WACHTELL, LIPTON, ROSEN & KATZ

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To Our Clients:

Takeovers; White Knight Search
Precludes a Successful Defense

The time of the commencement of a white knight search is the most difficult judgment call in a takeover defense. If the search is started before the court decision on a preliminary injunction, it will most likely destroy the target's litigation position and weaken the determination of the outside directors to remain independent. It has a negative impact on both the pragmatic and psychological aspects of takeover defense. If the search is delayed too long, there is a risk of takeover at the original offer price when a higher price might have been obtained if the search had started earlier.

A cogent illustration of the problem is the Wall Street Journal report today of Marathon approaching Texaco to be a white knight in Marathon's takeover battle with Mobil:

> Marathon Oil Co.'s antitrust posture in its battle to fend off Mobil Corp. suffered possible damage yesterday, when Texaco said it had been approached by bankers and stockholders on behalf of Marathon.
>
> The remarks put Marathon in the position of arguing before a Cleveland federal judge that a combination with Mobil would violate antitrust law, at a time when Marathon is suspected of having considered a merger with Texaco.

Immediately after the Journal story appeared, Marathon announced a white knight deal with U.S. Steel.

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The New York Times

Business

MORE ON TAKEOVERS

Boards Must Resist

By MARTIN LIPTON

IN their article, "When Shareholders Become the Victims" (July 12), Frank H. Easterbrook and Daniel R. Fischel argued that "acquiescence" should govern the directors and management of a company that becomes the target of a tender offer, effectively prohibiting any resistance to the offer. This would be a drastic change from the current law, called the business judgment rule, which requires the directors of a target company to evaluate the offer in good faith and determine whether it is in the best interest of the company's shareholders. Such a suggestion strikes me as very unwise and very undesirable.

In an April Harvard Law Review article by the two professors, from which their Times article was adapted, the key economic principles they set forth to support their proposed passivity rule are the following:

- Takeovers improve the economy by moving assets to more efficient management.
- The economy would not be harmed by a rule mandating unfettered takeovers, which would force companies that seek to avoid being a target to improve their market price by emphasizing short-run profits at the expense of long-term planning.

Neither of these principles is proven or universally accepted. In a recent study for the 20th Century Fund, Edward S. Herman, professor of finance at the Wharton School, found that in many acquisitions, the acquired company was more profitable than the acquiror. In addition, he contends that since well-managed and profitable smaller companies seem to be the most desirable targets, if a company is seeking to avoid a takeover, the incentive is to emphasize size over profitability. And to the extent that fear of a takeover causes management to be concerned with maintaining quarter-to-quarter and year-to-year profit increases, such short-term concerns may lead to an unwillingness to assume the risks inherent in planning for long-term profits, which ultimately is socially and economically damaging.

There are other defects in the professors' reasoning. Recognizing the importance of long-term planning, they acknowledge the damaging effects of requiring corporations periodically to assess their worth and, if that assessment is significantly above the current stock market value of the corporation, to seek a sale or merger.

But if Professors Easterbrook and Fischel are correct in assuming that passivity will encourage tender offers, 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 at regular intervals the differential between market value and full sale value and, whenever that differential is significant, initiate a sale or merger before a raider could make a tender offer. 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 produce the same results.

The professors seek in general to downplay the duty owed by directors to shareholders, and deny that in a takeover context that duty is more consistent with the application of the business judgment rule than with their rule of acquiescence. Indeed, they assert that because the management of a target company may have a self-interest in defeating a tender offer, the business judgment rule ought not to be applied. Every court that has considered this argument has rejected it, and quite properly so. The primary duty of a board of directors in a takeover situation is to assess a takeover offer and to reject it, if it is not in the shareholders' best interests.

WHILE professing 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. For, they say, even resistance, which results in a higher price to the target shareholders, is undesirable because that higher price has to be paid by someone, and, thus, "shareholders as a whole" (whoever that group may be) will not benefit. Surely, courts as well as shareholders would find this argument both peculiar and unpersuasive. Certainly Conoco shareholders, who have seen their stock go from less than $50 a share to more than $95 as the direct result of resistance rather than acquiescence, would agree with me and not with the professors.

Finally, the professors assume that corporate raiders are deterred from making tender offers by a target's ability to defend itself and to find a "white knight" at a higher price. While experience confirms this assumption, it is only a minor deterrent. The major deterrent to tenders is not the fear of being defeated or being outbid, but the fear of buying a company without the benefit of a full financial investigation. Yet, the professors do not urge that a prospective takeover target be required to permit a raider to make an investigation on request, even though such an "open books" rule would be most conducive to promoting the tender offers that the professors find so economically desirable.

As they apparently recognize, such a rule would be totally inconsistent with the way business is conducted in the United States. The same is true with their passivity rule — it is wholly alien to our way of corporate life.

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