COMMENTARY

TAKEOVER BIDS IN THE TARGET'S BOARDROOM: A RESPONSE TO PROFESSORS EASTERBROOK AND FISCHEL

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In recent articles in the *Harvard Law Review*[1] and *The Business Lawyer*[2] Professors Frank H. Easterbrook and Daniel R. Fischel argue against the applicability of the business judgment rule to the consideration of a tender offer by the board of directors of a target company. They would substitute for the business judgment rule a strict prohibition against any defensive action by the target's board. They urge that the board "should relax, not consult any experts, and let the shareholders decide."[3]

In advancing their passivity proposal Professors Easterbrook and Fischel take issue with my recent articles[4] showing that the business judgment rule *should apply* to the target's consideration of a tender offer. Although they accept my synthesis of the case law establishing that the courts currently *do apply* the business judgment rule to a target board's consideration of a takeover bid, they dispute the validity of the policy considerations I advance in support of the decisions in those cases. They argue that fundamental economic propositions mandate the dramatic change in the law they urge.[5]

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[1] Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 161 (1981).

[2] Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholder Welfare, 36 Bus. Law. 1 (to be published July 1981) (copy on file at New York University Law Review).

[3] Id. at 3.

[4] Lipton, Takeover Bids in the Target's Boardroom: An Update After One Year, 36 Bus. Law. 1017 (1981); Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979) (hereinafter Takeover Bids I).

[5] In addition to their economic arguments, Professors Easterbrook and Fischel claim that my articles and the court decisions applying the business judgment rule to takeovers "misunderstand the business judgment rule." Easterbrook & Fischel, supra note 2, at 15. They argue that because the management of a target may have a self-interest in rejecting or defeating a tender offer, the board of directors of the target must stand aside and in no way interfere with the tender offer. Like their economic arguments this argument ignores current thinking to the contrary, see, e.g., Conoco, Inc. v. Seagram Co., Civ. No. 81-4029, slip op. at 9 (S.D.N.Y. July 16, 1981) ("the Board of Directors are under a duty to exercise their best business judgment with respect to any proposal pertaining to corporate affairs, including tender offers."); GM Sub Corp. v. Liggett Group, Inc., No. 80-6155 (Del. Ch. Apr. 25, 1980), rev'd and remanded on other

The key economic propositions[6] underpinning Professors Easterbrook and Fischel's passivity proposal are (1) takeovers improve the economy by moving assets to more efficient management[7] and (2) the economy would not be harmed as a result of a rule that mandated unfettered takeovers and thereby forced companies seeking to avoid becoming a target to try to improve their market price by emphasizing short-run profits at the expense of long-term planning.[8] Neither of these propositions is proven or universally accepted. In a study for the Twentieth Century Fund published this year, Edward S. Herman, Professor of Finance at the Wharton School of the University of Pennsylvania, casts considerable doubt on the validity of both of these propositions. Professor Herman's summary is so cogent and succint it is worth quoting at length:

> Although there appears to be a tendency for undervalued companies to be taken over more frequently than others, the exceptions are numerous; in 19 of 41 British cases studied by Agit Singh, the acquired firm was more profitable than the acquiring firm, and U.S. experience is comparable. In the 1970s there has been an even more marked tendency for large, cash-rich firms to seek out well-managed and profitable smaller companies in areas of potential growth. Thus the most conspicuous characteristics observed in recent takeover experience are the vulnerability of small companies, the dominance of large companies as purchasers, and the lack of evidence of profitability enhancement as a consequence of acquisitions. Most important from the standpoint of impact on managerial incentives, the probability of takeover declines as company size

grounds, 415 A.2d 473 (Del. 1980); *see also* Zapata Corp. v. Maldonado, No. 81-113 (Del. May 13, 1981), and without example or even discussion assumes that the courts are unable to distinguish between good-faith exercise of business judgment and improper self-dealing. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 295 (7th Cir. 1981):

> [R]ather than proceeding under the business judgment rule, the plaintiffs here seek to apply a different test in the takeover context, and propose that the burden be placed upon the directors to establish the compelling business purpose of any transaction which would have the effect of consolidating or retaining the directors' control. In light of the overwhelming weight of authority to the contrary, we refuse to apply such a novel rule to this case.

[6] Professors Easterbrook and Fischel also advance some other economic propositions with which I strongly disagree, such as "[c]orporations, like apples, are commodities," *see* Easterbrook & Fischel, supra note 2, at 6; "the notion that stock is priced in the market at less than its full value is implausible," id. at 3; and "the contention that tender offers divert resources away from capital investment misunderstands the nature of markets," id. at 13. I have not undertaken a point-by-point refutation of these assertions, because they are not fundamental to their thesis and are only peripheral to the primary policy considerations that I advance in support of the continued vitality of the business judgment rule.

[7] Easterbrook & Fischel, supra note 1, at 1182.

[8] See id. at 1184.

> increases, with the result that for large but unprofitable firms further growth in size may be the preferred alternative survival strategy to the more onerous option of increasing profitability by internal renovation. Ironically, therefore, the rise of the "market for corporate control" via takeovers may increase inducements to grow large and merge at the expense of small- and medium-sized companies, perhaps also at the expense of more competitive and progressive market structures.
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> Another irony is that managers impelled to pay close attention to the concerns of stockholders may be *too* profit oriented—insofar as owners stress short-run stock prices, managers may be pressed toward a focus on quick gains at the expense of risk-taking and longer-term investment that more stable tenure might allow. Thus managerial capitalism may yield social inefficiencies by its better integration into an efficient capital market that heavily discounts large but uncertain long-term profits (and disregards the positive social externalities of the longer view and risk-taking). This may be a real social cost of the American Way as it has evolved in an environment of performance-oriented institutional investors, widespread preoccupation with the stock market, the takeover threat, and insecure managers.[9]

I think that Professor Herman is correct and that Professors Easterbrook and Fischel are wrong. But it is not necessary to resolve these issues to decide the debate. Absent clear evidence, or broad acceptance of the accuracy of the economic propositions on which they predicate their argument, no basis exists for the dramatic change in the law for which Professors Easterbrook and Fischel argue. As long as the economic benefits of takeovers are debatable,[10] rejection or acceptance of a tender offer should continue to be left to the business judgment of the target's board.

Apart from the question of the validity of the key economic propositions on which they support their passivity proposal, there are other reasons to question Professors Easterbrook and Fischel's reasoning. They recognize the importance of long-term planning to individual companies and to the economy as a whole. They accept my

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[9] E. Herman, Corporate Control, Corporate Power, 100-01 (1981) (emphasis in original) (footnotes omitted).

[10] The Easterbrook and Fischel thesis as to the beneficial effects of takeovers is refuted also by the Canadian experience. On July 29, 1981, the Canadian Government asked the major Canadian banks to reduce their lending for the purpose of financing foreign takeovers. In addition to citing the adverse impact of such lending on the exchange rate, the Canadian Finance Minister said that takeover lending was reducing the banks' ability to service other borrowers and "to support new enterprises and new productive activity." Giniger, Canada Acts to Curb American Acquisitions, N.Y. Times, July 30, 1981, at D1, col. 1.

argument[11] that a rule that would require corporations periodically to assess their worth and, if that assessment were significantly above the current stock market value of the corporation, to seek a sale or merger, would have a material adverse effect on long-term planning.[12] Therefore, Professors Easterbrook and Fischel go to considerable length in an effort to refute my argument that mandating passivity is the equivalent of mandating such periodic assessment.

However, their main theme forces Professors Easterbrook and Fischel to argue that the rule of passivity would encourage tender offers at prices between market value and full value and would result in takeovers at less than full value.[13] Indeed, that is their essential reason for the rule of passivity—to encourage tender offers by leaving an ample cushion between full value and the tender offer price so as to assure that raiders will be successful at prices favorable to them.[14] Professors Easterbrook and Fischel then justify their passivity proposal on the ground that it produces benefits for both the raider and the shareholders—the raider takes over a target at a price less than full sale value while the shareholders get a premium over stock market value.[15]

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[11] See Takeover Bids I, supra note 4, at 109-10.

[12] See Easterbrook & Fischel, supra note 2, at 14; Easterbrook & Fischel, supra note 1, at 1199-201.

[13] See Easterbrook & Fischel, supra note 1, at 1177-78.

[14] In their search to explain how a bidder can afford to offer a premium for a target corporation, Professors Easterbrook and Fischel refuse to accept that significant divergences might exist between current market price and the real value of a company's stock. Easterbrook & Fischel, supra note 2, at 2. Instead, they argue that because the stock market is efficient, a stock's price reflects "all of the available information about the firm and its prospects." Id. at 3. Therefore the premium must reflect real increases in productivity that the bidder expects to reap. However, the only evidence marshalled by Professors Easterbrook and Fischel in support of their argument that the stock market is efficient is studies showing that efficiency exists because no rule exists for stock picking that would enable a securities analyst to do better than he could have done by choosing stocks at random. Id. That evidence falls far wide of the mark of proving the argument that markets are efficient in the sense that bidders are wrong in perceiving real values that are not already reflected in the current market price. See, e.g., Bodenstein & Hansen, Paying a Premium for Control, Nat'l L.J., June 22, 1981, at 21, col. 1.

The financial press has termed the willingness of bidders to offer a premium for a target corporation as "a rational response to current economic signals." Included among those "signals" is the dramatic decline in recent years of market value as a percentage of the current replacement cost of assets, a development augmented by, among other things, high inflation, high rates of corporate and personal taxation, and " 'structural and technological changes in many industries — especially those with tough economic competition — [that] have rendered much of the U.S. capital stock obsolete.' " Furthermore, "estimates of companies' values will differ widely in times of economic uncertainty . . . [For example,] prices of many oil stocks recently dropped some 40% over six months . . . . [S]uch volatility can frequently present enticing bargains, even at hefty premiums." Meyerson, Merger Mania and the High Takeover Premiums, Wall St. J., July 20, 1981, at 16, col. 3.

[15] Easterbrook & Fischel, supra note 1, at 1173-74.

But if Professors Easterbrook and Fischel are correct in assuming that passivity will encourage tender offers in the manner they envisage, then the only way a board of directors could carry out its duty to shareholders and avoid a takeover at less than full sale value would be to assess periodically the differential between market value and full sale value and, whenever that differential is significant, to initiate a sale or merger before a raider could make a tender offer and thereby immobilize the target from seeking full sale value. Thus, the rule of passivity, if not the theoretical equivalent of a rule requiring periodic assessment of sale or liquidation, would as a practical matter come close to the same result and have the devastating impact on long-term planning that Professors Easterbrook and Fischel acknowledge to be undesirable.

Professors Easterbrook and Fischel seek in general to downplay the ability and inclination of directors to fulfill their duty under the business judgment rule to act in the best interest of shareholders. Indeed, they assert that because management of a target company may have a self-interest in defeating a tender offer, the business judgment rule ought not to be applied, but rather the law should require passivity. All courts that have considered this argument have rejected it, and quite properly so.[16] The primary duty of a board of directors in a takeover situation is to the shareholders of the company; this duty requires the directors to assess a takeover offer, and to reject it if it is inadequate or otherwise not in the shareholders' best interests. My experience suggests that directors—a majority of whom often are not affiliated with management—take their responsibilities to shareholders most seriously.

Although they profess to be likewise concerned with the interests of the target's shareholders, Professors Easterbrook and Fischel reveal in their *Harvard Law Review* article that their real aim is a feat of social engineering entirely unrelated to the target shareholders' interests. Professors Easterbrook and Fischel claim that even resistance that results in a higher price to the target shareholders is undesirable, because that higher price has to be paid by someone; thus, "shareholders as a whole" (whoever that group may be) will not benefit.[17] Surely, courts—and target shareholders—would find this argument both peculiar and unpersuasive.

Finally, Professors Easterbrook and Fischel fail to take into account one of the principal practical business considerations affecting the frequency of tender offers. An assumption implicit in their passiv-

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[16] See, e.g., cases cited in note 5 supra.

[17] Easterbrook & Fischel, supra note 1, at 1175.

ity proposal is that raiders are deterred from making tender offers by a target's ability to defend against a tender offer and to seek a white knight at a higher price.[18] My experience confirms this assumption. However, it is only a minor deterrent. The major deterrent to tender offers is an economic matter not discussed by Professors Easterbrook and Fischel. The vast majority of businessmen shy away from making tender offers not from fear of being defeated or being outbid by a white knight but because they do not want to buy a company without the benefit of a full investigation. If we accept the arguments of Professors Easterbrook and Fischel as to the economic desirability of tender offers, an "open books" rule would be most conducive to promoting tender offers. Yet Professors Easterbrook and Fischel do not urge that a prospective target be required to permit a raider to make an investigation on request.

Although as set forth above I believe their argument to be seriously flawed, Professors Easterbrook and Fischel have presented an interesting thesis. It deserves further study on an interdisciplinary basis. It is a subject not only for economists and lawyers but also for investment bankers, businessmen, and securities analysts. I believe such a study will prove that Professors Easterbrook and Fischel are in the minority as to most of their key economic arguments. Whatever the ultimate conclusion of such a study, there is no present support for the dramatic change in the law they advocate. Such a change must await general agreement as to the impact of tender offers on shareholders and the economy, and even then such a change would be for the legislature and not the courts.

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[18] See id. at 1174-79.