Columbia Law School
Scholarship Archive

Faculty Scholarship Faculty Publications

1989

Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?

Ronald J. Gilson
Columbia Law School, rgilson@law.columbia.edu

Reinier Kraakman
Harvard Law School

Follow this and additional works at: https://scholarship.law.columbia.edu/faculty_scholarship

Part of the Business Organizations Law Commons, and the Securities Law Commons

Recommended Citation

Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).
Available at: https://scholarship.law.columbia.edu/faculty_scholarship/2149

This Article is brought to you for free and open access by the Faculty Publications at Scholarship Archive. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarship Archive. For more information, please contact scholarshiparchive@law.columbia.edu.

Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?

By Ronald J. Gilson and Reinier Kraakman***

The courts have long struggled with a standard for reviewing management's efforts to deter or defeat hostile takeovers. The usual standards of review in corporate law, the business judgment rule and the intrinsic fairness test, do not seem adequate when courts must evaluate defensive measures that implicate both management's business acumen and its loyalty to shareholder interests. Because evaluating a sale of the company is a complex business decision, management's response to a takeover bid resembles the normal business decisions that the business judgment rule largely insulates from judicial review.[1] At the same time, however, a hostile takeover creates a potential conflict of interest, no matter what response it evokes from management. Target managers who approve an offer may be improperly influenced by post-transaction benefits;[2] target managers who reject an offer may act largely to secure their own

*Mr. Gilson, a member of the California bar, is professor of law at Stanford Law School and senior research fellow at the Hoover Institute.

**Mr. Kraakman is professor of law at Harvard Law School.

The authors thank Judy Hogan for her valuable research assistance and Joseph Grundfest, Leo Herzel, William Klein, W. Loeber Landau, and Charles Murdock for their valuable comments on an earlier version of this article.

The views expressed in this article are strictly those of the authors and do not represent those of the American Law Institute, for whose *Principles of Corporate Governance* one of the authors is serving as Reporter.

Editor's note: E. Norman Veasey of the Delaware bar served as reviewer for this article.

1. This argument has formed the core of Martin Lipton's tenacious defense of an undiluted application of the business judgment rule to defensive conduct. *See, e.g.*, Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101 (1979); Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 Bus. Law. 1017 (1981); Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities—An Update*, 40 Bus. Law. 1403 (1985). More recently, Lipton has concluded that, if abusive tactics by bidders were curbed, most defensive tactics would no longer be justified. *See* Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. Pa. L. Rev. 1 (1987).

2. The best example is a third-party leveraged buyout in which management participates. In such a transaction, target management receives a substantial ownership interest in the company if the buyout is completed. For example, in a sample of 28 companies given management buyout proposals between 1979 and 1984, target management's ownership interest in the company at the time of the proposal averaged 6.5%; in the 15 transactions consummated as buyouts, management's

positions. From this perspective, responding to a hostile takeover is an interested transaction that calls for judicial review under the intrinsic fairness test. Yet, invoking this rigorous standard would simply condemn most defensive tactics without any justification beyond the standard itself.[3]

In this article, we examine the Delaware courts' most recent response to the tension between the intrinsic fairness standard and the business judgment standard in the takeover context: An intermediate standard of review mandating that management's defensive tactics must be "reasonable in relation to the threat posed"[4] by a hostile offer. The evolutionary trajectory of this proportionality test is far from certain. Our goal here is neither to endorse proportionality review as the best approach to regulating defensive tactics nor to provide an exhaustive account of recent Delaware case law. Rather, taking Delaware's adoption of proportionality review as given, we seek to facilitate the informed development of this standard as rapidly, and with as little ambiguity, as possible.

There is good reason to chart the range of possible interpretations of Delaware's new test at an early date. Delaware corporate law—in which the proportionality test now plays a major role—governs the largest proportion of the largest business transactions in history. Yet, the sheer volume of takeover litigation threatens to deprive the proportionality test of the time and experience that ordinarily inform the articulation of a major common law doctrine. Therefore, commentary that attempts to resolve uncertainty about the substance of the proportionality test is critical.

This article begins by tracing the origins of the Delaware proportionality test. It then identifies two questions that are key to evaluating whether the proportionality test has substance. First, does the test require more than just a threshold inquiry; that is, if target management can show that some defensive action may be warranted, must the court nonetheless evaluate the appropriateness of management's particular response? Second, what characteristics of a hostile offer warrant defensive action; that is, what threats to shareholder interests might a tender offer pose? The next section examines in greater detail one of the most common—and for the proportionality test, the most troublesome—of the threats that target managers identify in support of defensive tactics. This threat, which we term "substantive coercion," is the claim that shareholders will voluntarily tender to an underpriced offer. Finally, we describe both the key elements and the beneficial consequences of a proportionality test that can effectively screen target managements' claims of shareholder coercion by underpriced offers.

ownership interest rose to an average of 24.3% after the transaction. Lowenstein, *Management Buyouts,* 85 Colum. L. Rev. 730, 736–37 (1985).

3. *See* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers,* 33 Stan. L. Rev. 819, 824–31 (1981).

4. Unocal v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985).

THE ORIGINS OF THE PROPORTIONALITY TEST

The proportionality test is not the Delaware courts' first effort to wrestle with the difficulty of reviewing defensive tactics. Long before the most recent wave of takeover cases, *Cheff v. Mathes*[5] demonstrated the subtlety with which the Delaware courts could disarm the seeming conflict between the intrinsic fairness and business judgment standards of review in takeover settings. *Cheff* framed a policy conflict/primary purpose test under which management's motives set the standard of review for defensive tactics. If a target's directors could demonstrate disagreement over corporate policy with a would-be acquirer, they were *presumed* to act from business considerations rather than self-interest. With the specter of a breach of duty of loyalty thus conveniently set aside, the appropriate standard of review became the business judgment rule: "[T]he directors satisfy their burden by showing good faith and reasonable investigation; the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made."[6] Because competent counsel could always document a policy conflict between a would-be acquirer and defending management, the *Cheff* test inevitably reduced to a routine application of the business judgment standard.

Ironically, *Cheff*'s resolution of the problem of judicial review survived unchanged only as long as its implication—blanket protection of defensive tactics—remained at least partly submerged. By the early 1980s, this implication was fully visible. Novel financing techniques and a dramatic rise in takeover activity stimulated demand for improved takeover defenses. New defenses, in turn, prompted new litigation and a long string of victories for targets[7] that soon revealed the full scope of management's discretion to block takeovers under *Cheff*'s motive analysis.[8] Experienced takeover lawyers passed *Cheff*'s implicit message on to their clients:[9] If target managers, in good faith and after reasonable investigation, could locate a policy conflict with a would-be

5. 41 Del. Ch. 494, 199 A.2d 548 (1964). For a detailed analysis of the authors' view of the *Cheff* test, see Gilson, *supra* note 3.

6. *Cheff*, 41 Del. Ch. at 506, 199 A.2d at 555.

7. Although defensive tactics were enjoined in a number of cases in this period, most of the losing targets were smaller companies without the benefit of advice from special counsel and investment bankers. *See* Podesta v. Calumet Indus., [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,433 (N.D. Ill. 1978); Applied Digital Data Sys. v. Milgo Elec. Corp., 425 F. Supp. 1145 (S.D.N.Y. 1977); Royal Indus. v. Monogram Indus., [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863 (C.D. Cal. 1976).

8. The expansion of management's freedom to take action to deflect hostile offers probably hit its apogee in Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied,* 454 U.S. 1092 (1981).

9. Arguably the interpretations of case law by experienced takeover lawyers are among the most important sources of takeover law. It is these interpretations, after all, that give operational content to the law. The discretion that *Cheff* appeared to promise from the outset remained latent until an accumulation of favorable precedent encouraged the corporate bar to exploit the full implications of the motive test.

acquirer, any defensive response would be protected under the business judgment rule.[10]

As *Cheff*'s implications became clearly visible, however, they attracted hostile notice from other corners. An outpouring of academic commentary called for constraints on defensive tactics,[11] and it even appeared possible that Congress might act to displace state law—and especially Delaware law—that was considered unduly favorable to target management. The political situation thus recalled the period prior to the Delaware Supreme Court's decision in *Singer v. Magnavox*.[12] At that time, the sensitive issue was the dearth of standards governing the freezeout of minority shareholders by majority or controlling shareholders. And when the outcry became too loud, the Delaware Supreme Court announced a new, seemingly more stringent standard of review that promised to constrain management's discretion to force out minority shareholders.[13] Thus, there was a historical basis for predicting that political pressure might eventually prompt the Delaware courts to tighten the lax standard of review implicit in *Cheff*'s policy conflict/primary purpose test.

In principle, the Delaware courts had two quite different doctrinal options for reforming the *Cheff* standard. On the one hand, the courts could have restricted defensive tactics by emphasizing the primacy of shareholder choice to accept or reject a hostile offer. This approach recognizes the role of the tender offer with respect to the structure of the corporation. Precisely because target management can unilaterally block a merger or sale of assets, a takeover can occur without management approval only through a tender offer made directly to target shareholders. Thus, management enjoys a monopoly over corporate control unless it is restrained from preventing shareholders from tendering to a hostile offeror.[14] Alternatively, the courts could have moved from the *Cheff* standard to an intermediate standard of judicial review that contemplated a genuine effort to distinguish defensive tactics that might benefit shareholders from suspect tactics designed to entrench management.

10. Martin Lipton put the matter as follows: "Where the directors have made a reasonable good-faith decision to reject the takeover on one or more of the bases set forth above, the business judgment rule should apply equally to any and all defensive tactics." Lipton, *Takeover Bids in the Target's Boardroom*, *supra* note 1, at 124.

11. *See, e.g.*, Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 Cornell L. Rev. 901 (1979); Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. Rev. 403 (1980); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981); Gilson, *supra* note 3; Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 Harv. L. Rev. 1028 (1982).

12. 380 A.2d 969 (Del. 1977).

13. For suggestions that the Delaware court's decision in *Singer* was influenced by political considerations, *see, e.g.*, Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 Yale L.J. 1354, 1354 n.2 (1978); R. Gilson, The Law and Finance of Corporate Acquisitions 870–72 (1986); Herzel & Colling, *Squeeze-Out Mergers in Delaware—The Delaware Supreme Court Decision in* Weinberger v. UOP, Inc., 7 Corp. L. Rev. 195, 229–30 (1984); Thompson, *Squeeze-Out Mergers and the "New" Appraisal Remedy*, 62 Wash. U.L.Q. 415, 420 (1984).

14. *See* Gilson, *supra* note 3, at 841–50.

In fact, the Delaware Supreme Court opted for the more conservative of the two approaches—the intermediate standard of review—in a trilogy of decisions handed down in 1985 and early 1986: *Unocal v. Mesa Petroleum,*[15] *Moran v. Household International*[16] and *Revlon v. MacAndrews & Forbes Holdings.*[17] These opinions fortify the older *Cheff* standard by adding a second step to the traditional policy conflict/primary purpose analysis. Under the new standard, management can no longer qualify for the protections of the business judgment rule simply by pointing to a "danger to corporate policy" based on a carefully orchestrated record. Now, defensive tactics must also face a proportionality test: They must be shown to be "reasonable in relation to the threat posed."[18]

The proportionality test brings a novel, objective standard to the review of defensive tactics—a reasonableness test that impliedly allows courts to identify and reject unreasonable tactics, whatever the motives of their authors. For corporate planners, however, the critical issue is how far the Delaware Supreme Court intends this novel rhetoric to signal a change in the actual substance of review. Again, Delaware's experience with adopting a more restrictive standard governing minority freezeouts provides a cautionary tale for the planner. In *Singer v. Magnavox,*[19] the Delaware Supreme Court boldly announced a new burden on controlling shareholders to show that freezeouts met an "entire fairness" standard and served an independent business purpose apart from simply eliminating minority shareholders. Yet, by the time that *Weinberger v. UOP, Inc.*[20] was decided six years later, *Singer*'s requirements had dwindled to little more than an inquiry into the fairness of the price paid to minority shareholders.[21] The key question, then, is whether a similar fate awaits the new standard for reviewing defensive tactics. Put differently, is proportionality review likely to have substance?

15. 493 A.2d 946 (Del. 1985).
16. 500 A.2d 1346 (Del. 1985).
17. 506 A.2d 173 (Del. 1986).
18. *Unocal,* 493 A.2d at 955. In *Revlon,* the court summarized both steps in the review:

> [W]hen a board implements anti-takeover measures there arises "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders . . ." This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation. In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance—that the responsive action is reasonable in relation to the threat posed.

506 A.2d at 180 (citations omitted).
19. 380 A.2d 969, 980 (Del. 1977).
20. 457 A.2d 701 (Del. 1983).
21. *Id.* at 715. *See* R. Gilson, *supra* note 13, at 904–07.

THE MEANING OF PROPORTIONALITY REVIEW

The uncertainty attending second-step proportionality review in the wake of *Unocal, Moran,* and *Revlon* centers on three issues. The initial question is whether the new standard is intended to be a substantive constraint on defensive tactics or merely another formal justification for defensive tactics that corporate planners must recite to succeed. If the standard is substantive, as we believe it is, two further questions follow from the requirement that defensive tactics be "reasonable" in relation to a "threat." First, does the new standard regulate defensive responses or merely pose a threshold test; that is, supposing some threat is shown, how far does the new standard nonetheless constrain the range of permissible tactics? Second, and closely related, what forms of hostile offers, if any, might fail to qualify as "threats" and so preclude *any* defensive tactics under the proportionality test?

DOES PROPORTIONALITY REVIEW HAVE SUBSTANCE?

Unocal, Moran, and *Revlon* can be read to suggest that proportionality review is primarily a formal, rhetorical instruction rather than substantive standard of review.[22] Under this reading, the new standard, like the old policy conflict/primary purpose test, serves chiefly to signal judicial concern and to invite planners to proceed with their defenses only after constructing a record that demonstrates reasonableness and that articulates a "threat." The best evidence for this construction is how little effort the Delaware Supreme Court devoted to determining that the discriminatory repurchase in *Unocal*[23] and the poison pill in *Moran*[24] were "proportional" to the threats posed by two-tier, front-end loaded offers and offers financed by junk bonds (or any offers made by T. Boone Pickens[25]). The *Revlon* case, moreover, may be consistent with this

22. *See, e.g.*, Johnson & Siegel, *Corporate Mergers: Redefining the Role of Target Directors,* 136 U. Pa. L. Rev. 315, 332–37 (1987).

23. In *Unocal,* the court's entire discussion of the coercive impact of two-tier offers consisted of the following sentence: "It is now well recognized that such [two-tiered] offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." 493 A.2d at 956 (citation omitted).

24. In *Moran,* the court's discussion of proportionality review consisted of the following paragraph:

> [T]o meet their burden, the Directors must show that the defensive mechanism was "reasonable in relation to the threat posed." The record reflects a concern on the part of the Directors over the increasing frequency in the financial services industry of "boot-strap" and "bust-up" takeovers. The Directors were also concerned that such takeovers may take the form of two-tier offers. . . . In sum, the Directors reasonably believed Household was vulnerable to coercive acquisition techniques and adopted a reasonable defensive mechanism to protect itself.

500 A.2d at 1356–57.

25. In *Unocal,* the court seems to have held that the very fact that the offer was made by Pickens constituted a sufficient threat: "Wholly beyond the coercive aspect of an inadequate two-tier tender offer, the threat was posed by a corporate raider with a national reputation as a 'greenmailer.' " 493

minimalist construction insofar as it pointedly invokes the directors' duty of loyalty in lieu of a proportionality argument when it enjoins management's defensive lock-up option.[26]

Construing proportionality review as simple rhetoric is difficult, however, because the Delaware court has taken such care to announce and reiterate the new standard. The court surely could have found less confusing ways to demonstrate rhetorical concern than to articulate a new and potentially far-reaching standard of review. A more prudent reading of the cases takes proportionality review seriously. The cases introducing the new standard point to the significance of concrete threats.[27] The Mesa offer in *Unocal* was at least potentially coercive, and the poison pill in *Moran,* because it could be redeemed by the board, did not foreclose a particular offer. Indeed, the court in *Moran* stressed that, should the board determine not to redeem the pill when an actual offer was made, its decision could then be reviewed under the two-step test. Thus, declining to redeem the pill would itself qualify as a defensive tactic that management would have to justify as reasonable in relation to the threat posed by the particular offer.[28]

Yet, concluding that *Unocal, Moran,* and *Revlon* are likely to contemplate a form of substantive review by the courts only begins the inquiry. The more difficult questions concern how rigorous a developed standard of proportionality review is likely to become.

A.2d at 956. The court expressed a similar view of Pickens in Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342 (Del. 1987).

26. The court stated that "when the Revlon board entered into an auction-ending lock-up agreement with Forstmann on the basis of impermissible considerations [the fear of threatened litigation by noteholders] at the expense of the shareholders, the directors breached their primary duty of loyalty." 506 A.2d at 182. *Revlon* also sets an additional limit on the operation of the proportionality test. Once it becomes "inevitable" that the target company will be sold, the obligation of the board changes appreciably:

> The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

Id. See also Ivanhoe Partners, 535 A.2d at 1338 (distinguishing between the proportionality test and "the *Revlon* obligation to conduct a sale of the corporation"). Determining when a sale becomes inevitable, therefore, is a critical question. For example, if target directors adopt a restructuring plan in response to a hostile bid, is the plan a defensive tactic governed by *Unocal* proportionality review, or is it a competing bid that demonstrates the inevitability of the company's sale, thereby triggering the *Revlon* auction standard? *See infra* note 65.

27. As the Delaware Chancery Court has recently observed: "Takeover bids found to be a threat have typically involved a coercively structured proposal, such as a two tiered hostile tender offer." Robert M. Bass Group v. Evans, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924, at 90,197 (Del. Ch. 1988) (citation omitted).

28. *Moran,* 500 A.2d at 1354.

IS THE NEW STANDARD MORE THAN A THRESHOLD TEST?

One question is whether the proportionality standard is a threshold test or a form of regulatory review. To see this distinction clearly, consider the ambiguous holdings of *Unocal* and *Moran,* which establish that potentially coercive bids justify *some* forms of defensive action without indicating the range of permissible forms. If the proportionality standard is a threshold test, any hostile offer that is arguably coercive would give management a free hand without further scrutiny by the courts. By contrast, if the standard is a regulatory test, management would be forced to justify its choice of defensive actions by reference to the amount of coercion associated with a particular bid. This difference is significant because any bid, apart from an any-or-all cash bid with a commitment to freeze out non-tendering shareholders at the bid price, may have *some* coercive effect on target shareholders.[29] Thus, unless the "proportionality" element in the new standard has regulatory import, second-step review will have very little meaning for most offers as they are now framed.

29. Consider an offer that may seem non-coercive on its face: a 100% cash offer at a significant premium, but without any commitment to buy out non-tendering shareholders at a fixed price. A shareholder who believes that the stock is worth more than the offer, perhaps because he expects a higher offer in the future, would prefer not to tender. However, if he does not tender while other shareholders do tender, he will be left holding minority shares in a controlled corporation with a market value that is likely to be well below the tender offer price. Thus any partial offer, including an any-or-all offer without a freezeout commitment, is potentially coercive. *See* Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers,* 98 Harv. L. Rev. 1695, 1717–35 (1985). How much shareholders are actually coerced in practice, however, is open to debate. The risk of competing bidders limits the opportunity for initially coercive bids. Thus, the evidence suggests that the creation of an informal auction period under the Williams Act, by rule 14d-8's extension of the minimum offering period in partial (including two-tier) offers from 10 to 20 days, eliminated the difference in premiums between two-tier and any-or-all bids. As part of the SEC's study of the recommendations of its Advisory Committee on Tender Offers, the Office of the Chief Economist studied 148 tender offers between 1981 and 1983, consisting of 91 any-or-all offers, 32 two-tier offers, and 25 partial offers. Although for the entire sample the average premium in any-or-all offers exceeded that in two-tier offers by 8.3% (63.4% versus 55.1%), the order was reversed for offers made after the lengthening of the offer period (average premium of 66.4% for two-tier offers and 49.6% for any-and-all offers). *See* R. Gilson, *supra* note 13, at 853–54. A later study that extended the sample to include 1984 offers (so that offers made after the extension of the offer period comprised approximately half the sample) confirmed this result. Over the entire sample, the premium averaged 56.6% in any-or-all offers and 55.9% in two-tier offers, a difference that was not statistically significant. Comment & Jarrell, *Two-Tier and Negotiated Tender Offers: The Imprisonment of the Free-Riding Shareholder,* 19 J. Fin. Econ. 283, 304–10 (1987). This may explain the recent dramatic decline in the use of two-tier bids in third-party offers. While in 1982 and 1983 there were 35 third-party two-tier bids amounting to about 20% of all tender offers, in 1985 and 1986 there were only 11 such bids amounting to only about 3% of all tender offers, and in the first five months of 1987, there were none. *See* Grundfest, *Two-Tier Bids Are Now a Defensive Technique,* Nat'l L.J., Nov. 9, 1987, at 26, col. 1.

The recent decision of the Delaware Court of Chancery in *AC Acquisitions Corp. v. Anderson, Clayton & Co.*[30] strongly argues that the proportionality test is more than a threshold standard. For our purposes, the facts of the case can be stated simply. A cash tender offer was made for a minimum of fifty-one percent of Anderson, Clayton's common stock at $56 per share, with the announced intention of a second-step freezeout merger also at $56 per share. Thus, the hostile offer was not coercive. A shareholder who viewed the $56 price as too low could decline to tender without fear of being disadvantaged; if other shareholders tendered and the offer succeeded, the non-tendering shareholder would still receive the same price.

Anderson, Clayton responded by offering an alternative transaction that the company believed would result in greater value for its shareholders: an issuer self-tender for sixty-five percent of its common stock at $60 per share.[31] The company's offer, however, had one wrinkle. Because it had to be accepted before the hostile offer was completed, shareholders were coerced into accepting it. A shareholder who did not tender to the company because he preferred the hostile offer would run a major risk. If other shareholders tendered to the company, the hostile offer would be withdrawn and the non-tendering shareholder would be left with, in effect, the back-end of the company's two-tier offer: the reduced value of the remaining company shares after the repurchase of sixty-five percent of its stock at a premium.[32]

In reviewing a challenge to this transaction, the *Anderson, Clayton* court easily approved the company's offer under the traditional first step of the two-step review: Providing shareholders with a competitive alternative to a hostile offer was self-evidently a valid corporate purpose. Yet, the court's analysis at the second step of the review was far from routine. The court might have reasoned, tautologically, that the company's offer should be considered "reasonably related" to the hostile offer by definition, merely because providing an alternative to this offer was an appropriate corporate purpose. But the court did not take this tack; instead, it carefully examined the alternative that the company actually provided:

30. 519 A.2d 103 (Del. Ch. 1986). For a more recent decision affirming the analysis of *Anderson, Clayton* on similar facts, see *Robert M. Bass Group,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924.

31. 519 A.2d at 104. The court described the calculation by Anderson, Clayton's investment banker of the value of the company's offer as follows: "$60 per share x 65.5% (proration figure) = $39.34 cash + the per share value of the remaining 34.5% equity interest ($13 to $18 per remaining interest) or in total a range of $52.34 to $57.34 per existing share." *Id.* at 108 n.6.

32. *Id.* at 113. Bradley & Rosenzweig, *Defensive Stock Repurchases,* 99 Harv. L. Rev. 1378 (1986), demonstrate that any repurchase by a target of less than the number of shares sought by the hostile bidder has the potential to be coercive in this way. Perhaps for this reason, two-tier offers have been most frequently used by management in recent years to support management buyouts or, as in *Anderson, Clayton,* to defend against a single-tier hostile offer. *See* Grundfest, *supra* note 29.

In *Anderson, Clayton,* the coercive effect was magnified because the company's investment banker declined to give an opinion on the expected value of Anderson, Clayton shares after the repurchase. Instead, he estimated a value range of $13 to $18. 519 A.2d at 108. At all but the top end of this range, the hostile offer was more valuable.

> The fatal defect with the Company Transaction . . . becomes apparent when one attempts to apply the second leg of the *Unocal* test and asks whether the defensive step is "reasonable in relation to the threat posed." The [hostile] offer poses a "threat" of any kind (other than a threat to the incumbency of the Board) only in a special sense and on the assumption that a majority of the Company's shareholders might prefer an alternative to the [hostile] offer. On this assumption, it is reasonable to create an option that would permit shareholders to keep an equity interest in the firm, but, in my opinion, it is not reasonable in relation to such a "threat" to structure such an option so as to preclude as a practical matter shareholders from accepting the [hostile] offer.[33]

Thus, *Anderson, Clayton* clearly indicates that proportionality review, unlike the policy conflict/primary purpose test, is not an empty threshold test: Defensive tactics must be justified in relationship to the particular terms of hostile offers.[34] This is an important result in its own right, even if it still leaves open the basic issue of how the Delaware courts will balance defensive tactics against the terms of hostile offers in other contexts.

WHAT CONSTITUTES A THREAT?

Thus far, it appears that, under the proportionality test, the nature of the threat associated with a particular hostile offer limits the range of permissible defensive tactics. It is a short step from this observation to the next question: What constitutes a "threat" under the proportionality test? If "threat" means that a takeover bid must pose a demonstrable risk of injury to target shareholders, might some takeover bids arguably not constitute any threat? The most serious aspect of developing the likely content of the proportionality test is that, in such cases, it might reasonably be construed to bar target management from initiating any significant defensive measures at all.

The bids in *Unocal, Moran,* and *Anderson, Clayton* illustrate easy circumstances under the proportionality test for locating threats that might reasonably seem to warrant a defensive response of some kind. In *Unocal* and *Moran,* the structure of the hostile offers threatened to coerce shareholders into tendering on unfavorable terms. In *Anderson, Clayton,* a hostile offer threatened to deprive shareholders of access to management's alternative offer. However, leeway to respond to these threats under the proportionality test will give little comfort to defensive planners who wish to keep their companies independent.[35] Indeed, a broad reading of *Anderson, Clayton* leads to a kind of safe harbor for hostile

33. 519 A.2d at 112–13.

34. *Id. Anderson, Clayton's* analysis is developed even more pointedly in the recent *Robert M. Bass Group* decision, where the Delaware Court of Chancery observes that a reasonable response to an alleged underpriced offer is to "develop an even more valuable economic alternative" for shareholders. [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924, at 90,198.

35. A fair reading of *Anderson, Clayton* suggests that management's real motive was to maintain independence.

acquirers: In response to a hostile bid that is *not* coercive on its face, management can do no more than offer a genuine alternative. Although this reading admittedly represents a significant narrowing of prior Delaware law, it accords with *Anderson, Clayton*'s holding that a hostile offer may be noncoercive when it promises to cash out non-tendering shareholders at an equal price.[36] As the court explicitly states, tactics that preclude shareholders from accepting a hostile offer are not, without more, reasonably related to the "threat" that shareholders will accept the offer.[37] Thus, the case may support the proposition that the proportionality test bars preclusive defensive action whenever non-coercive takeover bids offer equal treatment to non-tendering shareholders. Such a rule would dramatically restrict the flexibility of defensive planners in a market where hostile bidders can easily raise cash financing.

Similarly, defensive planners cannot take great comfort in *Anderson, Clayton*'s invitation to offer shareholders a noncoercive alternative. Inherent in *Anderson, Clayton*'s conception of providing shareholders with a choice is that they may choose to accept the hostile offer. Considered from this perspective, moreover, management's proposal for keeping a target company independent is simply an alternative to a hostile offer rather than a presumptively favored outcome. After all, if shareholders had selected Anderson, Clayton's self-tender offer, the company would have remained independent. *Anderson, Clayton* clearly allows management to offer the alternative of independence, but the logic of the opinion seems to foreclose preclusive tactics that *force* shareholders to accept the independence option (or prevent shareholders from choosing at all).[38]

36. 519 A.2d at 112.

37. *Id. See supra* note 33 and accompanying text (summarizing the court's holding). For a parallel analysis, see *Robert M. Bass Group,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924.

38. *Accord Robert M. Bass Group,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924, at 90,200.

The Delaware Supreme Court's recent decision in Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987), demonstrates that the road to doctrinal clarity in Delaware is neither straight nor straightforward. In that case, Newmont management believed the company was caught between two potentially coercive offers. On the one hand, Ivanhoe Partners, a Boone Pickens acquisition vehicle, had announced a hostile offer for 42% of Newmont's outstanding stock. Although the Ivanhoe Partners offer stated that Ivanhoe Partners intended to acquire all remaining shares for cash at the same price as the initial offer, the offer also stated, in contrast to the hostile offer in *Anderson, Clayton,* "that no specific second step transaction had been devised, and that there was no firm commitment to do so." *Id.* at 1339. As a result, the court concluded that the Ivanhoe Partners offer was a two-tier offer "fit[ting] perfectly the mold of . . . a coercive device." *Id.* at 1342.

On the other hand, Newmont management believed that Consolidated Gold Fields ("Gold Fields"), Newmont's largest shareholder with 26% of the outstanding stock, also posed a threat of coercion. Gold Fields held its shares subject to a 1983 standstill agreement that limited Gold Fields to a maximum holding of 33⅓%, but the standstill agreement terminated if any other party acquired more than 9.9%. When Ivanhoe Partners intentionally increased its holding to 9.95%, Gold Fields became free to "cancel the 1983 standstill agreement and acquire control of the company [presumably through market purchases], thus leaving the remaining shareholders without protection on the 'back end.' "

Because of this situation, Newmont's defensive tactic—financing a Gold Fields street sweep with a $33 per share special dividend that gave Gold Fields 49.7% of the outstanding stock, subject to a revised standstill agreement that limited Gold Fields's board membership to 40%—could be justified

From the perspective of defensive planners who want to keep a target independent (and "un-restructured"), the critical issue in evaluating Delaware's new two-step proportionality review is what can cabin a broad reading of *Anderson, Clayton*. Put in doctrinal terms, what "threats" from hostile bidders, apart from unequal treatment for non-tendering shareholders, are sufficiently grave to justify preclusive defensive tactics without offering any transactional alternative at all? To take an obvious candidate, suppose that management honestly believed that the price of a non-coercive hostile offer was inadequate; in management's view, the securities market undervalued the target company's assets by more than the premium offered by the acquirer. Would a preclusive defense be "reasonably related" to the "threat" that shareholders might accept what management deems to be an inadequate price?[39]

To date, the cases interpreting proportionality review offer little guidance on this single most important issue of what "threats" will support preclusive defenses by target managers. In *Unocal,* where the proportionality test was introduced, the Delaware Supreme Court provided a litany of factors that might bear on the existence of a threat:

> If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (*i.e.,* creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being

as a careful effort to steer a path between the coercion threatened, explicitly or implicitly, by *both* Ivanhoe Partners and Gold Fields.

Analysis is complicated, however, by the fact that the court also refers to Newmont's desire to remain independent: "The Newmont board acted to maintain the company's independence and not merely to preserve its own control." *Id.* at 1344. Our preferred interpretation of the court's opinion treats this discussion of independence as loose language occurring in a context in which coercion was the dominant consideration. If the court's language is interpreted as a statement that any hostile offer is a threat to a company's independence (and that any defense is therefore reasonably related to that threat), the proportionality test is reduced to rhetoric. Indeed, our goal in this article is to avoid precisely this type of confusion.

39. *Anderson, Clayton* itself avoids the issue by noting that the case presented an unusual circumstance in which target management did not claim that the price offered by the hostile bidder was inadequate:

> Unlike most of our cases treating defensive techniques, the Board does not seek to justify the Company Transaction as necessary to fend off an offer that is inherently unfair. . . . The Board recognizes that the [hostile] offer—being for all shares and offering cash consideration that the Board's expert advisor could not call unfair—is one that a rational shareholder might prefer.

519 A.2d at 112. Other recent opinions, however, address underpriced offers as threats per se when managers can identify more valuable economic alternatives. *See* BNS Inc. v. Koppers Co., 683 F. Supp. 458, 475 (D. Del. 1988); *Robert M. Bass Group,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924, at 90,198–99.

> offered in the exchange. . . . While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.[40]

How might these factors rise to the threshold of "threats" able to justify a preclusive defense against a non-coercive takeover bid? Clearly, these factors can be threats only if a target's directors believe that shareholders will *mistakenly* accept a non-coercive offer.[41] This returns us to our starting point: the options open to the Delaware Supreme Court after determining that defensive tactics required a more rigorous standard of review. The court might have proceeded directly by vesting *shareholders* with a qualified right to choose whether to accept a hostile offer without interference by target management. Instead, the court opted to proceed indirectly by adopting an intermediate standard of review to screen when *directors* might unilaterally block shareholders from choosing at all. But this intermediate standard can only lead back to the core issue underlying defensive tactics: If takeover bids are not coercive, why not allow shareholders to make up their own minds about how to respond?

This question highlights the inherent puzzle associated with the proportionality inquiry when a takeover bid lacks the obvious coercive features of the *Unocal* and *Ivanhoe Partners* offers. The inquiry into the relationship between the defensive tactic and the threat posed by the hostile offer is intelligible only if the nature of the threat—how the offer would injure shareholders in the absence of a defensive response—is understood. The only threat posed by a non-coercive offer that management considers unfair, ill-timed, or underpriced, is the threat that something will lead shareholders to accept it. But since such a threat is not *structurally* coercive, it will warrant a defensive response only if the offer is *substantively* coercive in that shareholders might somehow be led to accept unfavorable substantive terms voluntarily. Put another way, substantive coercion posits a likely mistake by target shareholders who would not accept the terms of an acquirer's offer if they knew what management knew about their own company, about the acquisitions market, or about management itself. In addition, since target management can be expected to tell shareholders, loudly and often, what it knows, substantive coercion must also generally posit that

40. 493 A.2d at 955–56 (citations and footnote omitted). This litany is repeated in *Ivanhoe Partners,* 535 A.2d at 1341–42.

41. A possible exception concerns the impact of a hostile offer on the target's non-shareholder constituencies. If directors could prefer the interests of these constituencies over those of shareholders, a hostile offer that shareholders would wish to accept in their own interest could pose a threat to non-shareholder interests. However, the Delaware Supreme Court seems to have foreclosed such a preference for non-shareholder interests in *Revlon,* when it observed: "A board may have regard for various constituences in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders." 506 A.2d at 182. Thus, the constituency factor is no different from the other factors set out by the court in *Moran.*

shareholders *do not believe* what management says about the real value of the company.

In sum, whether proportionality review can remain both internally consistent and able to accommodate preclusive responses to offers that are structurally innocuous, as in *Anderson, Clayton,* depends on the development of a coherent account of substantive coercion. Without such an account, Delaware's intermediate standard can follow only one of two roads. Either internal logic will dictate what we have termed the "broad reading" of *Anderson, Clayton*—that is, a rule limiting preclusive defenses to the *Unocal* genre of coercive bids—or, as proved to be the case with Delaware's prior high-profile effort at devising an innovative standard in *Singer,* the new intermediate standard will collapse into yet another rhetorical embellishment of the business judgment rule.

THE PROBLEM OF SUBSTANTIVE COERCION

As the preceding analysis suggests, substantive coercion requires an informational disparity between target managers and shareholders. Given a structurally non-coercive offer of the *Anderson, Clayton* variety, two elements must be present before rational shareholders can be described as "mistakenly" tendering their shares because of substantive coercion. First, management must be able to produce an expected market price for the company that is higher than the hostile offer; that is, management's claim that the offer is inadequate must be correct. But second, a majority of shareholders must nonetheless *believe* that management will not deliver on its promise. Without the first element, shareholders who accept a structurally non-coercive offer have not made a mistake. Without the second element, shareholders will believe management and reject underpriced offers. Put another way, substantive coercion can only arise when faithful managers prove unable to reassure a skeptical market.

MANAGERS' ABILITY TO GENERATE HIGHER PRICES

When managers justify a preclusive defense on the ground that a hostile offer is inadequate, they implicitly claim to be able to obtain greater value for shareholders. Managers might be able to accomplish this in at least three ways: (i) by bargaining for a better price from the bidder at hand; (ii) by locating other bidders who will pay more for the company; or (iii) by operating the firm so successfully that share prices will eventually exceed the offer price even without selling the firm.[42] Any of these assertions may be correct. As a practical matter, moreover, embattled managers may attempt to justify defensive tactics by making all three claims. Thus, target managers often compress these three claims into a single statement: "The firm is worth at least X if we are allowed to

42. *Cf. Robert M. Bass Group,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924, at 90,198–99 (listing management's alternative methods of generating greater value—negotiating, selling, or implementing a non-coercive restructuring transaction—as reasonable responses to the threat of an underpriced offer).

continue to operate it; we will repulse any offer below X, but we will negotiate in good faith with the bidder at hand or anyone else who offers more than X."[43] But while all three claims are often asserted simultaneously, they should be considered separately because they are unlikely to be equally plausible.

The least ambitious rationale for defensive tactics is the claim that management needs leverage to negotiate with a hostile bidder. Even in a competitive acquisitions market, disaggregated shareholders may require a bargaining agent to obtain top dollar for target assets.[44] Without a coordinated response from shareholders, any offer can succeed that exceeds the expected value of the firm in the hands of existing management or other competing bidders. By contrast, target managers who have the power to preclude hostile offers by deploying defensive tactics may be able to compel acquirers to pay out the bulk of their transaction gains.[45] Thus, the claim that an offer is too low may simply mean that there is room to dicker: Target managers reasonably believe that the offeror will pay a higher price based on their knowledge of the true value of the target company's assets or of the synergistic gains available to a particular offeror. The force of this claim and the concomitant use of defensive tactics to induce an offeror to sweeten its bid have been recently recognized by courts under *Revlon*'s analysis of the target board's obligation to conduct an auction that maximizes shareholder value.[46] The claim stands as a distinct justification for poison pills, quite apart from the potential value of the pill defense in insulating shareholders from the effects of street sweeps or structurally coercive offers.[47]

Beyond allowing managers to bargain credibly with particular offerors, however, defensive tactics might also benefit target shareholders by providing time for managers to "shop" the firm. In this case, managers who assert that an offer is too low must claim private knowledge about either the acquisition market or the value of the firm. They must believe that other potential acquirers

43. Needless to say, X is rarely given an exact dollar figure.

44. *See, e.g.*, Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?*, 28 J.L. & Econ. 151 (1985); Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis,* 71 Cornell L. Rev. 53, 64–70 (1985).

45. In a perfectly competitive auction market, successful bidders must presumably pay more than the value of the firm to the next highest bidder, even without management bargaining. Bargaining by target managers, however, may extract some of the incremental surplus of the highest bidder beyond the value of the firm to other bidders. In addition, such bargaining might offset competitive and strategic imperfections in the auction market. Note that for present purposes we assume that maximizing gains to target shareholders serves the broader objectives of shareholder and social welfare. This view is generally accepted by the courts but remains controversial among some commentators. *See, e.g.*, Easterbrook & Fischel, *supra* note 11; Schwartz, *Search Theory and the Tender Offer Auction,* 2 J.L., Econ. & Org. 229 (1986).

46. *See* CRTF Corp. v. Federated Dep't Stores, [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,711 (S.D.N.Y. Apr. 14, 1988); Facet Enters. v. Prospect Group, No. 88-9746 (Del. Ch. Apr. 15, 1988) (order denying motion for preliminary injunction).

47. As Judge Sand observed in *CRTF Corp.*, the pill defense "provides the directors with a shield to fend off coercive offers and with a gavel to run an auction." [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,711, at 98,299.

can be located who will pay more for the target than the hostile offeror. Because second bidders cannot always be found, this claim is more problematic than management's assertion that it can serve as a local bargaining agent. Nevertheless, "white knights" may emerge over time, particularly when management is willing to share confidential information. The empirical literature indicates that target management often can discover second bidders for target firms.[48]

Finally, the most ambitious rationale for defensive tactics is management's claim that it can better the price offered by a hostile bidder by preserving the target's independence and generating value internally. In effect, management asserts that the value of the target in its hands exceeds not only the target's pre-offer valuation by the securities market, but also the premium price offered by the acquirer. Management may rest an optimistic valuation of the target on confidential information about the company, on beliefs about the future success of the company's strategic plans, or more concretely, on an expert appraisal of the value of the firm's assets. Again, management's claims may well be correct, even when management relies on wholly public information to value the firm; the securities market often appears to "discount" the asset values of target firms.[49] Nevertheless, invoking the target's intrinsic value to justify continued independence in the face of a premium offer is always a delicate argument for the management of a target firm to make. Sooner or later, most shareholders sell their shares on the market, and the market has already assessed managers' efforts. Indeed, share prices might undervalue corporate assets precisely because shareholders mistrust management investment policies.[50]

Even if the securities market undervalues the target firm for reasons other than the company's poor performance, managers can seldom predict when the market will come to accept their own assessment of the value of the company or explain what would cause the market to alter its valuation.[51]

SHAREHOLDER MISTRUST

The mere fact that managers might truthfully claim to be able to improve upon a hostile offer does not itself render an offer substantively coercive. A second element is also required: Most shareholders must disbelieve managers' claims. Otherwise, shareholders simply would listen to managers' advice and reject underpriced offers out of hand. Indeed, this observation carries one step

48. *See* Jarrell, *supra* note 44, at 160–61.

49. *See* Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive,* 88 Colum. L. Rev. 891 (1988).

50. *See id.* at 897–98. Corporate assets that generate large free cash flows in declining industries are particularly likely to be discounted by share prices if shareholders fear that managers will simply reinvest funds in the same industry. *See, e.g.,* Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,* 76 Am. Econ. Rev. (Papers & Proc.) 323, 323–24 (1986).

51. A significant, if highly controversial, literature argues that biased or noisy share prices may discount asset values, as many managers have long suspected. *See* Kraakman, *supra* note 49, at 898–99. However, the assertion that a target is underpriced, even if correct, cannot guarantee that it will be accurately priced in the future unless management undertakes a major restructuring effort. *See id.* at 924–30.

further. A structurally non-coercive offer of the *Anderson, Clayton* variety that is underpriced is likely to fail even if the only market participants who believe managers' claim of underpricing are the arbitrageurs, as long as these arbitrageurs expect other savvy traders to share their valuation of the target.[52]

Moreover, shareholders have good reason to mistrust managers' claims of underpricing even if they know that defensive tactics can sometimes improve upon the terms of hostile offers. Both academic analysis and recent experience[53] persuasively demonstrate that managers' efforts to defeat hostile bids often occur or persist despite the best interests of shareholders. Indeed, apart from the bidder itself, no one is less likely to be objective in appraising a hostile offer than the target's incumbent board of directors and its top managers. Knowing this, shareholders must naturally fear that in some cases management's claims of value will be self-serving and, if believed, would impose a significant agency cost, that is, the difference between the offer price and the subsequent lower market price of the company after the offer is defeated. The fact that shareholders—and the securities market—are likely to accept a structurally non-coercive offer, despite management's claims of value, is compelling evidence of the shareholders' belief that the ability of managers to improve on the offer's terms is outweighed by the risk that managers have misrepresented either their abilities or their intentions.

This agency cost analysis is the chief justification for the broad reading of *Anderson, Clayton* discussed earlier. The decision to tender or sell into the market presupposes a judgment that the risk of management misrepresentation outweighs the likelihood that management's claim of a higher value is correct.[54] Because a court will be in no better position than the target's shareholders and the market to evaluate management's claims about future value, there is no basis for a court to override the evaluation of the marketplace by sanctioning preclusive defensive tactics. Thus, it is natural to conclude that the possibility that a structurally non-coercive offer may be substantively coercive poses no threat to shareholders on a risk-adjusted basis and, therefore, no defensive tactics are warranted.

52. This is more complicated than it looks. The question is to what extent the market acts as a check on shareholder skepticism. Suppose shareholders distrust managers but savvy market players know better. Then arbitrageurs will buy in at above the low-ball market price only if they expect enough other arbitrageurs to buy in to defeat the offer. We might safely say, however, that if there is some finite probability that shareholders will defeat the offer and arbitrageurs believe that the firm can do better, then target shares should trade at above the offer price and the offer will be defeated. The remaining question is how large the initial probability must be to induce arbitrageurs to participate.

53. The behavior of target management in *Anderson, Clayton* and *Revlon* provides recent examples.

54. For this purpose, a shareholder's decision to sell into the market while the offer is pending has the same implications, with respect to the shareholder's calculation of the likelihood that management's claim of a higher value is correct, as a shareholder decision to wait and actually tender. That the ultimate tender is then made by an arbitrageur is irrelevant. In this respect, the arbitrageur acts simply as a less risk averse proxy for the selling shareholder who, in effect, has cast her vote against management's valuation by selling. *See* Gilson, *supra* note 3, at 855–56.

The empirical literature analyzing what happens to share values following unsuccessful offers clarifies not only the basis for shareholder mistrust that supports a broad reading of *Anderson, Clayton* but also the risk of substantive coercion that supports a broad reading of *Unocal's* litany of potential threats. Every empirical investigation of failed takeover attempts reaches the same dramatic conclusion. Unsuccessful first offers that are followed by successful second offers yield better prices for target shareholders; but when first offers are defeated and no second offer follows, share prices for target firms eventually sink back to their pre-offer levels and thus inflict heavy opportunity costs on target shareholders. This general pattern of results has been demonstrated by two major studies of failed tender offers.[55] It has been replicated in parallel studies of failed mergers (as distinct from tender offers).[56] In addition, the pattern has emerged in other, narrower investigations of particular defensive tactics. Thus, Jarrell's well-known study of defensive litigation,[57] Mikkelson and Ruback's investigation of greenmail payments,[58] and recent SEC analyses of poison pills[59] all indicate that successful target defenses may indeed make shareholders better off—but *only* if target firms are subsequently acquired in a later transaction.[60]

55. *See* Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers,* 11 J. Fin. Econ. 183 (1983); Ruback, *Do Target Shareholders Lose in Unsuccessful Control Contests?,* in Corporate Takeovers: Causes and Consequences 137 (A. Auerbach ed. 1988). Bradley, Desai, and Kim examined 26 targets of failed tender offers that were not subsequently acquired by a second offeror. They found that, over a two-year period, the shareholders of these targets lost all gains associated with their initial offers. Bradley, Desai & Kim, *supra,* at 194. Ruback confirmed these results in a study employing a different design and extending over a three-year period. Ruback, *supra,* at 147–50. Many firms that resist first offers are later acquired. However, these results cannot confirm the apparent view of the market that successful resistance is a poor gamble. *See id.* at 150. For a critical review of the principal effort to show that shareholders benefit from remaining independent after defeating a hostile offer, see Pound, *Takeover Defeats Hurt Stockholders: A Reply to the Kidder Peabody Study,* Midland Corp. Fin. J., Summer 1986, at 33.

56. *See* Asquith, *Merger Bids, Market Uncertainty, and Stockholder Returns,* 11 J. Fin. Econ. 51 (1983); Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth,* 8 J. Fin. Econ. 105 (1980). Both studies find that the announcement of a merger termination dissipates all price gains associated with initial merger announcements. Asquith, *supra,* at 67; Dodd, *supra,* at 131.

57. *See* Jarrell, *supra* note 44, at 171–72.

58. W. Mikkelson & R. Ruback, Targeted Repurchases and Common Stock Returns (Sloan School of Management Working Paper No. 1707-86, 1986). Consistent with the general literature, Mikkelson and Ruback found that offer withdrawals following greenmail payments left shareholders with some gains over pre-offer prices but that these gains were eventually lost by the subset of firms that retained their independence. *Id.* at 30.

59. Office of the Chief Economist, SEC, The Effects of Poison Pills on the Wealth of Target Shareholders (1986).

60. One caveat relates to leveraged recapitalizations and other restructuring defenses in which target management attempts to defeat a hostile offer by pursuing its own reorganization plan. Recall, for example, management's offer in *Anderson, Clayton.* Shareholders are likely to benefit in these cases even if management's "offer" succeeds because, in effect, management plays the role of a second bidder. *See* Kleiman, *Shareholder Gains From Leveraged Cash-Outs,* 1 J. Applied Corp. Fin., Spring 1988, at 46. In these cases, then, the question is not whether shareholders will benefit

PROPORTIONALITY AND SUBSTANTIVE COERCION

The empirical literature poses a difficult challenge for the proportionality test because it presents a mixed message: Shareholders have good reason to be skeptical about preclusive defensive tactics, even though their skepticism is often mistaken. The implication of this message differs depending on whose perspective one adopts. From the external perspective of shareholders and the market, which cannot distinguish when management's representations about future value are correct from when they are self-serving, hostile offers that are structurally non-coercive cannot pose a threat; accordingly, defensive tactics that preclude such offers can only be harmful.[61] From the internal perspective of *well-intentioned* managers whose representations about value really are correct, however, some offers may nevertheless threaten shareholder welfare. Adopting the market's external perspective naturally leads to proscribing defenses against structurally non-coercive offers. But the price of such a rule is to abandon judicial deference to managers' business judgment—in this context a presumption that management's representations about future value are more often than not correct—on the basis of the movement of share prices and the aggregate statistical data that support the opposite presumption.[62] On the other hand, adopting the internal perspective and acceding to defensive tactics solely on the basis of managers' claims of intrinsic value imposes large and easily measurable agency costs on shareholders across all hostile offers considered in aggregate. Such a permissive rule would render the proportionality test meaningless whenever managers alleged that hostile offers were underpriced.

It follows that a meaningful application of the proportionality test to substantive coercion must recognize that management's representations about future value will sometimes be wrong and sometimes be right. For the game to be worth the candle, courts applying the proportionality test must be able to improve on the market's efforts to distinguish when management is right and when it is wrong. Otherwise, the aggregate market data would support a total ban on defensive responses to structurally non-coercive offers.

at all relative to pre-bid share prices, but whether they will gain as much as they would have gained if the hostile offer had succeeded. To us, management's preference for its own restructuring plan over a hostile offer implicates precisely the same concerns that provoked *Revlon*'s auctioneering norm in bidding contests between two offerors. *See supra* note 26. This point emerges with particular force on the facts of the recent *Robert M. Bass Group* decision, where the acquirer—the Bass Group—offered to match the exact terms of management's recapitalization plan and pay a higher price to target shareholders if the Bass Group were permitted to purchase the equity position that management had reserved for itself under the recapitalization plan. *See* Robert M. Bass Group v. Evans, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924, at 90,194–95 (Del. Ch. July 14, 1988).

61. Recall that share prices drop dramatically whenever hostile offers are defeated, thus inflicting a significant loss on shareholders. This loss is offset by even greater gains when a second offer follows and is followed by even larger losses when no second offer materializes. *See supra* notes 55–60 and accompanying text.

62. The ex ante response of share prices strongly suggests a presumption against management. Ex post statistical analysis can only be suggestive. *See supra* note 55.

DEVELOPING AN EFFECTIVE PROPORTIONALITY TEST

The preceding analysis demonstrates that the most difficult part of developing an effective proportionality test is the challenge of offers that are assertedly substantively—but not structurally—coercive, and that the central problem in applying the proportionality test to substantive coercion is suspect information. If management can correctly claim that the company is worth more than the value of a hostile offer, then substantive coercion is a real threat that may support preclusive defensive tactics under an intermediate standard of review. By contrast, if management's claims about value are incorrect, there is no threat to target shareholders and preclusive tactics are inappropriate. The premise of an intermediate standard of review is that the courts must exercise independent judgment in balancing the reasonable skepticism of shareholders (which considered alone would suggest prohibiting preclusive tactics) against the presumptive expertise of managers (which considered alone would suggest blanket business judgment protection of preclusive tactics). The hard question is: Can judges screen management's claims about value more accurately than the market? The answer, we believe, lies in how an effective proportionality test might elicit more careful analysis by the courts and, as a result, more accurate representations by target managers about the bases of their valuation claims in the first instance.

THE ELEMENTS OF AN EFFECTIVE PROPORTIONALITY TEST

The elements of an effective test of the proportionality of defensive tactics to an allegedly threatening hostile offer follow from the ambiguities in the Delaware Supreme Court's exegesis of existing doctrine. First, if the test is to serve as a true intermediate standard—that is, as a test more stringent than *Cheff* but less rigorous than the intrinsic fairness test—it must clearly identify the nature of the threats that fix the permissible range of defensive tactics. Second, an effective proportionality test must be more than a threshold test; it must explicitly link the range of permissible tactics to the scope or magnitude of the identified threat. Finally, an effective test must offer courts meaningful guidance in evaluating the likely accuracy of management's representations about both the magnitude of the threat posed by a hostile offer and how, given that threat, management's particular defensive response would serve shareholder interests.[63]

63. For a similar analysis of the promise of the proportionality test and a discussion of its likely course of development, see City Capital Assocs. v. Interco, Inc., No. 10,105, slip op. at 20–26 (Del. Ch. Nov. 1, 1988) (1988 WL 116,453). This decision, which refers to the working paper that preceded this article, introduces an analytical framework parallel to this article's and further develops the argument for searching judicial review of management's claim that a structurally non-coercive offer is a "threat," based solely on the risk that shareholder choice might pose to management's own alternative plans. *Id.* at 24–26.

A Typology of Threats

The first element of an effective test concerns the nature of threats posed by hostile offers. Merely limiting relevant threats to *threats to shareholder interest* —as *Revlon* already does within the limited confines of bidding contests[64]— would stress that *Unocal*'s litany of relevant circumstances rests on the fundamental, and seemingly unobjectionable, norm that shareholder interests are primary. Target management may take other corporate constituencies into account in framing defensive plans, but only to the extent it benefits shareholders by doing so.[65] Beyond this, our analysis suggests that the variety of "threats" discussed by the courts might be usefully grouped into three categories: (i) *opportunity loss,* or the *Anderson, Clayton* dilemma that a hostile offer might deprive target shareholders of the opportunity to select a superior alternative offered by target management; (ii) *structural coercion,* or the risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions; and, finally, (iii) *substantive coercion,* or the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value.

Of these three classes of threats, only a claim of substantive coercion requires that a court do very much more than review a simple statement of management's immediate plans and the terms of a hostile offer. Where management responds to the threat of opportunity loss from a hostile offer by proferring an alternative transaction, a court need only determine, as in *Anderson, Clayton,* whether management's alternative is itself structurally coercive.[66] Similarly, analysis of whether a hostile offer (or management alternative) is structurally

64. *See supra* note 41 and accompanying text (discussing *Revlon*).

65. We read *Revlon*'s stress on the primacy of shareholder interests in framing the duties of corporate directors as a specific application of a fundamental norm of corporate law. *See supra* note 41 and accompanying text. Management is no more free to sacrifice shareholder interests to those of other corporate constituencies in responding to a hostile offer than it is free to favor one participant over all others in an ongoing bidding contest. Any different understanding of management's fiduciary obligation to shareholders would render most of corporate law incoherent.

66. A problem may develop in distinguishing a preclusive defensive tactic from management's proffer of an alternative transaction. For example, defensive restructurings can be cast in a form that requires shareholder approval, whether by tender or vote, or in a form that may be implemented on management's authority alone. From our perspective, the distinguishing characteristic is the presence of shareholder choice. *See* R. Gilson, *supra* note 13, at 751–52. If shareholders retain the option of selecting the hostile offer, management's alternative offer, or neither offer, then management's transaction is an alternative that a judge need review only for structural coercion. If, by contrast, management effects the transaction without allowing shareholders the opportunity to reject it, then the threat must lie in the coercive character—whether structural or substantive—of the hostile offer with a resulting difference in the nature of the court's review.

The same dilemma—whether a management restructuring plan is merely a defensive tactic or an alternative proposal for the sale of the company—is also central to the Delaware Supreme Court's exegesis of proportionality review. Under *Revlon,* target management's duty to secure the highest price for the company is triggered by a conclusion that the company will be sold. If a management restructuring is viewed as an alternative control transaction, then a decision has been made to sell the company and *Revlon* is triggered; if management action is only a defensive response, the proportionality test remains applicable. *Compare* Black & Decker Corp. v. American Standard, coercive does not require detailed review, especially since *Anderson, Clayton* provides offerors a safe harbor by identifying the characteristics of an offer that is not structurally coercive.[67] An allegation of substantive coercion, however, places a more demanding burden on both the target's management and the reviewing court.

To support an allegation of substantive coercion, a meaningful proportionality test requires a coherent statement of management's expectations about the future value of the company. From the perspective of shareholders, substantive coercion is possible only if management plausibly expects to better the terms of a hostile offer—whether by bargaining with the offeror, by securing a competitive bid, or by managing the company better than the market expects.[68] To make such a claim requires more than the standard statement that a target's board and its advisers believe the hostile offer to be "grossly inadequate." In particular, demonstrating the existence of a threat of substantive coercion requires a showing of how—and when—management expects a target's shareholders to do better.[69]

A statement of management's plans for doing better might look to the role of defensive tactics in providing time or bargaining leverage to support the eventual sale of the firm at a higher price. Alternatively, it might promise to increase the market price of the firm's shares by independently managing the firm's operations with a plan to sell assets, to cut costs, or to follow another strategy for improving the company's performance. Either way, however, management must set forth its plan in sufficient detail to permit the court independently to evaluate the plausibility of management's claim.[70]

682 F. Supp. 772 (D. Del. 1988), *with* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987). *See infra* note 72.

67. *See supra* notes 36–37 and accompanying text.

68. *See supra* notes 42–51 and accompanying text.

69. An alternative construction of the proportionality test that may be functionally equivalent to requiring management to present detailed plans in order to show a threat of substantive coercion is to require a similarly detailed showing of management plans at the later stage of evaluating management's specific response to the alleged threat of an underpriced offer. At least one recent Delaware decision seems to incline in this alternative direction. *See* Robert M. Bass Group v. Evans, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924 (Del. Ch. 1988). Insofar as both of these constructions of the proportionality test would require the same showing from management and reach the same result, these two versions of the test would be practically identical. However, for the reasons indicated above, *see supra* text accompanying notes 42–62, we prefer to insert management's defense of its plans into the determination of whether a "threat" exists rather than into a subsequent evaluation of management's response to an asserted threat. The proposition that a premium offer might threaten shareholder interests apart from management's specific plans seems needlessly abstract and vulnerable to manipulation.

70. This type of disclosure also could be mandated under the federal securities laws. The Securities and Exchange Commission currently interprets Exchange Act rule 13e-3 to require quite detailed disclosure about the basis for a board of directors' belief that the price offered in a freeze-out merger is fair, as well as the purposes, benefits, and detriments of the transaction. See *In re* Meyers Parking Sys., Exchange Act Release No. 26,069, 41 S.E.C. Docket (CCH) 1061 (Sept. 12, 1988). It would be straightforward to amend rule 14d-9 to require a statement of the scope discussed

The discipline imposed by requiring management to state clearly just *how* it intends to cause the price of the company's shares to increase is a critical check on knee-jerk resort to assertions that a hostile offer's price is inadequate. For example, if management believes that the price of a hostile offer is inadequate because the market undervalues the company's unused investment tax credits, as the court apparently believed in *Smith v. Van Gorkom,*[71] an acceptable statement of the threat to shareholders would require management to describe the steps that it planned to correct the market's valuation.[72]

Proportionality: the Link Between Threat and Response

After defining the threat posed by a hostile offer, the second element in an effective proportionality test lies in detailing the relationship between the threat and the range of permissible defensive tactics. This relationship follows logically from the nature of the threat. Where the sole threat to shareholder interests is the risk that a hostile takeover might deprive shareholders of a superior management alternative, as in *Anderson, Clayton,* the only permissible defensive measures will be those that safeguard shareholders' choice between the hostile bid and management's alternative.[73] By contrast, when a hostile offer poses a significant threat of substantive or structural coercion, preclusive defensive tactics may be justified. A showing that some such response is justified, however, cannot mean that management enjoys complete discretion. In particular, some responses to hostile offers, such as leveraged restructurings, more closely resemble counteroffers than preclusive defenses. When these plans are deployed in

in the text in connection with a management recommendation that shareholders reject a pending tender offer.

71. 488 A.2d 858, 876 (Del. 1985).

72. *Cf.* Terry v. Penn Cent., 668 F.2d 188 (3d Cir. 1981) (Penn Central's strategy used up loss carry-forwards by acquiring profitable companies). We need not resolve here whether the securities market might, as a theoretical matter, underprice target assets even in the absence of significant nonpublic information. *See* Kraakman, *supra* note 49, at 898–901. Under some circumstances, target management might plausibly assert such underpricing and seek to demonstrate that the present value of the company's expected cash flows exceeds the hostile offer. However, such a demonstration alone would not justify preclusive defensive tactics without a plan (as in *Terry*) to assure that shareholders will *realize* the company's asset values in share prices. The price of the company's shares is an essential check on management's plan, even in instances of apparent underpricing, for two reasons. First, apparent underpricing by the securities market always creates suspicion about management's investment policies that is exceedingly difficult for a court to evaluate. Second, regardless of the origins of apparent underpricing, managers have a fiduciary responsibility to attempt to correct underpricing on behalf of shareholders. For further discussion of these issues, see Kraakman, *supra* note 49, at 933–39.

73. This seems the best reading of recent cases that allow target companies to facilitate conducting an auction of the company by declining to redeem a poison pill. *See* CRTF Corp. v. Federated Dep't Stores, [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,711 (S.D.N.Y. Apr. 14, 1988); Facet Enters. v. Prospect Group, No. 88-9746 (Del. Ch. Apr. 15, 1988); Henley Group v. Sante Fe S. Pac. Corp., No. 88-9569 (Del. Ch. Apr. 18, 1988). Although discussed in terms of the board's discretion in conducting a *Revlon* auction, this issue can be analyzed under the proportionality test without creating another standard, i.e., a separate *Revlon* auction obligation that multiplies doctrinal labels and creates its own ambiguities.

conjunction with preclusive defensive tactics, they deprive shareholders of the opportunity to choose not merely the problematic offer at hand, but *any* future offer as well. Thus, courts might reasonably require an especially probing demonstration of a benefit to shareholder interests before permitting management to execute such insulated restructuring plans. For example, a refusal to redeem a poison pill in the face of a two-tier hostile offer would be reasonably related to the threat of structural coercion embodied in the offer, but a leveraged restructuring to thwart the same offer would not be reasonably related to the same threat because the restructuring response would foreclose all future offers, including those that posed no threat at all. Such a preclusive restructuring plan would fail the proportionality test unless management could establish that it was substantively superior to the outsider's best offer.[74]

The Weight of Management's Burden

Finally, the third element of an effective proportionality test goes to the heart of meaningful judicial review: The weight of management's burden in persuading the court that management's defensive response will make shareholders better off, given the nature and magnitude of the threat posed by a hostile offer. As with confirming the existence of a threat in the first instance,[75] courts should have little difficulty in reviewing management's claims of structural coercion or a potential opportunity loss for target shareholders. The terms of a hostile offer or of management's alternative plan will suffice to establish the bona fides of these "threats." The real challenge to judicial review arises when management alleges that a hostile offer is substantively coercive because management—if only it were allowed to pursue defensive tactics that would provide it with the opportunity—could better the hostile offer through its own salesmanship or management efforts. Here, the court must be free to exercise its independent judgment in weighing whether management's plans present a plausible story: a

74. The hard case, once again, is management's allegation that the hostile offer competing with a restructuring plan is substantively coercive. A broad reading of *Revlon* or *Anderson, Clayton* would lead to a total ban on preclusive restructuring plans on the theory that shareholders should always be permitted a choice when the sole issue is comparative value. Arguably, however, management ought to have the opportunity to persuade a court that shareholders have underestimated the real value of management's proposed alternative. This is especially important when recapitalization leaves a hard-to-value equity "stub" in shareholder hands. Additionally, the fact that recapitalizations often *do* generate considerable value for shareholders suggests that the risks of permitting preclusive recapitalizations are smaller than the parallel risks of allowing management to retain the firm's independence without significant change. *See supra* notes 55–60 and accompanying text (drop in share prices following unsuccessful bids). For recent examples of judicial scrutiny under the proportionality test of defensive tactics to protect a restructuring plan, see *Robert M. Bass Group,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,924, at 90,198–99 (restructuring enjoined when it appeared likely to preclude economically superior offer); *Henley Group,* No. 88-9569 (Del. Ch. Apr. 18, 1988) (preclusive tactics proportional in part because management's previous efforts to sell the firm made entrenchment unlikely).

75. *See supra* notes 61–72 and accompanying text.

goal that improves on the value of the hostile offer and a means that is reasonably likely to achieve the goal.

Although a court must credit management's expertise in passing on management's plans, management's word is by no means the only evidence available to the court. The court can also examine the specificity and completeness of management's plan, the deliberations of the target's board, expert testimony from both sides, and, most important, the firm's performance history. In particular, evidence that management had alleged substantive coercion in the face of an earlier hostile offer and had already *failed* to meet its own projections of firm performance would seriously undermine allegations of substantive coercion. So, for example, an effective proportionality test would impose a heavier burden on claims of underpricing by Marshall Field's management in connection with B.A.T.'s hostile offer than would have been appropriate in connection with Carter Hawley Hale's earlier hostile offer, given Marshall Field's lackluster performance during the period between the two offers.[76]

WHY AN EFFECTIVE PROPORTIONALITY TEST CAN WORK

To this point, our development of an effective proportionality test remains subject to the same criticism that we leveled at the *Cheff* test. Particularly in the common case where management alleges substantive coercion because of price inadequacy, we would be hard pressed to demonstrate a necessary benefit from the proportionality test as we have developed it thus far. A deceptively clever story about future values might seem to be as capable of validating preclusive defensive tactics under the proportionality test as a clever story about policy conflicts was able to do under the old *Cheff* test. In our view, however, this criticism misses the systemic institutional effects of searching judicial review. A proportionality test that demands serious justifications for defensive tactics—and examines these justifications through the lens of shareholder interest—would serve a valuable screening function, even if it could not always guarantee the accuracy of management's representations. Such a test would facilitate planning in the easy cases where hostile offers did not threaten substantive coercion. For targets, the option of providing shareholders with an alternative plan would always be a defense, even to wholly non-coercive offers; for acquirers, the risk of

76. Carter Hawley Hale's best offer for Marshall Field was $42 per share on February 1, 1978. Panter v. Marshall Field & Co., 646 F.2d 271, 280 (7th Cir. 1981). Four years later, B.A.T. successfully offered $30 per share. Marshall Field & Co. v. Icahn, 537 F. Supp. 413, 420 (S.D.N.Y. 1982). To compare the two prices, we calculated the future value, on the date of the successful B.A.T. offer, of the $42 per share that Marshall Field's shareholders were denied by management's defeat of the Carter Hawley Hale offer. The shareholders would have had $57.14 on the date of the $30 B.A.T. offer if the Carter Hawley Hale offer had been accepted and the proceeds reinvested at an eight-percent assumed rate. Although this rough calculation ignores a variety of factors, most importantly the impact of taxes on non-exempt Marshall Field shareholders, the point is clear: The plans of Marshall Field's management to secure greater value for its shareholders left something to be desired.

preclusive defensive tactics could be measurably reduced by treating all target shareholders equally. In the harder case where management alleged substantive coercion, the demands of an effective proportionality test would impose a discipline that would reduce management's incentives to resort to preclusive defensive tactics in the first place.

Consider how a searching review under the proportionality test might affect managers who were tempted to veto a hostile offer without a concrete plan to generate greater value, either through continued management of the company or through selling the company at a later, more advantageous time. In other words, suppose management simply preferred to maintain the company's independence, a not unfamiliar sentiment. The mere task of establishing a plausible claim of substantive coercion—of framing a credible plan for increasing the company's stock price in the shadow of a probing judicial review—would itself be a significant deterrent to management entrenchment. If management's initial opposition to the hostile offer were unreflected, the exercise of developing a plan capable of surviving serious review under the proportionality test would provide an occasion to reconsider the decision to resist. Even if management were coolly disposed to resist a hostile offer in full knowledge of its superiority, the duty to frame a plan—to put implausible expectations on paper—would tend to deter. The less plausible management's claims actually were, the more difficult management would find the task of constructing a plan. Beyond this, a bogus plan would invite future reputational losses and shareholder conflicts even if it did not create a risk of liability for its authors. After all, managers would find themselves in the uncomfortable position of having to live with values and timetables that they could not expect to meet.

Under an effective proportionality test, moreover, the difficulty of constructing a plausible but inaccurate account of future value would be increased by the reluctance of secondary participants in a target's decisionmaking to acquiesce in such an effort. Presumably any case for substantive coercion would involve investment bankers as valuation experts and outside directors as formal decisionmakers. For an investment banker, passing on the credibility of a specific management plan would differ from merely opining on the fairness of an offer price because it would involve both greater specificity and an accountability check. Management's plan will eventually either succeed or fail for reasons likely to be discernible at the time the opinion was rendered; subsequent events will measure the quality of the investment banker's earlier opinion. Thus, the reputational consequences of supporting ill-conceived plans would encourage a considerable measure of private enforcement by investment bankers.[77]

For independent directors, who must assume formal responsibility for implementing management's plan to generate value, there are even stronger reasons for expecting conscientious self-enforcement under an explicit proportionality

77. As the facts in *Anderson, Clayton* show, valuations by investment bankers already act as a constraint on preclusive defensive tactics under the proportionality standard. *See supra* notes 31–33 and accompanying text (investment banker placed similar values on management plan and hostile offer).

test. On the fair assumption that independent directors generally wish to discharge their duties faithfully—if only their duties are sufficiently clear—we would expect a searching internal analysis of any management plan that the board would be expected to justify in court. We would also expect that after ratifying such a plan, independent directors would take particular care to assure the faithful implementation of the plan or, if the plan could not be implemented, to rectify the resulting harm to target shareholders.

Finally, beyond creating incentives for self-enforcement, an effective proportionality test would harness the acquisitions market itself in screening representations about substantive coercion. If target management misrepresented the prospects for generating future value on behalf of its shareholders, in all probability a second hostile offer would eventually follow.[78] One reason to expect a second offer is that target share prices would be likely to decline to reflect management's failure to meet its projections.[79] However, a meaningful proportionality test would provide another reason: Given management's unsuccessful past performance, a second hostile offeror would have much less to fear from preclusive defensive tactics based on a claim of substantive coercion. In effect, target management's past failure with its initial plan would undermine its credibility and open the target to the market. As a result, target management —including its independent directors—would have little incentive to mislead the court knowingly by misrepresenting the firm's prospects in the first instance. At most, misrepresentation at the time of the initial offer would only buy target management temporary relief from the acquisitions market.

Together, then, the incentive effects of an obligation to document a claim of substantive coercion and the prospect of a market challenge to unrealistic representations make judicial review of management's plans under an explicit proportionality test a potentially powerful check on spurious defensive tactics. Although courts are not better equipped to evaluate management's representations about future value than the market, the important point is that courts do not need to be more expert than the market to play a screening role. Judicial review can force corporate *participants* themselves to articulate clearly the interests of shareholders, the duties of corporate fiduciaries, and the expectations of management. The processes set in motion by forcing management to articulate the concrete link between its plan and shareholder interests can, by its own force, shift management's institutional incentives enough to provide an effective screen against ill-conceived or self-interested defensive tactics. In the end, if courts require a persuasive showing of a threat to shareholder interests under the proportionality test, they will not have to make close decisions about the feasibility of particular business strategies: Corporate participants, including target managers, will pre-screen strategies for the courts.

78. Again, the experience of Marshall Field & Co. serves as an example. *See supra* notes 61–72 and accompanying text.

79. Recall that share prices decline to pre-bid levels when hostile offers for targets fail and no subsequent offer follows. *See supra* notes 55–60 and accompanying text.

CONCLUDING REMARKS

Our analysis of how an effective proportionality test might function demonstrates that the Delaware courts have room to carve out a workable intermediate standard of review between nominal scrutiny under the old *Cheff* standard on the one hand, and the intrinsic fairness test or the equally stringent broad reading of *Anderson, Clayton* on the other. The room for this intermediate standard is defined by the risk of substantive coercion: the prospect that shareholders who mistakenly disbelieve well-intentioned managers' representations about future value may be led to tender to a hostile bidder against their own best interests. This risk is the real threat that underlies the litany of coercive circumstances identified by *Unocal* and its progeny as a possible basis for preclusive tactics.

Yet, substantive coercion is a slippery concept. To note abstractly that management *might* know shareholder interests better than shareholders themselves do cannot be a basis for rubber-stamping management's pro forma claims in the face of market skepticism and the enormous opportunity losses that threaten target shareholders when hostile offers are defeated. Preclusive defensive tactics are gambles made on behalf of target shareholders by presumptively self-interested players. Although shareholders may win or lose in each transaction, they would almost certainly be better off on average if the gamble were never made in the absence of meaningful judicial review. By minimizing management's ability to further its self-interest in selecting its response to a hostile offer, an effective proportionality test can raise the odds that management resistance, when it does occur, will increase shareholder value.

Over the next year, the currents of corporate litigation are likely to bring the Delaware courts to a crossroads. A parade of novel defensive tactics, bolstered by the new Delaware takeover statute, has placed the power to defeat a hostile bid within reach of target managements. If the proportionality test lives up to its promise as a meaningful intermediate standard of review, it can do much to correct the widespread view that Delaware law has taken a definitive turn against hostile acquisitions. By contrast, if the proportionality test follows the rhetorical slide seemingly suggested by some aspects of the analysis in *Unocal* and *Ivanhoe Partners,* it will become little more than another reminder to business planners to watch what the Delaware courts do and not what they say.