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Just Say No to Whom?

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INTRODUCTION

"Just say no" is the current rallying cry of those seeking to give target management the unrestricted power to block hostile tender offers. Not surprisingly, the turn of phrase chosen by management leaves ambiguous the precise issue on which the debate should turn: *To whom* does management want the power to say no? As target management poses the issue, it wants to say no to a raider. The image is of stalwart management protecting shareholders against a marauding outsider. However, that image is seriously misleading. In fact, target management seeks the power to say no to its own shareholders.

The recent case of *TW Services, Inc. v. SWT Acquisition Corp.*[1] illustrates the point. After 88% of the target stock had been tendered in response to a hostile offer, the target's chairman admitted that "I think the stockholders like the [tender offer] price."[2] Thus, when target management blocked the offer by declining to redeem its poison pill, it was, in effect, saying no to 88% of the company's shareholders. So understood, demands of critics that management justify its right to tell shareholders no are not surprising. Normally we don't allow the agent's preferences to trump those of the principal.

My goal in this article is to sketch a critical history of the justifications proponents have offered for giving target management the power to tell shareholders no. This history reveals three categories of justifications: legal, paternalistic and social. It also reveals a dramatic shift in the nature of the categories. The focus has moved from claims that blocking an offer benefits shareholders, to the very different claim that management is warranted in blocking an offer even if doing so is detrimental to shareholders. To telegraph where I'm going, the simple fact is that none of the proffered justifications hold up to analysis, a point that bears emphasis at this stage of the debate when it has become commonplace for courts to set forth potential justifications in a veritable litany, without pausing to establish the plausibility of any single justification. That leaves for last what may be the most interesting question of all: What is the real explanation for management's tenacious campaign for the right to "just say

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1. [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,344 (Del. Ch. Mar. 2, 1989).
2. *Id.* at 92,177.

no"?

To put the discussion of justifications in context and to simplify things just a little, assume a 100% cash offer at a premium, with an unconditional commitment to a second-step merger in which non-tendering shareholders would receive the same cash price—the type of offer that the Delaware Chancery Court has repeatedly found to be noncoercive.[3] In this setting, what would justify allowing management to tell shareholders no?

I. LEGAL JUSTIFICATIONS

The initial set of justifications, dating to the late 1970's, consisted of legal-style arguments that relied on analogy to support management's power to block a hostile tender offer. Given that management had the power to block transactions that were claimed to be the functional equivalents of tender offers, it should also have the power to block tender offers.

The argument took two forms. The managerialists first argued that tender offers were of no greater moment than other important transactions made solely by management—like investing in a new plant or deciding to enter a new market.

No one took this argument very seriously. What distinguishes tender offers from corporate investment and marketing decisions is that the central purpose of tender offers is change in control. Even state corporate statutes require special decision procedures for transactions, like mergers and asset sales, which involve transfers of control.

Recognizing that a tender offer inevitably contemplates a control transfer gave rise to the second analogy. By requiring director approval of mergers or sales of assets, state corporate statutes explicitly grant directors the right to just say no to these types of control transactions. Because a tender offer has the same result as a merger or sale of assets, the argument goes, management should have the same authority with respect to a tender offer.

The problem with this justification is its impact on the structure of the corporation's governance. If accepted, it would give management a virtual monopoly on the market for corporate control: Management could not be displaced without its own permission. This would raise the specter of a quite different analogy: a governance structure for profit-making corporations analogous to the explicitly self-perpetuating governance structure for nonprofit organizations. In the typical nonprofit corporation, members of the board of directors are elected by the corporation's voting members who, in turn, are defined as the members of the board. Recognizing the absence of any organizational constraint on management be-

3. *See, e.g.*, Shamrock Holdings, Inc. v. Polaroid Corp., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,340 (Del. Ch. 1989); Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988); City Capital Assocs. Ltd. v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986).

havior, the conduct of nonprofit corporations is typically subject to scrutiny by the state attorney general.

Pro-management advocates responded by pointing out that even if management can block tender offers, in addition to mergers and sales of assets, it still can be displaced through corporate political action—i.e., the hostile offeror can still wage a proxy contest. That response, however, gives away the game. Once management concedes that some way must exist to displace it without its permission, the issue reduces to whether a proxy contest is an effective displacement technique. Pro-management advocates have never attempted to demonstrate that, despite management domination of the proxy machinery and the collective action problems associated with shareholder voting, a proxy contest provides an effective way to displace management.[4] Moreover, a neutral observer might express real skepticism whether management truly wants the proxy system to function as an effective displacement mechanism. Recent case law is replete with management efforts to erect barriers to shareholder use of proxies, and recent state legislation restricting, for example, shareholders' right to call special shareholder meetings hardly makes the proxy process more effective.

In all events, these legal justifications never made much headway. By adopting a proportionality test for defensive tactics in *Unocal Corp. v. Mesa Petroleum Co.*,[5] the Delaware Supreme Court rejected the claim that management's role in tender offers should be the same as in mergers and sales of assets.

II. Paternalistic Justifications

The next set of justifications rested on paternalism. To benefit shareholders in general—or at least a particularly worthy subset of shareholders—management must prevent shareholders from choosing for themselves. This approach at least had the attraction of irony. There was something wonderful about corporate management joining with the Critical Legal Studies movement[6] in resurrecting paternalism as a policy counterweight to the Reagan era's focus on deregulation.

The first paternalistic justification sharply distinguished two categories of shareholders: good shareholders who are interested in the long-term future of the corporation; and bad shareholders (arbitrageurs and speculators) who are interested in short-term trading profits. In this view, blocking a tender offer is necessary to protect the good shareholders. If management doesn't act, bad shareholders, who will come to hold most of

4. *See* Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, Discussion Paper No. 166D, Kennedy School of Government, Harvard University (March 1988) (helpfully surveys the barriers to the conduct of a proxy fight and offers empirical evidence of their lack of success).

5. 493 A.2d 946 (Del. 1985).

6. *See, e.g.*, Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 Md. L. Rev. 563 (1982).

the stock of a company that is in play, will choose to tender their shares and the takeover will succeed.

This argument has never held together, largely because the function of arbitrageurs in tender offers belies the distinction between short-term speculation and long-term investment. Arbitrageurs undertake the risk that a tender offer will not succeed by acquiring their shares from risk-averse, long-term shareholders. Thus, it is hardly surprising that arbitrageurs always favor a tender offer. Arbitrageurs, in effect, stand as less risk-averse surrogates for long-term investors who have already demonstrated, by selling their shares to the arbitrageurs, that they perceived the long-term value of the company was exceeded by the size of the premium. In other words, arbitrageurs can only acquire shares when a company's long-term shareholders choose to sell them.

Although distaste for arbitrageurs still hangs heavy in the air, management more recently has identified a new category of disfavored shareholders whose interests can be appropriately disregarded to protect others. The new villains are the institutional shareholders who, like arbitrageurs, are said to be interested only in short-term profits.

It is puzzling why the fact that a majority of the shares of many major corporations are now held by institutional investors somehow entitles management to ignore the interests of its majority shareholders. But puzzles aside, this justification founders on the same rock that sank the arbitrageur argument. In both cases, pro-management advocates ignore the fact that the disfavored category of shareholders holds their stock in a representative capacity. Just as arbitrageurs hold their shares as proxies for the long-term shareholders who sold out, institutional investors act on behalf of those who hold the beneficial interests in the institutional investors themselves. If the argument is that the managers of institutional investors are disregarding the best interests of their own beneficiaries, then a variety of legal protections, starting with simple fiduciary duty to ERISA,[7] are available to protect the institutional investors' beneficiaries. The target company's management, two levels removed, is an unlikely source of additional protection.

The second paternalistic justification for allowing target management to save shareholders from themselves rests on an empirical claim: that management blocking an offer makes shareholders better off, because the value of the company's stock subsequently will appreciate by an amount greater than the takeover premium. Stated simply, the claim is that shareholder wealth increases when management defeats a hostile offer.

This was the pro-management forces' favorite argument because it could be framed in traditional terms—that management was acting to maximize the value of the shareholders' investment. The problem was that the argument turned out to be empirically incorrect.

Whether shareholders benefit when management keeps the target

7. Employee Retirement Income Security Act, 29 U.S.C. §§ 1001-1461 (1982). This law governs the operation of most private pension and benefit plans.

company independent by blocking a hostile offer by now has been empirically tested repeatedly with consistent results. Although a minority of companies do benefit, on average shareholders of a target company that remains independent after blocking an offer would have been significantly better off had they taken the offer.[8] The poison pill studies are a good example. Data show that a pill increases the premium paid to target shareholders when it is used to initiate an auction. However, when the pill is used to keep the target company independent—to "just say no" to the shareholders—the data show that shareholders lose. Thus, management's fear of putting a poison pill to a shareholder vote seems well founded; a pill that in the end allows management to "just say no" simply isn't in the shareholders' interests.[9] Interestingly, the data also suggest that shareholders might be amenable (I apologize for coining yet another awful phrase) to a "time release" pill. Such a pill would allow target management to block an offer for a period long enough to initiate an auction, but short enough that it could not be used as a subterfuge for keeping the company independent.

III. Social Justifications (Or "Let Them Eat Cake")

As it became increasingly clear that paternalism did not make shareholders better off, management turned to a group of justifications involving presumed benefits that accrue generally to the economy and society. Thus, management in all its wisdom should have the discretion to block a hostile offer *even if its own shareholders are made worse off.*

The most familiar of these social justifications builds on the claim that takeovers result in short-term management which, in turn, has caused the United States to become less competitive internationally. Peter Drucker has been the leading exponent of the competitiveness justification (and it clearly has been the most popular story told by businessmen testifying at congressional hearings). As Drucker puts it, "[A] good many experienced business leaders I know now hold takeover fear to be a main cause of the decline in America's competitive strength in the world economy . . . [i]t contributes to the obsession with the short term."[10] We would all be made better off (even if target shareholders are made worse off), the argument goes, if managers could block hostile takeovers. Then they would feel secure enough to return to long-term management which, after all, is what we really want them to do.

At one level, the short-term management justification for just saying no is difficult to evaluate. The evidence offered to support the claim that

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8. Judge Easterbrook recently summarized the evidence: "The best available data show that if a firm fends off a bid, its profits decline, and its stock price (adjusted for inflation and market-wide changes) never tops the initial bid, even if it is later acquired by another firm." Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 501 (7th Cir. 1989).

9. The relevant studies are summarized in R. Gilson & R. Kraakman, 1989 Supplement to Gilson's The Law and Finance of Corporate Acquisitions 133-38 (1989).

10. Drucker, *Taming the Corporate Takeover,* Wall St. J., Oct. 30, 1984, at 30, col. 3.

takeovers cause short-term management, which in turn causes international economic decline, fits the description of what I have heard referred to as the lawyer's definition of data: the plural of anecdote. The syllogism runs like this: In the post-war period, the economies of Germany and Japan have done very well internationally. Hostile takeovers are not possible in these countries. In contrast, the United States' economy has not done well. Hostile takeovers are possible in the United States. The conclusion, of course, is that if managers could "just say no," we would do well economically too.

Taking the argument on its face (and overcoming the urge to dissect one-dimensional, cross-cultural analysis), the short-term management justification can be tested empirically with about as much analytic rigor as it embodies. A testable hypothesis would be: If takeovers have caused our international decline, then those U.S. industries that have not experienced takeover pressure should be the most successful in meeting international competition. Our automobile industry, which has experienced no takeover pressure in the post-war period, perfectly fits the description. Yet, one would be hard-pressed to find an industry that has been less successful in meeting foreign competition. Even at the level of anecdotal empiricism at which the justification is proffered, it doesn't survive scrutiny.

The second "damn the shareholders" justification builds on the proposition that directors owe a responsibility not just to shareholders, but also to "stakeholders"—the corporation's employees, local communities, suppliers, and the like. The implication is that target directors should have the power to "just say no" to an offer favorable to *share*holders if it would be unfavorable to *stake*holders.

Whether expressed in corporate charters or in recent state statutes, the stakeholder justification for blocking hostile takeovers seems quite disingenuous. The problem is that the justification gives management the *power* to consider stakeholders' interests, but does not make them *accountable* if the stakeholders believe that their interests are given too little weight. Suppose management declines an offer of twenty-three dollars a share on the basis of stakeholder interests, but then accepts the same offer when the price is raised to twenty-five dollars. Unless stakeholders are given standing to challenge that decision, it is difficult to take management's profession of concern for stakeholder interests very seriously.

Moreover, one cannot help being uneasy about a justification which is not evenhanded in its application. Management claims the right to block a takeover because, for example, the would-be acquirer might close plants. But stakeholders have precisely the same concern when the company's original management closes a plant. Management's profession of concern for stakeholders would be a great deal more credible if, at the same time, management sought the right to block a takeover because of anticipated plant closings by the acquirer, it also supported plant-closing legislation that protected stakeholders from its own actions.

The final entry in the social justification category also sacrifices shareholder interests to those of a larger group. The idea is that management must be able to block a hostile takeover, even if shareholders would benefit from the takeover, because hostile takeovers are bad for the economy. Note that it is not takeovers in general that are disapproved, but only hostile takeovers. The premise seems to be that takeovers which management approve are good for the economy, but takeovers which they reject are not. I can understand wanting to identify ahead of time which acquisitions would have a positive and which a negative macroeconomic effect; and I can imagine, as a matter of public policy, that shareholders might have to take a back seat to general societal concerns. What I have difficulty understanding is why target management approval would be thought to separate between socially good and socially bad acquisitions.

Indeed, the empirical evidence seems to run in precisely the opposite direction. Harvard Business School Professor Michael Porter studied the track records of thirty-three large U.S. companies' efforts to diversify from 1950 to 1986. He found that where companies entered an unrelated line of business by acquisition prior to 1975, almost seventy-five percent of the acquisitions were subsequently divested.[11] Commentators like John Smale, Chairman and Chief Executive Officer of Proctor & Gamble Co., have relied on Porter's data to argue that hostile takeovers are bad for the economy.[12] The problem is that Smale gets it precisely backwards. The overwhelming majority of pre-1975 acquisitions, especially by large companies of the sort that comprise Porter's sample, were friendly, not hostile acquisitions. Thus the Porter data show only that friendly acquisition don't work. Indeed, in searching for a company that has successfully diversified by acquisition, Porter identifies Hanson Trust, a noted *hostile* acquirer.[13]

IV. WHAT'S THE REAL EXPLANATION?

If all the proffered justifications for allowing target management to "just say no" do not withstand analysis, then what is the real explanation? The short answer, I think, is management entrenchment. However, I have in mind not the venal concept of management entrenchment familiar in case law, where even independent directors self-servingly seek to keep their positions (and egos) intact at shareholder expense. Rather, what I imagine is at work is a deeply felt belief that a corporation is not an artificial entity which is the puppet of its shareholder owners, but is rather a living, independent entity—like Pinocchio, a real boy—with critical social, political, and economic roles to play.

It may come as a surprise to some that, in the United States, this organic view of the corporation is associated with Adolph Berle, more widely recognized for having emphasized the impact on shareholders of

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11. Porter, *From Competitive Strategy to Corporate Strategy*, 87 HARV. BUS. REV. 43 (May-June 1987).

12. Smale, *What About Shareowners' Responsibility?*, Wall St. J., Oct. 16, 1987, at 28, col. 3.

13. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

the separation of ownership and control.[14] As Yale Professor Roberta Romano has noted, Berle "refers to the modern corporation as the 'collective soul' and the 'consciousness-carrier of 20th century American society.'"[15] If one perceives the corporation this way, the question of who runs such an important social institution transcends shareholder interest in the price of their stock. In my mind, the often vigorous resistance of hostile takeovers by independent directors reflects their good faith belief that large corporations run by operating management with the guidance of traditional, independent directors will better serve society than corporations run by junk bond financed raiders like Carl Icahn, T. Boone Pickens, Asher Edleman, Saul Steinberg, or Samuel Heyman, regardless of whether shareholders benefit.

So understood, the debate over the "just say no" defense has both a judicial and a political side. The judicial side, which reflects traditional notions of corporate governance, should be quite inhospitable to arguments for target management veto power. For all of the reasons that the litany of justifications fails, shareholders should be free to decide whether to accept or refuse a hostile offer. Larger issues concerning the allocation of political, social and economic power within a democracy are not the province of the Delaware courts.

The political side of the "just say no" defense—that is, the role of the corporation as an intermediate social force between government and the individual—is appropriately directed at Congress, whose members are politically accountable for the political decisions they make. The best thing lawyers can do with respect to this side of the debate is to insure that the political substance of the issue is not obscured by rhetorical slogans like short-term management.

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14. *See* Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 936 (1984).

15. *Id.* at 937 (quoting A. BERLE, THE TWENTIETH CENTURY CAPITALIST REVOLUTION 148 (1955)).