, with powers of management, and shareholders, with defined voting powers having power to appoint the directors, and to take, in general meeting, by majority vote, decisions on matters not reserved for management. Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders, and indeed that the majority of shareholders cannot control them in the exercise of these powers while they remain in office (*Automatic Self-Cleansing Filter Syndicate Co. Ltd. v. Cuninghame* [1906] 2 Ch. 34), so it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. To do so is to interfere with that element of the company's constitution which is separate form and set against their powers. If there is added, moreover, to this immediate purpose, an ulterior purpose to enable an offer for shares to proceed which the existing majority was in a position to block, the departure from the legitimate use of the fiduciary power becomes not less, but all the greater. The right to dispose of shares at a given price is essentially an individual right to be exercised on individual decision and on which a majority, in the absence of oppression of similar impropriety, is entitled to prevail. Directors are of course entitled to offer advice, and bound to supply information, relevant to the making of such a decision, but to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold cannot be related to any purpose for which the power over the share capital was conferred upon them.[413]

Finally, the Court concluded that the power to issue and allot shares was improperly exercised by the issue of shares to Howard Smith.[414]

2. Canadian approach

There are Commonwealth decisions which took a line more favourable to

[413] *Id*, at 837-38.

[414] *Id.*

management in applying the proper purpose test. In *Teck Corporation v.Millar*[415], a British Columbia Supreme Court decision, the Court upheld the target directors' action to fend off a hostile takeover bid.

Afton Mines, a junior mining company, had for a long period of time actively sought to draw interests of major companies with regard to the development of its properties. A number of major companies, including the plaintiff, Teck, and the defendant, Canadian Exploration Ltd. ("Canex"), had shown interest in the properties and carried out negotiations with the Afton directors led by Millar. It was clear that Millar favoured Canex, a company with a long record of success, and felt that Afton's interest would be best served if Canex rather than Teck obtained the properties. Meanwhile, Teck had been active in the market, and acquired a majority of Afton's issued shares. When this became apparent, Millar and his co-directors entered into a contract with Canex which provided for the exclusive management by Canex of the development of the Afton property and for the acquisition by Canex at its option of shares in Afton equivalent to 30 percent of the issued capital. The effect of this agreement was to dilute Teck's majority position and frustrate its attempt to take over control. Teck then commenced the action on Afton's behalf, seeking *inter alia* a declaration that the Afton-Canex agreement was null and void on the grounds that the directors had acted for an improper purpose.[416]

---

[415] [1973] 2 W.W.R. 385 (B.C.S.C.).

[416] Id, at 385-87.

The Court dismissed the action and upheld the validity of the agreement. Berger J. reaffirmed the principle established by the *Automatic Self-Cleansinng Filter Suyndicate Co. Ltd. v. Cuninghame*[417] line of authorities that directors are free to manage the affairs of the company without any interference from the majority of members.[418] Berger J. said:

> My own view is that the directors ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interests if the company is take over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorised as improper.
>
> I do not think it is sound to limit the directors' exercise of their powers to the extent required by *Hogg v. Cramphorn Ltd.*, [1967] Ch. 254. But the limits of their authority must be clearly defined. It would be altogether a mistake if the law, in seeking to adapt itself to the reality of corporate struggles, were to allow the directors any opportunity of achieving an advantage for themselves at the expense of the shareholders.
>
> I think the courts should apply the general rule in this way: The directors must act in good faith. Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose.[419]

It is interesting to note that the Court referred to Delaware cases[420] addressing directors' duties for support and concluded that it was not prepared to follow *Hogg v. Cramphorn*.

---

[417] [1906] 2 Ch. 34 (C.A.).

[418] *Teck*, supra note 416, at 386-88

[419] *Id*, at 413.

[420] *Id*, at 414-15. The Court referred to *Bennet v. Propp* 187 A.2d 405(Del. 1962); *Kors v. Carey* 158 A.2d 136 (Del. Ch. 1960); *Cheff v. Mathes* 199 A.2d 548 (Del. 1964).

Teck has been cited in a number of subsequent Canadian and other Commonwealth cases, but in a recent Nova Scotia case, *Exco Corp. Ltd. v. Nova Scotia Savings & Loan Co.*[421], Richard J. confined the applicability of *Teck* to "a very unusual set of facts which must be somewhat unique to the mining industry."[422] Richard J. said that Berger J. had adopted a "business purpose doctrine" in contrast to Buckley J.'s stricter approach in *Hogg v. Cramphorn*, but had sought to qualify his liberal approach by requiring an underpinning of objectivity. Richard J. thought that even this was not enough. Directors must be able to show that the considerations upon which the decision to issue was based are consistent only with the best interests of the company and are inconsistent with any other interests. This burden ought to be on the directors once a share issue has been challenged.[423] *Exco* casts doubt on *Teck* and emphasises the lack of coherence in the Canadian authorities.

In 1991, the Saskatchewan Court of Appeal handed down the landmark decision of *347883 Alberta Ltd. v. Producers Pipelines Inc.*[424] where a shareholder rights agreement was in issue.

In late 1990, Saskatchewan Oil and Gas Corporation (Saskoil) revealed that it was interested in acquiring all shares of Producers Pipeline Inc. (Producers). In response to this proposed bid, Producers adopted a shareholder rights agreement (S.R.A.) dated 27 August

---

[421] (1987), 78 N.S.R. (2d) 91, 35 B.L.R.149 (S.C.).

[422] *Id*, at 164 N.S.R., 259 B.L.R.

[423] *Id*, at 170 N.S.R., 266 B.L.R.

[424] [1991] 4 W.W.R. 151.

1990. The S.R.A. granted each shareholder one "right" per share to purchase 10 additional common shares at a favourable price upon a triggering event, that is, in the event that any "acquiring person" acquired more than 10% of the outstanding shares of the company after 27 August 1990 and on or before December 1990. The S.R.A. was drafted in terms that effectively excluded Saskoil from the range of permitted bidders. On 3 December 1990, acting through its wholly owned subsidiary, 347883 Alberta Ltd, Saskoil purchased a block of Producers shares, which gave it control of 9.9% of the outstanding common shares of Producers while remaining below the S.R.A.'s 10% threshold until 27 December 1990, when the S.R.A. was meant to expire. However, Producers' directors twice extended the duration of S.R.A. up to 15 April 1991 without approval from shareholders. Acting at Saskoil's behest, 347883 Alberta Ltd applied for an order under section 234 of the SBCA (the statutory oppression remedy) that would set aside the S.R.A. and the issuer bid as being oppressive, or unfairly prejudicial to, or as unfairly disregarding its interests and those of other Producers' shareholders.[425]

Sherstobitoff J.A. noted that section 117 of the *Saskatchewan Business Corporations Act*[426] states that the duties of directors are owed to the corporation. But "the authorities say that the corporation cannot be considered as an entity separate from its shareholders." Thus, "[t]he directors must act in the best interests of the corporation and all

[425] *Id*, at 151-58.

[426] Subsection 117(1) of the SBCA states: Every director and officer of a corporation in exercising his powers and discharging his duties shall: (a) act honestly and in good faith with a view to the best interests of the corporation; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

its shareholders."[427]

After reviewing the decisions of *Teck* and *Exco*, as well as American authorities like *Unocal*, Sherstobitoff J.A. concluded that none of these decisions could serve as underlying principle in deciding the current case:

> They give no principles for determining whether or not the defensive strategy was reasonable in relation to the threat posed. They do not deal with the principle that shareholders have the right to determine to whom and at what price they will sell their shares as stated in Howard Smith Ltd. They fail to consider the effect of the take-over provisions in the provincial securities legislation.[428]

Consequently, he considered it necessary to turn to *National Policy 38* of the Canadian Securities Administrators for interpretative guidance. He emphasised that *National Policy 38* was designed both to limit unfair bidding tactics and to allow shareholders to decide to whom and at what price to sell their shares. Thus,

> Section 108 of the Securities Act, 1988, indicates that the primary role of the directors in respect of a takeover bid is to advise the shareholders, rather than to decide the issue for them. As noted in the policy statement, the primary objective of the legislation is to protect the bona fide interests of the shareholders of the target company and to permit takeover bids to proceed in an open and even-handed environment. Unrestricted auctions produce the most desirable results in takeover bids. Accordingly defensive measures should not deny to the shareholders the ability to make a decision, and it follows that, whenever possible, prior shareholder approval of defensive tactics should be obtained. There may be circumstances where it is impracticable or impossible to obtain prior shareholder approval, such as lack of time, but in such instances, delaying measures will usually suffice to give the directors time to find alternatives. The ultimate decision must be left with the shareholders, whether by subsequent ratification of the

---

[427] *Id.*

[428] *Id,* at 169.

> poison pill, or by presentation to them of competing offers or other alternatives to the take-over bid, together with the take-over bid itself.[429]

In summary:

> When a corporation is faced with susceptibility to a takeover bid or an actual takeover bid, the directors must exercise their powers in accordance with their overriding duty to act bona fide and in the best interests of the corporation even though they may find themselves, through no fault of their own, in a conflict of interest situation. if, after investigation, they determine that action is necessary to advance the best interests of the company, they may act, but the onus will be on them to show that their acts were reasonable in relation to the threat posed and were directed to the benefit of the corporation and its shareholders as a whole, and not for an improper purpose such as entrenchment of the directors.[430]

Sherstobitoff J. A. concluded that the most appropriate relief was to set aside the S.R.A. and to extend the closing date of the issuer bid to 45 days following the date of his judgement.[431]

3. Summary

Producers Pipeline has become the centre of controversy ever since it was handed down. It is problematic in several respects:

First, most modern corporation statutes provide that the business and affairs of a

[429] *Id*, at 165.

[430] *Id.*

[431] *Id.* Ultimately, Saskoil chose not to proceed with a new bid since this would have required it to make a more substantial offer than that contained in the issuer bid. *See* "Company News" *The Globe and Mail* (6 June 1991) B-14.

corporation shall be managed by the board of directors. The history of modern corporation law is a process of reducing constraints on management discretion in matters of corporate affairs. Corporate law barriers to business decisions have been considerably diminished in modern "enabling" corporate statutes such as CBCA. The board of directors should not easily abdicate its responsibility and turn it over to the shareholders, and takeover bids are not so different from other major business decisions as to warrant an unique sterilisation of the directors in favour of direct action by the shareholders. In the face of a ubiquitous spectre of conflict of interests, the independent directors are called upon to exercise their business judgement. Absent special circumstances, neither courts nor shareholders should interfere.

The principle of corporate legal personality, which was fully established by *Salomon v. Salomon & Co.*[432] in 1897, dictates that a company has its own interests which may be different from those of its members. As a corollary, corporate directors, while serving as the "trustees" of the company, owe fiduciary duties to the company and to the company alone. In general, the directors owe no duties to the individual members.[433] This common law principle is one of the rationales upon which Judge Allen reached the conclusion in *Time* that ". . . [d]irectors are under no obligation to act so as to maximize the immediate value of the corporation or its shares, except in the special case in which the corporation is in a "*Revlon* mode.". . .Delaware law does recognise that directors, when acting deliberately

[432] [1897] A.C. 22, H.L. ("[T]he company is at law a different person altogether from the subscribers. . ."),

[433] Gower, *Principles of Modern Company Law*, 551 (London: Sweet & Maxwell, 1992).

in an informed way, and in the good faith pursuit of corporate interests, may follow a course designed to achieve long-term value even at the cost of immediate value maximization."[434] Company law does recognise the circumstances when directors can stand a fiduciary relationship to members, for example, they well may if they are authorised by the shareholders to negotiate on their behalf with a potential takeover bidder.

In the circumstances under "*Revlon* mode" when a change of control is inevitable, shareholders will lose their last weapon - the voting power attached to their equities - to reverse the directorial decisions. Due to their inferior bargaining status and the coerciveness of takeover bids, shareholders naturally look to directors to obtain a fair price for them before they lose their equity in the company and the opportunity to realise the control premium in future. Only when the "*Revlon* mode" is triggered, could a fiduciary relationship between directors and shareholders be established, and an onus be put upon directors to auction off the control of the company and maximize the value of the shares for both the company and shareholders. Absent the "Revlon mode" circumstances, no fiduciary relationship could be established between directors and shareholders. Directors remain the fiduciaries of the company alone.

Producers Pipeline, however, did not bother to distinguish among subtle circumstances in the context of a takeover, and instead blanket-ruled that in the face of a takeover bid, directors are no longer entitled to exercise their business judgement, but

---

[434] *See Time, supra* note 223, at 538.

automatically owe a fiduciary duty to shareholders to hold an unrestricted auction.[435] The fiduciary duty meted out by Sherstobitoff J.A. was more like a castle in the air, with no foothold in the established principles of company law.

On the other hand, although the current regulatory regime in Canada has considerably diminished the coerciveness of tender offers, still little has been done to counteract the adverse effects of the shareholder short-term outlook and speculative mentality. The courts have done nothing to close the divergence of interests between shareholders preoccupied with short-run profits and the company shouldered with long-term missions. It is far from being judicious to prematurely reallocate the decision-making power from directors to shareholders, whose decisions may well generate a cost to the long-term interests of the company.

Second, it is far from obvious why policy statements, issued in a securities law context never having been considered by the legislature, should become the touchstone for the interpretation of corporate law provisions.

Until now, no authority dictates that the policy objectives underlying the business corporations and securities acts are identical. The business corporations acts display a profound concern to balance the need for flexibility regarding the structure, financing and management of a corporation with concerns about accountability,[436] whereas securities acts

---

[435] *Producers Pipelines*, *supra* note 424, at 165.

[436] For example, CBCA's takeover provisions contain measures whereby an acquiring company can squeeze

in Canada focus almost exclusively on the treatment of shareholders. In two cases handed down in 1994,[437] the O.S.C. made it clear that its responsibility was not to assess whether directors were acting for a proper purpose and reasonably in using the rights plan. Rather, its job was to "focus on whether it is in the public interest, more particularly the interest of target company shareholders, that the shareholder rights plan be allowed to continue to operate."[438] In both cases, the O.S.C. referred to *National Policy 38* as a touchstone for its analysis. The O.S.C. has therefore set about assessing the merits of rights plans on a premise that does not treat questions concerning a board's fiduciary duties as the major basis for analysis. At the same time, *Producers Pipeline* suggests that courts which do focus on corporate fiduciary duties are prepared to look to *National Policy 38* in providing guidance for the analysis of those duties. *Producers Pipelines* seems to suggest that in the context of hostile takeover bids, corporate fiduciary principles can no longer fulfil their mission of protecting the interests of shareholders, and that it is time to let securities policy rule. As Robert Yalden pointed out, "[I]f legislatures conclude that ultimately securities policy should rule the day, then so be it. But until they make clear that they have endorsed that state of affairs, courts have no mandate to subsume our business corporations law to the views of securities administrators."[439]

---

out remaining shareholders of the target corporation once 90% of its shares have been tendered to the bid. *See* Section 206. The Ontario Securities Act's take-over bid provisions do not address this issue. This difference reflects the CBCA's greater focus on flexibility in the management of companies and is but one demonstration of the different perspectives and rationales that underly the two statutes' approaches to takeover bids.

[437] *Lac Minerals Ltd. and Royal Oak Mines Inc.* (1994), 17 O.S.C.B. 4963 and *MDC Corporation and Royal Greetings & Gifts* (1994), 17 O.S.C.B. 4791.

[438] *Id, Lac*, at 4968.

[439] Robert Yalden, *Controlling the Use and Abuse of Poison Pills in Canada: 347883 Alberta Ltd. v.*

The Canadian approach, as was demonstrated in recent cases such as *Producers Pipelines*, takes a position that identifies with Gilson's structural theory. The holding that "the ultimate decision must be left with the shareholders"[440] closely resembles Gilson's general principle that "shareholders must make the decision".[441] In the realm of corporate control contests, securities regulatory policies loom large and company law principles fade away. The encroachment on the corporate law world by securities policy reflects the fact that the primary purpose doctrine cherished by the Canadian judiciary is no longer sufficient in tackling the problems posed by hostile takeover bid.

IV. Conclusion

The U.S. cases have gone the furthest in seeking to articulate the business judgement rule in relation to the duties of directors of a target company in a hostile bid. The Commonwealth courts generally adhere to the primary purpose test. There has been much incoherence and inconsistency in the theory of takeover defence regulation in Canada. *Teck* made a good start in developing a coherent and more specific standard addressing the issue, but the subsequent cases not only failed to keep up, but even contradicted and

Producers Pipelines Inc. 37 McGill L. J. 887, (1992)at 913.

[440] *Producers Pipelines, supra* note 424, at 166.

[441] Gilson, supra note 109, at 845.

confined *Teck*. Some decisions resorted to the harsher English standards, others turned to the pronouncements of Canadian securities administrators, i.e. *National Policy 38*. All the leading Canadian cases more or less referred to American cases for support, but none of them were able to follow the coherent reasoning and construction of specific standards established by the Delaware Supreme Court.

The proper (or primary) purpose test that is widely employed by the Canadian courts has been, however, an inadequate measure of management's discharge of its duty of loyalty in the context of corporate control. The principle underlying the proper purpose test is the intrinsic fairness standard that applies when directors' duty of loyalty is in dispute. As Harold Marsh has commented, "It is impossible to command the directors in this situation to avoid any conflict of interest, since it has been unavoidably thrust upon them."[442] Thus, it is impossible to identify at the outset any course management might take which would be free from the inherent conflict of interest. "Any action, whether rejection or approval, reflects the potential for diversion of benefit to management and away from shareholders."[443]

While the absence of judicial review was reasonable in non-conflict settings because other constraints meted out by market forces protected shareholders,[444] conflicts of interest

---

[442] Marsh, *Are Directors Trustees?*, 22 Bus. Law. 35 (1966) at 60.

[443] Gilson, *supra* note 109, at 826.

[444] Market forces will punish the poor managerial judgement by the low price paid for the stock. *See supra* note 113 and the accompanying text.

inherent in a potential change in control call for "rigid and careful scrutiny" of the fairness of management conduct.[445] A substantive review of business judgement necessarily involves judicial second-guessing - a task courts have expressly considered themselves incompetent. To avoid the quagmire of judicial second-guessing, courts shirked inventively the substantive review of directors' motivation in making business decisions.

In *Cheff v. Mathes*[446], the Delaware Supreme Court avoided the problem by shifting the focus of the inquiry. If the Court was ill-equipped to review the fairness of management's belief that the company would be better off without a change of control, it was at least competent to engage in an inquiry with a review of motive: ". . . [I]f the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decisions. . ."[447] Recognising that creative corporate lawyers could always discover a conflict over policy between management and an acquirer, the Court mandated an additional requirement: the board's determination that a policy conflict existed was based on "reasonable investigation."[448] The conflict of interest is eliminated wherever management demonstrates after reasonable investigation that a policy difference was the motivation for the defensive action. Absent a

---

[445] Gilson, *supra* note 109.

[446] 41 Del. Ch. 494, 199 A.2d 548 (1964).

[447] *Id*, at 554.

[448] *Id*, at 555. But management can easily overcome this hurdle by developing appropriate documents. *See* Israels, *Corporate Purchase of Its Own Shares - Are There New Overtones*?, 50 Cornell L.Q. 620, 624 (1965).

conflict of interest, the business judgement rule is the appropriate standard of review. Since management can almost always find a conflict over policy between itself and an insurgent,[449] the motive analysis of the proper purpose test collapses into the business judgement rule.

In *Unocal* the Court made a major improvement to the rule set out in *Cheff*. A demonstration of policy conflict can no longer entirely extricate directors from charges of self-dealing. In the face of this inherent conflict of interests, ". . . [d]erectors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. . . they satisfy that burden by showing good faith and reasonable investigation . . . such proof is materially enhanced by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the forgoing standards."[450] The Court resorted to the disinterestedness of outside directors to eliminate the conflict of interest. While the approach of motive analysis never solved management's conflict of interest, it did circumvent a substantive review of business judgement which the Court was institutionally incompetent to resolve.

The Court's neat circumvention of the fairness dilemma was also exemplified in *Producers Pipeline*. Although the Saskatchewan Court of Appeal paid a apparent

[449] *See, e.g., Braude v. Havenner*, 38 Cal. App. 3d 526, 532,(1974) ("[E}very contest involves or can be made to involve issues of policy").

[450] *Unocal*, 493 A.2d 946 (1985). at 960.

allegiance to the proper purpose test,[451] it furthermore resorted to *National Policy 38* and drew from it the underlying principle that ". . . the primary role of the directors in respect of a take-over bid is to advise the shareholders, rather than to decide the issue for them. . . accordingly, any defensive action should be put to the shareholders for prior approval where possible. . ."[452] Hereby the Court abdicated its power of substantive review of directors' motives to the shareholders, disregarding the fact that shareholders may be the most inappropriate party to do so.[453]

Why do Canadian courts maintain an aloof detachment to the U.S. development in the regulation of takeover defences? The reason for this may lie in the fact that although a couple of corporate statutes like CBCA are modelled much more closely on the American Model Business Corporation Act (MBCA) than on any English precedent, the Canadian judiciary generally displays a noteworthy tendency to accept English case precedents uncritically while showing a marked reluctance to adopt American decisions.[454] However, this judicial tendency is bound to wane as many of the current corporate statutes provisions derive directly from American precedents and have no parallels in English legislation. Furthermore, there is less substantive difference among the corporation laws of the three jurisdictions than might appear superficially. "In corporate litigation, it seems probable today that, given the same set of facts, a judge in England, the United States or Canada

---

[451] *See supra* note 427 and accompanying text.

[452] *See supra* note 429-430 at 961.

[453] *See*, Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101 (1979) at 113.

[454] Buckley, Gillen and Yalden, *Supra* note 320, at 155.

would reach the same result, although perhaps employing different verbal formulations to do so."[455]

As long as one of the major concerns of company law is to allow corporations and their boards a measure of flexibility in the pursuit of corporate objectives - flexibility that has at times had to be balanced carefully against the interests of various constituencies, including shareholders, Delaware courts seem to have fulfilled this goal most satisfactorily. It can be substantiated by the fact that Delaware is the winner in the competition of corporate chartering in the United States.[456] Professor Winter believed that Delaware won the competition because the market constraints forced corporate managers to seek a corporate law regime that would maximize the value of the corporation. Shareholders demand also contributed to the success of Delaware because market constraints would reduce the agency problem associated with the separation of ownership and control.[457] If the current Canadian fiduciary principles could no longer permit a creative expansion of fiduciary standards to the context of hostile takeover bids, it might be about time for the Canadian judiciary to whole-heartedly embrace the Delaware approach and subsume the proper purpose doctrine within the enhanced business judgement rule.

---

[455] *Id.*

[456] Approximately one-half of the largest U.S. industrial firms are incorporated in Delaware. For firms listed on national securities exchanges, more are incorporated in Delaware than in any other state. *See* R. Romano, *The Genius of American Corporate Law*, 6 (1993).

[457] R.K. Winter, *State law, Shareholder Protection and the Theory of the Corporation,* 6 J. of Legal Studies 251 (1977). *See* also *supra* note 113-116 and accompanying text.

Chapter Three

The Regulatory Environment of Hostile Takeovers

When the hostile takeover bids (tender offers) first emerged as an effective means of obtaining corporate control in the United States, it was unregulated by federal or state law. As a result of the regulatory vacuum in the tender offer area, many abuses developed. Because bidders were not required to disclose information, shareholders could not make an informed investment decision and thus could be easily misled by bidders. In addition, as offers were usually open only for a short period of time, offeree shareholders were typically forced to respond hastily. "First-come, first-serve" put undue pressure on shareholders to tender quickly. Lock-up of tendered shares and unequal consideration all exacerbated the situation. Furthermore, shareholders also faced substantial pressure from the target's management urging them to reject tender offers. The coerciveness and other unfair practices prevalent in tender offers which were detrimental to investor confidence in the securities market necessarily called for legislative response.

The 1980s witnessed an explosion of corporate takeover activity, which ended in an environment of increased regulation of corporate control transactions. In the United States, takeovers are regulated under a dual regime of federal and state laws. The principal federal legislation is the Williams Act,[458] which places disclosure and other substantive

[458] Pub. L. No. 90-439, 82 Stat. 454 (1968).

requirements on the takeover bidding process and is administered by the Securities Exchange Commission (SEC) and federal courts. Furthermore, federal tax and antitrust laws also affect takeovers. In Canada, corporate takeovers are regulated by provincial securities laws and securities commissions' policies. Laws of investment and competition also affect takeovers.

The chapter will survey the regulatory regimes of corporate takeover in the United States and Canada. Following the survey, an assessment will be made with regard to the underlying policy considerations of the regulations and their impact on takeover activity.

I. Regulatory Regime of the United States

Corporate takeover transactions are perhaps the most heavily regulated events in all of American law. Federal securities regulation, state corporate law and antitrust law play lead roles in these corporate transactions. Several other areas of the law - tax law, accounting law, labour law, law of various regulated industries, i.e., banking law, insurance law, aviation law etc. - also have peripheral effects on takeovers and may play a significant role in any given transaction. Limited by the scope of this chapter, only the laws that have shaped the world of corporate control transactions will be briefly surveyed herein.

1. Federal Laws

The federal securities laws provide the basic legal framework for take-overs. The federal securities laws affecting takeovers stem mainly from two sources: the Securities Act of 1933 and the Securities Exchange Act of 1934. Since promulgation, these laws have been revised frequently over the years. Both acts allow the SEC to adopt legal binding rules for the purpose of resolving ambiguities left by Congress and keeping the practical applications of the securities laws up to date.

1.1. Williams Act

The 1934 Act covers many more subjects and thus is more important in takeovers than the 1933 Act. The part of the 1934 Act that governs takeover bids, the Williams Act, was passed in 1968, which added Section 13(d) to require disclosure of substantial acquisitions of equity securities; Section 13(e) to regulate issuer repurchases; Sections 14(d) and 14 (e) to regulate tender offers, and Section 14(f) to regulate changes in the majority of directors in the context of a takeover bid. The Williams Act was amended in 1970,[459] in which the U.S. Congress expanded the authority of the SEC in making rules and regulations and reduced the reporting level of equity ownership from ten percent to five percent.

(1) Section 13(d) - Acquisitions of More Than Five Percent

[459] Pub. L. 91-567, §§1,2,3-5, 84 Stat. 1497 *et seq.*, December 22, 1970.

Section 13(d)[460] and Regulation 13D-G provide that any person or a "group" who acquires "beneficial ownership" of more than five percent of any class of registered equity security should file a schedule 13D with the SEC, the issuer, and securities exchanges on which the security is traded within ten days of the acquisition. Persons owning an aggregate of over five percent who agree to act in concert with respect to their investment in a company may constitute a "group" in Section 13(d).[461] Under Rule 13d-3(a), a person is the beneficial owner of shares if "he has or shares, directly or indirectly, the power to vote or direct the voting of such shares; or if he has or shares, directly or indirectly, the right to dispose or to direct the disposition of such shares."

(2) Section 14(d): Tender Offers

Section 14(d) and Regulation 14D require any person or "group" who makes a "tender offer" which would enable the offeror to own more than five percent of any class of registered equity security to file a Schedule 14D-1 concurrently with making the offer. In conventional usage, a "tender offer" is "a publicly made invitation addressed to all shareholders of a corporation to tender their shares for sale at a specified price."[462]

Regulation 14D mandates specific filing and disclosure requirements, optional

[460] 15 U.S.C. §78m(d).

[461] *See Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982).

[462] Note, *The Developing Meaning of 'Tender Offer' Under the Securities Exchange Act of 1934*, 86 Harv. L. Rev. 1250, 1251 (1973).

dissemination provisions and additional substantive provisions, including withdrawal rights and proration of tenders in partial offers.

Rule 14d-3 requires a bidder to file a Schedule 14D-1 with the SEC as soon as practicable on the date of commencement of the tender offer. The bidder must hand deliver a copy of the Schedule 14D-1 to the target company and to any other relevant bidder offering for the same class of target's securities. The bidder must also give telephonic notice of the tender offer and mail the Schedule 14D-1 to each national securities exchange where the subject class is listed.

Section 14d-1 prohibits the making of an offer unless the required filings are made at the time copies of the offer are first published, sent or given to security holders. Rule 14d-4 provides the methods of dissemination which satisfy the "published, sent or given" requirement: long-form publication[463], summary publication[464] and use of stockholder lists and security position listings[465] pursuant to Rule 14d-5.

Rule 14e-1(a), applicable to all tender offers, prescribes time requirements with respect to all tender offers. In general, any tender offer must be kept open for at least

---

[463] The alternative of dissemination which publishes the tender offer in a long-form newspaper advertisement.

[464] The bidder may publish a summary newspaper advertisement of the tender offer and furnish the tender offer material to security holders who request such material.

[465] Rule 14d-4 gives bidders a federal right to disseminate their tender offer materials by means of the stockholder lists of the target company and security position listings of clearing agencies obtained pursuant to Rule 14d-5.

twenty business days from the date it is first disseminated to stockholders. Under Rule 14e-1(b), if the offer is amended, it must remain open for at least ten business days from the date the notice of such increase or decrease in first disseminated to stockholders.

Section 14(d)(5) of the 1934 Act grants a statutory right of withdrawal within seven (calendar) days after the initial dissemination of tender offer material and at any time after sixty days (calendar) from such dissemination. Rule 14d-7, as amended in 1986, grants withdrawal rights during the entire period that the offer remains open.

Section 14(d)(6) provides that, in a partial tender offer, securities tendered within the first ten (calendar) days following dissemination of the offer, or within ten (calendar) days of publicly disclosing an increase in consideration in the offer, must be accepted on a pro rata basis. In December 1982, the SEC adopted a new Rule 14d-8, which overrides the statutory provision, and requires a bidder in a partial tender offer to accept on a pro rata basis all securities tendered during the entire period of the offer.

(3) Section 13(e): Issuer Bids

Section 13(e) of the 1934 Act gives the SEC rulemaking authority with respect to an issuer's repurchase of its securities. Rule 13e-1 provides that a target may not purchase any of its securities during the period of a takeover bid for such securities unless the target has made a filing of Schedule 13E-4 with the SEC disclosing certain prescribed information, including the purpose of repurchase. Rule 13e-4 regulates cash tender offers and exchange offers by an issuer or its affiliates for the issuer's securities. The rule prescribes filing, disclosure and dissemination requirements and includes specific antifraud provisions.

(4) Section 14(e): Fraud and Manipulation

Section 14(e) prohibits material misstatements, misleading omissions and fraudulent, deceptive or manipulative acts in connection with any tender offer. The SEC adopted Rule 14e-3 to regulate transactions by persons in possession of material non-public information relating to tender offers, and the tipping of such information.

(5) Section 14(f): Changes in Majority of Directors

Section 14(f) requires the filing of proxy statement type information with the SEC and dissemination of the information to all shareholders of the target if a majority of the directors of the target is to be elected or designated otherwise than at a shareholder meeting. Rule 14f-1 mandates a ten days period for such a filing to be made with SEC and transmitted to all shareholders before any person in new majority of directors is to take office.

(6) Section 13(f): Reports by Institutional Investment Managers

Section 13(f) and Rule 13f-1 require institutional investment managers who handle accounts with $100 million or more in exchange-traded or NASDAQ-quoted equity securities to file an information report on Form 13F with respect to the holdings of such accounts within forty-five days after the end of each calendar year and within forty-five days after the last day of each quarter during the next calendar year.

1.2. Other Relevant Regulations of the 1934 Act

(1) Rules Regulating Outside Purchases and Short Sales

Rule 10b-13 prohibits an offeror from purchasing target securities that are the subject of its tender offer directly or indirectly in the open market or otherwise outside its tender offer from the time of commencement of the offer till its termination. Rule 10b-4 makes it a "manipulative or deceptive device or contrivance" and a "fraudulent, deceptive, or manipulative act or practice" under Sections 10(b) and 14(e) of the 1934 Act for any person to tender any security for his own account unless, at the time of tender offer, he owns the security, or an equivalent security. The rule was adopted to prohibit short tenders[466] - the tender into an offer of borrowed shares or by a guarantee when one does not own the underlying shares before the tender offer but instead intends to purchase shares in the open market to cover the tender. It also prohibits "hedged" tenders - short sales of shares subsequent to the tender of such shares, in order to hedge the risk of having a substantial amount of shares returned due to pro rata requirement.

[466] Rule 10b-4(a)(4) defines "tender" to include delivery of a security or a guarantee of delivery or any other method by which acceptance of a tender offer may be made, provided that the person is *long* in such securities at the time of such tender.

(2) Rule Regulating Going Private Transactions

Rule 13e-3 was adopted by SEC in September, 1979.[467] The rule mandates certain disclosure with respect to going private transactions[468], including disclosure as to the fairness of the transaction, and imposes certain waiting periods prior to the consummation of such transactions.

The issuer or its affiliates engaging in a transaction subject to Rule13e-3 must file a Transaction Statement on Schedule 13E-3 with the SEC. Certain items in Schedule 13E-3 concern the fairness of the transaction which must be completely and prominently disclosed in the information provided to unaffiliated security holders.[469] The information must contain a statement on the transaction's purpose, the alternatives considered, the reasons for its structure and timing and the benefits and detriments of the transaction on the issuer, its affiliates and unaffiliated security holders, including the federal tax consequences.[470] The document furnished to security holders must also disclose whether appraisal rights are available to security holders, and include a detailed statement describing any appraisal or

---

[467] SEC Rel. No. 34-16075, CCH Fed. SEC. L. Rep. 82,166 (Aug. 2, 1979).

[468] "Going private transaction" refers to a single shareholder or a small group of investors acquiring all the shares of a public company. Two of the most important examples are the elimination of minority shareholders in public companies by the majority shareholder in a squeeze-out merger and leveraged buyouts of public companies.

[469] Rules 13e-3(1) and (3)(I).

[470] Schedule 13E-3, Item 7.

other rights which are or may be available under state law and procedure for exercising available appraisal rights.[471]

Rule 13e-3 also requires that for all transactions under the rule other than tender offers, dissemination in accordance with any applicable federal or state law must occur at least twenty days prior to the date of authorization or completion of the transaction.[472] The dissemination period imposes a waiting period of at least twenty days for all transactions which are subject to Rule 13e-3 except tender offers.

Rule 13e-3 contains a number of specific exceptions. Most noteworthy is the exception for second-step clean-up transactions following a tender offer, if the consideration offered in the second-step transaction is at least equal to the highest consideration offered in the tender offer.[473]

Although Rule 13e-3 does not explicitly regulate the substantive fairness of going private transactions, it has been argued that the required disclosure, in particular effect, does amount to a substantive fairness requirement.[474]

(3) General Antifraud Provision

---

[471] Schedule 13E-3, Items 13(a) and 17(e).

[472] Rule 13e-3(f)(1)(i).

[473] Rule 13e-3(g).

[474] Note, *Regulating Going Private Transactions, SEC Rule 13e-3,* 80 Colum. L. Rev. 782, 801 (1980).

Rule 10b-5 proscribes fraud in connection with the purchase or sale or securities. It can come into play in a wide variety of situations relating to takeovers. For example, Rule 10b-5 prescribes a company's obligation to the market for its shareholders to disclose merger negotiations. The Rule prohibits certain persons (corporate insiders) who possess material non-public information from buying or selling the securities of that corporation or making selective disclosure for trading or other personal purposes (i.e. tipping) unless they first disclose the information to the public.

1.3. Federal Regulation of Change of Control

Certain federal regulatory statutes require prior approval of relevant administrative agency before the consummation of a change of control. For instance, the Federal Bank Holding Company Act prohibits the direct or indirect acquisition of control of a bank in the business of making commercial loans without the prior approval of the Federal Reserve Board. "Control" is defined as "directly or indirectly owning or controlling the power to vote twenty-five percent or more of any class of voting securities of the bank."[475]

Certain federal statutory provisions restrict foreigners to obtain ownership of the stock of domestic companies in specified sectors of the economy. For example, the Federal Aviation Act provides that only U.S. citizen can be granted the certificate required for

[475] *The Bank Holding Company Act*, 12 U.S.C. §1842.

domestic air transportation. "U.S. citizen" is defined to exclude a corporation if (1) more than one-third of its directors and managing officers are foreigners or (2) more than twenty-five percent of its stock is held or controlled by foreigners.[476]

1.4. Antitrust Laws

(1) Clayton Act

A tender offer may be challenged on the ground that the transaction would violate section 7 of the Clayton Act.[477] Section 7 prohibits mergers, acquisitions, and other combinations "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." If the offeror engages in a line of commerce that is similar to (or that overlaps) that of the offeree, the target might claim that a combination of the two companies might substantially decrease competition or tend to create a monopoly in the market(s) in which the two companies currently compete.

(2) Hart-Scott-Rodino Act

[476] 49 U.S.C.§§1301(13), 1371.

[477] 15 U.S.C. §18; *See Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (holding that target's directors had right to challenge tender offer on antitrust grounds if they believed it to be illegal).

The Hart-Scott-Rodino Antitrust Improvement Act of 1976 (H-S-R Act)[478] was enacted to supply the United States antitrust agencies[479] with advance information about significant transactions so that the agencies can adequately review the negative effects of proposed mergers and acquisitions on competition prior to their consummation.

The H-S-R Act and the premerger notification rules[480] generally require the reporting of all mergers and acquisitions that satisfy the following standards: (1) one of the persons involved is engaged in United States commerce or in an activity affecting United States commerce;[481] (2) the transaction is between persons with minimum sizes of $100 million and $10 million, respectively, in gross assets or, for manufacturing companies, in sales;[482] and (3) as a result of the transaction, the acquiring person will hold (not acquire) either more than $15 million of the acquired person's voting securities and assets or 50 percent or more of the voting securities (or contractual control) of an issuer.[483]

The premerger notification form requires a description of the parties and the acquisition, current financial data, and a breakdown of dollar revenues according to the

---

[478] 15 U.S.C. §18a(a).

[479] For example, the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice etc.

[480] 16 C.F.R. Parts 801, 802 and 803 (1986).

[481] 15 U.S.C. § 18a(a)(1); Rules 801.1(1), 801.3.

[482] 15 U.S.C. § 18a(a)(2); Rule 801.1(j).

[483] 15 U.S.C. § 18a(a)(3); Rule 802.20.

Standard Industrial Classification codes. The H-S-R Act imposes a 30-day waiting period (15 days in the case of a cash tender offer) before the acquirer may accept tendered shares for payment. The report and waiting period requirement have a critical effect on a tender offer's timing and strategy.

2. State Takeover Statutes

While Federal tender offer rules and court decisions have long been key elements in the balance of takeover offence and defence, the focus has, however, shifted to state statutes which dramatically changed the balance in the 1980s.

2.1. First Generation Statutes

During the 1960s, state legislatures responded to the increasing tender offers bent on taking over existing enterprises by developing a separate body of law based on the states' customary authority to protect local enterprises and investors and to regulate corporations chartered in their jurisdictions. Beginning in 1968, some 37 states enacted laws now known as "first-generation" takeover statutes.[484]

Although the statutes varied from state to state, they tended to have common features: (1) they required offerors, prior to commencing a tender offer, to make more

[484] *See* generally, Warren, *Developments in State Takeover Regulations: MITE and Its Aftermath*, 40 Bus. Law. 671, 671 nn. 2-3 (1985).

extensive disclosure than that is mandated by the Williams Act; (2) they authorised state securities regulators to conduct hearings concerning tender offers, to delay offers on the ground of inadequacy of disclosures, and even, in some states, to block offers entirely upon a finding of unfairness; and (3) they broadly defined 'target company" in ways that extended the states' authority to transactions between tender offerors and target shareholders residing in other jurisdictions.[485]

The validity of first generation statutes was challenged under the Supremacy and Commerce Clause of the United States Constitution. Attacks on these laws culminated in *Edgar v. MITE Corp.*,[486] in which the Illinois Business Takeover Act - a classic example of first generation statutes - was held unconstitutional by the Supreme Court. The *MITE* majority held that a statute allowing the Illinois Secretary of State to block a nation-wide tender offer deprived shareholders throughout the country of an opportunity to sell their shares at premium prices, hindered the reallocation of resources to their most valuable uses, and reduced the incentive for incumbent management to perform well in order to sustain high stock prices.[487] In the wake of *MITE*, courts across the country invalidated many state takeover statutes typically on Commerce Clause grounds.[488]

2.2. Second Generation Statutes

---

[485] *Id*, at 677.

[486] 457 U.S. 624 (1982).

[487] *Id*, at 643.

[488] For a general discussion of post-*MITE* cases, *see* Warren, *supra* note 496, at 686-694.

Subsequent to *MITE*, several states passed second generation antitakeover statutes that were patterned to focus on the traditional state corporation law in order to increase the difficulty of taking over local enterprises.

The first of these second generation statutes was the Ohio Control Shares Acquisition Act of 1982.[489] The law, which applied to tender offers and other purchases, required prior shareholder approval of "[c]ontrol share acquisitions" that would result in concentrations of ownership exceeding the 20-percent, 33-1/3 percent, and 50-percent levels.[490] The law further provided that the approval of any covered acquisition by issuer's shareholders need an absolute majority of the shares voted at a meeting called to consider a bid and a majority of the shares voted by disinterested shareholders present at the meeting, thus excluding shares voted by the acquirer or by the target's officers or employee-directors.[491]

In *Fleet Aerospace Corp. v. Holderman*,[492] the District Court ruled that the Ohio Statute frustrated the objectives of the Williams Act and thus was pre-empted, under the Supremacy Clause, by the federal regulatory scheme. Another second generation statute adopted by Indiana was also rejected by the Seventh Circuit Court of Appeals in *Dynamics*

[489] Ohio Rev. Code Ann. §§ 1701.83.1, .83.2 (Anderson 1989).

[490] *Id.* §1701.831(E).

[491] *Id.* §1701.831(E)(1).

[492] 637 F. Supp. 742 (S.D. Ohio 1986).

Corp. of America v. CTS Corp.[493] on Commerce Clause and pre-emption grounds, but the Supreme Court reversed and sustained the validity of the Indiana act.[494] Justice Powell noted in *CTS* that:

> [t]he overriding concern of the *MITE* plurality was that the Illinois statute considered in that case operated to favour management against offerors, to the detriment of shareholders. By contrast, the statute now before the Court protects the independent shareholders against the contending parties. Thus, the Act furthers a basic purpose of the Williams Act, "plac[ing] investors on an equal footing with the takeover bidder. . .."
>
> The Indiana Act operates on the assumption, implicit in the Williams Act, that independent shareholders faced with tender offers often are at a disadvantage. By allowing such shareholders to vote as a group, the Act protects them from the coercive aspects of some tender offers . . . . In such a situation under the Indiana Act, the shareholders as a group, acting in the corporation's best interest, could reject the offer, although individual shareholders might be inclined to accept it. The desire of the Indiana Legislature to protect shareholders of Indiana corporations from this type of coercive offer does not conflict with the Williams Act. Rather, it furthers the federal policy of investor protection.
>
> . . . [T]he Indiana Act does not give either management or the offeror an advantage in communicating with the shareholders about the impending offer . . . . Nor does the Act allow the state government to interpose its views of fairness between willing buyers and sellers of shares of the target company. Rather, the Act allows shareholders to evaluate the fairness of the offer collectively.[495]

Second generation statutes had three primary forms or features: control share acquisition, fair price and right of redemption. The three features have been defined as follows:

> (1) control share acquisition statutes that require acquisitions of stock that

---

[493] 794 F.2d 250, 263-64 (7th Cir. 1986).

[494] *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 78 (1987).

[495] *Id*, at 81-85(citations omitted).

> constitute control, or the voting rights of such shares, to be approved by a majority of disinterested shareholders, (2) fair price statutes that require either a supermajority shareholder vote, disinterested board approval, or payment of a fair price for the second step of a two-tier acquisitions, and (3) redemption rights statutes that give all shareholders cash redemption rights against any acquirer of at least thirty percent of the firm's stock.[496]

Of the above three forms, fair price statutes proved to be the most popular type of second generation statute, as evidenced by the fact that they were adopted by fourteen of the twenty-one states enacting antitakeover laws.[497]

2.3. Third Generation Statutes

Although one of the reasons that the Supreme Court sustained Indiana's second generation statute was that it didn't upset the balance between takeover offence and defence struck by the Congress, the third generation statutes adopted by a few states invariably favoured target management.

The first of the third generation statutes was New York's antitakeover statute,[498] which forbids tender offerors who obtain more than twenty percent of the voting stock of a New York corporation from consummating a merger with a acquired firm for five years unless: (1) the target's board has approved the tender offer or merger before the tender

[496] R. Romano, *The State Competition Debate in Corporate Law*, 8 Cardozo L. Rev. 709, 725-26 (1987).

[497] *Id.*

[498] N.Y. Bus. Corp. Law § 912 (McKinney 1986).

offeror acquired the twenty percent stake, or (2) the tender offeror obtains ninety percent of the voting shares in one transaction.[499] The statute was upheld in a bench ruling by the District Court in February, 1989 in *Vernitron Corp. v. Kollmorgen Corp.*.[500]

Following the model of the New York statute, Delaware adopted a business combinations statute.[501] The Delaware statute prohibits any stockholder who purchases fifteen percent or more of a Delaware corporation from engaging in a business combination with that firm for three years unless the target board approves the transaction prior to the acquisition.[502] However, a business combination may proceed if the target board approves the combination after the acquisition and two-thirds of the disinterested shares vote to allow the combination or if the bidder acquires eighty-five percent of the voting shares in one transaction.[503] Significantly, Delaware firms may choose to opt out of the coverage of the statute. The Delaware statute was challenged unsuccessfully in *BNS Inc. v. Koppers Co.*[504] Despite the fact that the statute favours management, the Court found that the statute does not conflict with the Williams Act because it allows those tender offers that are beneficial to stockholders an opportunity to succeed.[505] The Court also ruled that the Delaware statute

---

[499] *Id.*

[500] No. 89 Civ. 241 (1989).

[501] Del. Code Ann. tit. 8, § 203 (1988).

[502] *Id.* §203(a)(1).

[503] *Id.* §203(a)(2).

[504] 683 F. Supp. 454, *amended* 683 F. Supp. 458 (D. Del. 1988).

[505] *Id.* at 470.

did not affect interstate commerce in a discriminatory manner.[506]

Another important third generation statute was the antitakeover law passed by Wisconsin.[507] The statute provides that no firm incorporated in Wisconsin and having its headquarters in Wisconsin, substantial operation in Wisconsin, or ten percent of its shares or stockholders in Wisconsin may "engage in a business combination with an interested stockholder . . . for three years after the interested stockholder's stock acquisition date, unless the board of directors of the Wisconsin corporation has approved, before the interested stockholder's stock acquisition date, that business combination or the purchase of stock."[508] The Wisconsin law effectively eliminates hostile leveraged tender offers.

The statute was also challenged unsuccessfully in *Amanda Acquisition Corp. v. Universal Foods Corp.*,[509] which opinion was authored by Frank Easterbrook. Being a scholarly and influential lawyer-economist and a steadfast advocate for deregulation of takeovers, Judge Easterbrook made it plain in his opinion that he has not altered any of his views.[510] Although he found the Wisconsin law to be economically onerous, but for precedential and legal theoretical reasons he would not fight this battle on constitutional grounds. "A law can be both economic folly and constitutional", he wrote, and "if our

---

[506] *Id.* at 472.

[507] Wis. Stat. Ann. § 180.726(2) (West Supp. 1989).

[508] *Id.*

[509] 877 F.2d 496 (7th Cir.), cert. denied, 110 S. Ct. 367(1989).

[510] *Id.* at 500.

views of the wisdom of state law mattered, Wisconsin's takeover statute would not survive."[511]

The result of *Amanda* and *BNS* decisions was to effectively eliminate hostile tender offers, leaving only the proxy right as the remaining means of disciplining management.[512]

2.4. The Fourth Generation Statute

Encouraged by the hands-free attitude displayed by the courts in a series of landmark decisions, the fourth generation takeover statute was introduced in a few states immediately following the wake of third generation statutes. The fourth generation statute goes farther than any earlier state laws in protecting target companies from hostile takeovers.

In addition to the share redemption statute,[513] the fiduciary duty statute[514] and the business combination statute,[515] Pennsylvania adopted the fourth generation statute[516]

---

[511] *Id.*

[512] Power, *Why the Proxy Fight is Back*, Bus. Wk., Mar. 7, 1988. at 32.

[513] 15 Pa. Cons. Stat. Ann. §§1408B, 1409.1(c)91)-(3), 1910 (Purdon 1986).

[514] 15 Pa. Cons. Stat. Ann. §1408 (Purdon Supp. 1984-1985).

[515] 15 Pa. Cons. Stat. Ann. §1101 (Purdon Supp. 1989).

[516] 15 Pa. Cons. Stat. Ann. §§102, 511-12, 1721, 2502, 2542, 2561-67, 2571-76, 2581-83, and 2585-88(Purdon Supp. 1991).

which took yet another step in granting protection against hostile takeovers. The law contained four major provisions: (1) required short-term shareholders who dispose of their shares within eighteen months after attempting to acquire control of a firm to disgorge their sales profits to the firm;[517] (2) withheld voting rights from acquirers of controlling shares until restored by the vote of a majority of pre-existing, disinterested shareholders;[518] (3) redefined the fiduciary duty of directors, providing that directors were not required to consider shareholder interests "dominant or controlling" when considering the effect of any action on the welfare of the corporation;[519] and (4) mandated severance pay and labour contract protections in the event of a hostile takeover.[520] The law granted affected firms a ninety day period following enactment to "opt out' of all or any of these provisions. In light of the considerable restrictions, it is evident that no prior state antitakeover law was as broad or as protective as Pennsylvania's fourth generation statute.

3. Summary

Federal takeover regulation, as exemplified by Williams Act, intended to remedy tender offer abuses by requiring full and fair disclosure for the protection of investors, and concurrently avoid tipping the scales either in favour of management or in favour of the tender offeror. The Williams Act could be considered successful in establishing a balance

[517] *Id*, at 2571-76.

[518] *Id.* at 2561-68.

[519] *Id.* at §515(B).

[520] *Id.* at 2581-83.

between takeover offence and defence. However, the rise of state takeover statutes in the 1980s have considerably changed the landscape. The four generations of state takeover statutes, purporting to outlaw hostile takeovers, have caused the scales to tip conspicuously in favour of management.

Generally speaking, the state takeover statutes have successfully survived judicial scrutiny. In light of the landmark decisions dealing with the constitutionality of state takeover statutes, it is obvious that any antitakeover law could be legally enacted as long as it observes two restrictions: (1) it can only regulate activities of corporations chartered in their state; and (2) the states cannot directly interfere with federal tender offer law and the SEC rules that establish the mechanics of tender offers. Instead, they must design their state statutes in terms of traditional corporation law subjects.

This judicial trend will almost certainly continue. Beginning with the U.S. Supreme Court's opinion in the *CTS* case, courts have become less certain than they had been to assume that takeovers are necessarily a good thing. As the takeover frenzy of 1980s began to wane, there were signs everywhere that the old consensus supporting the takeover boom has evaporated.[521] The conservative judges in the Supreme Court and the Federal judiciary appointed by the Reagan and Bush administrations are generally more reluctant to interfere with state legislation. An unfavourable environment for hostile takeover bid can be expected to persist in the United States in the foreseeable future.

---

[521] *See, e.g.*, Herzel and Shepro, *Bondholder Suits in the U.S.*, Financial Times 8, (Dec. 21, 1989).

II. The Regulatory Regime of Canada

In Canada, securities are provincially regulated and securities commissions have the authority to issue extensive policy statements regarding their views on the proper conduct of takeover bids which have largely sculpted the landscape of takeover activity in Canada. Historically, the Canadian legislative requirements relating to take-over bids and issuer bids have attempted to maintain a balance between the protection of shareholders and the efficient operation of the capital markets. The rules set out in Part XX of the Ontario Securities Act[522] are structured to provide shareholder protection while minimising interference with normal competitive and market forces and avoiding unnecessary participant cost.

However, there has been a shift of regulatory focus taking place in the past a few years. This shift has arisen, not from amendments to the legislation itself, but from policy statements issued by the Canadian securities administrators, i.e. *Ontario Securities Commission Policy 9.1* and *National Policy No. 38* etc. The following section will survey the major provisions of the Ontario Takeover Bid Code (Part XX of Ontario Securities Act) - a code which governs all major Canadian companies listed on the Toronto Securities Exchange (TSE) - and relevant policy statements issued by Canadian securities

[522] R.S.O. 1990, c. S.5, as amended by 1992, c. 18; 1993, c. 27; 1994, c. 11, c. 33.

administrators.

1. Requirements under the Ontario Securities Act

1.1. Applicable Legislation and Policies

Part XX of the Act provides a comprehensive code of conduct for all parties involved in a take-over bid or an issuer bid. There are also two national policy statements in this area: *National Policy No. 37, Take-over Bids: Reciprocal Cease Trading Orders*; and *National Policy No. 38, Take-over Bids - Defensive Tactics*. The following section will summarise the major provisions of the Part XX of Ontario Securities Act and Regulations under the Act relating to non-exempt take-over bids.

1.2. Disclosure Requirements

Subsection 98(1) of the Ontario Securities Act (OSA) obligates an offeror to deliver, with or as part of a take-over bid or issuer bid, a take-over circular or issuer bid circular to the shareholders. A take-over bid circular shall contain the information prescribed in Form 32, and the issuer bid circular shall contain the information prescribed in Form 33. The rationale underlying the above requirements is that offeree shareholders will be unable to make an informed and reasoned decision as to whether to tender their shares to a bid unless they have up-to-date and complete information concerning the offeror (particularly in connection with a share exchange bid), the offeree issuer, and the terms of the bid. A number of points should be noted concerning the required disclosure. If part or all of the consideration for the shares is cash, the offeror must have made adequate arrangements to secure the required funds and must disclose the source of those funds in the circular.[523] If the take-over bid is being made by an insider of the offeree issuer or if the offeror anticipates that a going private transaction will follow the bid, the offeror is required to include in the circular a formal valuation of the offeree issuer.[524]

A further obligation is imposed upon an offeror to provide a notice of change in the information contained in the circular or a notice of variation in the terms of the take-over bid as appropriate.[525] A notice of change of information is required when a change has occurred in the information contained in the circular "that would reasonably be expected to affect the decision of the holders of the securities of the offeree issuer to accept or reject the bid . . ."[526]

Once a take-over bid has been made, the directors of the offeree issuer are required to deliver to the offeree shareholders a directors' circular, the contents of which are set out in Form 35 under the Act. In the circular, the directors are required to recommend acceptance or rejection of the bid and set out the reasons for their recommendation.[527]

---

[523] *Id*, §96.

[524] §182, Ontario Securities Rules.

[525] §98(2), OSA.

[526] *Id*.

[527] §99, OSA.

An individual director or officer may deliver to offeree shareholders his or her own director's or officer's circular, the contents of which are set out in Form 35 under the Act.[528]

Likewise, where a change has occurred in the information contained in either a directors' circular or a director's or officer's circular that "would reasonably be expected to affect the decision of the holders of the securities to accept or reject the bid",[529] the board or the individual director or officer is required to deliver forthwith a notice of change in the form required in Form 34 and 35.

1.3. Procedural Requirements

The procedural requirements insure that all offeree shareholders are treated equally and that they have adequate time to consider the information provided to them and to make their decision. Time periods are prescribed for the delivery of circulars and notices of change or variation, for deposit and withdrawal periods, and for the taking up of, and payment for, shares tendered to the bid.[530]

---

[528] *Id*, subsection (3).

[529] *Id*, subsection (6), (7).

[530] *See* §201-203, Securities Rules.

The Act sets out various circumstances which exempt take-over bids and issuer bids.[531] For example, the private purchase exemption exempts purchases that are made from not more than 5 persons in aggregate, and that are not made generally to security holders of the class of securities that is subject to the bid, and that the value of the consideration paid for any of the securities is not greater than 115% of the market price of securities of that class at the date of the bid.[532] A bid made by a private company meeting certain conditions may also be exempt.[533]

The Act also restricts the circumstances under which the offeror can acquire shares before, during and after the bid, so as to prevent the offeror from acquiring shares outside of the bid under terms or for consideration not available generally to the offeree shareholders.[534] Sales by the offeror during the bid are, with limited exceptions, prohibited.[535]

All offeree shareholders must be offered identical consideration.[536] The offeror is prohibited from entering into collateral arrangements with any offeree shareholder that

[531] *See* generally §93 of OSA.

[532] §93(1)(b),(c) of OSA.

[533] §93(1)(d) of OSA.

[534] *See*, §94(2)(3),(4),(5),(6): Restrictions on acquisitions during takeover bid; Restrictions on pre-bid and post-bid acquisitions of OSA.

[535] §94(8), OSA.

[536] §97, OSA.

would, in effect, increase the consideration paid by that shareholder for his or her shares.[537] Where a bid is made for less than all of the class of shares subject to the bid and a greater number of shares is tendered, take-up must be proportionate.[538]

2. Remedies Under the Securities Act

2.1. Application to the Commission

The OSA provides that the Securities Commission may, considering that a person has not complied or is not complying with the Part XX or the regulations related to this Part, make an order to restrain the distribution of any record in connection with a take-over bid; require an amendment to or variation of any above-mentioned record; direct any person to comply with Part XX or the regulations related to this Part or restrain any person from contravening this Part.[539]

In addition to the order sought under the section 104, there are other regulatory powers available to the Commission that are set out in section 127, which provides that the Commission may, considering it to be in the public interest, order a person to comply with or cease contravening the provisions of the Act or other regulatory instrument or policy;

537 §97(2), OSA.

538 §95(7), OSA.

539 §104, OSA.

cease trade a specified security or a class of security, remove trading exemptions applied to a person, order a person to resign his/her directorship or officership, or prohibit a registrant or issuer from disseminating to the public any information described in the order etc.[540]

2.2. Application to the Ontario Court

The OSA provides that an interested person may apply to the Ontario Court for an order to compensate any interested person for damages suffered as a result of a contravention of Part XX or regulations related to this part, or to rescind a transaction of securities with any interested party, or require any person to dispose of any securities in a take-over bid or a issuer bid, or prohibit any person from exercising any or all of the voting rights attaching to any securities, or require the trial of an issue.[541]

The definition of "interested person" is set out in section 89. It is broadly defined to include all of the main players in a take-over bid. As well, the Commission is authorised to grant standing to other persons that the Commission considers to be proper persons to make an application under section 104 and 105.[542]

3. Civil Liability under the Ontario Securities Act

[540] §127, OSA.

[541] §105, OSA.

[542] §89 "Interested Person", OSA.

The OSA provides that if a take-over bid or an issuer bid contains a misrepresentation and a person to whom the circular was sent has a right of action for rescission or damages against the offeror, the person who signed the certificate in the circular, offeror directors and any other party who consented to the circular.[543] Likewise, where a director's circular or a director's or offer's curricular contains a misrepresentation, a person to whom the circular was sent has a right of action for damages against every director or officer who signed the circular.[544]

The remainder of section 131 sets out defences to an action under subsection (1) or (2) and provides that the liability imposed in those subsections is joint and several. Section 131(11) also provides that the statutory right of action for rescission or damages provided by the section is in addition to, and not in derogation from, any other right available.

4. Other Regulatory Developments

4.1. Ontario Securities Commission Policy 9.1

O.S.C. Policy 9.1 was developed to help ensure that all security holders of an issuer receive complete and accurate information and fair treatment in respect of transactions

[543] §131(1), OSA.

[544] §131(2), OSA.

between the issuer the interested parties of the issuer. Policy 9.1 applies to:

(1) "insider bids": take-over bids by insiders of the target corporation, or by associates or affiliates of such an insider or of the target corporation itself;[545]

(2) "issuer bids": bids by the corporation or a wholly-owned subsidiary for securities of the corporation;

(3) "going private transactions": in which a holder of a participating security can be bought out by the corporation without the consent of of the holder, other than by the exercise of an existing redemption right, a statutory purchase right or the substitution of another participating security of equivalent value in the corporation or a successor;[546] and

(4) "related party transactions": in which an asset, security or liability is acquired or transferred by a corporation to or from a "related party". "Related party" refers to a person or company which alone or in combination with others holds securities carrying more than 10% of the voting rights attached of the corporation or which otherwise are sufficient "to affect materially the control" of the corporation, or a director, senior officer, or affiliate of the corporation.[547]

To regulate the above four type of transactions, the Policy provides that:

(1) For an insider bid, enhanced disclosure and a valuation of the securities that are the subject of the bid are required; review by a special committee of the directors of the issuer is

[545] §2.2(6), OSC Policy 9.1.

[546] *Id*, §2.2(4).

[547] *Id*, §2.2(14).

recommended;[548]

(2) an issuer bid requires enhanced disclosure and a valuation of the securities that are the subject of the bid; review by a special committee of the directors is recommended;[549]

(3) a going private transaction requires enhanced disclosure, a valuation of the securities in which the interest of the holders will be terminated, and the minority approval of those holders, review by a special committee of the directors is recommended;[550] and

(4) a related party transaction requires enhanced disclosure, a valuation of the subject matter of the transaction and the minority approval of the holders of voting and equity securities; review by a special committee of the directors is recommended.[551]

The Policy provides exemptions for these requirements in each part. Exemptions are also available from the Ontario Securities Commission on a discretionary basis.

From a policy perspective, Policy 9.1 is intended to restore an appropriate balance between the protection of shareholders and the efficient operation of the capital markets in respect of transactions between the issuer and interested parties of the issuer. However, it seems that the Policy has gone too far in the direction of shareholder protection, to the detriment of corporate operations and the efficient flow of capital. While requirements such as minority approval and recommendation of special committee review may serve the purpose of investor protection and maintaining the integrity of the capital market, they can

[548] *Id*, Part II.

[549] *Id*, Part III.

[550] *Id*, Part IV.

[551] *Id*, Part V.

also be extra obstacles for bidders to consummate transaction. The Policy apparently anticipates these problems and attempts to address them. Specific exemptions from the requirements are provided in circumstances where the protections are considered unnecessary or the transactions are small. As well, the Policy states that "[u]njustifiable minority tactics in a situation involving a minimal minority position may cause the Commission or the Director to waive requirement of this Policy Statement."[552] However, it is obviously premature to conclude that the Policy in effect strikes an appropriate balance unless more evidence comes along to support it.

4.2. National Policy No. 38

In the face of a hostile takeover bid, the target directors can exercise their management discretion to employ certain defensive tactics. Some of the defensive tactics have been highly controversial - particularly, shareholder rights plans (poison pills) which give management too much power to defeat the takeover attempts. The Canadian Securities Administrators have addressed the issue of defensive tactics generally in *National Policy No. 38, Take-over Bids - Defensive Tactics*. *National Policy No. 38* recognises the need to balance shareholder protection with the goal of maintaining an efficient capital market, and provides, in part, as follows:

> [T]he primary objective of take-over bid legislation is the protection of the bona fide interests of the shareholders of the target company. A secondary objective is to provide a regulatory framework within which take-over bids may proceed in an open and even-handed environment. The rules should favour neither the offeror nor the management of the target company, but should leave the shareholders of the offeree company free to make a fully

[552] Id, §1.4.

> informed decision. The administrators are concerned that certain defensive measures taken by management may have the effect of denying to shareholders the ability to make such a decision and of frustrating an open take-over bid process.
>
> The administrators have determined that it is inappropriate at this time to specify a code of conduct for directors of a target company, in addition to the fiduciary standard required by corporate law. Any fixed code of conduct runs the risk of containing rules that might be insufficient in some cases and excessive in others. However, the administrators wish to advise participants to examine target company tactics in specific cases to determine whether they are abusive of shareholder rights. Prior shareholder approval of corporate action would, in appropriate cases, allay such concerns.

National Policy 38 reflects the stringent rules of take-over regulation in Canada. It also reflects the primary focus of securities administrators on the protection of the bona fide interests of the shareholders of the target company. Although the policy makers are admittedly reluctant to specify a code of conduct for directors, the Policy has, as a matter of fact, generated considerable influence on Canadian corporate fiduciary principles, which was expounded by the landmark case of *Producers Pipelines*.[553] As discussed in the foregoing chapter, such an influence might not be agreeable to corporate law world, since corporate law is more concerned about balancing the need for flexibility regarding the structure, financing and management of a corporation with the need for corporate accountability, yet securities regulation almost exclusively focuses on the protection of investors.

5. Antitrust Law

---

[553] *See supra* note 430 and accompanying text.

The first antitrust statute of Canada was the Combines Investigation Act (Canada)[554] enacted in 1910. Under the Act, a merger was offensive only if it could be proved beyond a reasonable doubt that it lessened competition to the detriment of the public.[555] Offences relating to anti-competitive mergers and other monopolistic behaviour were matters of criminal law. The criminal law standard of "proof beyond reasonable doubt" was apparently too strong to be applied in the context of mergers and acquisitions, as the standard is extremely difficult to establish and the courts were generally reluctant to impose criminal sanctions on corporate transactions. As a result, the merger provisions in the Act were practically ineffective and unenforceable.

Since the early 1970s, numerous attempts have been made to transform the antitrust provisions from criminal law to civil law. These efforts culminated in 1986, when the Competition Act (Canada)[556] was proclaimed in force. Under the Competition Act, the test is whether a merger or proposed merger "lessens competition substantially."[557] A specialised Competition Tribunal was created to adjudicate all non-criminal matters under the Act. Administrative bodies such as the Director of Investigation and Research (the Director) and the Bureau of Competition Policy were also established to increase bureaucratic involvement in the area of mergers and acquisitions.

---

[554] R.S.C. 1970, c. C-23, as amended.

[555] *Id*, Section 2.

[556] R.S.C. 1985, c. C-34

[557] *Id*, Section 92.

Section 92 of the Competition Act provides that on application of the Director of Investigation and Research, the Competition Tribunal, when finding that a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially, may order any party to the merger or any other person to dissolve the merger, dispose of assets or shares, or not to proceed with the merger or a part of the merger. Section 92 further provides that the decision of the Tribunal should not be solely based on the evidence of concentration of market share.

The Competition Act sets out pre-merger notification provisions[558] to allow the Director to review significant transactions before they are completed and to prohibit any transaction if the Director believes that it would prevent or lessen competition substantially. Merger transactions with certain value and size will be notifiable under Part IV of the Act. Pre-notification is not required unless the parties to the transaction have gross annual revenues that exceed $400 million in the aggregate, or the aggregate value of the assets involved in the transaction or the gross annual revenues from sales generated by the assets exceed $35 million.[559] Information required in pre-notification includes a description of the parties and the acquisition, current financial statements, and statements of the gross and net assets and the gross revenues from sales at the end of their most recent completed fiscal year.[560] Pre-notification provisions further mandates the waiting period of 7 days for short

---

[558] *Id*, Part IV.

[559] *Id*, Section 109.

[560] *Id*, Section 121-122.

form filings and 21 days for long form filings before a proposed transaction can be completed. Time begins to run from receipt of information by the Director.[561] In light of the pre-merger notification rules, the Competition Act (Canada) bears notable resemblance to the H-S-R Act of the U.S..

6. Summary

Canadian takeover regulatory regime is comparatively more stringent than that of the United States. Many takeover practices prevalent in the U.S. are simply outlawed in Canada. For example, the "identical consideration"[562] and "pre-bid integration"[563] provisions of OSA together effectively rule out practices like the two-tier, front-end loaded bid; prohibition of public companies from acquiring shares from certain shareholders without making an offer to all shareholders[564] effectively prohibits greenmail.

In contrast to the situation in the U.S. where state antitakeover statutes changed the environment of corporate control transaction, Policy statements of Canadian securities administrators have played a disproportionate role in the regulation of takeovers. While the provincial securities statutes are concerned with maintaining the balance between takeover

---

[561] *Id*, Section 123.

[562] §97, OSA.

[563] §94(5), OSA.

[564] §93, 95, OSA.

offence and defence, policy statements issued by securities administrators are preoccupied with protecting investors and maximising the shareholder wealth. Although the Policy statements such as *National Policy No. 38* are not necessarily meant to disturb the balance struck by the securities statutes, they do have a straitjacket effect on the management of the target company. Directors' business discretion is seriously curtailed in the context of a hostile takeover bid. The stringent rules of Canadian takeover regulatory regime demonstrate the determination of securities administrators to preserve fairness in takeover transactions, even at the expense of the flexibility of corporate planning.

III. Conclusion

The regulatory regimes in the United States and Canada have made considerable achievements in taming and reining in the once ferocious beast - the hostile takeover bid. Adequate information is ensured by rigorous disclosure requirements. Mandatory minimum bid periods, pro rata take-up and withdrawal rights have removed the undue pressure once being exerted upon shareholders. Identical consideration and valuation requirements have largely eliminated the unfairness of some takeover practices. After two decades of formulation, the takeover regulation in North America has successfully transformed the hostile takeover bid.

As discussed in Chapter I, the justification for the regulation of corporate takeovers lies in the coerciveness inherent in, and unfair practices associated with the takeover activity. However, driven by different initiatives, the takeover regulatory regimes in the

United States and Canada have gone farther than achieving the goal of full and fair disclosure of information and a level playing field.

In the United States, state takeover statutes have tended to thwart and burden takeovers and enlarge the power of target directors. The third and fourth generation takeover statutes purport to eliminate hostile takeovers and bring back the proxy fight as the primary tool of obtaining corporate control.[565] Most of current state antitakeover statutes have survived judiciary scrutiny.[566] Despite their predominance, state antitakeover statutes have been under vicious attack from many commentators. Roberto Romano believes that "an informed reading of the literature suggests that much of the existing regulatory apparatus is unwarranted;"[567] Stephen Mahle opines that "laws which eliminate tender offers, leaving proxy fights as the only avenue of corporate control change, are economic catastrophes."[568]

From the perspective of the principled eclecticism established in Chapter I, most state antitakeover statutes appear to go too far. As long as takeovers that create wealth and promote efficiency should be encouraged, it is inappropriate to eliminate hostile takeovers in the aggregate when some tender offers identifiably have disciplinary effects on

---

[565] *See supra* note 526 and accompanying text.

[566] *See supra* note 502-526 and accompanying text.

[567] Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9:107 Yale J. Reg. 119 (1992).

[568] Stephen Mahle, *Proxy Contests, Agency Cost, and Third Generation State Antitakeover Statutes*, 24 Securities L. Rev. 447, 451 (1992).

substandard management. Before a more effective and economical alternative of disciplinary mechanism is available to replace tender offers, any scheme purporting to eliminate hostile takeovers should be considered premature.

Canadian takeover regulation has achieved the same goal as that of its American counterpart. Full and fair disclosure of information in the process of a takeover bid is ensured. Procedural requirements have made the playing field as level as what was originally expected. Because securities are provincially regulated, the Canadian takeover regulatory regime appears to be more flexible than its American counterpart in expressly addressing some of the abusive practices which still exist in the United States. As a result, Canadian securities regulators have adopted a much more interventionist approach than the SEC and outlawed many coercive or unfair takeover tactics which still exist in the U.S..[569]

The interventionist approach of Canadian securities administrators was implemented not without cost. Securities administrators made it clear that "it is inappropriate at this time to specify a code of conduct for directors of a target company, in additional to the fiduciary standard required by corporate law."[570] However, in the landmark case of *Producers Pipelines* which attempted to establish a corporate fiduciary standard in the context of hostile takeovers, the Court resorted to the *National Policy No. 38* and subsumed the

[569] Dey and Yalden, *Keeping the Playing Field Level: Poison Pills and Directors' Fiduciary Duties in Canadian Takeover Law*, 17 Can. Bus. L. J. 252, 263 (1990).

[570] *National Policy No. 38*.

fiduciary standard under its principles.[571]

It is not yet practical to measure the economic cost brought about by securities policy's incursion into corporate principle, but in the long run, the grafting of legal principles is likely to affect the corporate world in an unfavourable way, given the fact that the policy considerations underlying corporate law and securities regulation are substantially different.

[571] *See Producers Pipelines, supra* note 431.

Chapter Four

Alternative Schemes for Takeover Regulation and Corporate Accountability

Economists have long argued that hostile takeovers are a "good thing" - an institution that law should encourage. Takeover bids monitor and discipline corporate managers, and because of the threat of takeover, managers operate the firm in a way that maximises shareholder returns.[572] In light of the current takeover regulation in North America - especially the state antitakeover statutes of the U.S. purporting to thwart and eliminate hostile takeovers, many commentators have argued that the empirical evidence is most consistent with explanations of takeovers as value-maximising events for target firms' shareholders that enhance social efficiency, and that the existing regulatory apparatus is unwarranted.[573]

Is the disciplinary function of hostile takeovers indeed so critical and indispensable to the health of an economy as to outweigh their huge costs and the economic and social consequences? There is no easy answer that can be found in the market for corporate

[572] *See supra* note 94-96 and accompanying text.

[573] *See e.g.*, Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. of Reg. 119 (1992).

control in North America. However, evidence from overseas may shed light on this question. Two other major economies of the industrialised world provide good examples for such an examination. In both Japan and Germany, we find developed and robust economies, the continued and comprehensive use of the modern publicly held corporate system, and most importantly, few hostile takeovers. Are there, perhaps, economic efficiencies made possible by the absence of hostile takeovers?

The United Kingdom also had an active takeover market in the 1980s. However, despite many US influences, the "two-tiered, front-loaded, bust-up and junk bond financed" takeover practices have rarely been seen in the U.K.. The "non-statutory" regulatory system of the U.K. has been lauded by commentators as avoiding tactical litigation and ensuring fairness to minority shareholders.[574] Can the British system be the model for any proposed reform of takeover regulation in North America?

Proponents of the disciplinary hypothesis of hostile takeovers tend to minimise the significance of other mechanisms that ensure corporate accountability - such as independent boards, shareholder voting, derivative litigation, or mandatory disclosure statutes.[575] Such alternative modes are seen as of limited utility because of shareholders' rational apathy and their free rider approach, which prevent shareholders from serving as effective monitors of

---

[574] *See, e.g.,* Thomas Hurst, *The Regulation of Tender Offers in the United States and the United Kingdom: Self-Regulation v. Legal Regulation*. 12 NC J. Intl. L. Comm. Reg. 389 (1987).

[575] For a representative statement of this point of view, *see* Fischel, *The Corporate governance Movement*, 35 Vand. L. Rev. 1259 (1982).

management. However, shareholder passivity becomes progressively less rational as the shareholders' stake in the corporation increases, and a shareholder with a significant stake in the corporation has an incentive to become actively involved in monitoring the performance of the corporation rather than to remain passive. There is plenty of evidence suggesting that large block shareholders - such as institutional investors - do have a role to play on the monitoring of corporate managers.[576]

If institutional investors could organise at low cost to intervene in managerial decision-making, they might serve as a better apparatus for ensuring corporate accountability, thereby eliminating the takeover bidder as costly and unnecessary middleman. After all, institutional monitoring of managerial performance could arguably work as well as takeover bids, but involve less disruption, cost, and adverse social impact.

This chapter will address the above-mentioned issues. First, it will review relevant evidence from other countries such as Britain, Japan, and Germany. Second, the role of institutional shareholders and independent directors in ensuring corporate accountability will be discussed. Finally, a conclusion will be reached with regard to the value of internal monitoring of corporate management.

---

[576] For a review of this evidence, *see, e.g.*, J.G. MacIntosh, *The Role of Institutional and Retail Investors in Canadian Capital Markets*, 31 Osgoode Hall L. J. 371 (1993); and B.S. Black, *The value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. Rev. 895, 917-27(1992).

I. A Review of Evidence from Overseas

1. Japan

In Japan, mergers and acquisitions exclusively between Japanese parties are regulated by the Commercial Code,[577] the Antimonopoly Law,[578] and the Securities and Exchange Law.[579]

The Commercial Code regulates capitalisation, shareholder rights, restructuring and dissolution of Japanese companies.[580] However, the vagueness of the Code requires judicial interpretation of its provisions.[581] For example, in the famous *Shuwa* Decision,[582] the Court established new standards for interpretation and enforcement of the section of the Commercial Code affecting shareholder rights in the event of defensive action to hostile takeovers through the issuance of new shares.[583]

[577] Shoho (Commercial Ccde), Law Nol 48 of 1899.

[578] Shiteki Dokusen no Kinshi oyobi Kosei Troihiki no kakuho ni Kansuru Horitsu (Law Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade), Law No. 54 of 1947.

[579] Shoken Torihikiho (Securities and Exchange Law), Law No. 25 of 1948.

[580] Whiteman, *The Legal Framework of Acquisitions in Japan*, Nat'l L. J., May 18, 1987, at 36.

[581] *See* Smith, *The Japanese Foreign Exchange and Foreign Trade Control Law and administrative Giudance: The Labyrinth and the Castle*, 16 Law & Pol'y in Int'l Bus., 417, 418 (1984).

[582] *Shuwa v. Inageya* and *Shuwa v. Chujitsuya*, 1317 Hanrei Jiho [Hanji] (Aug. 21, 1989).

[583] T. Huckaby, *Defensive action to Hostile Takeover Efforts in Japan: The Shuwa Decisions*, 29 Colmb. J. Transnational L. 439, 441 (1991).

The Japanese Tender Offer statute[584] imposes disclosure costs on the acquirer and reduces the speed and flexibility with which an acquirer can carry out a takeover. The acquirer must file a complex registration statement with the Ministry of Finance ten days before the offer's effective date.[585] Once the offer becomes effective, the acquirer must hold it open for at least twenty days.[586] Shareholders have the withdrawal right during the first ten days of the offer.[587] Identical consideration to all shareholders is required.[588] While the offer is outstanding, neither the offeror nor its affiliates may purchase target shares on the market.[589]

The Japanese antitrust statute prohibits a firm from acquiring the stock of any corporation if the acquisition "would substantially restrict competition in any field of trade."[590] The statute prohibits any stock acquisition that constitutes an "unfair trade practice."[591] Finally, the statute bans holding companies.[592] Though occasionally different

---

[584] Law No. 4 of 1971, *amending* Securities Exchange Act, Law No. 25 of 1948.

[585] *Id.* §§27-2(a)-(b), 8(a).

[586] *Id.* §27-3(b).

[587] *Shoken Torihiki ho shiko rei [Securities Exchange Act Enforcement Order],* Cabinet Order No. 321 of 1965, §13(e).

[588] *See supra* note 584, *at* §27-4(b), (c).

[589] *Supra* note 585, §13(a), (c)-(d).

[590] Antimonopoly Act, *supra* note 576, at §10(a).

[591] *Id.* § 10(a), 4(a).

[592] *Id.* § 9(a)-(b). Holding company is defined as a firm whose primary business is that of controlling domestic corporations through stock ownership. *Id.*

perhaps, the Japanese antitrust statute is hardly more onerous as to deter acquisitions than its American counterpart.[593]

A review of the Japanese legal framework on the regulation of takeovers can hardly explain why hostile takeovers are such a rarity in Japan.[594] Many commentators have emphasised non-legal barriers to hostile takeovers. First of all, observers of Japanese business assert that the Japanese consider hostile takeovers social taboo, even though they increase a firm's profitability. Professor James Abegglen found that "the Japanese company is seen as integrally including the people who compose it. Therefore, the purchase or sale of a business or company in Japan has the flavour of the purchase or sale of people. It is, in short, considered immoral."[595] The Japanese intellectual tradition has long emphasised harmony, loyalty, and consensus, as a result, most of corporate control transactions appear to be friendly.[596]

Japanese shareholding patterns also decrease the utility of a hostile takeover to an acquirer. In a wide variety of Japanese firms, managers exchange large blocks of their firm's stock with other firms through cross-shareholding agreements. Furthermore, many Japanese firms try to consolidate their relationship with their business partners by holding

---

[593] J.M. Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. Rev. 1, 37, (1987).

[594] *Id.* at 6.

[595] Abegglen, *Can Japanese Companies Be Acquired?*, Mergers & Acquisitions 16, 18 (Winter 1983).

[596] Ramseyer, *supra* note 591, at 19-20.

the partners' stock. Firms apparently would not easily sell their partners' stock to a hostile bidder. In general, Japanese companies are owned by a network of "stable shareholders." The largest shareholders in a particular company are likely to be associated with that company through pre-existing business relationships.[597] The holdings of related companies are not traded and constitute a stable controlling interest which prevents any individual shareholder from acting as a real hostile takeover threat.[598] Stable shareholders usually give blank proxies to management in exchange for the same type of treatment in their own corporations. Failure to follow this practice is considered an insult and jeopardises the relationship.[599] Stable shareholding groups usually conduct joint meetings, form interlocking directorates and engage in joint internal and external business dealings.[600] This shareholding pattern seriously diminishes the viability of hostile takeovers.

Despite the absence of hostile takeover bids, the rapidly growing economy in Japan in the 1970s and 1980s suggests that alternative disciplinary mechanisms may exist in Japan that are unavailable in the United States.

---

[597] Nearly 65% of shares of the Japanese companies listed on the Japaese stock exchanges are owned by other companies and organizations with close relationships)31% by financial institutions and 26% by corporations. The remaining 27% is held by individual investors. Abell & Kitarai, *Japanese M&A: The Barriers to Hostile Takeovers*, 8 Int'l Fin. L. Rev. 11, 12-13 (1989).

[598] *Id.*

[599] Heftel, *Corporate Governance in Japan: The Position of Shareholders in Publicly Held Corporations*, 5 U. Haw. L. Rev. 135, 165 (1983).

[600] Note, *Mergers and Acquisitions in Japan: New Options for Foreign Companies*?, 26 Colum. J. Transnat'l L. 575, 587 (1988).

According to Gilson's structural theory, apart from the market for corporate control, there are three other market forces that serve to discipline managerial shirking: the market for product and service, the market for managerial talent and the capital market.[601] In Japan, these market forces, combined with other corollary effects of the Japanese culture, work successfully to monitor internal firm efficiency.

Due to the fierce competition in the market for product and service, a firm that tolerates more extensive managerial shirking than its competitors may find itself bankrupt in short order. Competition significantly punishes managerial shirking in Japan. The market for managerial talent, however, takes a different form in exerting its influence. In Japan, the horizontal mobility of most managers is limited, probably due to the traditional value of loyalty.[602] Just as economist Albert Hirschman once pointed out, "voice feeds on the lack of opportunity for exit".[603] If managers do not have the ready option to exit, they will protest against any shirking behaviour that might jeopardise the future of the firm. Therefore, the mutual interest for survival determined by the limitations on horizontal mobility becomes an important monitor on managerial performance in Japan.

Japanese firms are more heavily leveraged than their US counterparts. Abegglen and Stalk estimated Japanese firms' average debt-equity ratio to be 2:1 as opposed to that

---

[601] *See supra* note 113 - 116 and accompanying text.

[602] J. Abegglen & G. Stalk, *Kaisha, The Japanese Corporation* (1985), at 199, 256-57.

[603] A. Hirschman, *Exit, Voice, and Loyalty* (1970), at 34.

of the US firms which is 1:2.[604] Other scholars even have higher estimates.[605] Debt may give banks both power and incentive to closely monitor the firms' management.[606] Japanese firms' shareholding patterns also serve to fulfil the disciplinary purpose. It is estimated that between 65 and 70 percent of the stock in all listed companies on the Tokyo Stock Exchange is held in interlocked cross-ownership groups called "*Keiretsu*".[607] Shareholders with larger blocks have greater incentives to invest their resources in monitoring the firm's managers. The large blocks of stock significantly increase the level of shareholder monitoring.

By and large, alternative disciplinary mechanisms do exist in Japan and can not be expected to develop in North America due to the special cultural environment that nurtures these practices. The tradition of loyalty and harmony that dominates the Japanese business world derives from the deep-rooted Confucianism. The organisation of *Keiretsu* reflects the collectivism prevalent in oriental cultures. The case study of Japan's market for corporate control provides little justification for the obsoleteness of hostile takeovers.

---

[604] *See supra* note 600, at 150.

[605] See, e.g., Crampe & Benes, *Majority Ownership Stategies for Japan*, 1 UCLA Pac. Basin L. J. 41, 74 (1982) (debt-equity ratio: Japan -80:20).

[606] *See supra* note 44 and accompanying text.

[607] *Keiretsu* means "faction or group arranged in order". It typically consists of a diversified confederation of companies clustered around a "main bank" that provides loans ot the members of the group as their chief source of financing. A *Keiretsu* resembles a miniature common market in which each member generally relies on the others as its principal trading partners, preferring them to external sources as suppliers, customers, and creditors. *See* J. Coffee, *Institutional Investors as Corporate Monitor: Are Takeovers Obsolete*? 12, 33 in *Takeovers, Institutional Investors and the Modernization of Corporate Laws*. (1993).

2. Germany

The German mergers and acquisition market historically consisted only of friendly takeovers.[608] Before the promulgation of the European Takeover Directive, no binding rules governed the takeover process in Germany.[609] Voluntary guidelines, which do not have the force of law, were promulgated in 1979 by the Stock Exchange Committee of Experts affiliated with the Federal Ministry of Finance. The guidelines are not binding on acquirers, and apply only to AGs (stock corporations) or KGs (limited partnerships).[610] The guidelines are far less stringent than the takeover codes in the United States or Britain. For example, there are virtually no restrictions on the offeror; partial offers are allowed, the offeror may continue the offer for as long as it wishes and, if unsuccessful, may make another offer at any time. No disclosure of any beneficial ownership is required, the method of publication and disclosures made in the offer is largely left to the discretion of the offeror, and the offer document does not have to be filed with any regulatory agency. In addition, there is no single regulatory authority like the Takeover Panel of the U.K. or the SEC of the US.[611]

---

[608] David J. Berger, *A Comparative Analysis of Takeover Regulation in the European Community*, 55 Law and Comtemporary Problems, 53, 68 (1992).

[609] For a general review of European Takeover Directive, *see* Mads Andenas, *European Takeover Directive and the City*, 18 The Company Lawyer, 101-104 (1997).

[610] For a summary of the guidelines, *see* Coopers & Lybrand, *Barriers To Takeovers In The European Community* (1989), at 10.

[611] *Id.*

Even with such a lax regulatory environment which Easterbrook and Fischel believe to be most conducive to the market for corporate control,[612] the hostile takeover bid is only rarely seen in Germany. Apparently, non-legal barriers have played an important role in deterring hostile takeovers.

German corporations depend upon their banking system for access to all forms of external finance even more so than Japanese firms. Coopers and Lybrand found that "Germany's stock markets have never been a significant factor in the equity raising process as companies have traditionally relied upon long term loans from their primary banks as the major source of finance."[613] There are only approximately 500 publicly traded German companies, many of which are either family controlled or controlled by a few dominant shareholders. Fewer than 100 lack a controlling shareholder or shareholder group. In fact, one source estimates that there are only approximately thirty companies that have a sufficiently dispersed shareholder base to allow a hostile takeover bid to succeed.[614]

There are also other structural barriers deterring hostile takeovers. In Germany public corporations (AGs) have a mandatory two-tiered board system. Under the system, the management of the company rests with a management board, the members of the management board are appointed by a separate, second-tier supervisory board of non-

---

[612] *See supra* note 105-108 and accompanying text.

[613] *Supra* note 608, at 16.

[614] *See* Eckart Wilcke, *Germany*, in *International M&A: A Guide to the Regulation of Mergers and Acquisitions Worldwide*, 1991 Int. Fin. L. Rev. at 49.

management directors. Supervisory directors are selected by shareholders and employees. In AGs having fewer than 2,000 employees, one-third of the supervisory board must consist of employee representatives; and one-half of the supervisory board must be employee representatives in AGs with more than 2,000 employees. Management board members are typically appointed for five year terms and cannot usually be removed within that term except in the case of fraud and illness. Management board members can not be removed directly by shareholders, although some companies do provide that loss of shareholder confidence can be cause for removal.[615] The two-tiered board can be a significant deterrent to hostile takeover bids. An acquirer can not immediately exercise control even if he/she has already obtained a control shareholding, since a majority shareholder often cannot displace a majority of the supervisory board, while the management board cannot be removed until their term expires.

Despite the atrophied market for corporate control, Germany has an economy that is indisputably one of the most robust and competitive in the industrial world. The reliance on internal monitoring rather than the market for corporate control has been a distinctive characteristic of the German system.

First of all, bank supervision of corporate management in Germany has been close and intensive. Unlike the Japanese banks, German banks are merchant banks that handle both commercial banking and securities underwriting. As German banks provide the

---

[615] *See generally*, Westminister Management Consultants, Ltd., *West Germany*, in *A Practitioner's Guide To European Takeover Regulaton and Practice*, at 316-20.

country's stock-brokerage services, German corporations generally deposite their shares with banks, which can vote the shares on behalf of them.[616] The three largest German banks hold on average around 34 percent of the votes in the 100 largest companies in Germany, 50 percent of the total voting power in the top 10 German corporations.[617] As one observer once noted, "through the exercise of voting rights the big banks greatly influence hirings and firings in West German corporations' executive bodies, the supervisory boards, as well as on managing boards. They have a voice in all fundamental business decisions."[618] Because of the illiquidity of German stock market, banks are compelled to exercise "voice" instead of "exit." Cooper and Lybrand found that the relationships between the three major German banks and their corporate clientele are "very close and stable," and noted that the problem of "short-termism" seldom arises.[619]

In addition to the bank control, it should be noted that German companies are major shareholders in each other - the corporate sector holds 42 percent of all shares in Germany - and are thus willing to closely monitor the corporate management of each other.[620] German corporate holdings are not purely investment, but also have a strategic purpose - to

---

[616] *See* Cooper & Lybrand, *supra* note 608, at 13-14.

[617] *See* Baums, *Corporate governance in Germany: The Role of the Banks*, 40 Am J. Comp. L. 503, 507-8 (1992).

[618] Hermann H. Kalfass, *The American Corporation and The Institutional Investor: Are There Lessons From Abroad*? Colum. Bus. L. Rev. 775, 783 (1988).

[619] *See* Cooper & Lybrand, *supra* note 608, at 14.

[620] *See* Schneider-Lenne, *Corporate Control in Germany*, in Vol 8 No 3 Oxford Review of Economic Policy: Corporate Governance and Corporate Control (1992), at 14.

reinforce a trading relationship and protect the company against a takeover. Because of their large stake, German corporate shareholders behave like a real owner and are willing to participate in governance. Furthermore, the strategic nature of their stakes makes corporate shareholders less interested in short-term profits and dividends and more in the stability and growth of the companies in which they invest.[621]

The two-tiered board system also serves as an internal monitor on corporate management. In Germany, the powers of the supervisory and management boards are rigidly separated. The supervisory board consists of nominees of shareholders and employee representatives. The supervisory board appoints the members of the management board, and has the exclusive right to dismiss them, though for cause within their contractual period of office. Management is obliged to make regular reports to the supervisory board on the performance of the business, and the latter is entitled to any additional information it requires. Among the 84 largest German companies, 75 have supervisory boards which are chaired by a bank representative. Bank nominees on the supervisory boards are assisted by the banks' industrial departments which are responsible for monitoring the affairs of major companies. Information available to supervisory directors in turn supports banks in their capacity as lenders, further facilitating their ability to monitor performance. Since German banks and corporate shareholders generally hold shares on a long-term basis rather than for trading purposes, they are relatively immune from the fear of insider dealing when they set out to gather information in the affairs of portfolio companies. The fact that German

[621] *See* Oxford Analytica Ltd, *Board Directors and Corporate Governance*: Trends in the G7 Countries over the Next Ten Years (Oxford, 1992) at 80.

companies are typically faced with a plurality of monitors who are independent not only of management but also of each other seems likely also to contribute to an optimal corporate performance.[622] The two-tiered board system provides a viable mechanism for banks and corporate shareholders to exercise their internal monitoring function.

The German style internal monitoring is epitomised by its two-tier board system, which has long been considered the guiding light of those responsible for the U.K. regulatory reform. The model of two-tier board was proposed by Bullock Committee years ago, but was rejected.[623] However, in the face of the emerging European common market, numerous efforts have been undertaken to converge the European and Anglo-Saxon models of corporate governance. The most prominent of these efforts has been the Cadbury Report promulgated in December 1992 - which purported to obtain a "half way house" between unitary and two tier board systems.[624]

3. The United Kingdom

Britain has long had the most active takeover market in the EC, as well as a widely respected system for regulating corporate control transactions. The hostile takeover is

---

[622] *See* generally, Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States* 102 Yale L. J. 1927, 1980-4 (1993)("the presence of several large shareholders with the incentive to monitor deters shareholder opportunism, and leads to power sharing, rather than the exercise of domination over management"); *see* also Schnerder-Lenne, *supra* note 619, at 19-20.

[623] Bullock Committee, *Report of The committee of Inquiry on Industrial Democracy* (1977) Cmnd 6706, HMSO. London.

[624] *The Cadbury Committee on the Financial Aspects of Croporate Governance* (December 1992).

believed to have developed as a corporate phenomenon in the United Kingdom in the 1950s.[625] The British system is widely referred to as a "non-statutory" system, relying on self-regulation by the securities industry rather than particular legal penalties for violations of specific laws.[626]

In the U.K., the takeover regulatory body is the London Takeover Panel, a non-government, non-statutory body that regulates the conduct of takeover bids. It is quite independent from the Securities and Investments Board and the Department of Trade and Industry. Its major mission is to ensure that the target company shareholders are fairly and equitably treated.[627] The Takeover Panel administers the City Code on Takeovers and Mergers ("Takeover Code"), which can be amended or altered at great speed. The system is flexible and speedy. Although the Panel does not have statutory power, its rulings and decisions have virtually never been disregarded, since the sanction of public censure and the other consequences that may flow from it are powerful.[628]

The Takeover Code governs the making of a public offer in the U.K.. The Code

---

[625] Ronald W. Moon, *Business Mergers and Takeover Bids*, 5th ed. (London, Gee & Co. Ltd., 1976), at p. 9.

[626] For a review of comparative study of takeover regimes between US and U.K., *see, e.g.*, Tony Shea, *Regulation of Takeovers in the United Kingdom*, 16 Brooklyn J. Intl L. 89 (1990); D. A. DeMott, *Current Issues in Tender Offer Regulation: Lessons From the British*, 58 NYU L Rev 45 (1983).

[627] Peter Lee, *Takeovers - The United kingdom Experience, supra* note 605, at 193.

[628] The Securities and Investments Board (SIB) established under the Financial Services Act and relevant Self Regulating Organisations (SROs) require pracrtitioners to co-operate with the Panel in its investigations, and the sanctions of the SIB and SROs are available for use against practitioners if breaches of the Code are such as to show them not to be "fit and proper" to carry out their businesses. *Id*, at 195.

consists of ten "General Principles" and thirty-eight specific "Rules." With respect to the timing of the offer, the Code requires that all offers be kept open for at least twenty-one days. In the case of an increasing offer price or other material changes, the offer must be kept open for additional fourteen days.[629] If the bidder fails to obtain at least fifty percent of the target's voting rights within sixty days of the date the offer was made, the offer must expire, and the bidder (as well as anyone acting in concert with the bidder) is prohibited from making a new offer within twelve months of the expiration of the previous offer.[630]

Unlike the Williams Act, the Code contains a mandatory provision requiring any person who acquires more than thirty percent of a target's voting securities to make an offer for all of the voting shares of the target, thus effectively prohibiting partial bids.[631] Any offer that could result in the bidder owning between thirty percent and fifty percent of the target's voting stock must be conditioned on the approval of a majority of the remaining voting shareholders.[632]

The Code contains significant rules concerning the pricing of the tender offer. The offer price must be equal to or higher than the highest price paid by the bidder for the target shares within three months prior to the bid.[633] If the bidder acquires shares during the

[629] Takeover Over Code, Rule 31.

[630] *Id*, Rule 35.

[631] *Id*, Rule 9.

[632] *Id*, Rule 36.

[633] *Id*. Rule 6.

tender offer at a price higher than the offer price, it must immediately disclose the details of the transaction and raise the offer price to equal or exceed that paid in the transaction.[634]

The Takeover Code also contains stringent limitations on both offeror and target. An bidder should not announce an offer unless it believes that it will be able to fully implement the offer. In the case of an cash offer, it means that the bidder must have the adequate cash available at the time that the offer is made.[635] The target board is prohibited from taking any action during the course of an offer, or even before the date of the offer, if the board has reason to believe that the action could frustrate, deter, or otherwise prevent the target's shareholders from receiving the offer. The target board is specifically prohibited from issuing new shares, selling assets, or entering into contracts other than in the ordinary course of business when an offer is imminent.[636] If the target provides information to one bidder, it must provide the information to all relevant bidders.[637] The Takeover Panel even considers litigation by the target against the bidder a violation of the Code.[638]

Based on its ten principles, the Code equally applies even when completely new situations or problems arise which are not covered by the Code. It is this flexible approach

---

[634] *Id.*

[635] *Id.* Rule 16.

[636] *Id.* Rule 21.

[637] *Id.* Rule 20.

[638] *See* Panel Statement *Minorco Plc. v. Consolidated Gold Fields Plc.* May 9, 1989.

that has been the major strengths of the system. The U.K. system also limits the number of participants with the access to the market for corporate control. The financial buyers who were once so active in the United States could not be expected to play the same role in the U.K., given the fact that it is impossible to make an offer conditional upon obtaining financing in the U.K..[639] The U.K. system also limits the types of takeover that can be implemented. The junk bond, high leveraged deals that were popular in the United States in the 1980s have been seldom successful in the United Kingdom.[640] The strengths of the U.K. system - its ability to maintain an active market for corporate control while minimising the financial and legal abuses spawned by the U.S. regulatory system - have led many European countries to view it as a model. The proposed European Takeover Directive is heavily influenced by the Takeover Code, especially regarding disclosure, mandatory bids, and the role of target directors.[641]

However, it is premature to conclude that the U.K. system could equally be a model for any proposed reform on the takeover regimes in the U.S. and Canada. The non-statutory, self-regulatory system which works well in the context of British market for corporate control, can not be expected to work as effectively in countries that relies almost exclusively on statutory regulations and government organisations to regulate corporate takeovers.

---

[639] *See* D. Berger, supra note 606, at 61.

[640] *Id.*

[641] *See* generally, Andenas, *supra* note 607.

4. The New Developments

The salience of the corporate governance systems of Japan and Germany that emphasise internal monitoring does not necessarily lead to the conclusion that the alternative scheme of internal monitoring is immediately viable in the United States and Canada. Deborah DeMott, in a very useful comparative study in 1987,[642] found two features of share ownership patterns that are crucial to the development of an active market in corporate control: (1) the shareholders' ability to transfer shares free of restraints within the unilateral control of the company's management, and (2) public ownership of shares holding voting rights sufficient to constitute corporate control. She points out that in countries in which hostile takeover activity is rare, one or both of these elements appear to be missing.[643] Therefore, the prominence of internal monitoring mechanism in Japan and Germany does not necessarily mean that it is in any way superior to external monitoring such as by the market for corporate control; it may only suggest that the market for corporate control in these countries is so under-developed that it is unable to undertake any monitoring task.

There is also other evidence suggesting that the bank-based economies of Germany and Japan - whose corporate governance systems make substantial use of voice instead of

[642] Deborah A. Demott, *Comparative Dimensions of Takeover Regulation*, 65 Wash. U. L. Q. 69, 75 (1987).

[643] *Id*, at 76.

exit - are not rational choices meant to optimise economic structure. In recent years, the growing internationalisation of capital markets, increased competition for capital, and regulatory reform have been forcing changes in traditional governance practices in both Japan and Germany.

Some observers believe that the *Keiretsu* mode of organisation in Japan is gradually disappearing. Over the last several decades, few of the most successful Japanese multinational corporations have been members of traditional *Keiretsu*.[644] The control of financial institutions was strong in times of capital scarcity during the 1950s and 1960s when Japan was recovering from the World War II. By the mid-1980s, the situation had changed: "with greatly increased liquidity in the Japanese economy, and with stronger company balance sheets, . . . the most successful of Japan's companies . . . are hardly under bank control. The leading companies have little debt, and they can choose their bank sources."[645] Ramseyer notes that once the Euromarket developed as an alternative source of credit, "Japanese firms deserted the banks in droves."[646] The rise of the international capital market may spell the end for financial monitors in the internal capital market in Japan.

The same situation existed in Germany. The development of international capital

---

[644] *See* Abegglen and Stalk, *supra* note 600, at 189-90.

[645] *Id.*

[646] *See* Ramseyer, *supra* note 591, at 98.

markets allowed German corporations to select their creditors, and hence escape their traditional bank monitors. Internal monitoring incurs costs. In the past, the German universal banks could be compensated for the monitoring cost by the near monopoly position as the sole or primary source of capital for German corporations. As the international capital market brought competition and a lower cost of capital to German corporations, the banks could no longer afford the monitoring. By 1989, the representation of German banks on the supervisory boards of the 100 largest firms fell to 7 percent of the board members.[647] One report states that in Germany the management has succeeded "in usurping the controlling function of the supervisory boards."[648]

The development of an international capital market also forced changes on regulatory regimes in Europe. Overseas financial institutions investing in European companies began to take an interest in corporate governance issues in the belief that insufficient priority was afforded to increasing "shareholder value." They are today directing more and more efforts to reforming restrictive voting structures and dismantling other barriers to investor participation in decision-making, and especially to takeovers.[649]

The emerging European Common Market considerably adds to the weight of the call for a reform of European takeover regulatory regimes. It is widely believed that, in

---

[647] *See* Josef Esser, *Bank Power in West Germany Revised*, 13 W. Eur. Pol. 17, 26.

[648] *Id*, at 27.

[649] *See* Oxford Analytica, *supra* note 620, at 142.

order to make European enterprises more competitive in the increasingly global market, they must be encouraged to expand and to develop the necessary scale. However, a variety of structural, legal, regulatory and practical barriers in most EC member countries has seriously deterred the growth of the merger and acquisition market. The EC Commission has been aware of these problems and issued an "amended proposal for a thirteenth Council directive on company law, concerning takeover and other general bids."("the takeover directive")[650] Part of the aim of the takeover directive is to facilitate mergers in order to create companies large enough to meet competition from firms of greater size outside the Community, and to invoke the market for control as a disciplinary mechanism.[651]

The European takeover directive closely resembles the City Code of the UK in many key rules.[652] Different from the Williams Act which employs a neutral approach, the directive takes a non-neutral attitude toward takeover bids. This is made explicit in the "Bangemann memorandum" of 14 May 1990, in which the Commission regards takeover bids in general as a positive phenomenon, to the extent they provoke market selection of the more competitive companies as well as a restructuration of firms, which is indispensable for their international competitiveness. Thus, takeover bids, at least the ones that respect the rules of the game, are to be encouraged.[653]

---

[650] COM(90)416 def. - SYN 186 (*Comment on amended proposal*).

[651] *See* Franks and Mayer, *European Capital Markets and Corporate Control*, in *European Mergers and Merger Policy* (Oxford, 1993), at p. 163.

[652] *See supra* note 640 and accompanying text.

[653] *Commission Communication of 14 May 1990 relating to hindrances of public takeover or exchange bids*: Europe/Documents (17 May 1990), No. 1619.

It is rather ironic that while the regulatory environment in the U.S. and Canada is becoming increasingly antagonistic toward takeovers, the movement of traditionally bank-based systems of continental Europe has taken off in the direction of the Anglo-American model. However affirmative the attitude of EC Commission towards takeover may be, the market for corporate control in Europe should not be expected to grow to the level of the 1980s in the United States. Considerable legal and structural barriers to takeovers, especially the two-tier board system and the co-determination principle underlying the corporate governance structure of many European countries, still exist. The capital market of continental Europe could hardly develop a liquidity as high as that of the United States. Furthermore, European's effort in dealing with corporate takeovers has not been that remarkable, since their mergers and acquisition market has been too under-developed to spawn any substantial abuses and adverse side-effects. The EC Commission could simply be over-estimating the virtues of hostile takeovers and yet under-estimating its vices, or they might feel confident that they have adequate measures to open the Pandora's Box without releasing the plagues.

II. An Assessment of Alternative Schemes of Corporate Accountability

The review of evidence from Japan and Europe suggests that there are alternative mechanisms other than the market for corporate control existing that serve to enhance corporate accountability. However, the question of relevancy herein is what can be done to initiate the change within the corporate governance system of the United States and Canada to nurture the alternative mechanisms of corporate accountability.

1. Institutional Shareholder Monitoring

If the passivity of individual shareholders to monitor the performance of the management can be attributed to their small stakes in the company, the antithesis to the shareholders' rational apathy might be that shareholder passivity becomes progressively less rational as the shareholders' stake in the corporation increases, and a shareholder with a significant stake in the corporation has an incentive to actively monitor the performance of the corporation rather than to remain passive.[654] If the antithesis holds good, institutional shareholders are perhaps the most appropriate player in the movement of shareholder activism.

1.1. Are Institutional Shareholders Immediately up to Their Monitoring Mission?

The growth of the institutional portfolio in both the U.S. and Canada has been truly staggering. In the U.S., institutional investors owned only 8.1 percent of all corporate equities, which was worth $107 billion in 1960. By the end of 1980, this figure had grown to about 52 percent and $6 trillion.[655] In the U.K., it is estimated that the major pension

---

[654] *See supra* note 573 and accompanying text.

[655] *See* B.S. Black, *Shareholder passivity Reexamined*, 89 Mich. L. Rev. 520, at 567-570 (1990).

funds hold 60 percent of the equity in U.K. corporations.[656] Institutional growth in Canada has followed a similar growth path. The Economic Council of Canada, for example, reported that the financial intermediation ratio (the ratio of the assets of financial institutions to total financial assets in the economy) rose from less than 0.28 in 1961 to 0.38 in 1987.[657]

Despite their increasing stakes in corporations, most institutional investors seem reluctant to become involved in corporate governance or managerial decisions, seldom intervene to effect changes in directorate or management personnel, and, in the U.K., seldom even vote.[658] Why do institutional investors still remain passive even after holding large stakes in corporations?

While institutional shareholders holding large stakes can play a significant role in monitoring corporate performance, it has been argued that several economic and legal factors constrain institutions from acquiring substantial stakes in corporations, and discourage them from actively participating in corporate affairs.

There are considerable constraints in the existing law which militate against the acquisition of substantial stakes in corporations by institutions. In the U.S., banks face tight

---

[656] *See* Jonathan Charkham, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad? - Hands Across the Sea*, (1988) Colum. Bus. L. Rev. 765, 766.

[657] *See* Economic Council of Canada, *A New Frontier: Globalization and Canada's Financial Markets* (Ottwa: Ministry of Supply and Services Canada, 1989).

[658] *See* J.C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Col. L. Rev. 1277 (1991); *see* also Davies, *Institutional Investors: A U.K. View*, 57 Brooklyn Law Review 129 (1991).

restrictions on stock ownership. Outside their trust departments, they can not own stock at all, and bank holding companies can own only 5% of the voting stock of an operating company. Savings and loans are forbidden to own any common stock. Insurance companies face limits on the percentage of their excess capital that they can use to invest in stocks. Mutual funds face tough conflict of interest rules if they exceed 5 percent ownership of a company.[659] In Canada, there are similar constraints that impose ownership limits on banks, trust companies, mutual funds and insurance companies.[660]

Even if institutional investors can lawfully obtain the substantial stakes in the corporation, there are still laws that constrain their ability to exert an influence on corporate management. Securities regulation stipulates proxy rules that can constrain communication between shareholders due to the risk that those communications may be subject to very costly proxy solicitation requirements.[661] Therefore, attempts by an institutional investor to contact fellow shareholders (i.e. other institutional investors) to express concerns about corporate performance are considerably inhibited. Even if large stockholders such as institutional investors do engage in a proxy contest, they will be unable to recoup their proxy solicitation expenses. Due to the insider trading restrictions of the securities law, most institutional investors are reluctant to appoint their employees to the board of directors of portfolio corporations, because it would subject them to the insider trading

[659] *See* Black, *supra* note 654, at 552.

[660] For a generally review, *see* J.G. MacIntosh, *The Role of Institutional and Retail Investors in Canadian Capital Markets*, 31 Osgoode Hall L. J. 371 (1993).

[661] *See* Black, *supra* note 654, at 536; *see* also MacIntosh, *ibid*, at 388.

rules and constrain their ability to sell the stocks.[662]

Former SEC Commissioner Joseph Grundfest summarised the over-regulation of institutional investors as follows:

> America seems not to trust her capitalists. For more than half a century, state and federal governments have limited investors' influence over the governance of publicly traded corporations. Investors' ability to monitor corporate performance, and to control assets that they ultimately own, has been subordinated to the interests of other constituencies, most notably corporate management.[663]

Since evidence shows that institutional investors are like "Prometheus chained to the rock by outmoded regulations that serve only to entrench and insulate incumbent management,"[664] many scholars have taken an activist stance and proposed specific courses of action by which institutional investors can directly influence substandard corporate management.[665] For these scholars, the deregulation of financial institutions seems to be the gateway to substantial increase in the size of institutional investor stakes in corporations, and in internal monitoring on corporate performance.

However, the above conclusion may prove to be over-simplified. As discussed in

---

[662] *Id.*

[663] Joseph A. Grundfest, *Subordination of American Capital*, 27 J. Fin. Econ. 89, 89-90 (1990).

[664] J. Coffee, *Institutional Investors as Corporate Monitors: Are Takeovers Obsolete*? in *Takeovers, Institutional Investors and the Modernization of Corporate laws.* (1993), at 19.

[665] See, e.g., R.J. Gilson & R. Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan L Rev 863 (1991).

Chapter one, the separation of ownership and control in modern public companies, as well as the existence of a liquid capital market conducive to short-run profits, generate a divergence of interests between highly transient shareholders as a group who are apathetic regarding company's management and preoccupied with short-run value maximization, and the company which must balance the short-term and the long term, and at times must pursue long-term goals at expense of short-term profits.[666]

Institutional investors are by no means immune from this divergence of interests. Martin Lipton finds that "institutional stockholders have little incentive or inclination to behave like traditional owners in the classical economic model - that is, to work actively towards the long-term operating success of the corporation. They tend to focus instead on the current market price of the corporation's stock."[667] Gilson and Kraakman recognise that institutional stockholders currently have little opportunity or incentive to take an interest in the long-term business development of the corporations whose stock they own.[668] These findings give rise to another school of thoughts. Defenders of corporate management are convinced that in the absence of political constraints, institutional investors would soon dominate corporate management and imbue the boardroom with their reckless short-termism. These thoughts are echoed by the recent regulatory and legislative developments. For example, The 1989 Report of the New York State Task Force on Pension Fund

---

[666] *See supra* note 164 and accompanying text.

[667] Martin Lipton & Steven R. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187, 205-206 (1991).

[668] Gilson & Kraakman, *supra* note 664, at 869-870.

Investment recommended that public pension funds be subjected to greater legislative control and guidance.[669] The Pennsylvania fourth generation anti-takeover statute provides that institutional investors could be forced to disgorge their profits on the sale of a Pennsylvania-chartered corporation's stock, if they participated in a control group.[670]

The short-termism of institutional stockholders is produced by several constraints. First, the over-diversification of institutional investors makes them incapable of assessing adequately the business performance of each portfolio company.[671] Second, institutional stockholders assess the performance of the investment managers who control their stock portfolio over a short period of time, typically quarter to quarter or year to year. This serves as an incentive for investment managers to out-perform the market average in each quarter or each year, which necessarily subject them to the temptation of short-term premiums for a portfolio stock.[672] Finally, the typical institutional stockholder owes a fiduciary duty to the beneficiaries of its portfolio and must act solely in their interest. Therefore, institutional investors are under considerable pressure to seek the short-term premium for their portfolio shares.[673]

---

[669] New York State Task Force on Pension Fund Investments, *Our Money's Worth: The Report of the Governor's Task Force on Pension Fund Investment* (1989).

[670] *See supra* note 531 and accompanying text.

[671] *See supra* note 664, at 869-870.

[672] Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U Pa L Rev 1 (1987), at 7-8.

[673] *See, e.g.*, Employee Retirement Income Security Act of 1974 (ERISA), 29 USC §§1001 et seq (1988), which requires plan fiduciaries to consider only the economic interests of the plan participants and beneficiaries in the shares held by the plan when deciding whether to tender shares in a tender offer.

The increasing activism of institutional shareholders may well be tainted by their preoccupation with short-term profits. During the takeover frenzy of the 1980s, a large number of institutional shareholders organised by influential groups such as the Council of Institutional Investors and the California Public Employees' Retirement System (CalPERS) has increasingly engaged in a proxy voting agenda, purporting to remove impediments from takeover premiums.[674] In addition, based on the proposition of CalPERS and the United Shareholders' Association, SEC has revised proxy rules in an attempt to increase the role of institutional investors in the proxy process and corporate governance.[675] It has been argued that unless the above measures to empower the institutional investors are part of a larger scheme to reorient stockholders towards a long-term perspective, the increased activism of institutional investors will only exacerbate the current problem of corporate governance.[676]

There are also other practical difficulties that prevent institutional shareholders from being effective corporate monitors. Liquidity means a lot to financial institutions. Consequently, mutual funds, banks, and insurance companies would consider taking a large control block of shares unacceptable, because their shareholders, depositors, or policyholders can withdraw their funds on short notice. When financial institutions are

---

[674] M. Lipton, *supra* note 666, at 212.

[675] *See* Meredith M. Brown, *The Impact of the SEC's 1992 Proxy Rule Amendments*, in *Contests for Corporate control: The New Environment* (1995) at 245.

[676] *See* M. Lipton, *supra* note 666, at 213.

preoccupied with liquidity, they will have little interest in control. The trade-off between liquidity and control closely resembles Albert O. Hirschman's famous dichotomy of "exit" and "voice" which shows that the members of any organisation face such a choice.[677] If any low-cost and readily available "exit" is possible, the members will rationally have little interest in exercising a more costly "voice". But if "exit" is blocked, the members will be forced to resort to "voice" in governance decisions. Similarly, institutional investors will hardly be interested in governance issues unless liquidity is no longer readily available to them.

Other obstacles also constrain institutional investors' ability to be effective monitors. In the U.S., the federal securities law greatly restricts the ability of an investment adviser to receive incentive compensation based on capital appreciation in the fund it manages.[678] If an institutional investor is compensated simply on the basis of an annual fee equal to a declining percentage of the fund it manages, it may have little incentive to engage in monitoring since it can not recoup the monitoring costs. Additionally, as most financial institutions only keep a skeletal, in-house staff, it is unrealistic to expect them to monitor all the voting decisions of their portfolio companies.

The foregoing discussion suggests that institutional shareholders at present are far from being up to the task of corporate monitoring. The current institutional shareholder

---

[677] *See supra* note 601.

[678] *See* Investment Advisers Act of 1940 § 205(1), 15 USC §80b-5(1) (1988).\

activism provides no viable solution as long as all legal and economic obstacles are still existing, and institutional shareholders are still holding their myopic outlook.

1.2. The Transformation of Institutional Shareholders into Corporate Monitors

It is obvious that institutional investors' perception about the corporate monitoring must be changed in some way before they could be competent corporate monitors. It has been argued that the process of transformation is one of reducing liquidity and enhancing control.[679]

As discussed in Chapter One, the existence of a liquid capital market which is conducive to short-run profits gives rise to the myopic outlook of most investors, individual as well as institutional.[680] In any organisation, if "exit" is blocked, the members will be forced to resort to "voice" in governance decisions.[681] This leads to the conclusion that if we restrict the liquidity of capital market accessible to financial institutions, we could probably hit two birds with one stone - correcting shareholders' myopia and enhancing their control over the corporations.

J.C. Coffee singles out three factors that serve to define the optimal corporate

[679] *See* J.C. Coffee, *supra* note 657, at 1318-29.

[680] *See supra* note 665 and accompanying text.

[681] *See supra* note 676 and accompanying text.

monitor:

> 1. The institutional monitor should be reasonably free from conflicts of interest so that its evaluation of corporate management will not be biased by the opportunity to earn fees or income not equally available to other shareholders;
> 2. Its stake in the corporation should be large enough to justify the expenditure of significant monitoring costs; and
> 3. Its preferred investment horizon should be sufficiently long so that it has an interest in improved corporate governance, even when no immediate value-maximising transaction, such as a takeover or LBO, is in the offing.[682]

Coffee finds that pension funds are relatively superior to other institutional investors in terms of these criteria.[683] Pension funds have an investment philosophy that is different from other institutional investors. It is estimated that nearly one third of all equity investments held by institutional funds are "indexed," and pension funds in particular are indexed.[684] For example, it has been estimated that of the $40 billion in equities held by the three principal New York pension funds covering state and local employees, $30 billion are in indexed portfolio.[685] CalPERS has an average holding period of between six and ten years for each security in its portfolio and an annual turnover rate of approximately 10 percent.[686] The indexed investors have essentially abandoned their "exit" option and have

[682] J.C. Coffee, *supra* note 663, at 80.

[683] For a discussion of superorities of pension funds over other institutional investors, *see* J.C. Coffee, *Id*, at 80-81.

[684] "Indexed" means that the equity investments are in a portfolio of securities that is intended to represent an accurate proxy for the stock market as a whole. Such passive investing seeks not to out-perform the market, but to duplicate its movements, and as a result, such investors tend hold for the long term. See Coffee, *id*, at 83.

[685] *See* William Taylor, *Can Big Owners Make a Big Difference*? Harv. Bus. Rev. Sept-Oct 1990, at 70.

[686] *See* Gilson and Kraakman, *supra* note 664, at 863.

become long-term holders.

The fact that pension funds are heavily indexed does not necessarily mean that they are inclined to be active monitors. After all, a major purpose of indexing is to economize on transaction costs; participating in corporate monitoring - such as proxy fights - is certainly costly. Besides, the skeletal internal staff of most pension plans is simply ill-equipped to undertake a detailed evaluation of numerous voting decisions of their portfolio companies. Although they have attributes conducive to effective corporate monitoring, pension funds still need extra-incentive and a viable mechanism to eventually fulfil that goal.

Various schemes have been put forward to overcome the situation. J.C. Coffee suggests that the legislature (1) makes monitoring mandatory for institutional investors; (2) unbundles investment services and quotes separate prices for investment management and proxy voting advice; (3) restricts over-diversification; (4) deregulates proxy advisers, mandates the minimum proxy service that institutions should provide and creates an actual market for professional services of proxy advice, etc.[687]

Theoretically, these schemes could work. Unbundling investment services and quoting different prices for investment management and proxy voting advice could alleviate the problem of the monitoring cost borne by institutions. Restriction of over-diversification could force institutions to increase the stakes in their portfolio companies so as to decrease

---

[687] *See* Coffee, *supra* note 663, at 88-94.

the liquidity of their equities and enhance their interest in "voice" instead of "exit." Creation of a market for professional services of proxy advice could remedy the structural weakness of financial institutions to engage in monitoring. In the U.S., regulatory initiatives have already began to make monitoring mandatory. Beginning in the mid-1980s, the US Department of Labour has required the pension plans and their investment managers to vote their shares in proxy contests, rather than to abstain, and has established procedures to ensure that their vote is informed.[688] It means that participation in corporate governance is no longer optional for pension funds fiduciaries.

In reality, the above proposed schemes entail a large scale overhaul of the current regulatory regime of financial institutions. Absent a vigorous political campaign and a high level of public consensus, such regulatory reform is prohibitively difficult. Even if moderate reform is possible which gives institutions the necessary incentive, problems over access to management information would obstruct a close monitoring role for institutional investors. Due to the fear of insider trading, institutions may be reluctant to obtain price-sensitive information. On the other hand, corporate management may not be able to disclose adequate information to institutional shareholders, as commercial confidentiality dictates that some information cannot be made public, while the selective release of information to shareholders is forbidden by securities regulators.

Since direct monitoring of corporate management by institutional investors involves

---

[688] For an overview, *see* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 Geo L J 445 (1991), at 568.

so many practical problems, some scholars resort to another perspective in dealing with corporate accountability problem. After all, it is directors, not shareholders, who hold the real power in corporate governance. The overloading problems of transforming institutional shareholders into effective corporate monitors could be avoided by delegating the task of monitoring to outside directors. The board-level monitoring, either by non-executive directors on a unitary board or by a separate supervisory board, offers a more practical alternative.

2. Board-level Monitoring

Outside directors have always played important role in corporate governance in the U.S. and Canada. The business judgement doctrine established by Delaware courts has regarded outside directors as a safeguard for the disinterestedness of the board decision.[689] However, there is plenty of evidence showing that absent a crisis, outside directors today play an inadequate monitoring role in the public corporations.[690]

Several factors prevent outside directors from being effective corporate monitors. First, most outside directors are part-time visitors to the corporation. The vast majority of outside directors at Fortune 1000 firms are CEOs of other corporations, who thus are subject to severe time constraints and other commitments. They devote on average only

---

[689] *See supra* note 291-292 and accompanying text.

[690] *See* Jay Lorsch, *Pawns or Potentates: The Reality of American Corporate Boards* (1989) (concluding that directors play an effective role in times of cirses, but seldom otherwise).

fourteen days a year to each board on which they serve.[691] Furthermore, since the outside directors regard themselves as visitors to corporations, they may adhere to a group loyalty which assumes that outsider directors, like house guests, should not question or criticise the host.[692] Second, there are few incentives for outside directors to challenge or criticise the incumbent management. The potential pay-off from such conduct is disproportionate to the risk of getting removed from the board.

2.1. Gilson & Kraakman's Scheme of Independent Directors

Nevertheless, board-level monitoring remains as a more practical approach than the institutional shareholder monitoring to realise the goal of corporate accountability. Various schemes have been proposed to reform corporate governance at the board level. Among them, the solution proposed by Ronald Gilson and Reinier Kraakman is noteworthy.

Recognising that it may not be rational for institutions with widely dispersed holdings to scrutinise closely the affairs of individual companies, Gilson and Kraakman suggest that the institutions may form an agency to recruit and nominate monitoring directors to particular companies. Since the appointments would be taken out of the hands of management, this would ensure the independence of appointed outside directors.[693]

---

[691] *Id*, at 18.

[692] *Id.* at 17.

[693] Gilson and Kraakman, *supra* note 664, at 873-4.

Furthermore, the outside directors would be economically dependent on the institutional investors that the directors are expected to serve. Specifically, the institutions would identify through the agency a cadre of professional outside directors specialising in corporate monitoring. Each director would serve on a full-time basis as the representative of institutional investors on the boards of a number of corporations in their portfolios. The multiple board memberships could enable the professional directors to earn decent compensation, but unlike most current outside directors, they would have no other major commitments, and thus could become more involved in the corporate affairs.[694] In essence, Gilson and Kraakman would turn the traditional role of outside director as an independent referee into a full-time agent of an identifiable class of shareholders such as institutional investors.

The scheme proposed by Gilson and Kraakman has several advantages. First, it combines institutional monitoring and board-level monitoring creatively. The scheme involves less structural reform than that proposed by J.C. Coffee, and thus would be much easier to implement. For most institutional investors, organising an agency to appoint professional independent directors to the boards of their portfolio companies is much less cumbersome than monitoring directly with the assistance of proxy advisers. It also solves the problem of a lack of incentive for outside directors to monitor corporate performance, since the appointed professional directors would be dependent on institutions for their continued service in future. Second, it provides an "analytically satisfying answer to the

[694] *Id*, at 873-892.

question of who will monitor the monitors."[695] The professional outside directors would be monitored by their appointing agency on the institutions' behalf. The agency would also provide support services to independent directors in the manner of German banks.

Gilson and Kraakman further envisage that although independent directors are normally in the minority on a unitary board, they would have a much more significant impact if they have the power to appoint and remove the executive directors.[696] In conjunction with the other scholars who suggest that independent directors should not be involved in management decisions, since by participating in policy-making they lose the ability to assess management performance objectively,[697] it seems that the role of professional independent directors might be performed better by a separate supervisory board.

2.2. Cadbury Report: The Code of Best Practice

Corporate governance has become a highly debated issue in the U.K. in recent years. Scandals such as BCCI, the collapse of the Maxwell empire, Polly Peck and directors' excessive remuneration have heightened concerns about the role of directors within the corporate governance system. In the face of the emerging European Common Market, the traditional corporate governance system has began to evolve toward the two-tier board

[695] *Id*, at 873.

[696] *Id*.

[697] *See* Davis and Kay, *Corporate Governance, Takeovers, and the Role of the Non-executive Directors*, in Bishop and Kay, *European Mergers* (Oxford, 1993), at 208-215.

structure set out in the draft of EC Fifth Directive[698].

In May 1991, the Committee on the Financial Aspects of Corporate governance under the chairmanship of Sir Adrian Cadbury, was established by the Financial Reporting Council (FRC), the London Stock Exchange and the Accountancy profession. Its report (hereinafter called "Cadbury Report")[699], which was issued in May 1992, was aimed at restoring trust and confidence in the corporate system and ensuring shareholders were given a more effective voice within the governance system.[700]

The Report has recognised a public interest in the governance of public companies requiring a measure of corporate accountability:

> The country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.[701]

At the very heart of the Cadbury Report is the proposal for a "Code of Best Practice (hereinafter called 'the Code')," which is specifically designed to achieve the necessary high standards of corporate behaviour. Although the Cadbury committee holds that it is directors

---

[698] 1988 Com (90) 629; OJ C7, 11.1.91.

[699] *The Report of the Committee on the Financial Aspects of Corporate Governance* ('the Cadbury Report') (London: Gee, 1992).

[700] *See* Sir Adrian Cadbury, *Restoring Trust and Confidence in the Corporate System* (1992) ICCLR 403.

[701] The Cadbury Report, para 1.1.

who are ultimately responsible for the governance and the operation of their companies, it does enlist the support of the London Stock Exchange and other sponsors convened by FRC, thereby establishing an ongoing review process to monitor the implementation of the Code. The London Stock Exchange now requires all listed companies registered in the U.K., as a continuing obligation of listing, to state whether they are complying with the Code, and if not, why not.[702]

One of the main recommendations of the Code has been for companies to appoint non-executive directors to their boards: "The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions."[703] The Code further points out that "to meet the Committee's recommendations on the composition of sub-committees of the board, boards will require a minimum of three non-executive directors, one of whom may be the chairman of the company provided he or she is not also its executive head. Additionally, two of the three non-executive directors should be independent in the terms set out in paragraph 2.2 of the Code."[704]

The Code provides that "non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct."[705] The majority of non-executive directors should

---

[702] Saleem Sheikh and William Rees, *Corporate Governance and Corporate Control - Self-Regulation or Statutory Codification*? in *Corporate Governance and Corporate Control, supra* note 178, at 383.

[703] The Code of Best Practice, para. 1.3.

[704] *Id*, note 1.

[705] *Id*, para 2.1.

be independent of management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgement.[706] The selection of non-executive directors must be made through a formal process by the nomination committee, which should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director.[707]

Regarding the reporting and control responsibilities, the Code recommends that "the board should establish an audit committee of at least 3 non-executive directors with written terms of reference which deal clearly with its authority and duties."[708] The audit committee should be "formally constituted as sub-committees of the main board to whom they are answerable and to whom they should report regularly."[709] The audit committee should "have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information."[710]

The implementation of the Code can be considered satisfactory. By 1995, it is estimated that 90 percent of the listed companies have complied with the recommendations of the Code. The Code also has considerable impact on other Commonwealth countries.

---

[706] *Id*, para 2.2.

[707] *Id*, para 2.4. and note 7.

[708] *Id*, para 4.3.

[709] Id, note 11(a).

[710] *Id*, note 11(e).

The recommendations of the Code were adopted by the Toronto Stock Exchange Committee on Corporate Governance in the development of its similar draft report. The draft also recommends that listed companies disclose annually in their information circulars whether they comply with the proposed guidelines, and if not, why not. Like the Cadbury Committee, the TSE also suggests that the compliance with the guidelines should not become mandatory.[711]

The Cadbury Report believes that executive and non-executive directors contribute to the company in different and complementary ways. Non-executive directors have two distinctive roles which are not inconsistent with the unitary board system:[712] (1) reviewing the performance of the board and executive; and (2) taking the lead where potential conflicts of interest arise.[713] Both of these roles of non-executive directors closely resemble the role of a supervisory board in a two-tier system. It seems evident that the recommendations of Cadbury Report reflects a compromise solution of increasing the input of non-executive directors without inducing the fundamental change in philosophy and power which would result from the full application of the two-tier structure set out in the EC Fifth Directive.

3. Combining Institutional Monitoring and Board-level Monitoring

---

[711] Gina Cole, *The Cadbury Committee Report - Implementation and Influence*, in *Corporate Governance and Corporate Control*, supra note 178, at 358-359.

[712] *Cadbury Report*, para 4.4.

[713] *Id*, at para 4.5.

Although theoretically institutional activism shows promise in providing an ultimate solution to the problem of corporate accountability, the foregoing discussion clearly indicates that there are yet numerous legal and economic barriers to overcome before institutions could be up to the monitoring task.

In comparison, board-level monitoring seems to be a more practical alternative solution. After all, it is directors who are responsible for the governance of their companies, and a well-conceived surgery at the board level is naturally closer to the heart of the issue of corporate accountability. Both the professional independent directors conceived by Gilson and Kraakman and the non-executive directors recommended by the Cadbury Report reflect to certain extent a simulation of the two-tier board system of continental Europe. Such a reflection can be considered at least a recognition that the two-tier system does provide more leverage in enhancing corporate accountability.

However, it is premature to downgrade any contribution that institutional shareholders may make toward a better mechanism of corporate accountability. The Cadbury Committee paid much expectation to institutional investors in ensuring the adequate compliance of the Code:

> Because of the importance of their collective stake, we look to the institutions in particular, with the backing of the ISC (Institutional Shareholders Committee), to use their influence as owners to ensure that the companies to comply with the code provides institutional and individual shareholders with a ready-made agenda for their representations to boards. It is up to them to put it to good use. The committee is primarily looking

to such market-based regulation to turn its proposals into action.[714]

The Institutional Shareholders Committee, in turn, expressed the same message as the Cadbury Report did in the document *The Responsibility of Institutional Shareholders* in 1991. It recommends that institutional investors should take an interest in the affairs of the companies and exercise their influence through use of the vote or in discussion before the voting stage was reached.[715]

Gilson and Kraakman's scheme provides an excellent initiative by which institutional shareholders and independent directors could join hands in creating effective monitoring on corporate performance. It offers a valuable supplement to the Code of Best Practice. The formation of an agency representing the interests of institutional shareholders provides a logistically viable solution to the issue of "who monitors the monitor" which is overlooked by the Cadbury Report. The selection and appointment of a cadre of professional directors by the institutions' agency is supposedly superior to the scheme of nomination committee proposed by the Code, because the appointment of non-executive directors is made outside the boardroom so that it is arguably free from any influence of executive directors or management. The Cadbury Report, on the other hand, provides a code of conduct for professional independent. The simulation of a two-tier system within the unitary board, emphysizing an exclusive supervisory role for non-executive directors can be a viable

[714] *The Cadbury Report*, para 6.16.

[715] Julian Potter, *The Role of Institutional Shareholders' Committee*, in *Corporate Governance and Corporate Control, supra* note 178, at 288.

solution to the concern of Gilson and Kraakman that independent directors may have inadequate impact on the board due to their minority position.

It should be noted that institutional shareholders are not at present up to the task of corporate monitoring. Considerable deregulation of financial institutions is necessary to enable institutional shareholders to assume positions of corporate monitoring. The institutions participating in corporate monitoring should also be closely scrutinised in order to prevent any short-termism from penetrating into the mechanism. J.C. Coffee points out that pension funds are most qualified corporate monitors.[716] The rapid growth of pension funds in both the U.S. and Canada considerably increases the promise of the proposed corporate monitoring system operated by institutional shareholders.

III. Summary

Corporate governance strives to provide a balance between the freedom of management to make commercial decisions and control over that management. Control could be achieved in different ways. Market forces that have the disciplinary effects on corporate management serve as the external monitors. They include the market for product and service, the market for managerial talent, the capital market and the market for corporate control.[717] The market for corporate control - specifically the tender offers -

---

[716] *See supra* note 682-685 and accompanying text.

[717] *See supra* note 113-120 and the accompanying text.

provides the most drastic measure (or some scholars say, the most effective means) of achieving corporate accountability. The takeover wave of the 1980s and its profound social and economic fallout have led many to question the value of the market for corporate control as an effective corporate monitoring.

The opposite end of the spectrum is so-called internal monitoring realised by either shareholder activism or board-level monitoring - mechanisms operating within the corporate system. The traditional bank-based economies such as Japan and Germany provide excellent examples of effective corporate monitoring in the absence of a market for corporate control. Unfortunately, due to various reasons, the experience of Japan and Germany can not be easily followed in the United States and Canada.[718] Nonetheless, institutional shareholders do have the potential to be effective corporate monitors, although considerable legal and economic barriers have to be removed before they are up to any monitoring task.

The board-level monitoring proves to be a more practical solution than the institutional monitoring. The two-tier system of continental Europe under which the supervisory board has the power to hire and fire the executive board and control over the executives is achieved by the supervision of the supervisory board is a noteworthy example. There has been visible movement within the Common Law world that evolves toward the two-tier model. The Code of Best Practice proposed by the Cadbury Report reflects such a trend.

---

[718] *See supra* text at p. 165.

The author believes that internal monitoring as a mechanism for corporate accountability is superior to the market for corporate control, in that it involves much less disruption, waste of financial and human resources, conflict of interests between various constituencies, and other social and economic impact. There are also viable schemes proposed by Gilson & Kraakman and the Cadbury Report that are likely to succeed in establishing an effective monitoring mechanism in North America. Although the necessary deregulation of financial institutions and the reform of the unitary board system may be a difficult task, it should not be overly optimistic to expect that in the foreseeable future the establishment of an effective system of corporate accountability in North America will finally eliminate any justification for hostile takeovers to exist in the name of corporate monitoring.

Chapter V: Conclusions

This thesis has surveyed various theories purporting to explain and evaluate the controversial phenomenon known as the hostile takeover (or tender offer). The survey shows that the hostile takeover, as a corporate phenomenon, is rather heterogeneous. Some takeovers may optimise the allocation of economic resources and promote efficiency through so-called disciplinary effects which displace incompetent management; some may cause misapplication of resources, thus decrease efficiency; and there may be others which are neutral in terms of economic efficiency but involve substantial wealth transfers with tremendous costs. Therefore, it is inappropriate from the perspective of public policy to try to decide whether hostile takeovers should be encouraged or chilled in the aggregate. Takeovers that create wealth or promote efficiency should be encouraged; and those that only involve costly wealth-transfers or even misapplication of resources should be discouraged.

The coercion and other abusive practices that were once prevalent in takeover transactions called for regulation. The regulatory regime of corporate takeovers in North America employs a neutral approach toward the tender offers. The focus of the takeover regulation in both the United States and Canada is to avoid tipping the scales either in favour of management or in favour of the acquirer, and to require full and fair disclosure for the benefit of investors. However, there have been new developments in the regulatory regimes of the U.S. and Canada that disturbed the balance struck by the securities statutes.

In the U.S., the recent state anti-takeover statutes have purported to greatly enlarge the power of management and eliminate hostile takeovers.[719] In Canada, policy statements issued by securities regulators have subsumed corporate fiduciary principles and considerably constrained the latitude of target management discretion in the face of a hostile takeover.[720]

In the wake of the takeover frenzy of the 1980s, people have become less certain about the merits of hostile take-overs and more aware of the fallout they have left behind. The emergence of various state anti-takeover statutes in the U.S. which were endorsed by the Supreme Court reflects such a change of mentality. Some scholars even suggest that takeovers may be obsolete.[721]

The major justification for the existence of takeovers lies in their alleged merits of promoting efficiency through corporate discipline. However, in view of the tremendous consumption of material and human resources, as well as profound economic and social consequences that are involved in hostile takeover transactions, their justification for existence may easily evaporate if there is alternative corporate monitoring mechanism available which involves less disruption, waste of resources and adverse side-effects.

---

[719] *See supra* note 536-536 and accompanying text.

[720] *See supra* note 566-568 and accompanying text.

[721] *See e.g.*, J.C. Coffee, *supra* note 663.

A survey of evidence from abroad indicates that there are indeed alternative corporate monitoring mechanisms that have been operating quite effectively in Japan and Germany where hostile takeovers are a rarity. These mechanisms can be summarised as institutional shareholder monitoring and board-level monitoring. Financial institutions such as banks play pivotal monitoring roles in Japanese and German corporate system. In addition, the two-tier board system also serves as an effective monitor on corporate performance in Germany.

The rapid growth of institutional investors in North America has also led many to expect that shareholder activism will provide an ultimate solution to the issue of corporate accountability. However, there is evidence showing that institutional shareholders are far from being immediately up to the task of corporate monitoring, and considerable legal and economic barriers are yet to be removed. In comparison, board-level monitoring may seem to be a more practical solution for the time being. The United Kingdom has taken lead in enhancing board-level monitoring. The Cadbury Report sets out the Code of Best Practice which emphasises the role of non-executive directors. The Code sculpts a two-tier system within the unitary board without involving the fundamental change of philosophy and power which may result from the full application of the two-tier board model set out by EC Fifth Directive. There is much for the U.S. and Canada to learn from the U.K. experience.

The establishment of a two-tier board system represents a shift from "shareholder power" to power concentrated in other hands. The shift is fundamental because it involves a change of the residence of power, which derives from the underlying conceptual understanding of the nature of companies. The Anglo-American legal system generally espouses a contractual theory of company law. The contractual theory considers the firm as a nexus of contractual relations between its constituencies: shareholders, employees, managers, customers and suppliers of material and capital.[722] Shareholders have the divisible residual claims on the assets and cash flow of the firm, which can generally be sold without the approval of the other contracting parties. The shareholders' residual risk-bearing is deemed to entitle them to the ultimate control over the company.[723] Based on the premise that the shareholders are the primary interest group in a company, there is a broad consensus that acquisitions and their regulation should be in the shareholders' interest. Under this principle, the maximisation of shareholder wealth, no matter how it is realised, can be a sufficient justification for hostile takeovers to exist.

The continental-European countries, however, display a different view of the firm. Business enterprises are viewed as organisations "which serve the creation of profits but also constitute an autonomous and enduring group of human beings, technical means and capital, directed at a continuos economic activity."[724] This so-called "institutional" view of the company dictates that in a company the shareholders' interests must be balanced against those of other constituencies: employees, creditors, suppliers and customers etc.. This combination of interests, which is referred to as the "company's interest", is most

---

[722] *See* Easterbrook & Fischel, *The Corporate Contract*, 89 Col. L. Rev. 1416, 1426-27, (1989).

[723] *See* Fama & Jensen, *Agency Problems and Residual Claims*, 88 J. L. Econ. 327, 328 (1983).

[724] Jan Wouters, *Toward a Level Playing Field for Takeovers in the European Community? An Analysis of the Proposed Thirteenth Directive in Light of America Experiences*, 30 Common Market L. Rev. 267, 274 (1993).

appropriately guarded by the board of directors.[725] The institutional view of the company is the underlying rationale of the two-tier board system and the co-determination principle in Germany.

Although the contractual theory of the firm is the corner-stone of the Anglo-American company law, the institutional view of the company also has considerable support in North America. In the U.S., it takes the form of the idealistic approach to corporate social responsibility, which advocates that the expansion of the purpose of the corporation to include the interests of groups other than shareholders. The idealistic approach to corporate social responsibility has been elaborated in the context of the so-called "the corporate stockholder debate." Adolph Berle and Gardner Means, with their book *The Modern Corporation and Private Property* which was published in 1932, sparked a debate about corporate governance structures. They raised the issue "who were the proper constituents to whom directors ought to owe duties." Their conclusion was that claims of shareholders to ownership rights should not outweigh the establishment of a community program "comprising fair wages, security to employees, reasonable service to their public, and stabilisation of business."[726] To Berle and Means, it seemed "almost essential if the corporate system is to survive - that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public

---

[725] *Ibid.*

[726] Berle & Means, *The Modern Corporation and Private Property*(1932), at 356.

policy rather than private cupidity."[727]

The corporate stockholder debate has considerably compromised the preoccupation of American company law on shareholders' interests. Several states in the U.S. have enacted corporate constituency statutes that allow corporations to take the interests of non-shareholder interests into account. In Canada, directors of public corporations believe that "they ought not to represent . . . shareholders at the expense of employees, customers, local communities and the company at large," instead, "the board should regard the balancing of these interests and the provision of wider and longer term perspectives as integral parts of their tasks."[728] Non-shareholder interests have also become one of the considerations that justify target directors' defensive tactics against the hostile takeover bid.[729]

Although there seems to be an almost insurmountable barrier for Anglo-American company law to espouse the two-tier board system, a survey of the current situation proves that it may not be totally out of the question. The institutional view of the company underlying the two-tier system has began to gain broad acceptance in North America. Even Englishmen, whose conservatism is well known around the world, have taken practical steps to construct a two-tier structure within their unitary board system.. Although it is simplistic to conclude that the company law in the U.S. and Canada will follow the steps of the

---

[727] *Ibid.*

[728] The Conference Board, *Canadian Directorship Practices: A Critical Self-examination* ix, (1977) at 94-109.

[729] *See* Buckley, Gillen and Yalden, *Corporations, Principles and Policies* (1995) at 558-559.

British, reform at the board level based on the two-tier model should not be regarded as completely unlikely at some point in the future.

Finally, the author concludes that it is premature for the time being to declare that the hostile takeover is obsolete in North America. Alternative corporate monitoring structure is yet to be constructed. However, there is considerable potential for developing a less costly but more effective monitoring system, which operates on institutional shareholder activism and board-level monitoring. Hostile takeovers, as a mechanism to monitor and discipline corporate management, are bound to fade away as the corporate governance structure of North America evolves towards the institutional view of public corporations - as a community cherishing a conglomerate of interests of all constituencies.

BIBLIOGRAPHY

Books

Abegglen & Stalk, *Kaisha, The Japanese Corporation* (1985)

Baumol, W., *Business Behavior, Value and Growth* (rev.ed. 1967)

Berle & Means, *The Modern Corporation and Private Property (1932)*

Berle, *The 20th Century Capitalist Revolution* (1954)

Block, Barton & Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers*, 36 (1988)

Buckley, Gillen and Yalden, *Corporations -Principles and Policies* (3rd ed., 1995)

The Cadbury Committee on the Financial Aspects of Croporate Governance (December 1992)

Clark, Robert, *Corporate Law* (1986).

The Conference Board, *Canadian directorship Practices: A Critical Self-Examination* ix, 94-109 (1977).

Coopers & Lybrand, *Barriers To Takeovers In The European Community* (1989)

Dertouzos, Lester and Solow, *Made in America* (1989)

Galbraith, J., *The New Industrial State* (1967)

Gower, *Principles of modern Company Law* (5th ed.)

Henn & Alexander, *Laws of Corporations and Other Business Enterprises* (1983)

Hirschman, A., *Exit, Voice, and Loyalty* (1970)

Keynes, *The General Theory of Employment, Interest and Money* (1936)

Lorsch, Jay, *Pawns or Potentates: The Reality of American Corporate Boards* (1989)

Loss, L., *Fundamentals of Securities Regulation* (Boston, Little, Brown & Co., 1983)

Lipton & Steinberger, *Takeovers and Freezeouts* (Law Journal Seminals - Press 1991)

Malkiel, Burton, *A Random Walk Down Wall Street*, 30-31 (1990)

Manne, H., *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965)

Marris, R., *The Economic Theory of "Managerial" Capitalism* (1964)

Moon, Ronald W., *Business Mergers and Takeover Bids*, (5th ed. 1976)

Oesterle, Dale A., *The Law of Mergers, Acquisitions and Reorganisations* (American Casebook Series 1990)

Oxford Analytica Ltd, *Board Directors and Corporate Governance: Trends in the G7 Countries over the Next Ten Years* (Oxford, 1992)

Ravenscraft, D.J., & Scherer, F.M., *Mergers, Sell-offs, and Economic Efficiency* (1987)

Saleem Sheikh & William Rees, *Introduction* to *Corporate Governance & Corporate Control* (1995)

Shubik, *Corporate Control, Efficient Markets, and the Public Good*, in *Knights, Raiders & Targets: The Impact of the Hostile Takeover* (1988)

Tarasofsky & Corvari, *Corporate Mergers and Acquisitions: Evidence on Profitability* (1991).

Weston, Chung and Hoag, *Mergers, Restructuring and Corporate Control* (1990)

Williamson, O., *Markets and Hierarchies: Analysis and Antitrust implications* (1975)

Articles

ABA Committee on Corporate Law, *Other Constituencies Statutes: Potential For Confusion*, 45 Bus. Lawyer 2253 (1990)

Abell & Kitarai, *Japanese M&A: The Barriers to Hostile Takeovers*, 8 Int'l Fin. L. Rev. 11 (1989)

Alberts, *The Profitability of Growth by Merger, The Corporate Merger* (1982)

Arsht, *The Business Judgement Rule Revisited*, 8 Hofstra L. Rev. 93, 97 (1979)

Baums, *Corporate governance in Germany: The Role of the Banks*, 40 Am J. Comp. L. 503 (1992)

Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 Va. L. R. 1257, 1263 (1985)

Bebchuk, Lucian A., *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv. L. Rev. 1693 (1985)

Berger, David J., *A Comparative Analysis of Takeover Regulation in the European Community*, 55 Law and Comtemporary Problems, 53 (1992)

Beveridge , Norwood Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction,* 41 DePaul L. Rev. 655 (1992)

Bhagat, Shleifer and Vishny, *Hostile Takeovers in the 1980s: The Return to Corporate Specialisation*, Brookings Papers on Economic Activity: Microeconomics 1990

Black, B.S., *Shareholder passivity Reexamined*, 89 Mich. L. Rev. 520 (1990)

Black, B.S., *The value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. Rev. 895 (1992)

Block, D.J., Contests for Corporate Control: The New Environment (Practising Law Institute 1995)

Bradley, Desai & Kim, *Synergistic Gains For Corporate Acquisitions and Their Division Between the Stockholders of Targets and Acquiring Firms*, 21 J. Fin. Econ. 3 (1988)

Brown, Meredith M., *The Impact of the SEC's 1992 Proxy Rule Amendments*, in *Contests for Corporate control: The New Environment* (1995) at 245

Cable, John, *Capital Market Information and Industrial Performance: The Role of West German Banks*, 95 Econ. J. 118 (1985)

Charkham, Jonathan, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad? - Hands Across the Sea*, Colum. Bus. L. Rev. 765 (1988)

Clark, *Vote Buying and Corporate Law*, 29 Case W. Res. L. Rev. 776, 788 (1979)

Coffee, J.C. Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Columbia L. R. (1984)

Coleman, G., *Poison Pills In Canada*, 15 Ca. Bus. L. J. 1 (1988)

Coffee, J.C., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Col. L. Rev. 1277 (1991)

Cramton & Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J. L. Econ. & Org. 27 (1991)

Davies, *Institutional Investors: A U.K. View*, 57 Brooklyn Law Review 129 (1991)

DeMott, Deborah, *Comparative Dimensions of Takeover Regulation*, 65 Wash. U. L. Q. 69 (1987)

Dey and Yalden, *Keeping the Playing Field Level: Poison Pills and Directors' Fiduciary Duties in Canadian Takeover Law*, 17 Can. Bus. L. J. 252 (1990)

Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 Bus. law. 1733 (1981)

Easterbrook & Fischel, *The Corporate Contract*, 89 Col. L. Rev. 1416 (1989)

Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981)

Fama & Jensen, *Agency Problems and Residual Claims*, 88 J. L. Econ. 327 (1983)

Farrar, *Business Judgment and Defensive Tactics in Hostile Takeover Bids*, 15 Ca. Bus. L. J. 15 (1989)

Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 Tex. l. Rev. 1, 1 (1978)

Fischel, *The Corporate governance Movement*, 35 Vand. L. Rev. 1259 (1982)

Finkelstein, *Antitakeover Protection Against Two Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 Sec. Reg. L. J. 291, 293 (1984)

Franks and Mayer, *European Capital Markets and Corporate Control*, in *European Mergers and Merger Policy* (Oxford, 1993)

Friendly, *Make Haste Slowly*, in *Commentaries on Corporate Structure and Government* 525 (1979)

Gilson & Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan L Rev 863 (1991)

Gilson, Ronald, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819 (1981)

Grundfest, Joseph A., *Subordination of American Capital*, 27 J. Fin. Econ. 89 (1990)

Heftel, *Corporate Governance in Japan: The Position of Shareholders in Publicly Held Corporations*, 5 U. Haw. L. Rev. 135 (1983)

Herzel & Shepro, *Bidders & Targets: Mergers and Acquisitions in the U.S.* (1990)

Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 Corp. L. Rev. 107 (1980)

Huckaby, *Defensive action to Hostile Takeover Efforts in Japan: The Shuwa Decisions*, 29 Colmb. J. Transnational L. 439 (1991)

Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?* 28 J. L. & Econ. 151 (1985)

Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure*, 3 J. Fin. Econ. 305 (1976)

Jensen, M., *Eclipse of the Public Corporation*, Harv. Bus. Rev. 61 (Sept. -Oct. 1989)

Jensen, M., *The Takeover Controversy: Analysis and Evidence, in* Knights, Raiders & Targets: The Impact of the Hostile Takeover (1988)

Jensen, M, *Takeovers: Their Causes and Consequences*, 2 J. Econ. Perspectives (1988)

Kahan, *Paramount or Paradox: The Delaware supreme Court's Takeover Jurisprudence*, J. Corp. L. 583, 589 (spring 1994)

Kalfass, *The American Corporation and The Institutional Investor: Are There Lessons From Abroad?* Colum. Bus. L. Rev. 775, 783 (1988)

Kurp, H.H., *Corporate Takeover Defences After QVC: Can Target Boards Prevent Hostile tender Offers Without Breaching their Fiduciary Duties?* 26 Loyola U. Chicago L. J. 29 (1994)

Leibenstein, *Allocative Efficiency vs. "X-Efficiency,"* 56 Am. Econ. Rev. (1966)

Levin, Raiding the Establishment: *New Perspectives on Takeover Law*, 26 U. Rich. L. Rev. 567 (1992)

Lewellen, Loderer & Rosenfeld, *Merger Decisions and Executive Stock Ownership in Acquiring Firms*, 7 J. Acct. & Econ. 209 (1985)

Lipton, Martin & Rosenblum, Steven R., *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187 (1991)

Lipton, Martin, *Corporate Governance in the Age of Finance Corporatism*, 136 U Pa L Rev 1 (1987)

Lipton, Martin, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101 (1979)

Lipton, Martin, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U.L.Rev. 1231 (1980)

Lipton, Martin, *Takeover Bids in the Target's Boardroom: An Update After One year*, 36 Bus. Law. 1017 (1980)

Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 Colum. L. Rev. 249 (1983)

MacIntosh, J.G., *The Role of Institutional and Retail Investors in Canadian Capital Markets*, 31 Osgoode Hall L. J. 371 (1993)

Mahle, Stephen, *Proxy Contests, Agency Cost, and Third Generation State Antitakeover Statutes*, 24 Securities L. Rev. 447 (1992)

Manning, *The Business judgment rule and the Directors' Duty of Attention: Time for Reality*, 39 Bus. Law. 1477(1984)

Marsh, *Are Directors Trustees*?, 22 Bus. Law. 35 (1966)

Mueller, D.C., *The Effects of Conglomerate Mergers,* J. Bank Financ. (1977)

Note, *Regulating Going Private Transactions, SEC Rule 13e-3,* 80 Colum. L. Rev. 782 (1980)

Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 Yale L. J. 1238 (1979)

Note, *The Developing Meaning of 'Tender Offer' Under the Securities Exchange Act of 1934*, 86 Harv. L. Rev. 1250 (1973)

Ramseyer, J.C., *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. Rev. 1 (1987)

Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States* 102 Yale L. J. 1927 (1993)

Roll, Richard, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. Bus. 197 (1986)

Romano, R., *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. (1992)

Romano, *The State Competition Debate in Corporate Law*, 8 Cardozo L. Rev. 709 (1987)

Securities Exchange Commission, Office of the Chief Economist, *The Economics of Any-or-All, Partial, and Two-Tier Offers* (April 19, 1985)

Seidler, Carol, *Assessing The Wisdom of The Business Judgment Rule in Corporate Control Contests: Is It Time to Make Shareholders' Interests Paramount?* 23 Loyola of Los Angeles L. Rev. (1990)

Shea,Tony, *Regulation of Takeovers in the United Kingdom*, 16 Brooklyn J. Intl L. 89 (1990)

Shleifer & Summers, *Breach of Trust in Hostile Takeovers*, in *Corporate Takeovers: Causes and Consequences* (Univ. of Chicago Press 1988)

Sikora, Martin, *The M&A Bonanza of the '80s . . . And Its Legacy ("M&A Bonanza")*, Mergers & Acquisitions, Mar./Apr. 1990

Simpson, *The Emerging Role of the Special Committee - Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 Bus. Law. 665 (1988)

Smith, *The Japanese Foreign Exchange and Foreign Trade Control Law and administrative Giudance: The Labyrinth and the Castle*, 16 Law & Pol'y in Int'l Bus., 417 (1984)

Varalya, N. P., *The "Winner's Curse" Hypothesis and Corporate Takeover*, 9 Managerial & Decision Econ. 209 (1988)

Whiteman, *The Legal Framework of Acquisitions in Japan*, Nat'l L. J., May 18, (1987)

Wilcke, E., *Germany*, in *International M&A: A Guide to the Regulation of Mergers and Acquisitions Worldwide*, 49 Int. Fin. L. Rev. (1991)

Winter, *State law, Shareholder Protection and the Theory of the Corporation*, 6 J. of Legal Studies 251 (1977)

Wouters, Jan, *Toward a Level Playing Field for Takeovers in the European Community? An Analysis of the Proposed Thirteenth Directive in Light of America Experiences*, 30 Common Market L. Rev. 267 (1993)

Yalden, Robert, *Controlling the Use and Abuse of Poison Pills in Canada: 347883 Alberta Ltd. v. Producers Pipelines Inc.* 37 McGill L. J. 887 (1992)

Zuckerman, Larry, *Shades of the Go-Go '80s: Takeovers Are Making A Comeback*, N.Y. Times, Nov. 3, 1994

Cases

347883 Alberta Ltd. v. Producers Pipelines Inc. (1991) 4 W.W.R. 577

Aronson v. Lewis, 473 A.2d 805 (Del. 1984)

Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir.), cert. denied, 110 S. Ct. 367(1989)

BNS Inc. v. Koppers Co., 683 F. Supp. 454, *amended* 683 F. Supp. 458 (D. Del. 1988)

Briess v. Woolley (1954) A.C. 333, H.L.

Briggs v. Spaulding, 141 U.S. 132,149 (1891)

City Capital Assocs. Ltd. Partnership v. Interco Inc., 551 A. 2d 787, 803 (Del. Ch.)

Devall v. Wainwright Gas Co. Ltd., [1932] 1 W.W.R. 281, 26 Alta. L.R. 274 (S.C. App. Div.)

Dodge v. Ford Motor Co., 170 N.W. 668 (1919)

Dynamics Corp. of America v. CTS Corp. 749 F. 2d 250, 253 (7th Cir. 1986)

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

Fleet Aerospace Corp. v. Holderman, 637 F. Supp. 742 (S.D. Ohio 1986)

Hodges v. *New England Screw Co.*, 3 R.I. 9, 18 (1853)

85956 Holdings Ltd. v. Fayerman Brothers Ltd. 38 Sask. R. 64 (Q.B.)

GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1918 (S.D.N.Y. 1985)

Guth v. Loft, Inc., Del.Supr., 5 A.2d 503, (1939)

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

Joy v. North, 692 F.2d 880, 885-86(2d Cir. 1982)

Lac Minerals Ltd. and Royal Oak Mines Inc. (1994), 17 O.S.C.B. 4963

MDC Corporation and Royal Greetings & Gifts (1994), 17 O.S.C.B. 4791.

Mill Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988)

Moran v. Household International, Inc., 500 A. 2d 1346 (Del. Sup. Ct., 1985)

Norline Corp. v. Rooney, Pace Inc., 744 F.2d 255, 258 (2d Cir. 1984)

Paramount Communications, Inc. v. Time, Inc., 1989 Fed. Sec. L. Rep. 94

Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994)

Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829)

Percival v. Wright (1902) 2 Ch. 421

Polk v. Good, 507 A.2d 531 (Del. 1986)

Re Vanalta Resources Ltd. B.C.S.C. Unreported Decision No. A760559/76 Dec. 17, 1976

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)

Shuwa v. Inageya and *Shuwa v. Chujitsuya,* 1317 Hanrei *Jiho [Hanji] (Aug. 21, 1989)*

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)

Teck Corp. v. *Millar* (1972), 33 D.L.R. (3d) 228 (B.C.)

The Queen v. McClurg, [1990] 3 S.C.R. 1020, [1990] D.L.R. (4th) 217

Unocal v. Mesa Petroleum, 493 A. 2d 946 (Del. Sup. Ct. 1985)

Wellman v. Dickinson, 682 F.2d 355, 363 (2d Cir. 1982)

Statutes, Regulations and Policy Statements

Canada Business Corporations Act R.S.C. 1985, C.44.

The City Code on Takeovers and Mergers.

Clayton Act 15 U.S.C. §18.

Delaware Business Combinations Act, Del. Code Ann. tit. 8, § 203 (1988).

The EC Commission Takeover Directive.

Hart-Scott-Rodino Antitrust Improvement Act 15 U.S.C. §18a(a).

Model Business Corporations Act.

National Policy No. 38.

New York antitakeover statute, N.Y. Bus. Corp. Law § 912 (McKinney 1986).

Ohio Control Shares Acquisition Act of 1982

Ontario Securities Act, R.S.O. 1990 C.S. 5 (as amended).

Ontario Securities Act, R.S.O. 1990 Reg. 1015.

Ontario Securities Commission Policy 9.1.

Securities Act of 1933.

Securities Exchange Act of 1934.

Securities and Exchange Commission Rule

Shoho (Commercial Code), Law Nol 48 of 1899, Japan

Shiteki Dokusen no Kinshi oyobi Kosei Troihiki no kakuho ni Kansuru Horitsu (Law Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade), Law No. 54 of 1947, Japan

Shoken Torihikiho (Securities and Exchange Law), Law No. 25 of 1948, Japan

Williams Act 15 U.S.C. §78.

Wisconsin Antitakeover Statute, Wis. Stat. Ann. § 180.726(2) (West Supp. 1989).