Vanderbilt Law Review

Volume 32
Issue 2 *Issue 2 - March 1979*

Article 7

3-1979

Corporate Directors' Liability for Resisting a Tender Offer: Proposed Substantive and Procedural Modifications of Existing State Fiduciary Standards

Oby T. Brewer, III

Follow this and additional works at: https://scholarship.law.vanderbilt.edu/vlr

Part of the Commercial Law Commons, Securities Law Commons, and the State and Local Government Law Commons

Recommended Citation
Oby T. Brewer, III, Corporate Directors' Liability for Resisting a Tender Offer: Proposed Substantive and Procedural Modifications of Existing State Fiduciary Standards, 32 *Vanderbilt Law Review* 575 (1979)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol32/iss2/7

This Note is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Law Review by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact mark.j.williams@vanderbilt.edu.

NOTE

Corporate Directors' Liability for Resisting a Tender Offer: Proposed Substantive and Procedural Modifications of Existing State Fiduciary Standards

TABLE OF CONTENTS

I. INTRODUCTION 575
II. DEVELOPMENT OF THE TENDER OFFER AS A METHOD FOR OBTAINING CORPORATE CONTROL 577
  A. *Tender Offer Mechanics* 578
  B. *Tender Offer Defense Strategies* 581
    (1) The Maturation of Defense Tactics 581
    (2) The Director's Dilemma 585
III. LEGAL LIMITATIONS ON A TARGET DIRECTOR'S CAPACITY TO RESIST A TENDER OFFER 586
  A. *The Federal Attempt* 586
  B. *State Governance of Corporate Directors' Responsibilities* 589
    (1) *Berman v. Gerber Products Co.* 590
    (2) *Cheff v. Mathes* 590
    (3) *Condec Corp. v. Lunkenheimer Co.* 592
  C. *Reconciling Judicial Inconsistencies* 594
IV. A PROPOSED STANDARD 597
  A. *Contemporary Notions of Corporate Responsibility* 597
  B. *A Procedural Proposal: Shifting the Burden of Proof* 599
  C. *A Substantive Proposal: Justifying Defensive Action* 601
  D. *Summary* 604
V. THE IMPACT OF *Singer v. The Magnavox Co.* 605
VI. CONCLUSION 607

I. INTRODUCTION

The tender offer for purchase of corporate shares clearly has emerged as the principal method of overtaking control of an existing

public corporation.[1] Although a tender offer may assume various forms,[2] typically the tender offeror[3] publicly or privately announces its intent to purchase a substantial number of shares from shareholders of the target company at some price above market value.[4] A tender offer proposal, therefore, often presents to target shareholders an investment opportunity unavailable in the general market. Conversely, target directors generally perceive a tender offer as a direct threat to the target's continued autonomy and to their positions as corporate leaders.[5] In response to this perceived threat, and to the time pressures imposed by the offeror,[6] directors often implement defense tactics designed to defeat the tender offer proposal.[7] The successful defense against a tender offer, however, deprives target shareholders of a potentially large investment gain. In response to several recent successful defense maneuvers, target shareholders have brought suit against their directors, alleging that the directors' implementation of defense tactics constituted mismanagement and a breach of fiduciary obligations to the target shareholders.[8]

Prior to the federal district court opinion in *Altman v. Knight,*[9] shareholders brought the great majority of these mismanagement

1. During the 1950's and early 1960's, the proxy battle reigned as the ultimate weapon for gaining control of public corporations. *See generally* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL (1968). In the 1960's, however, the tender offer displaced the proxy contest as the principal takeover method. *See* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL, at v-vi (1973) [hereinafter cited as TENDER OFFERS].

2. *See* notes 17-19 *infra* and accompanying text.

3. For purposes of convenience in discussion, the individual or corporation proposing the tender offer will be referred to as the offeror. The company whose securities the offeror proposes to purchase will be referred to as the target.

4. To enhance the tender offer's chances for success, the offeror will offer an exchange price substantially in excess of market or book value. *See* Greenhill, *Structuring an Offer,* 32 BUS. LAW. 1305 (1977); Weiss, *Tender Offers and Management Responsibility,* 23 N.Y.L. SCH. L. REV. 445 (1978).

5. A prime consideration in an offeror's decision to bid for the purchase of a target company is the present inability or incompetency of the target's directors and management. *See* Troubh, *Takeover Strategy: The Investment Banker's Role: Characteristics of Target Companies,* 32 BUS. LAW. 1301 (1977). Consequently, the offeror often intends to displace existing management upon the tender offer's success. For a discussion of the investment impact of the offeror's desire to replace existing target management, see Gulf & Western Indus. v. Great Atl. & Pac. Tea Co., 476 F.2d 687, 696 (2d Cir. 1973).

6. A tender offer proposal usually will remain open for two to three weeks only. *See* Weiss, *supra* note 4, at 445 n.1; Note, *The Courts and the Williams Act: Try a Little Tenderness,* 48 N.Y.U. L. REV. 991, 993 (1973).

7. *See* notes 38-48 *infra* and accompanying text.

8. *E.g.,* Berman v. Gerber Prods. Co., 454 F. Supp. 1310 (W.D. Mich. 1978); Altman v. Knight, 431 F. Supp. 309 (S.D.N.Y. 1977); Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969).

9. 431 F. Supp. 309 (S.D.N.Y. 1977).

claims in federal court, alleging that their directors' actions violated federal securities laws.[10] In *Altman,* however, the court held that if a shareholder's claim against target directors for resisting a tender offer alleges only that those directors breached their fiduciary duties, a cause of action does not lie under federal law.[11] Therefore, after *Altman,* the greater number of shareholder claims against target directors for defeating a tender offer must be filed in state court and must assert a cause of action under state law. Recently, however, state courts have applied inconsistent fiduciary standards in factually similar shareholder suits[12] and, for the most part, the standards that have been applied permit directors to resist tender offer proposals without accounting for the resulting loss to shareholders.

This Note will review recent decisions applying state law fiduciary standards and will propose procedural and substantive modifications to existing standards. The proposed modifications will compel target directors to recognize and fulfill fiduciary obligations when faced with a decision whether or not to resist a tender offer.

II. DEVELOPMENT OF THE TENDER OFFER AS A METHOD FOR OBTAINING CORPORATE CONTROL

Since the tender offer for corporate control displaced the proxy contest as the most commonly used takeover device, the frequency and magnitude of tender offers has exceeded even the broadest predictions.[13] Accompanying this increased activity has been the maturation of tender offer mechanics and defense techniques.[14] With the adoption and implementation of federal securities laws emphasizing disclosure to prospective target shareholders,[15] the target directors' responsibilities during the pendency of the tender offer proposal have become increasingly difficult to meet within time

10. The majority of mismanagement claims brought before 1977 claimed that the target's directors violated sections 10(b) and 14(e) of the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78h(e) (1976).

11. *See* notes 81-88 *infra* and accompanying text.

12. *See* Part III(B) *infra.*

13. *See* E. ARANOW, H. EINHORN, & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL, at vi (1977) [hereinafter cited as DEVELOPMENTS IN TENDER OFFERS]. An excerpt from Ehrbar, *Corporate Takeovers Are Here to Stay,* FORTUNE, May 8, 1978, at 91, reveals the magnitude of recent tender offers:

> In general, the targets are a lot bigger than they used to be. Six of last year's takeovers came to $300 million or more. Two of them—J. Ray McDermott's acquisition of Babcock & Wilcox and Kennecott Copper's purchase of Carborundum—cost more than $500 million, and Unilever paid $482 million for National Starch.

Id.

14. *See* notes 38-48 *infra* and accompanying text.

15. *See* Part III(A) *infra.*

constraints. Target directors must consider not only their responsibilities to their own shareholders but also the content of the offeror's proposal and the economic impact of the offer's success on the corporation and on their own position.[16]

A. *Tender Offer Mechanics*

Although the form of a tender offer varies according to the interests of the offeror, the offeror's capability to consummate the transaction, and the resistance expected from the target,[17] recent tender offers have tended to fit a flexible mold. The potential offeror, for various reasons,[18] offers to purchase control of a target company either for cash, for exchange of its own securities, or for a combination of both.[19] A solicited target typically has widespread ownership with no significant concentration of ownership in any single individual or in the management group.[20] Ordinarily, the target has a successful recent earnings record—earnings per share and book value usually are high—but the target's stock has been trading at a low price/earnings ratio and at or below book value.[21] Most

16. *See* Parts III(B)-(C) *infra*.

17. The offeror may be interested simply in gaining voting control, in which case it will seek to purchase only a significantly large share of the target to exercise control. Alternatively, the offeror might wish to merge with the target after the offer, in which case it must obtain a very large percentage of the target's outstanding shares. The tactic used by the offeror will depend on the offeror's ultimate objective—if it wants only voting control, it will consider open-market purchases; if it desires sufficient ownership to force a merger, it probably must publicly announce its intention to purchase any and all shares at a substantial premium. *See, e.g.*, TENDER OFFERS, *supra* note 1, at 38; Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. PA. L. REV. 317 (1967).

18. Ordinarily the offeror seeks to diversify its production by the addition of a target company operating in an industry that complements the other industries in which the offeror is engaged. Alternatively, the offeror may simply desire to add a profitable subsidiary to enhance its own sluggish performance. *See* Note, *supra* note 6, at 993.

19. *See* notes 25-30 *infra* and accompanying text. *See also* TENDER OFFERS, *supra* note 1, at 29.

20. A target company with widespread stock ownership and without significant holdings in any single individual or management should be easiest to obtain by tender offer because diverse owners ordinarily seek only to obtain the highest investment return and thus are more receptive to a "premium" offer. *See* Fleischer, *Disclosure Problems in Tender Offers and Freezeouts: General Disclosure Principles*, 32 BUS. LAW. 1365 (1977); Troubh, *supra* note 5, at 1301. Moreover, if a target company is comprised of a widespread and diverse shareholder group, these shareholders typically have no geographical or corporate ties and consequently would be more likely to tender their shares when offered a premium. *See* TENDER OFFERS, *supra* note 1, at 6.

21. A potential target company with a low price/earnings ratio may be acquired for a relatively low offering price in relation to present and projected earnings. For an example of how acquisitions of a low multiple offeror by means of an exchange offer can increase the offeror's earnings per share, see TENDER OFFERS, *supra* note 1, at 3. *See also* Troubh, *supra* note 5, at 1302. One commentator notes that, contrary to common belief, most target shares purchased during a tender offer were selling above rather than below book value at the date

important, however, an offeror will seek a target company with weak or arrogant management who maintain poor stockholder relations.[22] Other target characteristics considered important by an offeror include low debt ratio, recent large capital expenditures through cash flow, and substantial liquid assets in excess of that needed for operations.[23]

Once a potential offeror selects a target company, it must choose a form and price for the offer.[24] A cash offer provides several advantages. Investors readily can interpret the investment impact of a cash offer. Moreover, in contrast to an exchange offer, a cash offer relieves the offeror of the necessity of convincing target shareholders that they should accept the offeror's stock in exchange for their target shares.[25] If the offeror cannot finance a cash offer, or if the offeror's securities appear especially appealing to the investing public, the offeror might attempt an exchange offer of its common or preferred stock, convertible or nonconvertible debentures, bonds, or warrants. Alternatively, the offeror may consider combining both a cash and equity exchange offer.[26]

Selection of the offering price probably represents the most important and most difficult planning decision the offeror must make. A premium, or cash value above the target stock's market value, should be offered to enhance the tender offer's chances for success. In setting the tender offer price, the offeror must consider the value of the target company, the target company's current market share price, current market conditions, the number of outstanding target shares, and the likelihood that target management will

---

of the tender offer. Merjos, *Takeover Targets: They Share, an Analysis Reveals, a Good Deal in Common*, BARRONS, May 15, 1978, at 9.

22. *See* TENDER OFFER, *supra* note 1, at 9; Troubh, *supra* note 5, at 1301.

23. For discussion and empirical analysis of target company characteristics, see D. AUSTIN & J. FISHMAN, CORPORATIONS IN CONFLICT—THE TENDER OFFER (1970); Hayes & Taussig, *Tactics of Cash Takeover Bids*, HARV. BUS. REV., MAR.-APR. 1967, at 135: 20 ME. L. REV. 237 (1965).

24. Quite often, the offeror will acquire a relatively large initial block of the target's stock before announcing its tender offer in order to provide a base from which to attempt the takeover. TENDER OFFERS, *supra* note 1, at 19. If the offeror obtains more than 5% of the target's outstanding equity securities, however, it must report this ownership to the SEC, thereby revealing its position. 15 U.S.C. § 78n(d)(1) (1976); 17 C.F.R. § 240.13d-101 (1978); TENDER OFFERS, *supra* note 1, at 19. Accordingly, the offeror may announce a public tender offer without previously acquiring any target shares and utilize the advantage of surprise.

25. *See* TENDER OFFERS, *supra* note 1, at 29-30. *See also* INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 64, pt. 5, 92d Cong., 1st Sess. 2833 (1971) [hereinafter cited as INSTITUTIONAL INVESTOR STUDY].

26. The effect of an exchange offer is to dilute ownership in the hands of existing offeror shareholders. Therefore the use of debt securities and combination debt and cash offerings reduces this dilution. *See* TENDER OFFERS, *supra* note 1, at 30.

resist the offer.[27]

Once the offeror sets the form and price of the offer, it might seek to obtain control of the target through the use of one or a combination of several tender offer strategies. For example, the offeror might engage in a concerted program of individual open market purchases at market prices,[28] an active but private solicitation of preselected shareholders,[29] or a conventional public tender offer announcement to purchase a specific number of shares, either on a first-come, first-served or pro-rata basis.[30] Typically, the offeror will reserve the right to refuse to purchase any shares if less than the desired number of shares required to obtain control are tendered.[31] Any shareholder desiring to tender shares must follow the offeror's specific instructions, which usually provide for the deposit of tendered shares with the offeror's designated depositary or forwarding agent.[32] Any shares not accepted are returned to the tendering shareholder.[33]

Each tender offer strategy, whether pursued independently or in combination with other strategies, imposes upon the solicited public shareholder an investment decision; the shareholder must decide to sell or not to sell. The Securities and Exchange Act of 1934 expressly refused to define the term "tender offer."[34] Under interpretive case law, however, whether a purchase strategy constitutes a tender offer, as opposed to an unregulated open market purchase, depends on the amount of selling pressure exerted by the offeror.[35]

27. Furthermore, the offeror must consider the percentage ownership that it wishes to obtain in the target. Obviously, the greater percentage the offeror seeks, the higher the premium must be to persuade a sufficient number of shareholders to tender. *See* Greenhill, *supra* note 4, at 1307-08 (1977). *See generally,* TENDER OFFERS, *supra* note 1, at 38-41; Hayes & Taussig, *supra* note 23, at 135.

28. An offeror frequently will utilize this method to gain a base for a later conventional public tender offer. *See* note 24 *supra.* For an example of the combined use of private and public tender offer strategies, see Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973).

29. In an interesting variation on this strategy, an offeror might solicit a friendly institutional investor to acquire a large equity ownership in the target. *See* INSTITUTIONAL INVESTOR STUDY, *supra* note 25, at 2835; TENDER OFFERS, *supra* note 1, at 25.

30. Section 14(d)(6) of the Securities and Exchange Act of 1934, requires that if an offeror solicits less than all outstanding target shares and more shares than the offeror sought are deposited within 10 days, the offeror must purchase a pro-rata number of shares from every tendering shareholder. If less than the solicited number of shares are tendered, the offeror may purchase any or all of those tendered, on a first-come, first-served basis. 15 U.S.C. § 78n(d)(6) (1976).

31. TENDER OFFERS, *supra* note 1, at 48-49; Note, *supra* note 6, at 993.

32. TENDER OFFERS, *supra* note 1, at 59.

33. *Id.* at 50.

34. *See* DEVELOPMENTS IN TENDER OFFERS, *supra* note 13, at 1.

35. *Id.* at 1-25; Einhorn & Blackburn, *The Developing Concept of "Tender Offer:" An*

If the offeror contacts individual shareholders personally, or announces publicly its intent to purchase a large block, a court probably would construe the solicitation as a tender offer because substantial selling pressure exists.[36] Nevertheless, a program of public purchases at market prices might also constitute a tender offer if any individual purchase is so large that selling pressure results.[37] Since both federal and state laws intend to reach a broad range of fraudulent and unfair securities activity, any solicitation determined to be a tender offer under federal law also should constitute a tender offer for purposes of state court scrutiny of directors' conduct.

B. *Tender Offer Defense Strategies*

(1) The Maturation of Defense Tactics

Once target directors recognize a potential or actual tender offer and make a decision to resist, they may utilize many alternative defense tactics. The choice of defense tactics depends in part on the target's position and in part on the stance taken by the offeror.[38] The various tactics available may be divided into two categories: those designed to dissuade existing shareholders from selling and those designed to dissuade the offeror from buying.[39] Furthermore, target directors may implement tactics in either category before a potential offer or during the pendency of an actual offer.[40]

The surge of takeover activity in the 1960's produced a great number of lawsuits testing the usefulness of individual defense tactics[41] and afforded directors and commentators an opportunity to

---

Analysis of the Judicial and Administrative Interpretations of the Term, 23 N.Y.L. SCH. L. REV. 379 (1978).

36. *Id. See, e.g.,* Cattlemen's Inv. Co. v. Fears, 343 F. Supp. 1248 (W.D. Okla. 1972).

37. *See* Lipton, *Open Market Purchases,* 32 BUS. LAW. 1321 (1977). This proposition was raised in D-Z Inv. Co. v. Hollaway, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,771 (S.D.N.Y. 1974), but most courts have rejected it. *See* Einhorn & Blackburn, *supra* note 35, at 380-81.

38. *See, e.g.,* TENDER OFFERS, *supra* note 1, at 234-76.

39. Tactics such as maintaining shareholder relations are designed to dissuade target shareholders from selling. Instituting an antitrust action against the offeror obviously is designed to dissuade that offeror from buying. *Id.*

40. The tactics discussed in both TENDER OFFERS, *supra* note 1, at 234, and DEVELOPMENTS IN TENDER OFFERS, *supra* note 13, at 193, are categorized as implemented before or during a pending tender offer.

41. For example, numerous suits involving allegations that a tender offeror's proposed purchase violates federal antitrust laws have established specific guidelines defining when a court will enjoin a tender offer as potentially violative of antitrust prohibitions. *See* DEVELOPMENTS IN TENDER OFFERS, *supra* note 13, at 147-60. Consequently, target directors now have a wealth of case law upon which they may draw in deciding whether to file an antitrust action to enjoin a proposed tender offer.

consider and develop further imaginative defense strategies.[42] From this experience emerged a number of complex preoffer strategies such as the "shark-repellent" amendment of a corporation's articles of incorporation,[43] reincorporation in states with antitakeover statutes,[44] and establishment of employee stock ownership plans.[45] Common defense tactics used during the pendency of a tender offer include the solicitation of a "white knight" or friendly offeror who will compete with the hostile offeror either to drive up the bid price or to defeat the hostile offer altogether,[46] the institution of litigation against the offeror alleging violation of a number of state or federal laws,[47] and publicity campaigns designed to dissuade target shareholders from tendering their shares.[48]

A frequently used defense tactic that now faces potential invalidation is a target's utilization of state tender offer statutes to delay a pending offer, which provides target management with an opportunity to mount a more concerted defense strategy.[49] Most state tender offer statutes presently require the offeror to notify the target prior to announcing the offer and to wait a period of from ten to sixty days before consummating the purchase.[50] Because state tender

---

42. *See* notes 43-48 *infra* and accompanying text.

43. A potential target that fears the consequences of a tender offer might dissuade a prospective offeror from offering to purchase its shares by amending its articles of incorporation to require an 80% target shareholder vote before a subsequent merger between the target and offeror could be transacted. *See* Buford, *Amending the Corporate Charter,* 32 BUS. LAW. 1353 (1977).

44. *See* notes 49-53 *infra* and accompanying text.

45. An employee stock ownership plan obviously fosters some shareholder loyalty to the target and thereby reduces the probability that a tender offer might succeed. *See* DEVELOPMENTS IN TENDER OFFERS, *supra* note 13, at 197-99.

46. For a frightening indication of the pitfalls involved in soliciting a friendly defensive merger, see Chris-Craft Indus. v. Piper Aircraft Corp., 516 F.2d 172 (2d Cir. 1975), *rev'd,* 430 U.S. 1 (1977).

47. Target companies often bring suit against an offeror immediately after a tender offer proposal, alleging that the tender offer violates federal securities laws, state tender offer laws, antitrust restrictions, or various other federal statutes such as the Atomic Energy Act. *See, e.g.,* Babcock & Wilcox Co. v. United Technologies Corp., 435 F. Supp. 1249, 1288-89 (N.D. Ohio 1977).

48. An excellent public relations campaign designed to inform target shareholders frequently that their directors are looking after shareholder interests decreases the probability that a tender offeror will receive a block of target shares sufficiently large to give the offeror absolute control. When accompanied by a dividend reinvestment plan, this strategy attracts long-term shareholders who would be reluctant to tender. *See* Robinson, *Strategy to Prevent a Tender Offer,* 32 BUS. LAW. 1301, 1362 (1977).

49. This tactic is illustrated in the discussion of the impact of state tender offer statutes on the bids for Copperweld Corporation, Otis Elevator Company, and Youngstown Steel Door Company in DEVELOPMENTS IN TENDER OFFERS, *supra* note 13, at 220-25.

50. For example, Virginia requires a waiting period of 60 days. VA. CODE § 13.1-531(a) (Supp. 1977). *See also,* Gould & Jacobs, *The Practical Effects of State Tender Offer Legislation,* 23 N.Y.L. SCH. L. REV. 399, 409 (1978); Nathan & Moloney, *State Tender Offer*

offer statutes assert broad jurisdiction, most offerors now must file extensive information with one or more state administrative agencies and potentially wait the longest applicable waiting period before proceeding with their offer.[51] Moreover, several states require a hearing to consider the offer's merits when requested by target management.[52] During this waiting period, target directors are free to consider the catalogue of defense tactics. In fact, defense tactics whose success depended in part on the time delay provided by state law have defeated several substantial tender offers.[53]

The Fifth Circuit's decision in *Great Western United Corp. v. Kidwell,*[54] however, probably renders unconstitutional many state tender offer statutes. In *Kidwell,* Great Western sought review of the application of Idaho's takeover statute to its tender offer bid for the controlling interest in Sunshine Mining and Metal Company.[55] Great Western alleged that the Idaho statute, as applied, constituted an impermissible burden on interstate commerce and that the Williams Act preempted the Idaho statute.[56]

The Fifth Circuit agreed with both allegations, finding that the market approach to investor protection adopted by Congress in the Williams Act preempted the fiduciary approach adopted by Idaho in its takeover statute. According to the court, the Williams Act preserved a neutral regulatory stance by providing individual shareholders with sufficient information to evaluate a tender offer by requiring full disclosure of relevant information by both the offeror and target management. Conversely, the Idaho statute permitted target management unilaterally to delay the tender offer by invok-

---

Statutes: An Analysis of the Practical and Policy Considerations, 23 N.Y.L. SCH. L. REV. 647, 658-59 (1978).

51. *See, e.g.,* Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978) (Great Western's tender offer bid for Sunshine Mining and Metal Company potentially came under the tender offer jurisdictions of Idaho, New York, and Maryland). *See* notes 54, 59 *infra* and accompanying text.

52. *See, e.g.,* IDAHO CODE § 30-1503(4) (Supp. 1977); Nathan & Moloney, *supra* note 50, at 663.

53. *See* note 49 *supra.*

54. 577 F.2d 1256 (5th Cir. 1978).

55. Great Western announced its decision to purchase 2,000,000 shares of Sunshine's common stock on March 21, 1977. Idaho thereafter asserted that Great Western's tender offer fell under the jurisdiction of Idaho's takeover statute. Great Western, potentially faced with having to comply with conflicting requirements of the New York and Maryland takeover statutes, filed suit seeking an order declaring all three statutes invalid as applied to Great Western's offer. The federal district court dismissed the claim against New York and Maryland and found the Idaho statute unconstitutional. Great Western United Corp. v. Kidwell, 439 F. Supp. 420 (N.D. Tex. 1977). Thereafter, Great Western consummated its acquisition, but because Idaho could seek an injunction or require rescission if the appellate court reversed, the issue was not moot. 577 F.2d at 1264-65.

56. 577 F.2d at 1264.

ing a hearing before the director of the Idaho Department of Finance and thereby postponing the offer until receipt of state approval.[57] The court thereby concluded that the Idaho statute constituted a fiduciary approach to investor protection that denied investors their individual choice. Thus the court held the Idaho statute incompatible with the Williams Act. Further, the court held that since the statute permitted the state director of finance unilaterally to block a thirty-one million dollar tender offer, the statute constituted an impermissible burden on interstate commerce.[58] According to the court, the burdens this statute imposed on the free flow of interstate commerce were disproportionate to the statute's legitimate benefit of protecting Idaho investors.[59]

The conclusion reached in *Kidwell* inevitably sounds the death knell for other overbroad state tender offer statutes.[60] Congress, however, previously had adopted the Hart-Scott-Rodino Antitrust Improvements Act,[61] which requires notification to both the Justice Department and the Federal Trade Commission of any substantial tender offer.[62] Although an offeror may announce its tender offer prior to notifying these departments, according to recent rules prescribed by the FTC,[63] it will have to wait a mandatory fifteen days to complete a cash offer and thirty days to complete an exchange offer,[64] which gives target companies an extended period during which to consider defense strategies.[65] Moreover, the Act grants both

57. IDAHO CODE § 30-1503(4) (Supp. 1977) provides:

A take-over offer becomes effective when approved by the director [of finance]. The director may call a hearing if he deems it necessary or appropriate for the protection of offerees in this state, *and shall call a hearing if so requested by the target company, acting through its board of directors.*

58. 577 F.2d at 1284.

59. *Id.* at 1286.

60. Although the Idaho statute is especially overreaching, the legal standards applied by the Fifth Circuit undoubtedly would also render unconstitutional most other state tender offer statutes that permit offeror management unilaterally to invoke a hearing before a state commission. *See* text accompanying note 58 *supra*.

61. Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a (1976).

62. The Hart-Scott-Rodino Antitrust Improvements Act requires prior notification by both parties to the Justice Department and the FTC of any acquisition in which a company with more than $10 million in net annual sales or total assets is being acquired by another company with more than $100 million in net annual sales or total assets when, as a result of the acquisition, the acquirer will hold 15% or more of the voting securities or assets of the acquired company. *Id.*

63. 16 C.F.R. §§ 801-803 (1978).

64. 16 C.F.R. § 803.10 (1978).

65. According to tender offer authorities Martin Lipton and Joseph Flom, the waiting periods required by the Hart-Scott-Rodino Antitrust Improvements Act will be applied more fairly than state waiting periods and will not significantly slow down the frequency of tender offers. NAT'L L. J., Oct. 30, 1978, at 6, col. 2.

the Justice Department and the FTC power to extend these waiting periods by requesting further disclosure by the offeror.[66] Thus, although *Kidwell* probably renders unconstitutional many state takeover statutes, the FTC's promulgation of waiting period rules under the Hart-Scott-Rodino Antitrust Improvements Act allows target management at least fifteen days to consider and implement various defense strategies. This waiting period presents a problem to a target company that seeks a "white knight" offeror, however, because, once selected, the "white knight" must wait a second, independent period during which the original offeror might consummate its offer.

The variety of complex and tested strategies available to target directors encourages their implementation when those directors face a potentially hostile tender offer. Moreover, the time delays available to target directors greatly enhance the ultimate likelihood of a strategy's success. Even though target directors have faced a recent surge of shareholder suits for successfully maintaining defense actions,[67] because of the defense strategies' probability of success and the directors' potential loss of control of the target company, the temptation to defend nevertheless remains.

(2) The Director's Dilemma

Whenever a target director chooses to resist and successfully defends against a tender offer, that action may result in the target shareholders' loss of an opportunity to tender their shares for a price higher than the prevailing market price and in a subsequent shareholder suit alleging corporate mismanagement as the cause of that loss.[68] Since the majority of mismanagement claims now must be brought under state law,[69] the allegation of mismanagement typically will allege that the target directors acted in bad faith and for their personal interests in defending the tender offer, violating their fiduciary obligations to the target shareholders.[70] The dilemma facing target directors arises because, once faced with the defense decision, the directors must consider both the preservation of their own positions and the fiduciary obligations they owe to target sharehold-

66. 16 C.F.R. § 803.20 (1978).

67. *See* Green, *Two-Front Wars—Some Firms Fighting Tender Offers Provoke Suits by Own Holders*, Wall St. J., Aug. 3, 1977, at 1, col. 1. *See also* Berman v. Gerber Prods. Co., 454 F. Supp. 1310 (W.D. Mich. 1978); Reeves v. Texas Gulf, Inc., 78 Misc. 2d 579, 357 N.Y.S.2d 662 (1974).

68. *See, e.g.*, Reeves v. Texas Gulf, Inc., 78 Misc. 2d 579, 357 N.Y.S.2d 662 (1974).

69. *See* notes 81-88 *infra* and accompanying text.

70. *See* notes 89-95 *infra* and accompanying text.

ers. Implicit in every decision to resist a tender offer is the target directors' determination either that the target company will operate at least as profitably as an autonomous enterprise under their own control or that they desire to maintain control of the target even though the offeror may operate the target more profitably.[71] Implementing the defense decision for either purpose furthers the directors' individual interests insofar as the successful resistance perpetuates their control. Since most state fiduciary standards test managerial decisions upon the degree of self-dealing and bad faith involved in a decision,[72] a director's avoidance of personal liability largely depends on a court's resolution of the issue of self-serving motivation. Thus to refrain from imposing liability upon target directors, a court must be convinced that although the directors' resistance of the tender offer preserved those directors' positions, it also satisfied fiduciary obligations owed by the directors to their shareholders.

III. Legal Limitations on a Target Director's Capacity To Resist a Tender Offer

A. The Federal Attempt

In response to mounting complaints that target shareholders were receiving very little information about the tender offeror upon which they might base an informed investment decision, Congress in 1968 enacted the Williams Act[73] as an amendment to the Securities and Exchange Act of 1934.[74] This amendment requires detailed disclosure by any person making a solicitation or recommendation to accept or reject a tender offer.[75] Section 14(e) imposes liability on any person making an untrue statement of material fact or engaging in any fraudulent, deceptive, or manipulative act or practice in connection with the invitation for tenders or the recommendation that shareholders oppose or favor any tender offer.[76] Thus the Wil-

71. Even if present directors are assured that they will retain their positions over their corporation as a subsidiary of the offeror after the purchase, directors often do not desire to report to anyone other than themselves. For example, the president of Microdot Inc. acceded to a purchase of Microdot by Northwest Industries on the promise that he would retain his position. He later quit however, stating that he "wasn't used to having a boss." *See* Metz, *Inevitable Escalation of Corporate Takeovers,* NAT'L L.J., Nov. 20, 1978, at 19, col. 1.

72. *See* text accompanying notes 89-95 *infra.*

73. 15 U.S.C. §§ 78m (d)-(e), 78n (d)-(f) (1976).

74. 15 U.S.C. §§ 78a-78kk (1976).

75. 15 U.S.C. § 78m(d) (1976).

76. 15 U.S.C. § 78n(e) (1976) provides in part:

> It shall be unlawful for any person to make any untrue statement of a material fact or to omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage

liams Act attempts to insure truth in disclosure not only from the offeror, but also from target directors who recommend that shareholders oppose or favor the pending offer.[77]

Subsequent to the enactment of the Williams Act, target shareholders utilized its antifraud provisions as a basis for lawsuits seeking damages from the target's directors for "fraudulently" dissuading shareholders from tendering their shares.[78] Several problems exist, however, in applying section 14(e) to target directors' action designed to defeat a potential or pending tender offer. For example, it is unclear whether defensive action taken prior to a tender offer announcement constitutes fraud "in connection with a tender offer."[79] Although this question has not been litigated specifically in the context of a shareholder suit against target directors for instituting defensive tactics, the question should be resolved in favor of allowing a cause of action to further the Williams Act's goal of truthful disclosure.[80] A second and more important question is whether a target company's institution of defensive tactics constitutes a fraudulent, deceptive, or manipulative practice and thus allows target shareholders to bring suit when the target's directors neither recommended that shareholders oppose the offer nor communicated with shareholders in any other way.

The federal district court for the Southern District of New York considered this question in *Altman v. Knight*[81] and concluded that allegations constituting only a claim of corporate mismanagement or breach of fiduciary duty cannot be brought under section 14(e).[82] In *Altman* the target company's directors, faced with a pending

in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

77. Target management may inform target shareholders that an offer is pending, that target directors are considering the offer, and that shareholders should not act until they receive management's recommendation. 17 C.F.R. § 240.14d-2(f) (1978).

78. *See, e.g.*, Neuman v. Electronic Specialty Co., [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,591 (N.D. Ill. 1969).

79. Recent cases suggest that if there is some public acknowledgement of a forthcoming tender offer, any target action taken in defense might be construed as "in connection with a tender offer." *See* Applied Digital Data Sys., Inc. v. Milgo Elec. Corp., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,824 (S.D.N.Y. 1977). When directors take defensive action, however, merely to prevent the possibility of a takeover, jurisdiction of § 14(e) over that action may not exist.

80. Whenever target management seeks shareholder approval of any corporate change designed surreptitiously to insulate the target from a potential takeover attempt, target shareholders may be harmed in the same manner as if their directors acted unilaterally to defend a pending tender offer. Therefore, disclosure of management's true purposes for instituting preoffer defense tactics should be compelled.

81. 431 F. Supp. 309 (S.D.N.Y. 1977).

82. *Id.* at 314.

tender offer, approved the purchase of a third company, thereby causing the tender offeror to withdraw its offer.[83] The target company's shareholders subsequently brought suit alleging that the price paid for the third company was excessive and that the target directors approved the purchase solely to block the tender offer and to perpetuate their own control.[84] Finding that the shareholders' claim amounted to no more than an allegation that the target directors breached their fiduciary duties, the court rejected the application of section 14(e), concluding that this was "precisely the kind of claim the Supreme Court [in *Santa Fe Industries v. Green*] felt should be decided under state law."[85] In addition, the court ruled that even if directors make a misstatement of fact in connection with implementation of defense tactics, no cause of action will arise unless that misstatement caused the shareholders' injuries.[86] If the decision to implement defense tactics does not require shareholder approval and the directors act solely to discourage the offeror rather than to dissuade their own shareholders, it is the act of implementing defensive tactics and not any accompanying misstatement or omission that causes the shareholders' harm.[87] Thus the court concluded that a shareholder action alleging that their loss was caused by the act of defending a tender offer, and not by any accompanying misstatement, states a claim only under state law.[88] Therefore most future shareholder claims against target directors for resisting a tender offer will have to be brought in state court alleging only causes of action under state law, unless other facts support the shareholders' allegations of fraud.

---

83. Anaconda Company, during the course of a tender offer by Crane Company to purchase Anaconda shares, negotiated the purchase of Walworth Company. Anaconda thereby deprived its shareholders of the opportunity to tender their shares to Crane. *Id.* at 311.

84. Plaintiffs, shareholders in the Anaconda Company, brought suit against Anaconda, alleging that it purchased Walworth Company solely to block a tender offer for Anaconda shares by Crane Company, and not for any other valid business purpose. *Id.*

85. Citing Santa Fe Indus. v. Green, 430 U.S. 462 (1977), the court concluded that even if Anaconda's purchase of Walworth furthered no valid business purpose, that alone would not constitute a manipulative or deceptive device as required by § 14(e). The court thus held that since the shareholders had alleged only that the terms of the transaction were unfair, without alleging Anaconda's failure to disclose fully and fairly the transaction's circumstances, no federal claim existed. 431 F. Supp. at 313-14.

86. 431 F. Supp. at 314.

87. According to the court, since Anaconda's purchase of Walworth required no prior shareholder approval, any loss that shareholders could prove resulted from the directors' actions in transacting the purchase and not from any accompanying misstatement to shareholders. *Id.*

88. *Id.*

B. State Governance of Corporate Directors' Responsibilities

Once corporate directors are entrusted with the investing public's funds, state law imposes a duty upon those directors to manage the corporation's affairs with care and loyalty.[89] Although technically not trustees, corporate directors stand in a fiduciary relationship with the corporation and its shareholders and have affirmative duties to protect the interests of both.[90] Traditional corporate legal standards, however, permit directors to exercise substantial discretion in rendering daily business decisions without fear of judicial interference at the insistence of dissatisfied shareholders.[91] This latitude of business judgment prevails as long as directors administer the corporation's affairs in good faith and in the shareholders' best interests. In theory, this "business judgment" doctrine reflects a judicial policy that noninterference with directors' corporate decisions will encourage endeavor in high-risk ventures that, if successful, benefit society as a whole.[92] Consequently, courts will not compensate aggrieved shareholders for losses resulting from questionable director decisions, however unlikely the decisions' chances of success might have been at the time they were made. This traditional presumption of proper business judgment is overcome only by affirmative shareholder proof that management acted contrary to the corporation or shareholders' best interests and in furtherance of selfish interests.[93] Shareholder proof of the directors' selfish interests, however, is an especially rigorous burden because this motivation rarely is admitted and must be proved affirmatively by circumstantial evidence.[94] Accordingly, application of the business judgment rule in most contexts results in a favorable decision for corporate directors.[95]

---

89. *See, e.g.*, N.Y. BUS. CORP. LAW § 713 (McKinney 1970); ABA-ALI MODEL BUS. CORP. ACT § 35 (rev. ed. 1975).

90. For a classic statement of a director's fiduciary obligations, see Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939), in which the court stated:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

Id. at 270, 5 A.2d at 510.

91. *See* Briggs v. Spaulding, 141 U.S. 132 (1891); 4 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 1039 (rev. perm. ed. 1975).

92. *See* Note, *The Continuing Vitality of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562, 565 (1967).

93. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

94. *See* 70 YALE L.J. 308, 319 (1960).

95. *See* Note, 57 VA. L. REV. 1223, 1230 (1971) ("The business judgment test, therefore, seems to reflect a judicial predilection to decide in favor of the defendant . . . .").

(1) *Berman v. Gerber Products Co.*

Application of traditional corporate legal standards to shareholder claims alleging that a director breached his fiduciary duty by resisting a tender offer proposal fails to afford meaningful judicial scrutiny into whether the directors acted in good faith and in the best interests of the corporation and the shareholders. The recent opinion in *Berman v. Gerber Products Co.*[96] amply illustrates this point. In *Berman* shareholders of Gerber alleged that Gerber's directors violated federal and state law[97] by instituting legal proceedings that resulted in Anderson, Clayton & Co.'s withdrawal of a tender offer to purchase any and all outstanding Gerber common shares.[98] Noting that after *Altman* the claim no longer was cognizable under the federal securities' antifraud laws, the court stated, in dicta, that even if the claim were cognizable, Michigan law, which follows the business judgment rule, would not hold the directors liable for good faith errors in judgment.[99] Although the *Gerber* court was not required to render a binding determination of this state law issue, it concluded, without analysis of whether Gerber's directors acted for their own interests, that the business judgment rule protected the directors from liability for their decision to defend. Thus the *Gerber* court's dicta represents the cursory resolution achievable by application of the business judgment presumption. The court's analysis ignored the conflict of interests facing Gerber's directors and failed to require any proof by the directors of their good faith, care, and loyalty in deciding to defend against the tender offer.

(2) *Cheff v. Mathes*

In *Cheff v. Mathes,*[100] a shareholder action against a target company's directors alleging improper use of corporate funds to purchase all target shares owned by the offeror, the Delaware Supreme

96. 454 F. Supp. 1310 (W.D. Mich. 1978).

97. Plaintiffs, shareholders of Gerber, alleged that Gerber violated section 14(e) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78n(e) (1976), as well as common law principles of fiduciary duty. 454 F. Supp. at 1316.

98. On April 18, 1977, Anderson, Clayton & Company publicly announced its intention to purchase through a cash tender offer any and all of the outstanding shares of Gerber common stock. On April 25, Gerber's directors issued a press release recommending that its shareholders reject the offer. On the same day, Gerber filed suit seeking to enjoin the offer. On September 19, 1977, Anderson, Clayton announced that it was withdrawing its tender offer. *Id.* at 1314-16.

99. Citing Thomas v. Satfield Co., 363 Mich. 111, 108 N.W.2d 907 (1961), for the proposition that Michigan law clearly scrutinizes a director's dealings with his stockholders, the court nevertheless concluded that management may not be held liable for good faith errors in judgment. *Id.* at 1319.

100. 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1969).

Court refused to apply the business judgment standard, focusing instead on the question of the target directors' self-dealing. In *Cheff*, Motor Products Corporation, through its chairman, Maremont, engaged in a series of open-market purchases that ultimately gave Maremont controlling interest in the Holland Furnace Company.[101] Maremont subsequently demanded a position on Holland's board of directors and expressed an opinion that Holland's distribution system was obsolete.[102] Rather than concede to Maremont's demands, Holland's directors negotiated the purchase of Maremont's entire interest in Holland with corporate funds,[103] ostensibly for the purpose of implementing a stock option plan.[104] Thereafter, several of Holland's minority shareholders brought suit alleging that the directors had used corporate funds solely to perpetuate their own control.[105]

The lower Delaware court found that Maremont's impending control posed no real threat to Holland, that the asserted stock option plan was an insufficient rationale to support the directors' action, and that the directors' actual motive for the purchase was their desire to perpetuate their own control.[106] On appeal, the Delaware Supreme Court reversed, holding that Holland's directors engaged in a reasonable investigation into Maremont's background and that the results of that investigation, together with consideration of Maremont's express discontent with Holland's distribution system, justified their *belief* that Maremont posed a threat to Holland's continued existence.[107] In reaching this conclusion, however,

101. Between early 1957 and October 1957, Maremont, through a series of open-market purchases, acquired 155,000 shares of Holland Furnace.

102. According to the testimony of Cheff, Holland's Chief Executive Officer, Maremont, upon demanding a position on Holland's board, "indicated immediately that he had no interest in [Holland's] type of distribution, that he didn't think it was modern, that he felt furnaces could be sold as she sold mufflers, through half a dozen salesmen in a wholesale way." 41 Del. Ch. at 500, 199 A.2d at 551.

103. *Id.* at 501, 199 A.2d at 552.

104. On August 30, 1957, after Maremont demanded a position on Holland's board, Holland's directors authorized the purchase of company stock on the open market with corporate funds for use in a stock option plan. In fact, the stock option plan never was implemented. *Id.* at 501-03, 199 A.2d at 552-53.

105. Plaintiffs, owners of 60 Holland shares, filed a derivative action naming all of Holland's individual directors and Holland itself as defendants. *Id.* at 502, 199 A.2d at 553.

106. *Id.*

107. Emphasizing that Holland's directors were held only to a standard of good faith and reasonable investigation, the court concluded that because unrebutted testimony indicated that the directors first received advice from Dun and Bradstreet indicating that Maremont had liquidated past corporations, second, received professional financial advice recommending that Holland purchase Motor Products, and third, from personal investigation uncovered Maremont's alleged poor reputation, the directors were justified in transacting the purchase with corporate funds. *Id.* at 507, 199 A.2d at 556.

the *Cheff* court expressly shifted to the directors the burden of justifying the corporate action as being primarily in the corporation's best interests.[108] Citing *Bennett v. Propp,*[109] the court noted that since use of corporate funds by directors to defeat a takeover attempt necessarily perpetuates the directors' control, directors face a conflict of interests and should bear the burden of proving the propriety of their actions. The court found, however, that Holland's directors had satisfied this burden by proving a reasonable investigation, the results of which supported their good faith belief that Maremont's takeover would threaten corporate policy.[110]

Although *Cheff* was not a shareholder action contesting the validity of a target director's defense action that resulted in the shareholders' loss of a tender option, it represents an analysis of a shareholder's complaint that target directors acted unilaterally to preserve their directorate status at the expense of the shareholders. Since target shareholders who lose a tender option as a result of unilateral directorate action similarly contend that management acted without shareholder approval to perpetuate their own power, the *Cheff* analysis is appropriate in the tender offer context. This analysis recognizes the inherent conflict of interests facing target directors who desire to defeat a takeover attempt and, rather than resolving the conflict through cursory application of the business judgment presumption, shifts the burden to the directors to prove that the defense action furthered the corporation's best interests.

(3) *Condec Corp. v. Lunkenheimer Co.*

In *Condec Corp. v. Lunkenheimer Co.,*[111] a Delaware chancery court decision subsequent to *Cheff,* the court refused to apply the burden of proof shift mandated by *Cheff,* but nonetheless required a higher substantive showing on the part of the directors. In *Condec* the Lunkenheimer directors, in response to Condec's proposal to purchase an outstanding portion of Lunkenheimer common stock,[112]

108. *Id.* at 504, 199 A.2d at 554.

109. 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962). In *Bennett,* Sadacca, chairman of the board of Noma Lites, Inc., arranged for the open market purchase of Noma shares in an attempt to defeat a threat by Textron Inc. to purchase over 50% of Noma's outstanding stock. After failing to secure personal financing to consummate the purchase, Sadacca influenced Noma's board of directors to adopt the purchase in the corporate name. Noting that directors who utilize corporate funds to remove a threat to corporate policy are confronted with a conflict of interests, the court shifted the burden to Sadacca and Noma's directors to justify the stock purchase as transacted primarily in the corporate interest. *Id.* at 22, 187 A.2d at 409.

110. *See* note 107 *supra.*

111. 43 Del. Ch. 353, 230 A.2d 769 (Ch. 1967).

112. After Lunkenheimer rejected Condec's proposal for a friendly merger, Condec

authorized the issuance of 75,000 unissued Lunkenheimer shares in exchange for 75,000 shares of U.S. Industries, Incorporated.[113] Because this exchange effectively defeated Condec's takeover attempt, Condec, which already owned a substantial block of shares, instituted a suit alleging that Lunkenheimer's directors transacted the exchange solely to serve their personal interests and that the exchange was not made in the exercise of prudent judgment, or in furtherance of any legitimate corporate purpose.[114] The Delaware chancery court noted, however, that the mere allegation of self-dealing did not shift the burden of proof to defendants; since Condec had not *established* that the directors in fact voted for their own interests, the court did not impose upon the directors the "full burden" of proving that the stock issuance was authorized in the corporate interest.[115] Nevertheless, the court found that Lunkenheimer's directors had not engaged in direct, objective investigation or professional consultation that justifiably would lead them to believe that the Condec takeover attempt represented a reasonable threat to Lunkenheimer's continued existence.[116] Moreover, the court reasoned that since Condec possessed an equitable right to obtain a controlling interest in the Lunkenheimer Company, and since the directors' action in issuing the shares was not designed to further a proper corporate purpose, that action constituted impermissible corporate manipulation.[117]

Thus, under the *Condec* analysis, although a shareholder's mere *allegation* of self-dealing will not shift the burden of proof to directors to prove absence of self-dealing, a court will not summarily dismiss a shareholder complaint on the business judgment pre-

---

purchased 21,000 shares of Lunkenheimer. Thereafter, on April 21, 1967, Condec announced publicly its tender offer proposal to purchase, on a first-come, first-served basis, 190,000 additional Lunkenheimer shares. If successful, this last purchase would have given Condec slightly more than 50% of Lunkenheimer's outstanding shares. *Id.* at 357, 230 A.2d at 771-72.

113. *Id.* at 358, 230 A.2d at 772-73.

114. *Id.* at 359, 230 A.2d at 773.

115. *Id.* at 365, 230 A.2d at 776-77. In *Cheff,* however, the court shifted the burden of proof to the directors on the mere existence of a conflict of interests. 41 Del. Ch. at 504-05, 199 A.2d at 554. *Condec's* requirement that plaintiffs *establish* self-dealing thus violates the *Cheff* precedent.

116. When asked why he rejected Condec's merger proposal, Lunkenheimer's president stated that he had investigated Condec through reports prepared by Moody's and Dun & Bradstreet and through conversations with a financial representative at White-Weld Company, all of which revealed that Condec's debt was excessive and its profit low in relation to sales. Nevertheless, the court deemed this investigation insufficient because it failed to reveal any intent on Condec's part to alter Lunkenheimer or that Condec's growth rate might not counteract poor debt and profit figures. 43 Del. Ch. at 360-65, 230 A.2d at 774-76.

117. *Id.* at 365-66, 230 A.2d at 777.

sumption, but will require the directors to come forth with some proof—first, that they investigated the offeror's intentions; second, that this investigation revealed sufficient justification to believe that success of the offer represented a threat to the target's continued operation; and third, if fear of such a threat was not justified, that the directors' action furthered some other legitimate corporate purpose.[118]

C. *Analysis of Judicial Inconsistencies*

The decisions in *Gerber, Cheff,* and *Condec* reveal the courts' inconsistent application of fiduciary standards to a shareholder's challenge of his directors' decision to resist a tender offer. *Gerber's* application of the strict business judgment standard fails to identify whose interests directors must further and, moreover, fails to determine whether directors acted solely or primarily to fulfill their own interests.[119] Reliance on the business judgment rule presumes that since a director's interest in maximum profits corresponds to his shareholders' interest in maximum return on their investment, directors always will act to further the corporation's, and consequently the shareholders', best interests. This assumption fails, however, when applied to directors' tender offer defense decisions. Because directors have a stake in the preservation of their independent power, they clearly are tempted to defend against a tender offer even though their defense decision might harm the corporation and its shareholders.[120] In this regard, the defense decision is unlike a true business decision. Defense against a tender offer serves only to interrupt a potential contractual relationship between the offeror and target shareholders. Although a defense decision normally is justified if consummation of the offer would harm both the corporation and its shareholders,[121] the fiduciary standard applied by the

118. The court in *Condec* implied that if the stock issuance had been authorized for some legitimate corporate purpose such as a stock option plan, it might have passed scrutiny. On the other hand, the court concluded that since the issuance "was obviously designed for the primary purpose of reducing Condec's stock holdings in Lunkenheimer," it could not be upheld. Thus the court does not conclude whether, if the issuance served some corporate purpose but also was utilized primarily to defeat a takeover, it would pass scrutiny. *Id.* at 365, 230 A.2d at 777.

119. For another example of the cursory analysis resulting from application of the business judgment standard to a director's decision to resist a tender offer, see Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969).

120. Because a tender offer often reflects the offeror's conclusion that present target mismanagement is incompetent, a tender offer might provide a better opportunity for future target growth. A target director's unilateral defense decision thus may result in the target's loss of this growth potential. Moreover, the defense decision may also deprive target shareholders of their investment opportunity.

121. For example, target management obviously should, and perhaps must, resist a

courts should require that directors recognize their shareholders' interests and act in a manner that furthers these interests. Application of the business judgment standard compels neither a director's recognition of nor his fulfillment of shareholder interests and consequently does not sufficiently analyze applicable fiduciary responsibilities.

The decision in *Cheff* illustrates judicial recognition that a director's inherent selfish motives render the deferential business judgment standard inappropriate in the tender offer defense area. After determining that Holland's directors faced a conflict of interests in deciding to purchase Maremont's control, the *Cheff* court expressly shifted to those directors the burden of proving the propriety of their decision. This shifting of the burden of proof placed emphasis on whether the directors acted in furtherance of their fiduciary obligations. In concluding that Holland's directors met their burden of proof by showing a reasonable belief that Maremont posed a threat to Holland's continuity, however, the court failed to delineate precisely whose interests conflicted with the directors' interests and, moreover, whether the directors' action furthered these conflicting interests. The court's adoption of a standard that approves the defense decision if the directors acted on a good faith belief in a threat to the target's continuity assumes that directors must act only to maintain the corporation's status quo to avoid liability. A deeper underlying assumption presumes that corporate continuity enhances a shareholder's investment return. In fact, if present directors are acting incompetently, a change in the corporation's status quo undoubtedly would further its shareholders' interests. Moreover, even if target directors are extremely competent, target shareholders may not care whether corporate continuity is maintained if the offeror presents a substantial cash offer.[122] Thus, although *Cheff* purports to enforce the directors' fiduciary responsibilities by shifting the burden of proof, its corresponding substantive standard for justifying a tender offer defense decision fails to consider whether target directors have actually protected their shareholders' investment.

The decision in *Condec* cited *Cheff* as controlling but refused to shift to Lunkenheimer's directors the burden of proving the propriety of their decision to issue stock. *Cheff's* procedural standard shifts the burden of proof upon a finding that the directors faced a conflict of interests. As the *Condec* court concluded, Lunkenhei-

tender offer by a known looter announced through fraudulent representations. *See, e.g.,* Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969).

122. *See also* text accompanying note 156 *infra*.

mer's directors acted in furtherance of their own interests. Although declining to shift the full burden of proof to the directors, *Condec* in effect applied a more rigorous standard of proof than did *Cheff*. Emphasizing that Condec possessed an equitable right to control,[123] the court concluded that Lunkenheimer's directors failed to demonstrate sufficient justification for believing that Condec posed a threat to Lunkenheimer's future continuity. Lunkenheimer's directors, however, produced evidence justifying their belief in Condec's threat that was almost as compelling as the evidence Holland presented of Maremont's threat.[124]

Despite apparent inconsistencies, *Condec* and *Cheff* adopted several analytical procedures that, if properly applied, would compel directors to satisfy their fiduciary obligations. Principally, *Cheff* recognized the inherent conflict of interests confronting directors who resist a tender offer and therefore shifted to those directors the burden of justifying their decision to defend. *Condec* expressly rejected this procedural shift but nevertheless held the target directors to a higher burden of proof by rejecting the directors' contention that the insurgent posed a real threat to the target corporation's continuity when in fact the evidence presented did not compel that conclusion.[125] Both courts emphasized that directors must investigate the offeror before deciding to resist a takeover attempt. If measured against the proper interests, this investigative duty would compel target directors to fulfill their fiduciary obligations.[126] Because both courts allow directors to consider only the corporation's abstract interest in its own continuity, neither court forces directors to consider their shareholders' investment interests. Since the

123. On the date Lunkenheimer agreed to authorize the issuance of 75,000 unissued shares, Lunkenheimer shareholders had tendered a sufficient number of shares to give Condec equitable control. 43 Del. Ch. at 357, 230 A.2d at 772.

124. The directors in both *Cheff* and *Condec* reviewed the financial background of the respective insurgents and sought the advice of independent third party financial experts. *See* notes 107 and 116 *supra* and accompanying text. An important distinction arises in that Holland negotiated to purchase Maremont's control in *Cheff*, while the unilateral stock issuance in *Condec* not only deprived Condec of control but also left Condec with a share value substantially lower than the share value of a controlling block. Moreover, Condec, as remaining shareholder, was the actual plaintiff in *Condec*, while minority shareholders instituted the *Cheff* suit. Nonetheless, from the standpoint of the effect of the directors' action on shareholder interests, these distinctions are insufficient to justify differing conclusions.

125. According to the *Condec* court, although the record was "replete with accounting reasons in justification of Lunkenheimer's continuing fight against Condec's [insurgent] efforts . . . [t]here is no evidence of record that the management of Condec in the past has either substantially altered or threatened to alter the business of any company with which it has formed a business association . . . ." 43 Del. Ch. at 364, 230 A.2d at 776.

126. Whatever interests directors must satisfy in fulfillment of fiduciary obligations, investigation of the offeror's price and its intentions give directors a factual basis for rendering the defense decision.

shareholders' investment interests often diverge from the corporation's abstract interest in its own continuity,[127] the substantive fiduciary standard applied in both *Condec* and *Cheff* cannot compel directors to protect sufficiently their shareholders' interests during the pendency of a tender offer.

IV. A Proposed Standard

A. *Contemporary Notions of Corporate Responsibility*

Any proposal that attempts to impose a higher standard of responsibility upon a corporation's directors must reflect contemporary notions of corporate responsibility. Since the early 1960's, the Securities and Exchange Commission, within the boundaries of its jurisdiction, has attempted to impose a heightened standard of responsibility upon corporate directors.[128] Federal courts have responded by adopting the Commission's suggestions in many instances. Some federal courts have even prescribed a checklist standard of conduct for directors acting under certain circumstances.[129] For example, cases and commentators suggest that when a director incurs a duty to disclose various facts,[130] he cannot escape that duty by failing to inform himself of those facts; the director must make further inquiry.[131] Consequently, courts have imposed substantial liability on directors for violations of the federal securities laws,[132] and directors have responded by implementing decisionmaking strategies designed to heighten their awareness, such as the increased use of committees of directors primarily responsible for overseeing corporate activity.[133] Successful use of a committee system and other devices designed to increase directors' awareness demands a more reliable and complete flow of information upon

---

127. *See* text accompanying note 122 *supra.*

128. *See, e.g.,* Sommer, *Directors and the Federal Securities Laws,* 241 Sec. Reg. & L. Rep. (BNA) F-1 (1974) (speech before the Colorado Association of Corporate Counsel). *See also* Report of Investigation in the Matter of Stirling Homex Corporation Relating to Activities of the Board of Directors of Stirling Homex Corporation, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,219.

129. *See* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc) (Oakes, J., dissenting).

130. A duty of disclosure is imposed by 15 U.S.C. § 78(n)(e) (1976) upon any person attempting to influence a shareholder's decision "in connection with any tender offer." *See* note 76 *supra* and accompanying text.

131. *See, e.g.,* Feit v. Leasco Data Processing Equip. Co., 332 F. Supp. 544 (S.D.N.Y. 1971) (director/attorney's duty to investigate).

132. *See, e.g.,* Chris-Craft Indus. v. Piper Aircraft Corp., 516 F.2d 172 (2d Cir. 1975) (imposition of $35,800,000 damages), *rev'd,* 430 U.S. 1 (1977).

133. *See* Hahn & Manzoni, *The Monitoring Committee and Outside Directors' Evolving Duty of Care,* 9 Loy. Chi. L.J. 587 (1978).

which directors may base their decisions.[134] Our modern society of passive investment and limited informational flow to investors[135] justifies continuing future emphasis on fiduciary standards designed to increase informational flow to investors and to further directorate accountability. An increasing modern fear is the corporate board of directors' capability of exercising its vast power to the economic detriment of literally thousands of shareholders.[136] Threat of widespread liability remains an ultimate deterrent to any irresponsible corporate governance.[137]

Should this contemporary trend of heightened directorate responsibility extend to a director's decision to defend against a tender offer? As previously noted, directors, as fiduciary agents, act primarily for the benefit of their principals, the shareholders. Their shareholders' investment return ultimately depends on the performance of the corporation and, consequently, on the competency of the corporation's directors. In a real economic sense, all decisions that directors make should reflect the directors' consideration of the ultimate impact on the shareholders' investment.[138] Thus any decision to resist a tender offer should reflect the directors' conclusion that the tender offer's defeat will provide a greater investment return to shareholders than will concession to the offer.[139]

An additional, compelling rationale for imposition of a higher standard of directorate responsibility in the tender offer area is the necessity of maintaining an unimpeded market for corporate control. In many instances, a tender offer proposal represents the offeror's conclusion that existing target management must be displaced, or at least better organized, before the target company may realize maximum profitability. If a target company's directors may act unilaterally to defeat a tender offer without fear of judicially imposed liability for failing to serve their shareholders' best interests, these directors effectively impede the market for corporate control. Continued existence of a market for control compels a corporation's directors to act to the best of their abilities in furtherance

---

134. *Id.* at 589-91.

135. *See, e.g.*, A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119 (1932).

136. *See* Sommer, *Foreword: Fiduciary Duties—The Search for Content*, 9 LOY. CHI. L.J. 525 (1978).

137. *Id.*

138. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW § 14.5 (2d ed. 1977).

139. Essentially, this point is the premise of this Note. Fiduciary obligations arise because shareholders entrust their funds in management's hands. The relationship is essentially contractual. *Id.* § 14.3. Thus fiduciary standards should compel directors to consider their shareholders' interest in investment return above all other interests. *See, e.g.*, Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

of their shareholders' interests.[140] Imposition of a higher standard of directorate responsibility would demand that directors act in their shareholders', rather than their own, interests and would therefore promote a competitive market for corporate control.

Finally, a very practical reason exists for imposing a high standard of directorate accountability in this area. In recent tender offers, the premium offered to shareholders who tendered their securities has averaged eighty percent over market value and in some instances has exceeded one hundred percent of market value.[141] Successful implementation of defense tactics costs shareholders this premium. For example, in Great Western United Corporation's bid for Sunshine Mining and Metal Company, Sunshine defended by instituting a suit alleging that Great Western had violated the Williams Act. When the two companies eventually settled that suit, Great Western consummated the purchase of Sunshine shares for seventy-five cents per share less than it had originally offered.[142] Similarly, Gerber Products' successful defense of Anderson, Clayton & Company's tender offer cost Gerber shareholders at least seven dollars per share and probably more.[143] With future tender offers expected to present even higher premiums for select companies,[144] the economic consequences of a successful defense stance might be devastating for target shareholders. Only imposition of a higher fiduciary standard for target directors will moderate directors' ability to perpetuate their own control and compel those to protect the investment interests of the target shareholders.

B. *A Procedural Proposal: Shifting the Burden of Proof*

The Delaware Supreme Court's decision in *Cheff* pinpointed an extremely critical consideration that *Condec* implicitly rejected. Recognizing the potential conflict of interest that confronts directors who cause the corporation to repurchase its own shares during the pendency of a takeover bid, *Cheff* placed the burden of proof on the target's directors to defend the repurchase as having been ef-

---

140. *See* R. Posner, *supra* note 138, at § 14.6.

141. *See* Ehrbar, *supra* note 13, at 91.

142. Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978).

143. On April 17, 1977, Anderson, Clayton & Company offered to purchase any and all outstanding shares of Gerber common for $40 per share. On September 19, 1977, Anderson, Clayton withdrew its offer and the Gerber market price fell from $34 to $28 per share. By the date of trial, the price had risen to $33. Consequently, Gerber shareholders lost an opportunity to tender for $40, losing at least $7 and possibly $12 per share. Berman v. Gerber Prods. Co., 454 F. Supp. 1310, 1316 (W.D. Mich. 1978).

144. *See* Ehrbar, *supra* note 13, at 92.

fected primarily to further the corporate interest.[145] This standard for shifting the burden of proof to target directors upon the mere allegation of self-dealing reflects a judicial recognition that target directors are the best source of evidence indicating whether target directors acted to further their own interests. Since the success of the shareholder suit depends on whether the fact finder believes that the target directors engaged in self-dealing, shareholders must elicit some proof of the directors' motives, which is a state of mind peculiarly within the knowledge of the directors.[146] As fiduciaries, directors are bound to further the interests of their shareholders. Shifting the burden of proof simply requires directors to set forth evidence sufficient to prove that an action potentially taken in furtherance of the directors' personal interests actually was intended to and did further shareholder interests. Furthermore, placing the burden of proof on target directors is consonant with the economic policy of maintaining a market for corporate control and furthers the contemporary corporate policy requiring directors to maximize their shareholders' investment yield.

Because directors who take action that defeats a takeover bid confront a very real conflict of interests, *Cheff's* procedural standard for shifting the burden of proof should be adopted. Future decisions should require that directors justify their actions if the complaining shareholder *alleges* that the target directors acted primarily to further personal interests and *alleges facts* sufficient to indicate that those directors faced a conflict of interests. The first allegation is quite simple. The second allegation requires definition. Directors face a conflict of interests when their personal reasons for reaching a decision *might* differ from their shareholders' primary interests. Under this definition directors face a conflict of interests whenever a tender offeror offers target shareholders a premium over market price, regardless whether the offeror desires to displace or maintain the present directors. In either case, the directors' interests might differ from their shareholders' interests.[147]

---

145. Although *Cheff* expressly shifted the burden of proof to target directors because they confronted inherent conflicts of interest, *Condec* expressly refused to shift the burden of proof. 43 Del. Ch. at 365, 230 A.2d at 776-77. Subsequent cases have readopted *Condec*'s standard by shifting the burden of proof only after shareholders establish that their directors had acted in their own interests. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

146. Placing the burden of proving a fact on the person who has peculiar knowledge of that fact long has been recognized as a proper evidentiary standard. *See* 9 WIGMORE, EVIDENCE § 2486 (3d ed. 1940). Although this rule is invoked only when the circumstances so demand, fairness compels that directors, as fiduciaries, assume the burden of proof.

147. Whether the offeror desires to displace or maintain present directors, the directors may nevertheless have a personal interest in maintaining the corporation as an autonomous enterprise so that they will not have to report to anyone other than themselves. This interest

C. *A Substantive Proposal: Justifying Defensive Action*

The decisions in *Condec* and *Cheff* recognize a director's right to defend a takeover bid under two circumstances—first, if the defensive action furthers an independent, justifiable corporate purpose, and second, if after reasonable investigation, the directors believe that the offeror presents a threat to corporate interests.[148] Absolving directors of liability upon proof that the defensive action furthered an independent, justifiable corporate purpose avoids the ultimate concern whether the directors fulfilled their fiduciary obligations. If directors may avoid liability upon proof that defensive action simultaneously furthers some corporate purpose, directors will implement only those defensive strategies that involve an undertaking in which the corporation may justifiably engage in the absence of a control struggle. For example, the target might repurchase its own shares for the ostensible purpose of implementing an employee stock ownership plan,[149] or merge with a third company that the offeror would be unable to acquire.[150] Consequently, this standard of nonliability allows target directors to avoid the primary issue whether they acted to further their shareholders' interests.

The second circumstance, proof that target directors reasonably believed the offeror posed a threat to the corporation's interests, squarely meets the issue of directors' fiduciary duties insofar as it recognizes that directors are in fact responding to the takeover threat by engaging in defensive tactics. Permitting target directors to justify defensive actions as necessary to protect the corporation

---

clearly might be adverse to their shareholders' interest in tendering their shares and receiving the premium.

148. Both *Condec* and *Cheff* considered whether the defensive action under scrutiny served either to further an independent corporate purpose or to defend against a threat to the corporation's best interests. *See* notes 122-24 *supra* and accompanying text. Neither court expressly required proof of both purposes, and the *Cheff* court found that the target directors reasonably believed that the offeror, Maremont, posed a threat to corporate purpose. The *Cheff* court, however, accepted the lower court's rejection of the target director's contention that the stock repurchase was made to enable Holland Furnace to implement an employee stock ownership plan. *See* 41 Del. Ch. at 505-07, 199 A.2d at 555-56. Thus the court found an absence of independent corporate purpose. This finding implicitly suggests that proof of either purpose will absolve directors of liability.

149. *See, e.g.,* Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964).

150. For example, a target might merge with a smaller company engaged in some industry that competes with the offeror or one of its subsidiaries. Such an action potentially would raise antitrust problems if the tender offer were consummated. In IC's hostile bid to take over Pet, problems arose because Pet was engaged in the final negotiations of a merger with Hardee's, which IC did not want to acquire. After a brutal round of negotiations, Pet agreed to accept IC's proposal—without Hardee's—and IC agreed to pay Hardee's legal expenses. *See* Wysocki, *Takeover Tussle: IC Bid to Gain Control of Pet Inc. Stirred Up Wide-Ranged Battle,* Wall St. J., Aug. 7, 1978, at 1, col. 6.

from express or implied threats of manipulation, however, incorrectly implies that the corporation's and its shareholders' interests diverge.[151] In fact, these interests do not diverge; directors, as fiduciaries must be required to further the interests of the shareholders whose investment gives the corporation its existence and the directors their positions. If its shareholders desire to dissolve their corporation because dissolution will yield those shareholders their highest investment return, the corporation's directors have no standing to contest that decision as "not in the corporation's best interests."[152] Consequently, the second *Cheff-Condec* standard fails to compel target directors to meet the fiduciary obligations that arise when shareholders entrust their investment dollars.

A proposed substantive standard that directors must meet to justify successsful defensive action thus should ensure that directors recognize their shareholders' interests and reasonably act in furtherance of those interests. The strictest standard furthering the recognition and protection of shareholder interests would require target directors to take a shareholder vote during a pending or proposed offer to determine whether shareholders desire to tender or to defend. This standard is impractical and unjustified for two reasons: first, time constraints imposed by a tender offer render impossible a shareholder vote, and second, individual shareholders would not accept the burden of attending a meeting that inevitably would require days or weeks to discuss the tender offer's merits.[153] A somewhat lesser standard might require target directors to take a neutral stand by allowing shareholders to "vote" through the uninfluenced tender of their shares. This standard fails as well because it deprives shareholders of a valuable source of information. Allowing directors

151. In Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960), for example, the target directors' expenditure of corporate funds to buy out a prospective insurgent was upheld because "directors, while bound to deal with stockholders as a class with scrupulous honesty, may in the exercise of their honest business judgment adopt a valid method of eliminating what appears to them a clear threat to the future of their business by any lawful means . . . ." *Id.* at 55, 158 A.2d at 141. *See also* 70 YALE L.J. 308 (1960). This holding necessarily implies that even though target shareholders may not care whether the offeror changes the corporate practice after cashing them out, target directors nevertheless may defend upon perceiving this threat.

152. *See* ABA-ALI MODEL BUS. CORP. ACT § 83 (rev. ed. 1975).

153. Nothing stated herein is intended to imply that a shareholder vote could not be required by the target's articles of incorporation. Moreover, in close corporations, directors might be able to deduce the interests of the shareholders by personal contact and avoid the requirement of a shareholder vote. Nonetheless, since shareholders are normally so numerous and scattered, directors would have great difficulty in assembling a quorum within the time allowed by the offeror. *See* Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2095 (1978).

to oppose a tender offer by instituting defense tactics not only affords directors the opportunity affirmatively to meet their fiduciary obligations but also insures shareholders access to inside information that target directors might uncover. For example, through numerous sources the target's directors might discover that the offeror intends to reduce dividends in an exchange offer, or freeze-out minority shareholders at a price lower than the tender offer price in a pro-rata cash offer.[154]

A proposed substantive standard therefore should entitle directors to defend against a tender offer without prior shareholder approval as long as they reasonably believe that a successful defense furthers shareholders' interests. Because contemporary notions of separation of ownership and control justify the assumption that the shareholders' predominant interest is financial,[155] directors should be absolved from liability for defeating a tender offer only if they reasonably believed, as a result of objective investigation, that defeating the tender offer would yield target shareholders their highest investment return. Imposition of a requirement that directors con-

---

154. In Anderson, Clayton & Company's bid for Gerber Products, for example, Gerber's directors felt that an important consideration in instituting defense tactics was Anderson, Clayton's record of foreign bribes. Gerber filed suit under § 14(e) of the Williams Act to force Anderson, Clayton to provide more detailed disclosure of admitted foreign payments. The court held that Gerber's shareholders had a right to know about Anderson, Clayton's integrity. Moreover, the information was deemed material because in those countries where payments were discontinued, sales began to fall. Thus, in many instances, target management might be a valuable source to target shareholders of knowledge about a prospective offeror. *See* Berman v. Gerber Prods. Co., 454 F. Supp. 1310 (W.D. Mich. 1978), *discussed in* [1978] CORP. L. GUIDE (CCH) ¶ 11,061. *See also* Note, *A Proposal for Affirmative Disclosure by Target Management During Tender Offers*, 75 COLUM. L. REV. 190, 190-92 (1975).

155. Professor Posner has outlined the economic realities supporting this assumption:

> The typical shareholder (except in the closely held corporation or where one shareholder owns a very large percentage of the shares of the corporation) is not knowledgeable about the business of the firm, does not derive an important part of his livelihood from it, and neither expects nor has an incentive to participate in the management of the firm. He is a passive investor and, because of the liquidity of his interest, has only a casual and frequently quite transitory relationship with the firm. His interest like that of a creditor is a financial rather than managerial interest. In a technical sense the shareholders "own" the corporation but they do not own it in the same sense in which they own their own automobiles; it would be better to speak of their owning the common stock of the corporation.

R. POSNER, *supra* note 138, § 14.5, at 301.

Moreover, imposition of a higher fiduciary standard that relies on this assumption comports with contemporary notions that shareholders essentially are "voteless" insofar as they must rely on the managerial discretion of directors, with recourse only in their right to vote in subsequent elections of directors. Requiring directors to protect their shareholders' investment interests during the "invulnerable" period between elections of directors furthers the fulfillment of fiduciary obligations in our modern society of limited shareholder democracy. *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION, A LEGAL ANALYSIS § 3.3, at 24 (1976); A. BERLE & G. MEANS, *supra* note 135, at 277-87.

sider only the investment yield to their shareholders comports with traditional economic realities of a shareholder's position and compels directors to fulfill fiduciary obligations by best benefiting their shareholders.[156] Furthermore, requiring directors to reach a defense decision only after reasonable investigation ensures the accuracy of the directors' informed decision and is consonant with the investigative duty imposed by *Cheff* and *Condec.*

D. *Summary*

Adoption of this proposed higher standard of fiduciary responsibility—shifting the burden of proof upon the allegation of directors' self-dealing when confronted with conflicts of interest, and requiring directors to justify defense action as taken to yield shareholders their highest investment return—serves several practical purposes. Primarily this standard compels directors to investigate the tender offer's overall investment impact and to document their reasons for instituting defensive action. Since the propriety of their defense decision depends on whether objective evidence reasonably justified that decision, directors would have to resort to the informed but objective advice of outside counsel and third party investment bankers.[157] Objective evidence to be considered should include, in the case of an exchange offer, whether the projected future yield of the offeror's securities exceeds the expected future yield of retained target securities. In the case of a cash offer, the evidence should include whether the projected future yield of the reinvested cash exceeds the expected future yield of retained target securities.[158] This stricter standard thus will compel directors to fulfill fiduciary obligations by considering only the best interests of their sharehold-

156. For a discussion of whether directors must act to benefit shareholders in a market sense, see Bromberg, *Tender Offers: Safeguards and Restraints—An Interest Analysis,* 21 CASE W. L. REV. 613, 655-56, 680 (1970); Liman, *Has the Tender Offer Movement Gone Too Far,* 23 N.Y.L. SCH. L. REV. 687 (1978). *See also* Small, *Defending Target Companies: General Perspectives,* 32 BUS. LAW. 1349 (1977).

157. This emphasis on investigative duty in effect gives directors a due diligence defense. As in the federal securities law context, meeting this due diligence standard requires directors to apprise themselves of all relevant and material information and to reach an objective impartial determination whether that evidence justifies implementation of defense maneuvers that deprive target shareholders of an investment alternative. Accordingly, the informed but objective advice of third parties not confronted with the same conflicting interests as shareholders would be vital to establishing a due diligence defense. *See generally* Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

158. For a discussion of various relevant market factors that directors should consider in reaching a decision that institution of defense tactics best furthers a shareholder's investment return, see Small, *supra* note 156, at 1350-52. Since the shareholder, as a market investor, can be expected to reinvest the cash price, directors must and should assume that the reinvestment will yield only the average market return.

ers. Furthermore, the proposed standard will maintain a competitive market for corporate control insofar as it restricts a director's capacity to interfere with a tender offer if the offering price is sufficiently high to yield target shareholders the highest investment return.[159]

V. THE IMPACT OF *Singer v. Magnavox Co.*

In *Singer v. Magnavox Co.*[160] the Delaware Supreme Court held that a majority shareholder breaches his fiduciary obligation owed to minority shareholders when he transacts a merger solely to eliminate the minority's interest.[161] According to the court, in an interested merger transaction,[162] the majority shareholder assumes the burden of proving both that the majority transacted the merger for some legitimate corporate purpose and that the transaction was entirely fair to the cashed-out minority. The court concluded that a legitimate corporate purpose is not established if the majority approved the merger for the sole purpose of eliminating minority shareholders.[163] Thus *Singer* expressly adopted a corporate purpose requirement that majority shareholders must establish to satisfy their fiduciary obligations to minority shareholders.[164]

---

159. Conceptually, this standard should apply to defense action taken in anticipation of a tender offer as well as to action taken after announcement of a tender offer. The difficulty in analysis arises, however, in the former situation because directors cannot measure what an offeror might offer if no tender offer is announced. Thus, in a preoffer defense tactic suit, a director should be held only to some proof that a defense tactic would tend to yield a higher, rather than a lower, price.

Any remedy formulated under the proposed standards must serve both to deter target directors and to compensate aggrieved target shareholders. In formulating a remedy, however, courts must be sensitive to that remedy's potential effect. If the complaining shareholders still own an equity interest in the corporation, granting full compensation might bankrupt individual directors and thereby harm the corporation's chances of future success. Courts therefore might consider imposing liability only to the limits of the directors' liability insurance or restraining directors from interfering with future tender offers without prior court approval. Whatever remedy the courts adopt, it must protect both the shareholders' and the corporation's interests.

160. 380 A.2d 969 (Del. 1977).

161. Under the Delaware long-form merger statute, DEL. CODE tit. 8, § 251 (1975), upon a two-thirds vote, the majority shareholders may merge their corporation and force the minority shareholders to exchange their shares for cash. Delaware also provides that dissatisfied minority shareholders may seek a judicial appraisal of their shares if they feel the price offered is inadequate. DEL. CODE, tit. 8, § 262 (1975).

162. An interested merger occurs when the corporate parties share common interests or directors and typically occurs in a parent's merger with its majority-owned subsidiary. *See* E. FOLK, THE DELAWARE GENERAL CORPORATE LAW 333 (1972).

163. 380 A.2d at 980.

164. After *Singer,* the Delaware court, in Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977), held that the majority meets this business purpose requirement upon proof that the parent's corporate purposes were satisfied, even though the cashed-out shareholders

The *Singer* decision potentially affects the tender offer defense analysis in two ways. First, it revives acknowledgement that fiduciaries might satisfy fiduciary obligations by proof that their action furthered some legitimate corporate purpose. Second, it implies that directors will not be held liable for acting to the detriment of shareholders unless their *sole* motivation is improper. Extension of the *Singer* standards to a target shareholder's action against target directors for interfering with a tender offer therefore might result in a judgment for the target directors if those directors establish that resisting the tender offer served some traditional corporate purpose, or if they establish *any* legitimate motive for resisting other than a desire to perpetuate their own control.[165]

Confined to its facts, the *Singer* decision clearly serves as a compromise between conflicting judicial and state interests. The *Singer* court recognized the state's interest in allowing freeze-out mergers as evidenced by its adoption of a freeze-out merger statute. Accordingly, the court imposed on majority shareholders a fiduciary obligation sufficiently stringent only to proscribe the majority's abuse of their merger power, thereby furthering both the state interest and the judicial interest in protecting minority shareholders.[166] In the tender offer defense context, however, the conflicting interests are entirely judicial, and the judiciary therefore may impose a higher fiduciary obligation without interfering with state interests.[167] In devising a fiduciary standard governing a director's legal

held an interest in the subsidiary. *Id.* at 1124. This holding reduces *Singer*'s impact but is proper insofar as the minority shareholder's right to contest the merger arises not from his status as shareholder, but from the legitimacy of the majority's interest in transacting the merger. *See* McBride, *Delaware Corporate Law: Judicial Scrutiny of Mergers—The Aftermath of* Singer v. The Magnavox Company, 33 BUS. LAW. 2231, 2239 (1978).

165. Permitting directors to justify defense actions as furthering some legitimate corporate purposes affirms the result reached in *Condec* and should be roundly criticized as failing to enforce properly defined fiduciary obligations.

Permitting directors to avoid liability by proving the existence of any legitimate motive other than self-dealing approaches the business judgment standard and its accompanying presumption in favor of managerial discretion.

166. This compromise between state and judicial interests explains the court's holding in *Tanzer v. International General Industries. See* note 164 *supra.* In *Tanzer* the court permitted the majority shareholder to establish a legitimate corporate interest with proof that the merger furthered the parent corporation's business purpose. This holding acknowledges the court's deference to the state's interest in allowing freeze-out mergers by circumscribing the majority's legal capacity to transact this type of merger for very broad purposes, thus implying that the court believed that this broad standard would satisfy fiduciary obligations in a manner least restrictive of the state's interests.

167. This discussion is based on the premise that fiduciary standards in the corporate area are flexible and should be sufficiently stringent to serve whatever interests are adopted. Thus a court must consider all circumstantial facts, recognize the interests involved, and formulate a fiduciary standard that will compel the fiduciary to act in a manner that best

capacity to defend against a tender offer, courts must compromise between competing economic considerations: the promotion of free transferability of corporate shares and the interest in giving deference to a director's business judgment. Since social and economic policies greatly favor the free transferability of shares,[168] courts are free to formulate a fiduciary standard sufficiently stringent to protect these interests even at the cost of infringing on director's freedom to make unchallenged business decisions. Therefore, the logic and holding of *Singer* are inapplicable to shareholders' challenges of their directors' decisions to defend against tender offers. Courts faced with this issue should reject the fiduciary standard adopted by *Singer* and apply the more stringent proposed standard that adequately protects the shareholders' interest in their investment return.

VI. CONCLUSION

Recent federal and state emphasis on heightened directorate fiduciary responsibility reflects a public demand that those persons entrusted with corporate funds place the interests of their beneficiaries ahead of their own. The enforcement of fiduciary responsibilities remains a critical economic component of our contemporary corporate structure of.passive investment entrusted to professional management. Without the assurance that directors are bound by law to protect and enhance their beneficiaries' investment, passive investors would be less willing to commit resources to the private corporation. Consequently, proper articulation and application of fiduciary standards in a manner designed to enhance the investors' wealth promote the efficient allocation of private resources and a corresponding refinement of our economic system.[169]

With the corporate form and the range of permissible corporate activity assuming greater complexity, proper articulation of fiduciary standards becomes a more difficult task. Traditional fiduciary standards favoring noninterference, such as the business judgment rule, no longer guarantee corporate and shareholder protection. The Delaware decision in *Singer v. Magnavox Co.* evidences judicial recognition that traditional fiduciary standards must be flexibly defined and applied to a director's action during a complex merger transaction. Defensive action taken during a tender offer presents a similar possibility that directors might act in a manner that harms

serves the adopted interests. For a discussion of factors giving rise to a flexible application of fiduciary responsibilities in a merger context, see McBride, *supra* note 164, at 2246-49.

168. *See* text accompanying note 140 *supra*.

169. *See* Sommer, *supra* note 136, at 527.

either the corporation, its shareholders, or both. Accordingly, courts must adopt and apply a flexible fiduciary standard to a director's decision to resist a tender offer to ensure that directors act in the interests of those persons who have placed trust in the director's good faith and competency.

Since today's passive shareholder most frequently is interested only in his investment return, directors must assume that shareholders primarily are interested in whether directors act to maximize shareholders' investment yield. A director's response to a tender offer proposal greatly affects a shareholder's return. Therefore, a proper fiduciary standard for testing the defense decision should demand that directors act in a manner that maximizes their shareholders' wealth. Shifting the burden of proof to directors to establish that their shareholders' investment interests were the foremost consideration in acting to defeat a takeover bid adequately compels directors to fulfill properly defined fiduciary responsibilities.

OBY T. BREWER III