

Of Lollipops and Law — A Proposal for a National Policy Concerning Tender Offer Defenses

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Early last year, Mesa Petroleum Company made a tender offer for shares of Unocal Corporation in an effort to take over Unocal. Unocal responded by using the "lollipop" defense, which is a discriminatory issuer self-tender offer. Unocal's use of this defense resulted in huge economic losses to many of Unocal's small shareholders who were not knowledgeable about the ramifications of their participation or non-participation in the tender offer. The Delaware Supreme Court upheld Unocal's use of this defense as an appropriate exercise of business judgment. A federal district court in California refused to strike down the lollipop under federal law because it was exclusively a state law question. In this Article, Professor Fiftlis argues that broad federal legislation is needed to limit possible abuses of the lollipop and similar tender offer defenses.

INTRODUCTION

In spring 1985, Unocal Corporation made a self-tender offer for its own shares in a successful effort to defeat a hostile "two-tier, front-end-loaded," tender offer by Mesa Petroleum.¹ The secret to Unocal's vic-

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References herein shall be to sections of the Securities Exchange Act of 1934 instead of to the United States Code.

¹ For a description, see *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) [hereafter *Unocal* (Del.)]; *Unocal Corp. v. Pickens*, 608 F. Supp. 1081 (C.D. Cal. 1985) [hereafter *Unocal* (Fed.)]. A "two-tier, front-end loaded" bid typically is a cash tender offer for a portion of the shares, usually in an amount sufficient to give the bidder control, to be followed by a freeze-out merger of the target with a subsidiary of

tory was its discriminatory exclusion of Mesa from the offer.

Unlike many currently popular tender offer defenses, the Unocal defense may operate successfully not only against two-tier, front-end-loaded bids, but also against partial bids without the second tier merger. In either of these circumstances, the issuer may offer to buy some or all of the shares not bid for by the hostile party. The crucial feature is that the issuer's offering price must be too high for the bidder to afford, yet not too high for the issuer. To illustrate, in simplest terms, and excluding many complicating factors of judgment: A hostile bidder deems the target worth no more than \$80 per share. It offers to buy fifty-one percent of the target for \$85 per share with the expectation of paying no more than \$74.79 per share for the remaining forty-nine percent in a second stage acquisition, for a blended price of \$80. Under these circumstances, the issuer might offer up to \$80 for the forty-nine percent if it has estimated value in the same amount as the bidder. Since the bidder cannot pay more than \$74.79 for the forty-nine percent after completing the first tier, the issuer presumably will succeed in its bid. In that case, if the bidder accepted the fifty-one percent, it would end up owning one hundred percent (as its shares become the only ones outstanding) at a cost of \$85 per share for the partially depleted company. Since the shares are worth only \$80, the bidder presumably will withdraw, leaving the issuer, if it proceeds with its self-tender, with a smaller company (unless the consideration is debt, which will leave the company with a higher debt-equity ratio). Thus, the issuer will have incurred an acceptable cost of only \$80 per share. Of course, it is also possible that after the hostile bidder withdraws, the issuer may do the same. However, this mutual withdrawal is not likely to occur because the issuer's management will foresee the impact on its

the bidder, in a "triangular merger" (i.e., one involving a subsidiary of the bidder), the merger price to be received being less than that received on the front-end tender offer.

The two-tier feature is said to be coercive because shareholders are induced strongly to tender at the higher first step price in order to avoid being squeezed out at the lower price in the second stage. Thus, even shareholders who would have preferred to remain shareholders of the firm will sell. Another effect is that sophisticated speculators and insiders are more likely to tender in the first stage than are small, unsophisticated ones. See *infra* text accompanying note 10.

The first stage of the technique has striking parallels to the cases involving sale of control by a single shareholder or group of shareholders for a control premium. See, e.g., *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955). Courts have generally permitted the sale of control at a premium despite theoreticians' views that the premium belongs to the corporation or all the shareholders. This concept is now being invoked in "equal price" statutes (without attribution, one may add). The debate has been one of the longest-run, unresolved questions of corporate law.

shareholders, who would be unlikely to support management thereafter.

This type of discriminatory issuer self-tender offer, which has been dubbed a "lollipop,"² was upheld by the Delaware Supreme Court³ as within the Unocal directors' business judgment. The hostile bidder was, in the court's view, either seeking "greenmail,"⁴ which the court ruled the directors were entitled to prevent, or planning to issue "junk bonds"⁵ for acquisition of the remaining forty-nine percent, which the Unocal directors were entitled to replace with higher quality Unocal debt.⁶ In a separate federal court proceeding in the Central District of California, Judge Tashima also refused to invalidate the Unocal lollipop under federal law because it was exclusively a question of state law. Judge Tashima held that "Congress never intended to substantively regulate tender offers."⁷

² See *Suckered by the "Lollipop" Ploy*, Wall St. J., Sept. 16, 1985, at 25, col. 1 (letter to editor from T. Boone Pickens, Jr.) [hereafter Pickens letter]; Cohen, *More Firms Using "Lollipop" Tactics to Fight Takeovers*, Wall St. J., Aug. 20, 1985, at 3, col. 4.

³ *Unocal* (Del.), 493 A.2d 946.

⁴ "Greenmail" is a premium payment by a target to the bidder for its target shares and a covenant not to do it again.

⁵ "Junk bonds" are high-risk, high-yield debt instruments. In the takeover situation, the typical arrangement is for an investment banker to call upon a stable of speculative investors for commitments to buy the bonds from the bidder for a fee, with the expectation that the takeover may or may not eventuate. If it does not, the committers have earned a fee without more. If the takeover is consummated, the expectation is that the merged companies will assume the debt.

For a comprehensive study of junk bonds, especially as they relate to takeovers, see CONGRESSIONAL RESEARCH SERVICE FOR THE USE OF THE SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION AND FINANCE OF THE HOUSE COMM. ON ENERGY AND COMMERCE, *THE ROLE OF HIGH YIELD BONDS [JUNK BONDS] IN CAPITAL MARKETS AND CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS*, 99th Cong., 1st Sess. 99-W (Comm. Print 99-W 1985).

Mesa's president, T. Boone Pickens, has asserted that neither he nor Unocal ever contemplated that Mesa should receive greenmail. See *The World According to Pickens*, BARRON'S, Sept. 23, 1985, at 8, 9.

The issue of precisely when directors have license to oppose a hostile bid in their business judgment, or to mount prebid defenses, is not likely to be settled in a manner that will avoid the need for case-by-case adjudication. Compare, e.g., *Unocal* (Del.) with *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239 (Del. 1985) (business judgment rule did not prevent avoidance by the court of the target's defense). This Article, however, is concerned with federal law only.

⁶ *Unocal* (Del.), 493 A.2d at 956-57.

⁷ *Unocal* (Fed.), 608 F. Supp. at 1082. The court also stated that "state courts [have the jurisdiction] to deal with substantive issues of corporation law and corporate gov-

The result, according to Mesa's president, was that the Unocal shareholders who tendered to Unocal received a blended value of \$43 when, without the Unocal self-tender, all shareholders would have received a blended value of \$54 per share from Mesa.⁸ Perhaps more disturbing are the additional consequences: Unocal insiders received the \$72 front-end price for a portion of their shares, and Mesa received the \$72 for a portion of its holdings when it settled as defeat became apparent. The holders of twenty million Unocal shares, who never tendered their shares, wound up with shares valued at \$29.⁹ Mesa's president later stated the obvious: "These shares were presumably owned by small, unsophisticated shareholders who were not adequately informed about the consequences of not participating in the exchange. As a result, these shareholders lost \$300 million. Unocal's directors and officers, on the other hand, were able to . . . receive a portion of the \$300 million these shareholders left on the table."¹⁰ One might add: "as was Mesa."¹¹

One may properly ask whether it is appropriate for Delaware, which conceivably may not be the abode of a single Unocal shareholder, to fix national policy in an international securities market, while Congress and the federal courts, Nero-like, abdicate a policymaking role. Indeed, if the reputed actualities of Delaware lawmaking are taken into account,¹² the question is: is it appropriate for perhaps four or five lawyers in Delaware to fix that national public policy?

The question is not limited to the lollipop defense to takeovers. It applies to most defenses because the law of the target's state of incorporation, not federal law, regulates the validity of defenses.¹³ The only

ernance, including issues of the fairness in a corporation's treatment of its shareholders." *Id.* at 1083.

⁸ See Pickens letter, *supra* note 2.

⁹ *Id.*

¹⁰ *Id.*

¹¹ Lollipops need not take the simple form of the Unocal discriminatory tender offer. They would include any discriminatory offers, such as "poison pills," which give certain rights to all but the shares of a hostile bidder; these rights hinder the hostile bid by increasing its costs. *See infra* note 20. For example, Revlon, early in the takeover by Pantry Pride, issued rights to its holders other than Pantry Pride to allow them to sell their shares back to the company at a premium. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239 (Del. 1985).

¹² *See, e.g.,* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969).

¹³ *See* *Gearhart Indus. Inc. v. Smith Int'l*, 741 F.2d 707, 719 n.4 (5th Cir. 1984), in which the court felt compelled to scold counsel for forgetting that the usual choice-of-

defenses clearly governed by federal law are those involving a target's disclosure failings.¹⁴ In most states, this means that management may raise defenses, without shareholder consent, in the exercise of its "business judgment."¹⁵

As we shall see, the SEC's position, contrary to Judge Tashima's view, is that the lollipop defense is unlawful under existing federal law, and the Commission is currently proposing an explicit rule to outlaw the defense.¹⁶ The question of whether the SEC is correct may be

law rule selects the law of the state of incorporation to regulate internal affairs. The choice of law of the state of incorporation to regulate target management defenses is not constitutionally compelled by the due process, impairment, or full faith and credit clauses. See Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1968); Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955); see also discussion in *Norlin v. Rooney Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984). Of course, the Commerce Clause may prohibit a state from adopting tender offer legislation that may unduly burden commerce. See, e.g., *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). Also, due process prohibits a state with no relevant interests from regulating any person. *Home Ins. Co. v. Dick*, 281 U.S. 397 (1930).

¹⁴ See *infra* text accompanying notes 28-32.

¹⁵ See, e.g., *Unocal* (Del.), 493 A.2d 946; see also *Moran v. Household Int'l*, 500 A.2d 1346, 1350 (Del. 1985):

Other jurisdictions have also applied the business judgment rule to actions by which target companies have sought to forestall takeover activity they considered undesirable. See *Gearhart Industries, Inc. v. Smith International*, 5th Cir., 741 F.2d 707 (1984) (sale of discounted subordinate debentures containing springing warrants); *Treco, Inc. v. Land of Lincoln Savings and Loan*, 7th Cir., 749 F.2d 374 (1984) (amendment to by-laws); *Panter v. Marshall Field*, 7th Cir., 646 F.2d 271 (1981) (acquisitions to create antitrust problems); *Johnson v. Trueblood*, 3d Cir., 629 F.2d 287 (1980), *cert. denied*, 450 U.S. 999 (1981) (refusal to tender); *Crouse-Hinds Co. v. InterNorth, Inc.*, 2d Cir., 634 F.2d 690 (1980) (sale of stock to favored party); *Treadway v. Care Corp.*, 2d Cir., 638 F.2d 357 (1980) (sale to White Knight); *Enterra Corp. v. SGS Associates*, E.D. Pa., 600 F. Supp. 678 (1985) (standstill agreement); *Buffalo Forge Co. v. Ogden Corp.*, W.D.N.Y., 555 F. Supp. 892, *aff'd* (2d Cir.), 717 F.2d 757, *cert. denied*, 104 S. Ct. 550 (1983) (sale of treasury shares and grant of stock option to White Knight); *Whittaker Corp. v. Edgar*, N.D. Ill., 535 F. Supp. 933 (1982) (disposal of valuable assets); *Martin Marietta Corp. v. Bendix Corp.*, D. Md., 549 F. Supp. 623 (1982) (Pac-Man defense) (only partial citations included).

When management's self-interest is implicated, the standard is altered. *Id.*

¹⁶ SEC Rel. No. 33-6596 [1984-85 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,798 (July 1, 1985) (proposing amendments to Rule 13e-4). The Commission, in Release 33-6595 (July 1, 1985), concurrently proposed Rule 14d-10, among other things, to require third party tender offers to be made to all holders. SEC Rel. No. 33-6596 [1984-85 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,797.

mooted before publication of this Article if the SEC decides not to adopt its proposal, or if a court, after adoption, upholds or strikes down the rule.¹⁷ Nevertheless, the lollipop is the vehicle of discussion here because it is the subject of current interest. We shall see that the SEC is probably wrong. However, even if courts uphold the proposed rule, or if the rule stands unchallenged, state law will continue to regulate exclusively numerous other target company defenses. Therefore, this Article's subject will have continued relevance.

The lollipop defense illustrates vividly the problems arising in the law governing tender offer defenses. The SEC and the federal courts are generally impotent in regulating tender offer defenses under existing law. Thus, Congress must set national policy to replace state law. This Article argues that when Congress assumes that responsibility, it should not attempt to establish a comprehensive policy, but should leave that task to the SEC and the federal courts. However, the states should continue to regulate these defenses until the SEC fully formulates a national policy.

The recommended legislation to achieve these goals is straightforward and simple. The only alteration necessary is to include in the definition of the term "manipulative" as used in the tender offer anti-fraud section (section 14(e) of the 1934 Act) "all cunning devices," as defined by SEC rules, even if not based on misrepresentations or non-disclosures. This definition is more in keeping with the generally understood meaning of the term and perhaps the original understanding of Congress when it adopted the Williams Act in 1968, as this Article later discusses. This legislation would validate the SEC's proposals concerning lollipops. It also would legitimize several other questionable extant rules of the Commission.¹⁸ It would enable the Commission to act on a case-by-case basis to consider whether to adopt rules concerning two-tier deals, "lock-ups,"¹⁹ "poison pills,"²⁰ "superstock,"²¹ and the

¹⁷ Some securities lawyers have expressed the view that the validity of the proposals, if adopted, may go untested because issuers will not be willing to sue at the risk of delaying defensive steps. *See, e.g.*, oral remarks of Ralph Ferrara, former general counsel of SEC, at 18th Annual Rocky Mountain State-Federal-Provincial Securities Conference, Oct. 18, 1985. Harvey Pitt, another former general counsel of the Commission who was present at the same meeting, seemed to concur.

¹⁸ For example, it has been suggested that after *Schreiber v. Burlington Northern, Inc.*, 105 S. Ct. 2458 (1985), discussed *infra* text accompanying notes 28-30, rule 14e-1, requiring all tender offers to remain open for 20 business days, may be invalid. *See Pitt & Cherno, Williams Act Rejected as Tool to Ensure Fairness*, Legal Times, June 17, 1985, at 27.

¹⁹ "Lockups" are of two varieties, each of which may take the form of either an

like. Because the proposal would operate only if the SEC adopts a rule,

option or a grant. Under one, the target grants to a white knight (*i.e.*, a friendly suitor brought in by the target as a rival to the hostile bidder because it is believed that the target will gain greater benefits) shares, or an option to purchase shares, of the target sufficient to give it a high probability of success in a tender offer to defeat a hostile bidder. The other is a grant or an option to buy valuable assets or a business line (the "crown jewel") of the target, usually at a bargain price. Some would distinguish invulnerable lockups from vulnerable ones by terming the latter "leg-ups." But exactitude is not suited to jargon; it would profit one little to pretend to such precision.

Two important recent decisions deal with the validity of lockup options. *Hanson Trust PLC v. SCM Corp.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,376 (2d Cir. 1986) (independent directors had an enhanced duty of care when granting, in the face of a hostile bid, a lockup option to assure a leveraged buyout in which management is participating; failure to inquire as to bases for advice of counsel and financial advisers is negligent when the possible effect of the lockup is to cut off bidding or otherwise cause shareholders harm); *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,333 (Del. Ch. 1985), *aff'd*, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,357 (Del. 1985) (lockup granted to one bidder to be tested by duty of loyalty once directors have decided to auction the company in a bidding contest; duty of loyalty applicable at least when management is partially motivated by concern for its own liability and when the lockup precludes further bidding).

For the ultimate invulnerable lockup, see *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 464 U.S. 1018 (1983), described *infra* text accompanying notes 58-64.

²⁰ "Poison pills" are various but are typified by the technique explained in *Moran v. Household Int'l*, 500 A.2d 1346 (Del. 1985). The basic concept is that if the bidder succeeds in its takeover, it will receive a company subject to liabilities that will make the takeover fatal. For example, the target may provide that its shareholders will be entitled to options to purchase shares of the surviving corporation (should a merger occur) or of the target (after a takeover without a merger) for half price.

²¹ "Superstock" is a stock that has disproportionately high voting power in a format that is undesirable to a bidder. For example, American Family holders voted in 1985 to multiply all votes by 10, but required any subsequent shareholder to hold for four years before becoming entitled to the extra nine votes per share.

The New York Stock Exchange ostensibly has a policy against disparate voting for common stock. See NEW YORK STOCK EXCHANGE COMPANY MANUAL (CCH) §§ A-30, A-31. It is reconsidering this policy because it has lost some listings recently and may have to delist several companies which are now in violation. See INITIAL REPORT OF THE SUBCOMM. ON SHAREHOLDER PARTICIPATION AND QUALITATIVE LISTING STANDARDS, DUAL CLASS CAPITALIZATION, Jan. 3, 1985. Since SEC approval of stock exchange rules is required (*see* § 19(b) of the 1934 Act), the Commission has used its power to prod the exchange to reconsider its reconsideration; but to avoid unfair competition the Commission has urged the other exchanges and the NASD to agree to identical policies. Congress is waiting in the wings. Presumably the problem will be resolved sometime in 1986.

Interestingly, no one seems to question the propriety of federal law being applied in this context to a tender offer defense. Perhaps that is because most observers do not

the statute would preserve the states as the primary lawmakers until and unless the SEC acts. Further, a more visible federal forum would exist for making tender offer policy, in contrast to the murky procedures now followed in many state capitols.²² Finally, the proposed legislation would enhance flexibility; the SEC could act more quickly than Congress, congressional oversight would provide a constraint on radical actions, and rulemaking procedures would assure due process. Each of these felicitous results appear more desirable than the current state of affairs.

I. THE PRESENT IMPOTENCY OF THE SEC AND THE FEDERAL COURTS REGARDING TENDER OFFER DEFENSES — A CASE HISTORY

The lollipop has been touted as an extremely powerful defense to hostile two-tier and partial bids since the Unocal battle, to the great discomfort of the SEC. The Commission was dissuaded from intervening in the California federal court case, probably because it was in a vulnerable strategic position.²³ Subsequently, however, it published a proposal to outlaw lollipops by requiring self-tender offers to be made to all holders of the class of security being sought.²⁴ It also published another proposed rule to apply the same "all holders" rule to third party bids.²⁵ In its two releases, the Commission asserted that the lollipop, and any other discriminatory bid, always has been unlawful even without the proposed rules. The Commission contends that the Williams Act contains "an implicit requirement for equal treatment of security holders" under both section 14(d), regulating offers by third parties,²⁶ and section 13(e), regulating issuers' securities acquisitions

believe that federal law is applied when a stock exchange enacts a rule, although those rules are subject to SEC approval or even initiation. That belief seems incorrect.

²² Most securities lawyers are well aware that much takeover legislation is lobbied through by one or a very few companies in any particular state and that state legislators have in mind only the immediate local interest of those companies.

²³ See Victor, *Unocal: Questions Remain*, Legal Times, June 3, 1985, at 1. The article explains that both sides had lobbied the SEC heavily in *Unocal* concerning intervention and that three factors were important in its decision not to intervene: (a) each side was well-represented; (b) the Commission had earlier proposed but failed to adopt an all-holders rule; and (c) Mesa's hands were somewhat soiled in the view of Judge Tashima, who had earlier found failures to disclose and active concealment with respect to § 13(d) filings concerning Mesa's intentions to seek control of Unocal.

²⁴ See *supra* note 16.

²⁵ *Id.*

²⁶ See [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 87,560. The Williams Act, 82

including tender offers.²⁷ These provisions thus prohibit offers not made to all holders of any class of securities for which an offer is made. The releases do not point to explicit language or articulated policies of the Act to establish this all holders rule, and it is difficult to find any in the text of the statute.

Given the potency of lollipops, the two *Unocal* court decisions, and the SEC's all holders rule proposals, it is necessary to consider two questions: (1) whether the lollipop is now illegal under federal law, as the Commission claims, contrary to Judge Tashima's opinion, and (2) whether the Commission's proposed rules would be valid if adopted. This Article's conclusion is that it is extremely unlikely that the Commission is correct on either score.

A. *The Schreiber Opinion*

Last term, in *Schreiber v. Burlington Northern, Inc.*,²⁸ the Supreme Court held that in the absence of misrepresentation or nondisclosure, there is no "manipulative" act in connection with a tender offer and therefore no transgression of section 14(e) of the Williams Act.²⁹ Thus

Stat. 455, was originally codified in 1968 as §§ 13(d), (e) and 14(d), (e), (f) of the Securities Exchange Act of 1934.

²⁷ See [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 87,570. Section 13(e), the rules-enabling act for all issuer repurchases, reads in pertinent part:

It shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 12 of this title, or which is a closed-end investment company registered under the Investment Company Act of 1940, to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices. Such rules and regulations may require such issuer to provide holders of equity securities of such class with such information relating to the reasons for such purchase, the source of funds, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and such additional information, as the Commission deems necessary or appropriate in the public interest or for the protection of investors, or which the Commission deems to be material to a determination whether such security should be sold.

²⁸ 105 S. Ct. 2458 (1985).

²⁹ Section 14(e), a general antifraud provision concerning tender offers, reads:

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

nondeceptive tender offers or defenses thereto, even if unfair, are not subject to section 14(e). Perhaps more importantly, the Court made clear that the grant to the SEC of rulemaking power in the last sentence of section 14(e) is also limited to regulation of manipulative acts involving only misrepresentation or nondisclosure, including prophylactic measures, only if designed to prevent deception or nondisclosure. This appears from the Court's statement that the Commission has "latitude to regulate nondeceptive activities" but only "as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself."³⁰

Thus, one significant effect of *Schreiber* is to throw into question the prophylactic rules, such as rule 14e-1, adopted under section 14(e). The significance of the potential invalidity of rule 14e-1 is far greater than may at first meet the eye. The rule requires all tender offers (even those not involving offers regulated by sections 14(d) and 13(e) — that is, offers by 1934 Act registrants, certain closed-end mutual funds and insurance companies³¹) to remain open for a minimum of twenty days after the offer commences. Therefore, many state statutes that conflict with this requirement may be preempted, as, for example, was the Michigan takeover statute.³² Obviously, however, if 14e-1 is invalid, it can have no preemptive effect.

Schreiber was an easy case in which the Supreme Court resolved the most important tender offer law problem of the term, if not the decade, although, as Harold Bloomenthal points out, the case itself did not pose the problem.³³ *Schreiber* marks the completion of a trilogy of Supreme Court decisions dealing with the term "manipulative" in the antifraud

manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative.

It is not absolutely clear whether a negligent nondisclosure or misrepresentation may be a manipulation under § 14(e), but *Schreiber*, in the light of the Court's opinions involving § 10(b) of the same act, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and *Aaron v. SEC*, 446 U.S. 680 (1980), would seem to preclude liability for negligent nondisclosure or misrepresentation.

³⁰ 105 S. Ct. at 2458 n.11.

³¹ Insurance companies are regulated only by § 14(e), not § 13(e).

³² *L.P. Acquisition Co. v. Tyson* [Current Vol.] *FED. SEC. L. REP. (CCH)* ¶ 92,271 (6th Cir. 1985).

³³ Bloomenthal, *RICO, Pari Delicto, Deception, and the Supreme Court*, 7 *SEC. AND FED. CORP. L. REP.* 49, 53-55 (1985).

provisions of the 1934 Act.

The first of the cases, *Ernst & Ernst v. Hochfelder*,³⁴ held that scienter is necessary for both deceptions and manipulations under rule 10b-5.³⁵ The Court also referred to the term “manipulative” in section 10(b), stating first it is “virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”³⁶ The Court took this definition of “manipulative” from the second edition of Webster’s International Dictionary, published in 1934.³⁷ The purpose of the Court’s statement was to substantiate its holding that negligent conduct was not included. It did not define manipulations beyond requiring scienter. Moreover, the Court not only spoke of deception, but also included an alternative design to “defraud,” a concept that could well have included nondeceptive acts.³⁸

The Court described the legislative history of the section as “bereft of any explicit explanation of Congress’ intent.”³⁹ It then relied on the legislative history of section 10(b) to show that it was by no means clear that Congress intended to require misrepresentation or nondisclosure for a manipulation.⁴⁰ The Court noted that an early draft of the section would have allowed the SEC to outlaw the use of “any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors.”⁴¹

³⁴ 425 U.S. 186 (1976).

³⁵ Section 10(b) of the 1934 Act reads:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

³⁶ 425 U.S. at 199.

³⁷ *Id.* at 199 n.21.

³⁸ For example, see some of the early cases under rule 10b-5 that were cited and overruled in *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), discussed *infra* notes 46-48 and accompanying text.

³⁹ 425 U.S. at 201.

⁴⁰ *Id.* at 201.

⁴¹ *Id.*

Clearly this draft of the section was not intended to require deception. However, the Court stated that this broad power was “abbreviated and modified” in a later draft to make unlawful by statute “any manipulative device or contrivance.”⁴² The Court, however, failed to describe how Congress modified the prior draft. After pointing out that this history left the “intended scope of section 10(b)” unclear (still addressing the issue of whether negligence was sufficient), the Court went on to state:

The most relevant exposition of the provision that was to become § 10(b) was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:

“Subsection (c) (section 9(c) of H. R. 7852 — later section 10(b)) says, ‘Thou shalt not devise any other cunning devices.’ . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices.” Hearings on H. R. 7852 and H. R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934).

This brief explanation of § 10(b) by a spokesman for its drafters is significant. The section was described rightly as a “catchall” clause to enable the Commission “to deal with new manipulative [or cunning] devices.”⁴³

Thus, it seems the *Hochfelder* Court’s view was that the only legislative history in point indicated that Congress purposefully left the term “manipulative,” although a “term of art,” undefined. This, the Court concluded, was to give the SEC flexibility in drafting rules to proscribe new and artful or “cunning” devices, albeit excluding those lacking in scienter. But if “manipulative” meant cunning devices as a catchall category, *Hochfelder* did not purport to limit them to a small segment of all cunning devices — those involving misrepresentation or nondisclosure. Clearly *Hochfelder* had left undecided any question of whether a manipulation required deception or nondisclosure; all the legislative history it cited was characterized to include a broad range of intentional wrongdoing — perhaps including “cunning devices” not based on deception but merely amounting to unfair use of power.

Hence, a shareholder might believe she had a claim for manipulation if she knew about it but was powerless to prevent it. The fact that in popular parlance many people speak of someone being “manipulated,”

⁴² *Id.* at 201-02.

⁴³ *Id.* at 202-03.

although not deceived, bolsters this conclusion.⁴⁴ Manipulation includes misuse of power, not just the use of misrepresentation or nondisclosure — the oft-sought resources of those without power. Indeed, the Second Circuit on a petition for rehearing in *Green v. Santa Fe*⁴⁵ saw no obstacle in *Hochfelder* to a finding that manipulations may include nondeceptive acts. But the Supreme Court in the second case of the trilogy, *Santa Fe*,⁴⁶ reversed the Second Circuit, holding that a short-form, cash-out merger forced upon minority shareholders by a parent corporation at an unfair price was not a “manipulation” under rule 10b-5 when the parent had disclosed data as to the fairness of the price. The Court assumed, as did the parties, that the exclusive remedy for the unfair price was a dissenter’s appraisal right under state law and reasoned that the plaintiffs, having received full disclosure prior to the time for exercise of their rights, had not been deceived in a way that caused them loss.⁴⁷ The Court then recognized only the first part of the *Hochfelder* dicta, which stated that “manipulative” was a term of art. The Court found that “[t]he term refers *generally* to practices, such as wash sales, matched orders, or rigged prices, that are intended to mis-

⁴⁴ WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY (1971) includes in its definitions of “manipulate” the following:

1: to treat, work, or operate with the hands or by mechanical means: handle or manage esp. with skill or dexterity. . . . 2 a: to treat or manage with the mind or intellect [nature may be so *manipulated* that mathematical laws may be applied to it — M.R. Cohen] [if we can only quantify our material and [manipulate] it statistically — S.L. Payne] . . . b (1) : to control the action or course of by management : utilize by controlling and managing [providence has strangely *manipulated* events toward this end — Agnes S. Turnbull] [wealth is *manipulated* much as it is in our society — Abram Kardiner] [*manipulating* a situation to achieve certain advantages — F.G. Hawley] (2) : to control, manage, or play upon by artful, unfair, or insidious means esp. to one’s own advantage [*manipulated* the Indians for national purposes, involving them in successive wars — H.M. Hyman] [knew how to [*manipulate*] his weaknesses — Mary Deasy] [being used and *manipulated* by the knowing men around him — *New Republic*] . . .

Clearly the word extends beyond misrepresentation and nondisclosure in nonlegal contexts.

⁴⁵ *Green v. Santa Fe Indus.*, 533 F.2d 1283 (2d Cir. 1976), *aff’d in part and remanded in part*, *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977). The Second Circuit panel decided *Green* on Feb. 18, 1976, before *Hochfelder* was decided on Mar. 30, 1976. The Second Circuit, however, denied rehearing after *Hochfelder*, on June 30, 1976.

⁴⁶ 430 U.S. 462.

⁴⁷ *Id.* at 474 n.14.

lead investors by artificially affecting market activity” and that “non-disclosure is *usually* essential to the success of a manipulative scheme.”⁴⁸ It then went on to determine that it did not believe that Congress intended the present squeeze-out to be included in the term “manipulative.”

Thus, the Court had not yet held that misrepresentation or nondisclosure was a necessary condition to a 10b-5 violation; it was merely a usual incident. The Court seemed instead to hold that the unfair squeeze-out was not of the same nature as the classic manipulations it had described, most of which involved some element of deception. In fact, the Court stated that by this decision it did no more than “adhere to the position that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.”⁴⁹ Here, the Court relied on the case that extended 10b-5 to its farthest boundaries, *Superintendent of Insurance v. Bankers Life & Casualty Co.*⁵⁰ In Part IV of the *Santa Fe* opinion, which drew three dissents, the Court also held that 10b-5 did not cover traditional state law fiduciary breaches.

The Court was correct in not overstating its position, because some classic manipulations do not require deceit. For example, a “corner” on the market in which a manipulator controls the supply of a commodity or security does not depend on misrepresentation; nor does a bear raid⁵¹ whereby supply is artificially increased to depress prices. Of course, secrecy or misrepresentation, as the Court said in *Santa Fe*, and as in the case of any wrongdoing, usually accompanies these manipulations and will facilitate success.

Santa Fe, to the credit of the opinion’s author, Justice White, avoided relying on Webster’s Dictionary to define “manipulative.” However, *Santa Fe* also paid little heed to what Justice Powell in *Hochfelder* described as “[t]he most relevant exposition” of section 10(b): its statement that “Thou shalt not devise any other cunning devices.” The Court also ignored the *Hochfelder* Court’s characterization of 10(b) as a catchall clause to enable the Commission to deal with new manipulative or cunning devices.⁵²

⁴⁸ *Id.* at 476-77 (emphasis added).

⁴⁹ *Id.* at 479.

⁵⁰ 404 U.S. 6, 12 (1971). However, the *Santa Fe* Court was also at pains to find a deception in the *Superintendent of Insurance* case as well.

⁵¹ A bear raid is the sale of securities or a commodity in quantities and under circumstances designed to reduce the price because of the excessive supply forced on the market.

⁵² *Santa Fe*, 430 U.S. 462, 468.

The facial inconsistency between the "catchall" purpose and the description of the term as one of art was not commented upon, perhaps because it was unnoticed, or perhaps because artfulness was not intended to connote a restricted list of classic manipulations. Nevertheless, at no point did *Santa Fe* categorically compel nondisclosure or deception in order to establish a manipulation. This tension set the stage for the Court to consider whether tender offer defenses not involving deception or nondisclosure might nevertheless "artificially [affect] market activity" and hence be held manipulative under section 14(e).

Tender offer defenses inherently involve efforts by issuers' managements either to raise the cost of shares or the transaction costs to a bidder or to inhibit or otherwise prevent purchases altogether. In the lay sense, as Webster's Third Edition clearly shows, these are "manipulations" of the securities market in the target's shares since to manipulate simply means to treat, work, or operate with the mind or intellect, a meaning derived from the original meaning, which is treatment or working by the hands.⁵³ Indeed, congresspersons seeking to articulate in a word the general character of defensive measures by target managements could reasonably settle on "manipulation" as being most descriptive even of those not including deception or nondisclosure. As the above discussion demonstrates, the ultimate language of section 10(b) may not have modified congressional intent.

Moreover, section 14(e), involving tender offers, clearly furthers policies different from section 10(b).⁵⁴ While section 14(e) resembles section 10(b), it also resembles section 14(a) and the proxy rules thereunder, and closely resembles the terminology of section 15(c)(2). The courts therefore were free to decide on the basis of logic and policy, unconfined by legislative history, precedent, the policies behind rule 10b-5, or statutory language, whether manipulations in the tender offer context could include nondeceptive acts.

The ensuing history is generally familiar to securities lawyers. The issue was posed in the Mobil Oil hostile offer for Marathon Oil stock when Marathon granted two lock-up options to U.S. Steel, one of which involved Marathon's crown jewel, the Yates oil field. In a widely discussed⁵⁵ opinion, the Sixth Circuit held that Marathon (but not U.S.

⁵³ See *supra* note 44.

⁵⁴ See *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538, 1544 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984); Loewenstein, *Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons*, 71 GEO. L.J. 1311 (1983).

⁵⁵ See, e.g., Nelson, *Mobil Corp. v. Marathon Oil Co. — The Decision and Its*

Steel) had manipulated the price of its stock in violation of section 14(e), despite the lack of deception or nondisclosure.⁵⁶ However, several other courts of appeal soon thereafter refused to follow suit, reading the *Santa Fe* 10b-5 opinion to require deception or nondisclosure under section 14(e).⁵⁷

With the aid of prior decisions, Judge Sofaer, in the district court opinion in the *Data Probe* case, which was reversed on appeal,⁵⁸ viewed both lines of cases as failing adequately to consider the issues. In the most thoughtful opinion on this issue to date, he held that manipulations under section 14(e) may include an unfair scheme, even absent deception, that effectively blocks the free choice of a target's shareholders to accept or reject a hostile bid. The Second Circuit panel based its reversal on considerations of federalism, later endorsed by the Supreme Court in *Schreiber*.⁵⁹

In *Data Probe*, in the face of a hostile bid, the target's management had simply entered into a friendly merger agreement at \$1.40 per share. It also granted a lock-up option to the merger partner to purchase shares equal to 200 percent of the number then outstanding at \$1.40 each, thereby assuring the partner at least two-thirds of all shares. The partner's position was thus guaranteed regardless of whether existing shareholders tendered all their shares to the hostile bidder and regardless of how any shareholders other than the merger partner voted for the proposed merger. The hostile bidder's offer was \$1.55 but, of course, was conditioned on the competing merger not being completed.

Judge Sofaer framed the issue as follows: whether the Williams Act permits the management of a target company, without a shareholder voice, unilaterally to thwart an ongoing tender offer by granting to one contestant an option that effectively precludes further bids.⁶⁰ He sug-

Implications for Future Tender Offers, 7 CORP. L. REV. 233 (1984); Profusek, *Tender Offer "Manipulation": Tactics and Strategies After Marathon*, 36 SW. L.J. 975 (1982).

⁵⁶ *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982).

⁵⁷ *Feldbaum v. Avon Prods.*, 741 F.2d 234 (8th Cir. 1984); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983).

⁵⁸ *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F.Supp. 1538 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 464 U.S. 1052 (1984).

⁵⁹ This Article's position is that federalism concerns required the affirmance of Judge Sofaer in *Data Probe*, not reversal. See *infra* part III.

⁶⁰ 568 F. Supp. at 1545. In the Pantry Pride takeover of Revlon, the Delaware court

gested this as a more realistic statement of the issue than the typical issue proposed by target lawyers: whether the Williams Act is more than a disclosure statute.⁶¹

He then discussed the legislative history of the Williams Act, which he felt indicated a dual legislative purpose including not only full disclosure but also a fair opportunity for shareholders to use the disclosures.⁶² Analyzing the Sixth Circuit's *Marathon* decision, he pointed out the difference between market trading (the object of 10b-5) and tender offer battles (the object of 14(e)) in order to suggest the possibility for different meanings of the term "manipulative" within each section.⁶³ But because of concern that the *Marathon* test of artificial im-

struck down under state law such an invulnerable lockup on the basis of what the court characterized as a "component of the business judgment rule" — the duty of loyalty when the directors were motivated in part by self-interest. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,222 (Del. Ch.), *aff'd*, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,357 (Del. 1985). (This characterization must come as a surprise to corporate lawyers who have generally believed that, if anything, the business judgment rule is a component of the duty of care.)

The opinion attempts to draw a fine line between situations in which "there is only one genuine bidder in the picture and there is a risk of losing his participation in a fast-moving situation" (a valid lockup) and the *Revlon* situation in which the option is granted after two bidders are in the picture. In the latter case, the court said, if self-interest motivates the directors, the lockup is void. This line drawing is unsatisfactory since in both cases the effect of the lockup is to avoid an auction. But the question of the correctness of *Revlon* is beyond the scope of the subject matter of this Article.

In *Data Probe, Inc. v. CRC Information Sys.*, No. 92138-1983 (N.Y. Sup. Ct. 1982), the court reached essentially the same conclusions as a matter of New York state law as the chancellor had in *Revlon* under Delaware law.

See also *Hanson Trust PLC v. SCM Corp.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,376 (2d Cir. 1986), in which the court found that there is an enhanced duty of care for directors in granting a lockup in a leveraged buyout involving management when the directors by their actions risk causing loss of a better deal for shareholders. None of these state law cases is well articulated, and turmoil in subsequent decisions may be confidently predicted. Indeed one gets the impression that the Delaware court, at least, may be reacting out of fear of federal intervention, just as they did in the squeezeout cases. See *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977). However, once the pressure for federal intervention diminished, Delaware reverted to its old ways. *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983). This further evidences the value of the position taken in this Article — that there is need for SEC rulemaking pursuant to new enabling legislation.

⁶¹ 568 F. Supp. at 1545.

⁶² *Id.* at 1545-47.

⁶³ *Id.* at 1549, 1555. The market for corporate control, partially regulated by the Williams Act, is distinct from the capital markets, which are impacted by regulation of fiduciary duties generally. Winter, *State Law, Shareholder Protection, and the Theory*

pact on market prices might be too broad, Judge Sofaer stated he would outlaw only options that "unduly interfere with the tender offer process,"⁶⁴ thereby allowing defenses that encourage auctions but not those that conclusively determine the contest, as in the *Data Probe* lock-up. The judge left the line between these two categories to be drawn on a case-by-case basis. Thus the grant of an option for perhaps fifteen to twenty percent of the target may be acceptable because, in the best interests of shareholders, it would encourage competitive bidding in an auction for the target. On the other hand, the 200 percent option in *Data Probe* would be invalid as preventing an auction.

On appeal the Second Circuit reversed because it believed *Santa Fe* and Second Circuit decisions required deception for a manipulation under section 14(e) and because, as stated in Part IV of *Santa Fe*, breaches of fiduciary duty traditionally are for state courts. The Second Circuit gave short shrift to Judge Sofaer's thoughtful views.

The Supreme Court denied certiorari in *Data Probe*, as it had in *Marathon*, but accepted certiorari in the third case of the trilogy, *Schreiber v. Burlington Northern, Inc.*,⁶⁵ which did not involve the important issue of the validity of nondeceptive tender offer defenses. Instead, *Schreiber* involved a rather insignificant situation in which the bidder made a hostile partial tender offer but withdrew it, as permitted by the terms of the offer, when the target and the bidder settled their differences. The compromise was that the bidder make a new partial bid benefiting insiders by cutting down on the number of shares purchased from outsiders, including the plaintiff who had accepted the first bid. The plaintiff, a target shareholder, claimed she was wronged because if the first bid had been accepted rather than opposed by insiders, a larger number of her shares would have been accepted. The Supreme Court found no manipulation, a result with which one could hardly quarrel.⁶⁶ However, the Court based its holding on the broadest possible ground — that deception or nondisclosure was necessary to a manipulation. The Court thus confirmed opinions like those of the Second Circuit in *Data Probe* and overruled *Marathon*, but without the benefit of the *Data Probe* or *Marathon* records and arguments.

The Court in *Schreiber* categorically ruled that all manipulations must involve deception or nondisclosure. This sharply contrasts with its

of the Corporation, 6 J. LEGAL STUD. 251, 287-89 (1977).

⁶⁴ 568 F. Supp. at 1551.

⁶⁵ 105 S. Ct. 2458 (1985).

⁶⁶ See Bloomenthal, *supra* note 33, at 53, 54.

carefully worded opinion in *Santa Fe*,⁶⁷ which stated that deception “usually” accompanies manipulation and held that the squeeze-out was not “manipulative” under rule 10b-5. The Court’s categorical ruling in *Schreiber* was broad dicta, not only undocumented but contrary to well-accepted notions that courts should decide only issues presented by the case.

This overbreadth is merely one item of evidence of the lack of care that went into this opinion. Further evidence is *Schreiber*’s reference to Webster’s Third New International Dictionary to bolster its decision. In a stultifying *faux pas*, the Court quoted a portion of the definition of “manipulation” as “management with use of *unfair*, scheming, or underhanded methods.”⁶⁸ This to uphold its decision that manipulation does not include unfairness! The Court also overlooked that *Hochfelder* had relied on Webster’s second edition, published in 1934, for the definition of “manipulation” concurrent with the enactment of section 10(b). The second edition’s definition was very different from that of the third, and seemed to require deception. By 1971, Webster’s meaning was changed to include nondeceptive artifices, but the Court, in quoting the new language, apparently failed to read it.⁶⁹ This error is cited only to support the charge of inadequate consideration; one might, of course, engage in pedantic quibbling about the change in meaning from 1934 (concurrently with the second edition) when section 10(b) was adopted, to 1968 when section 14(e) was adopted or 1970 when it was amended (just prior to the third edition). But this definitional quibbling would simply compound the Court’s own error in both *Hochfelder* and *Schreiber* in thus “making a fortress out of the dictionary.”⁷⁰

⁶⁷ See *supra* note 46 and accompanying text.

⁶⁸ 105 S. Ct. at 2462 n.5.

⁶⁹ See *supra* note 44.

⁷⁰ *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945). Judge Learned Hand pointed out that “it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning.” See also Chief Justice Marshall’s passage on the meaning of words in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 414 (1819):

Such is the character of human language, that no word conveys to the mind, in all situations, one single definite idea; and nothing is more common than to use words in a figurative sense. Almost all compositions contain words, which, taken in their rigorous sense, would convey a meaning different from that which is obviously intended.

Justice Holmes also iterated the same thought in his magnificent phrase, “a word is but the skin of a living thought and may vary greatly in color and content according to

In this trilogy of cases the Court also seems to have ignored one of the basic reasons for the securities acts — to maintain public confidence in the integrity of the securities markets. Section 2 of the 1934 Act goes so far as to recite as one of its bases: “to insure maintenance of *fair and honest* markets” in securities transactions. This policy alone would have been a sufficient basis to construe “manipulative” in keeping with current usage since the adoption of the Williams Act. Yet the Court failed to address this point.

Another careless error occurs in note 8 of the opinion: the Court incorrectly describes section 13(e) as imposing “specific disclosure duties.”⁷¹ Additionally, the Court failed to recognize the anomaly that section 14(e), unlike 10b-5, has a separate provision for misrepresentations and half truths, beyond “fraudulent, deceptive, or manipulative acts or practices.” Nor did it consider the term “fraudulent,” not found in section 10(b). It similarly failed to acknowledge that section 14(e) substitutes the terms “acts or practices” for the words “device or contrivance,” words which the Court heavily relied upon in *Hochfelder*.⁷² Nor does the logical result of *Schreiber*, making redundant all the terms in 14(e) except the word “deceptive,” appear to have occurred to the Court. All in all, the most charitable thing that may be said is that *Schreiber* is a sorry opinion, although it is now the law of the land.

Again, it must be added that this Article does not endorse any particular approach to the serious problem of determining the intent of Congress in 1968 or 1970. The purpose is only to illustrate that the Court, which in its recent opinions has relied so heavily on the words of the statute,⁷³ here failed even to consider most of the relevant words. It is also to show that Congress may reverse the Court’s decision, as recommended below, without doing violence to either sound reasoning or logic.

B. The SEC’s Power After *Schreiber*

Given *Schreiber*’s deception or nondisclosure requirement, section 14(e) does not affect a nondeceptive self-tender even if it discriminates against a hostile bidder or anyone else. There is no reasonable prophy-

the circumstances and the time in which it is used.” *Towne v. Eisner*, 275 U.S. 418, 425 (1917).

⁷¹ See *supra* note 27 (quoting § 13(e)).

⁷² See *supra* note 29 (quoting § 14(e)).

⁷³ The Court has grown fond of stating that the starting point of statutory interpretation is the language of the statute. See, e.g., *Schreiber*, 105 S. Ct. at 2461, at Part II (A).

lactic objective (based on preventing deception) for outlawing fully disclosed lollipops. Presumably after *Schreiber* there also is no longer room for argument that 10b-5 applies to nondeceptive acts in tender offers even though *Santa Fe* had not foreclosed this possibility, as noted above. Nor do other sections of the Williams Act alter this result. Since section 14(d) does not apply to an issuer's repurchase of its own shares,⁷⁴ this leaves only section 13(e), the existing rules thereunder, and other rules under other rules-enabling provisions as possible bases for invalidating a nondeceptive lollipop. A review of section 13(e) and these other provisions shows they provide no basis for outlawing lollipops.

1. Section 13(e)

Repurchases in tender offers or otherwise, of their own equity securities by 1934 Act registrants and certain registered closed-end investment companies are made unlawful by section 13(e) if such repurchases are "in contravention of such rules as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices."

Since the section is merely a nonself-executing rules enabling act, we must begin by looking to the SEC's rules to determine whether lollipops are unlawful. These rules show that only rule 13e-4, with its proration requirement,⁷⁵ might express a policy that a tender offer for a class of securities must be made to all holders of the class. Because a lollipop is by definition a partial tender offer, the proration rule, requiring pro rata acceptance of all shares tendered, arguably may require acceptance of a pro rata portion of the hostile bidder's shares if tendered. However, this logic sticks in the craw because the only reason all lollipops are partial offers is that shares of the hostile bidder are being excluded. To say that all holders' tenders, including those of the hostile bidder, are to be accepted pro rata does no less than alter the issuer's offer, to address it to a different group of holders including the excluded hostile bidder. The SEC, if it had intended this meaning by its proration rule, showed an extraordinary regard for economy of words.

⁷⁴ Section 14(d) regulates only third party tender offers for 1934 Act registrants, certain closed-end mutual funds, and insurance companies.

⁷⁵ Rule 13e-4(f)(3) requires proration of acceptances when a partial tender offer is oversubscribed.

Further, the proposal releases do not purport to rely on the proration rule, and for good reason. Even assuming for the moment that a requirement of nondiscriminatory tender offers is the necessary implication of the proration rule, there is a major difficulty with that interpretation of the rule under section 13(e). The statute makes unlawful only violations of the Commission's rules, which in turn are limited to (a) definition of acts and practices that are fraudulent, deceptive, or manipulative and (b) prescription of means reasonably designed to prevent such acts and practices — the same limits as in section 14(e), the subject of *Schreiber*.

Lower courts certainly should interpret section 13(e)'s language consistently with section 14(e)'s identical language. Hence no nondeceptive act and no prophylactic rule not reasonably designed to prevent deception should be held to be within section 13(e)'s enabling provisions.

However, *Schreiber*'s footnote 8 contains enigmatic language that may undermine the foregoing analysis; this would occur if the lower courts used this language to alter the aforesaid implications of *Schreiber* concerning the meaning of section 13(e). That note states:

The process through which Congress developed the Williams Act also suggests a calculated reliance on disclosure, rather than court-imposed principles of "fairness" or "artificiality," as the preferred method of market regulation. For example, as the bill progressed through hearings, both Houses of Congress became concerned that corporate stock repurchases could be used to distort the market for control. Congress addressed this problem with § 13(e), which imposes specific disclosure duties on corporations purchasing stocks and grants broad regulatory power to the Securities Exchange Commission to regulate such repurchases. Congress stopped short, however, of imposing specific substantive requirements forbidding corporations to trade in their own stock for the purpose of maintaining its price. The specific regulatory scheme set forth in § 13(e) would be unnecessary if Congress at the same time had endowed the term "manipulative" in § 14(e) with broad substantive significance.⁷⁶

Obviously, the Court here emphasizes disclosure (although the opinion is wrong in suggesting section 13(e) has any specific disclosure provisions) but it also states that section 13(e) also "grants broad regulatory power to the Securities and Exchange Commission to regulate [issuer] repurchases."⁷⁷

This language could be taken to extend the Commission's power to develop prophylactic rules under 13(e) beyond its power under 14(e) on the ground that the Court failed to equate expressly the prophylactic

⁷⁶ *Schreiber*, 105 S. Ct. at 2463 n.8.

⁷⁷ *Id.*

provisions of the two sections. The problem of issuer repurchases is quite different from fraud in tender offers generally, as is obvious from the historical differences in the implementation of sections 14(e) and 13(e).⁷⁸ However, given the first sentence of the note, it would seem that such a construction would pervert the Court's opinion.

It would seem therefore, even assuming that rule 13e-4's proration requirement is an all holders rule, that it would be difficult, as we have already found under section 14(e), to find a relationship between an all holders rule, prohibiting lollipops, and the prevention of deception.

Presumably the Commission's staff was not unaware of these difficulties in the application of section 13(e) because it has failed to suggest any basis for the proposal beyond what it has described as an implicit requirement of the Williams Act.⁷⁹ Its release proposing rule 14d-10 merely asserted its all holders position under section 14(d),⁸⁰ which has a statutory proration rule not subject to the *Schreiber* infirmity requiring deception or a deceptive propensity for proscribing conduct. The SEC's second release, under section 13(e), which is subject to the *Schreiber* infirmity, cross referenced to the section 14(d) release without pointing out this distinction.

The cross reference to section 14(d) reveals another weakness in the section 13(e) basis for the all holders rule. This reference to section 14(d) implicitly reasserts the position taken earlier by the Commission, that any rule under section 14(d), relating to third party offers, may be promulgated as well under 13(e).⁸¹ The difficulty with this position is that it is not supported by the text of section 13(e), which reads quite differently from section 14(d), and under the Supreme Court's clear direction, as we have noted, the words of the securities statutes are to

⁷⁸ The differing histories of §§ 14(d)-(f) generally and § 13(e) are evident from the Commission's all holders releases which, in addition to proposing the all holders feature, attempt to make the limitations on issuer's tender offers parallel to those on third party tender offers.

For a description of the SEC's view regarding the differences between issuer and third party tender offers, see SEC Rel. No. 34-14234 (Dec. 7, 1977) [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,380.

⁷⁹ SEC Rel. No. 33-6596 (July 1, 1985) [1984-85 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,798.

⁸⁰ SEC Rel. No. 33-6595 (July 1, 1985) [1984-85 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,797.

⁸¹ SEC Rel. No. 34-16,112 (Aug. 16, 1979) [1978-79 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,182, at 82,207; 44 Fed. Reg. 49,406 (1979). Section 13(e) is much narrower than § 14(e) in one respect. The former regulates only 1934 Act registrants and certain others while § 14(e) regulates tender offers for any firm, thus only including companies having neither registered securities nor reporting under the 1934 Act.

be given a fairly literal reading. Therefore it seems highly unlikely that the Commission's power under section 13(e) is coextensive with section 14(d)'s provisions.

2. Section 3(b)

Several other, more general, rules enabling provisions in the 1934 Act pertain to the SEC's power to adopt an all holders rule; three of these provisions may be quickly disposed of, and the fourth gives only slight pause.

The first of these, section 3(b),⁸² authorizes the Commission to define terms used in the Act. This would permit a definition of "tender offers." However, even if tender offers were defined to exclude lollipops, this would not make them unlawful. Alternatively, "manipulations" conceivably could be redefined as a "technical trade" term based on the Court's own statements that it is a term of art. However, section 3(b) requires that definitions be consistent with the purposes of the Act, and the Court in *Schreiber* has held the purposes include regulation only of deception or nondisclosure. Moreover, it would be unseemly now for the Commission to attempt to overrule the Court. Thus, there is no other technique for using definition to outlaw lollipops. Indeed, the Commission has expressly stated that it does not define terms in its proposals.⁸³ Therefore section 3(b) seems unavailing.

3. Section 9(a)(6)

The second relevant section, 9(a)(6),⁸⁴ is equally unavailing. That provision prohibits pegging, fixing, or stabilizing the price of exchange-

⁸² Section 3(b) reads:

The Commission and the Board of Governors of the Federal Reserve System, as to matters within their respective jurisdictions, shall have power by rules and regulations to define technical, trade, accounting, and other terms used in this title, consistently with the provisions and purposes of this title.

⁸³ See *supra* note 16 (describing Release No. 33-6595).

⁸⁴ Section 9(a)(6) reads:

(a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or by any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange . . .

(6) To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regula-

traded securities in contravention of SEC rules. But an all holders rule is not an antiprice-manipulation rule and hence section 9(a)(6) cannot be a basis for it.

4. Section 15(c)(1)

The third pertinent rules enabling act, section 15(c)(1),⁸⁵ reads very similarly to section 14(e) except that it relates to purchases and sales and regulates broker-dealer off-exchange “manipulations.” However, section 15(c)(1) could apply to purchases or sales in tender offers since they usually involve arrangements with broker-dealer agents. But here too, given *Schreiber*, “manipulations” presumably must be taken to mean only deceptive acts as under section 14(e) and section 10(b).

5. Section 23(a)

Possibly a more fruitful section for finding SEC power to adopt an all holders rule may be section 23(a),⁸⁶ which authorizes rules “appropriate to implement the provisions of this title.” Is an all holders rule for issuer tender offers “appropriate to implement the provisions of [the

tions as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

⁸⁵ Section 15(c)(1), in pertinent part, reads:

(c)(1) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance, and no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

⁸⁶ Section 23(a) reads in pertinent part:

(1) The Commission, the Board of Governors of the Federal Reserve System, and the other agencies enumerated in section 3(a)(34) of this title shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which they are responsible or for the execution of the functions vested in them by this title, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof.

Williams Act]”? Doubtless any advocate could find much fodder in the word “appropriate” but a court would ordinarily find that it must mean that rules to implement the *purposes* of section 13(e) are authorized, not that anything deemed appropriate by the Commission is acceptable.⁸⁷ Those purposes clearly include the protection of investors from misrepresentation and nondisclosure as the Court has held, but an all holders rule has no relation to such wrongs, as we have seen.

Section 13(e) does not seem to have an implicit purpose of protecting investors by prohibiting discrimination against any of them in issuer self-tenders. As to bidders, one should recall that in the *Chris Craft* case, the Court held that hostile bidders may not claim the rights of shareholders under section 14(e);⁸⁸ presumably this would include section 13(e).⁸⁹ However, one may see a distinction between *Chris Craft*, in which the hostile bidder was defeated and hence was injured only *qua* bidder, and a lollipop, in which the bidder is injured in both capacities. But this seems unlikely of acceptance.

Is there any implicit purpose in section 13(e) to protect the hostile bidder *qua* stockholder or to preserve the freedom of other shareholders to accept or reject a tender offer? If so, because lollipops may effectively defeat or discourage bids, they could be outlawed under section 23(a).

Judge Sofaer seems to infer such a purpose in his opinion in the *Data Probe* case,⁹⁰ based on his analysis of *Edgar v. MITE Corp.*⁹¹ As noted, however, he was reversed by the Second Circuit. Was he nevertheless correct? His position is attractive because it would fully implement the widely held view that target managements should be limited to taking measures to encourage an auction of the shares.⁹² The legisla-

⁸⁷ See, e.g., *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 419-23 (1819), so construing the “Necessary and Proper” clause of the Constitution even though it was a “Constitution which [the Court was] construing” there, which makes *McCulloch* an a fortiori case. The Court has been faithful to this view ever since in construing statutes like § 23(a) of the 1934 Act. *Mourning v. Family Publications Serv., Inc.*, 411 U.S. 356, 369 (1973); *Thorpe v. Housing Auth.*, 393 U.S. 268, 280-81 (1969); see also *Touche Ross & Co. v. SEC*, 609 F.2d 570, 577 (2d Cir. 1979) (rule 2(e) valid under § 25(a) of the 1934 Act).

⁸⁸ *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 35 (1977).

⁸⁹ See, e.g., *Kalmanovitz v. G. Heileman Brewing Co.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,238 (3d Cir. 1985).

⁹⁰ 568 F. Supp. 1538, 1543 (S.D.N.Y. 1983).

⁹¹ 457 U.S. 624 (1982).

⁹² For an excellent review of the different views of academics, including the one here referred to, see Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1146-61 (1984).

tive history may not negate this result because in 1968 when the Williams Act was adopted, it was generally believed that there was always room for a contest between bidders and target management, thus permitting auctions. Now that targets have developed nearly invulnerable defenses such as lollipops against two-tier hostile bids, it could be that the courts should find, as did Judge Sofaer, that such invulnerable defenses were not intended by Congress to be permitted.

The major difficulty with this reasoning is its dependence on the logical fallacy that since Congress did not anticipate invulnerable target defenses and two-tier front-end loaded bids, it would have outlawed the defenses had it considered them. The logic fails for the obvious reason that Congress might just as plausibly have chosen the alternative path of not outlawing them. Certainly there is currently substantial political support for both views. If Congress had consciously considered both, there is no telling how it would have decided.

Nor can it be argued persuasively that Congress has established the policy of encouraging auctions. Congress at most seems to have developed a policy of preserving the relative positions of targets and bidders under federal and state laws, that is, without itself favoring either, or permitting the states to alter the balance of power.⁹³ Since the target company defenses devised by imaginative target advisors were available from the beginning and are not the result of new state legislation, the power of these defenses was always held by targets and the balance may not now be altered by federal courts.

II. SHOULD CONGRESS ADOPT A NATIONAL POLICY TO REGULATE TAKEOVER DEFENSES?

Congress is understandably puzzled as to what policy, if any, it should adopt with respect to tender offer defenses. There is pressure to increase target management's power to fend off takeovers as well as pressure to limit that power. The result has been, as with Nero, inaction while the problems mounted. In addition, under our federal system, Congress' inaction does result in a policy — the policy of abdication of power to the states to control these questions. For the reasons discussed below, it is imperative that Congress take affirmative steps to increase both Congress' role and the role of the SEC in regulating takeover defenses.

The policy of encouraging auctions seems also to be the fundamental basis for the recent Delaware and New York decisions outlawing the lockups granted under the circumstances of the cases. *See supra* note 19 (discussing *Hanson Trust* and *Revlon*).

⁹³ *See* Judge Winter's opinion in *Data Probe*, 722 F.2d 1 (2d Cir. 1983).

A. *State Law Bias Toward Incumbents*

Perhaps the most important consideration is that the law of the state of incorporation governs fiduciary duties of directors and managers in tender offer disputes. This and the further facts that directors and managers control the selection of the state of incorporation and that state revenues and legal fees are enhanced by local incorporations, lead to the result that state courts and legislatures vie with each other to provide ever more hospitable climates for managers and directors. This is, although oversimplified here, the well-documented "race of laxity"⁹⁴ that has resulted in Delaware's leading the way in most states' efforts to maximize managements' comforts. The consequence, in the tender offer context, is that state legislation may be expected to favor incumbent managements. Clearly, if desirable public policy conceivably may include encouragement of tender offers, the bias described may prevent a fair consideration of whether this policy is desirable. Bluntly put, the Delaware legislature and courts cannot be expected to be fair in considering competing policies to serve the national public interest.

B. *Economic Analysis, the Market for Capital, and the Market for Control*

Perhaps surprisingly, conventional economic analysis also calls for federal law to govern tender offer defenses. That analysis shows that it is not irrational to make certain nondeceptive tender offer defenses invalid under federal law, overruling *Schreiber*, while at the same time requiring deception or nondisclosure in order to establish violations under rule 10b-5 as in *Santa Fe*.

As is manifest, the congressional action recommended in this Article would make tender offer defenses a matter of federal law while leaving other alleged breaches of fiduciary duties a matter for the chartering state as under *Santa Fe*. It may be argued persuasively that this is precisely the correct result based on an economic analysis. Thus, the argument of then Professor Winter, later the author of the *Data Probe* Second Circuit opinion, was that federal chartering of corporations, or establishment of federal fiduciary standards generally, would be unwise for economic reasons.⁹⁵ But in that same article, Judge Winter pointed out that the economic basis for continuing state chartering and regulation of fiduciary duties in general — to preserve competition in the

⁹⁴ *Liggett Co. v. Lee*, 288 U.S. 517, 541 (1933) (Brandeis, J., dissenting). For further explication, see authorities cited *supra* note 12.

⁹⁵ Winter, *supra* note 63.

capital markets thereby enhancing efficiency — has little to do with the market for corporate control. For this reason, he called for elimination of state takeover statutes.

This seems correct. In parallel with Winter's conclusion, the logic also dictates that state fiduciary law should not regulate takeovers.⁹⁶ Perhaps stated overly simply, that logic is:

(a) if corporate managers know what is good for them, that is, if they wish to remain in office by avoiding a takeover, they will incorporate in states that will enhance shareholder values, and since they have had free choice of the locus of their corporate charter for decades, they must be choosing the states that do so enhance values; hence there is no economic reason to change the current status of state law chartering or fiduciary duties to one of federal chartering or federal fiduciary duties;

(b) however, takeover defenses, if powerful enough, will work directly contrary to the policy of continued state chartering; the fundamental economic reason Judge Winter asserts for state chartering — to encourage management to enhance shareholder values in order to avoid takeovers — is destroyed when the chartering state's laws enable managers to avoid takeovers by other means, such as lollipops, lockups, or poison pills.

Thus, even those who argue against federalization of corporate fiduciary law generally on economic terms, are led by the same logic to the result that tender offer defenses should be subject to federal, not state law, limitations.

C. *Need for Legislation Rather Than Adjudication: Edgar v. MITE Corp.*

Another reason for federal legislation is that tender offer policy is largely a political-economic question: what interests should be served by the law? These questions are for legislatures, not the judiciary. Yet under *Edgar v. MITE Corp.*⁹⁷ the Supreme Court has made clear that state legislatures are hobbled seriously in taking the steps they may feel

⁹⁶ Judge Winter's article went on to suggest that state takeover statutes should not be upheld on the economic grounds he suggests for upholding continued state chartering and state regulation of fiduciary duties. But he did not address the subject of state common law takeover defenses and it is not clear that he would agree with this Article's conclusion. Among other reasons, he addressed the first generation takeover statutes which applied to foreign corporations as well as domestic. But the common law takeover defenses are tied only to the state's domestic corporations since the law of the state of incorporation governs fiduciary duties. *Id.*

⁹⁷ 457 U.S. 624 (1982).

desirable in implementing any particular policy. *MITE* concluded that aggressive state tender offer legislation violates the Commerce Clause because this legislation unduly burdens interstate commerce.⁹⁸ Thus, the people's representatives may not act. Instead, virtually all regulation of defenses is for state common law, administered by state or federal courts (the latter exercising pendent or diversity jurisdiction). Even if state judges are politically responsive when elected to office, this type of responsiveness is not of the same quality as that of a large, representative legislative body. Also, courts do not have access to the legislative tools useful for fashioning comprehensive rules to regulate tender offers such as waiting periods, limitations, establishment of arbitration panels, or the like. Thus, the constitutional strictures of *MITE* cry for legislative action by Congress as opposed to state legislative or judicial regulation.

D. Uncertainty of State Law Administered by Federal Courts or Courts of Other States

Our federal system gives another reason for rejecting the approach of *Schreiber* and prohibiting a broad range of manipulative devices. The continued application of state law regulation of tender offer defenses to a national problem assures uncertainty. Necessarily, even if each state ultimately developed a clear-cut rule of law, the federal system would result in varying applications of that law, with no single court vested with jurisdiction to coordinate the varying views — an undesirable status for a system of law.

Thus, in many cases a federal court will be required to apply state law because of pendent jurisdiction. Once federal jurisdiction attaches, not even the highest court of the state will have a part in the matter, thereby leaving the federal courts to their own devices. A recent illustration is the *Hanson Trust* case⁹⁹ in which a majority of panel members of the federal Court of Appeals applied the New York business judgment rule in a novel manner, although the decision was fully discredited in the dissent. The majority imposed an “enhanced” duty of care on independent directors who, in the face of a hostile tender offer, granted a lockup option in a leveraged buyout in which management would participate. Although some would disagree, it appears that the majority, rather than deferring to the directors’ business judgment, in

⁹⁸ *Id.*

⁹⁹ See *Hanson Trust PLC v. SMC Corp.* [Current Vol.] FED. SEC. L. REP. (CCH) ¶ 92,376 (2d Cir. 1986); see also *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984).

fact determined subjectively that the deal was not a good one. The dissent argues compellingly that the New York courts would not have so held. In any event, regardless of whether this was so in *Hanson Trust*, it is a likely probability in many cases.¹⁰⁰ Other states' courts will also frequently entertain suits involving takeover of foreign state's corporations with no appeal to the foreign state's courts.

E. Resolution of Issues Instead of Continuing Experimentation

The fact that Congress has not yet developed a policy governing tender offer defenses is no basis for abdicating responsibility to the states. Admittedly, use of the fifty states as the exclusive laboratories for continued experimentation with tender offer regulation would be reasonable in some circumstances. But this experimentation has already taken place for nearly twenty years and much has been learned. Moreover, the subject is a rapidly evolving one that does not permit leisurely progress. In addition, the suggestion that the national government establish a federal policy does not require discontinuance of state experimentation. As *MITE* makes clear, the federal securities laws do not occupy the field of tender offers so as to preempt all state law. Therefore, the states, at least by common law, may continue to act until an appropriate federal rule or regulation preempts the state law.

F. The SEC as an Additional (and Better) Experimentor

Moreover, the SEC is a better repository than the states for at least some of the power that Congress does not exercise. In other portions of the securities laws, such as some of the antifraud provisions and proxy regulations, when Congress knew it wanted a federal answer to the federal problem, but had not yet itself developed an answer, it delegated rulemaking power to the SEC. This time-honored method is equally available here — as is suggested below in part III — if Con-

¹⁰⁰ Another illustration of federal courts misconstruing state law, well known to securities lawyers, occurred in the insider trading context some years ago when the Second Circuit decided in *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973), that the Florida law relating to insider trading was in accord with an unusual New York case, *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S. 2d 78 (1969). Although Florida had a referral statute permitting federal courts to refer questions of Florida law to the Florida courts for an advisory opinion, the Second Circuit at first failed to take advantage of it. However, the Supreme Court reversed and ordered the reference. *Lehman Bros. v. Schein*, 416 U.S. 386 (1974). Thereupon the Florida Supreme Court corrected the Second Circuit panel's misconception of Florida law. *Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975).

gress agrees that tender offer defenses should be regulated by federal, not state, law.

G. Hearing All Views

In addition, a federal policy would ensure that all interests are heard. The federal government provides a national forum on which all interest groups can focus their attention. Additionally, the influence of most interests on Delaware law is nil. Therefore, federal action would allow all views to be heard.

H. A National Market for Control

There are still more reasons for a national policy concerning tender offer defenses. The value of the securities of all publicly traded companies in the United States is approximately 2.5 trillion dollars, or twenty-two percent of the total assets of the nation.¹⁰¹ That the market for control of these companies is a national market is not open to question. Thus, national control seems appropriate.

I. A National Credit Market

A major part of this market for control includes the credit markets of the nation. Cash offers, which are the typical form for hostile bids, require large sums often financed by bank credit, arbitrageurs, and purchasers of "junk bonds." According to the *Economic Report of the President* transmitted to the Congress in February, 1985:

Although the number of transactions remains below previous peaks, the total value of merger and acquisition transactions has recently reached new highs. The announced value of merger and acquisition transactions reported in the first 9 months of 1984 was \$103 billion. (Ed.'s Note: This activity reached \$124 billion (nominal) by the year end, an increase of about 11 percent over the previous peak recorded in 1968 when the major form of consideration was corporate paper.) Indeed, the average annual reported real value of mergers and acquisitions during 1981-84 is approximately 48 percent greater than the average reported during any 4 years of the late 1960s and early 1970s. Thus, fewer transactions have been generating a relatively larger dollar volume of merger and acquisition activity. . . . The large dollar volume of recent merger and acquisition activity is attributable primarily to a substantial increase in the size of the largest individual transactions, most of which involve publicly traded corporations. Of the 100 largest merger and acquisition transactions recorded through year-end 1983, measured in nominal terms, 65 occurred between

¹⁰¹ ECONOMIC REPORT OF THE PRESIDENT ch. 6, transmitted to the Congress, Feb. 1985, at 187.

1981 and 1983, 24 occurred between 1979 and 1981, and only 11 occurred prior to 1979. Prior to 1976 the largest acquisition on record, measured in constant 1983 dollars, had a value of \$3.3 billion. Today, the record stands at \$13.3 billion. Indeed, transactions with a nominal value in excess of \$1 billion used to be rare and only 12 such transactions were recorded in the 12-year span from 1969 to 1980. However, between 1981 and 1984 alone, there have been at least 45 such transactions.¹⁰²

In 1985, twenty-four takeover transactions involved sums exceeding \$1 billion.¹⁰³ The impact on the nation's credit markets from these demands is clearly a matter of national interest, far beyond the province of the states.

As a result of borrowings to finance these takeovers, ratios of long-term debt to equity (an important measure of risk) are increasing dramatically. The average debt-equity ratio (based on market, not book values) is now 71.4 percent¹⁰⁴ as compared to 35.3 percent in 1961 and 46.7 percent in 1971.¹⁰⁵ Given the magnitude of many recent acquisitions and the large aggregate size of takeovers, there is a great public interest in the continuing viability of these businesses. The recent bailouts of Chrysler, Lockheed, and the Continental Bank remind us that the ultimate risk bearers of large public corporations may well be the federal government. It is clear also that no state, and certainly not Delaware, is able to aid a failing mega-corporation. At the very least, this increased accumulation of debt has a striking effect on the creditors, suppliers, employees, and customers of these companies. An obvious example is the sale of the acquired companies' assets and subsequent laying off of its employees as necessary to meet the debt created by the acquisition itself. In other words, the interest involved goes beyond that of the shareholder and is certainly national in its scope and effect.

Recently, the Federal Reserve Board has recognized this national interest and brought certain aspects of tender offer financings, specifically the use of junk bonds issued by shell corporations, under its margin regulations. The reactions by numerous federal agencies toward the Board's action further evidences the national character of the interests

¹⁰² *Id.*

¹⁰³ Reed, *A Time for Reflection and a Time to Look Ahead*, 20 MERGERS & ACQUISITIONS 46 (1986). W.T. Grimm & Co. also publishes data annually and because varying criteria are used, slightly different results accrue. W.T. Grimm & Co. concludes that 26 deals worth at least \$1 billion each were *closed* in 1985.

¹⁰⁴ See N.Y. Times, Dec. 29, 1985, at F1, col. 3.

¹⁰⁵ *Id.*

involved.¹⁰⁶

J. Shareholders' Federal Proxy Rights

Another reason for federal rather than state regulation lies in the need to vindicate a long standing federal policy of shareholder protection found in the proxy rules. A fundamental change in the nature of corporate governance is taking place because of various takeover defenses in contravention of the policy of shareholder democracy established by the proxy regulations. Although that policy has largely failed, it remains vital in some ways; for example, proxy contests are the sole alternative to tender offers for removing unwanted management or altering corporate policies. However, the basic thrust of many of the currently used defenses against takeovers is to take away the little power held by shareholders through their voting rights.

The problem was articulated, although denied, in Part VI of Vice-Chancellor Walsh's opinion in *Moran v. Household International*,¹⁰⁷ addressing a poison pill plan. The elements of the poison pill in that case included a program that granted existing stockholders of the potential target the right to purchase either the target's own shares or any successful bidder's shares at a bargain price. The effect was to dilute the bidder's proportional share after a takeover. The rights were triggered either when a certain percentage of the target's shares were acquired or a certain percentage of proxies to vote its shares were acquired. This latter feature deviates from the normal proxy contest characteristics. The two triggering events together diminish unhappy shareholders' powers to sell in a tender offer or grant proxies to insurgents in a proxy contest. The small shareholders' only remaining escape is the so-called "Wall Street rule" of "love it or leave it": they can sell their shares on the market, at a deflated price that reflects the fact that buyers will have the same diminished rights. The Vice-Chancellor held this diminution of shareholders' rights to be permissible if its purpose is not to entrench management's control further but is, in the business judgment of management, to protect the corporation, including its various nonshareholder constituents.

Once defenses such as the poison pill are established, virtually no power will exist in shareholders of public companies to prevent managements from having exclusive power over retention or sale of control.

¹⁰⁶ FRB Reg. § 207.112 (Jan. 8, 1986). See the report of the FRB action adopting the interpretation, Wall St. J., Jan. 9, 1986, at 2, col. 3.

¹⁰⁷ 490 A.2d at 1346, 1359, 1379 (Del. 1985).

Thus an important check on management power will be lost, contrary to longstanding national policy. Indeed, one may protest that this is not shareholder democracy; it is noblesse oblige at best, corporate fascism at worst.¹⁰⁸

K. *The Unimportance of the Tradition of State Law*

On the other side of the argument — favoring the status quo of state law regulation — is the traditional view that corporate law is for the states. However, this traditional view is anachronistic in the takeover game, as shown above. Perhaps 150 years ago when even the largest public corporations were truly local businesses, both economically and legally,¹⁰⁹ there was validity to placing power in the states. That is no longer true. Indeed, many of the business corporations of the type here being discussed are now multinational. In addition, tender offer defenses are in a different category from the concepts of preemptive rights and dividend regulation, which may be appropriate subjects for local control. This is illustrated by the fact that proxy regulation and most aspects of tender offer regulation are acknowledged as national, not local concerns. Tender offer defenses are not concerned with operation of the corporation but are concerned, as demonstrated above, with the market for the control of the corporations.

A fuller documentation of these essayed arguments in support of a national policy to regulate tender offers would belabor the obvious. It seems that the emotional appeal of allowing state law to regulate corporate activity, even if valid for corporate internal affairs, has no place in the regulation of the market for control of public corporations and the credit markets of the nation.

III. A PROPOSAL FOR LEGISLATION

Once it is determined that Congress should adopt some policy to regulate tender offer defenses, the next question is, what should that policy be? Here we meet the cause of prior inaction — the absence of a consensus. Some commentators believe that target managements should be prohibited altogether from making any defenses, while others believe that they should be allowed to raise only defenses that would compel an

¹⁰⁸ Reed, *supra* note 103, at 48.

¹⁰⁹ See *Liggett Co. v. Lee*, 288 U.S. 517, 541, 548-56 (1933) (Brandeis, J., dissenting) (describing charters of the 19th century limiting companies' capital, geographic bounds, and purposes).

auction.¹¹⁰ Others believe that corporate managers must serve not only their shareholder constituency but also employees, suppliers, consumers of the company's product, communities where company plants are located, or others, therefore requiring a business judgment rule. Still others are more concerned with bigness as badness than with any other aspect of the problem. All these views have degrees of legitimacy and force. Since these views point in varying directions, and since no consensus has developed on any one of them, it is clear that it is probably wise to allow the now fifty state "laboratories" to continue to experiment with various laws affecting tender offers. However, some aspects of tender offer defense law are already the subject of general consensus based on neutral principles. I believe that the illegitimacy of the Unocal type discriminatory self-tender is one of these.

To accommodate all these considerations is a surprisingly simple matter — and one that probably was within the original intent of Congress when it adopted the Williams Act in 1968. That is to include in the concept of "manipulative" transactions whatever cunning devices the SEC, by rule, establishes, including those not resting on misrepresentation or nondisclosure — such as the fully disclosed, discriminatory self-tender offer.

To implement this objective, section 14(e) could be amended to add a sentence at its end. It would then read as follows (the proposed amendment is in italics):

(e) It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection by rules and regulations define, and prescribe means reasonable designed to prevent such acts and practices as are fraudulent deceptive, or manipulative. *For purposes of the preceding sentence of this section only, the term "manipulative" is not limited to acts or practices based in misrepresentations or non-disclosures.*

Alternatively, borrowing a leaf from the preliminary version of section 10(b) previously described¹¹¹ instead of adding a new sentence, the last sentence of existing section 14(e) could be amended to read: The Commission shall, for the purposes of this subsection only, prohibit or

¹¹⁰ See Coffee, *supra* note 92, at 1146-61 (describing the different views).

¹¹¹ See *supra* text accompanying note 41.

regulate the use of any act or practice which it finds detrimental to the public interest or to the proper protection of investors.

Either amendment would serve several valuable functions:

(a) State law would continue to apply, until and unless the SEC adopted a contrary rule;

(b) A national lawmaking forum would exist, in full public view and subject to the normal political processes, and taking into account national interests, allowing thorough consideration of poison pills, lock-ups, superstock, and the like;

(c) Flexibility would exist because there would be no need to invoke the cumbersome Congressional legislative process to enact new rules or amend or repeal old ones;

(d) Procedural due process provided by current rulemaking processes under the Administrative Procedure Act¹¹² would assure an airing of all views;

(e) Congressional oversight would exist to check overzealousness on the part of the SEC;

(f) Current prophylactic rules of the Commission, such as Rule 14e-1 requiring tender offers to remain open 20 days, would be validated; and

(g) The law of rule 10b-5 would continue as is.

CONCLUSION

The federal courts and the SEC are presently incapable of regulating tender offer defenses in any meaningful way. This is a direct result of the Supreme Court's holding in *Schreiber* that section 14(e) of the Williams Act applies only to manipulative devices that involve deception or nondisclosure. Popular tender offer defenses, including the powerful "lollipop" defense, poison pills, lock-ups, and superstock do not rely on deception or nondisclosure. Since other federal law is inapplicable, present federal law does not regulate defenses. The economic magnitude of takeovers and attempted takeovers, and their utility in legitimizing continued state chartering and regulating of fiduciary duties, necessarily implicate national interests. Therefore, the time has come for congressional action to bring takeover defenses within the zone of federal regulation.

¹¹² 5 U.S.C. § 553 (1982).

