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TOWARD UNDISTORTED CHOICE AND EQUAL TREATMENT IN CORPORATE TAKEOVERS

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TOWARD UNDISTORTED CHOICE AND EQUAL TREATMENT IN CORPORATE TAKEOVERS*

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In this Article, Mr. Bebchuk proposes two objectives — “undistorted choice” and “equal treatment” — for the legal rules governing corporate acquisitions in general, and corporate takeovers in particular. Mr. Bebchuk argues that undistorted choice is essential to the efficient operation of the market for corporate assets and that equal treatment is suggested by both efficiency and fairness considerations. Current takeover rules, Mr. Bebchuk demonstrates, lead to distorted choice and unequal treatment. He therefore puts forward a set of rules that would ensure undistorted choice and equal treatment in corporate takeovers without creating any significant efficiency costs. Although Mr. Bebchuk’s analysis focuses on takeovers, he also discusses, in light of the proposed objectives, the legal rules that should govern other methods of corporate acquisition.

TAKEOVER bids, public offers to purchase shares of a target corporation for either cash or securities, are a popular and important method of acquiring widely held corporations. These bids provide the only means of acquiring such corporations without their management’s approval.¹ In addition, they have become a very common means of consummating negotiated acquisitions.²

* This Article is part of a larger project, the aim of which is to put forward a legal framework to govern all aspects of corporate acquisitions.

As part of that project, I have constructed a mathematical, game-theoretic model of the outcome of takeover bids under current and alternative legal rules. The analysis of that model formally derives many of this Article’s points. The model is presented and analyzed in L. BEBCHUK, A MODEL OF THE OUTCOME OF TAKEOVER BIDS (Discussion Paper No. 11, Program in Law and Economics, Harvard Law School) (forthcoming Sept. 1985). Throughout this Article, references will be made to that Discussion Paper for a formal derivation or fuller treatment of various points.

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¹ See Easterbrook & Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1199–1201 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 842–44 (1981).

² See Freund & Greene, *Substance over Form S-24: A Proposal to Reform SEC Regulation of Negotiated Acquisitions*, 36 BUS. LAW. 1483, 1485–88 (1981). Takeovers have been increas-

This Article focuses on two related problems concerning the current operation of corporate takeovers. The larger share of the analysis focuses on the problem of "distorted choice." Shareholders' decisions whether to tender in the face of a takeover bid are at present subject to substantial pressures and distortions. A target's shareholder might well tender his³ shares to a bidder even if he views the offered acquisition price as lower than the value of the independent target.⁴ For one thing, the shareholder might tender out of fear that, if he does not tender, the bidder might still gain control, in which case the shareholder would be left with low-value minority shares in the acquired target.

Because of the existing distortions of shareholder choice, a bidder might currently succeed in taking over a target even if the value-maximizing course of action for the target's shareholders would be to reject the bid. Consequently, a target might be acquired even if the most efficient use of its assets would require that it remain independent or that it be acquired by another buyer. The current distortions thus reduce social welfare by leading to an inefficient allocation of corporate assets. Moreover, these distortions provide the only possible justification for allowing target managements to use obstructive defensive tactics; eliminating these distortions would therefore remove the only defensible obstacle to prohibiting such tactics, which are very costly both to target shareholders and to society.⁵

The second and closely related problem with which the Article deals is that of "unequal treatment." In takeovers accomplished under current law, the total acquisition price is disproportionately distributed among the target's shareholders.⁶ Some shareholders have all or most of their shares purchased for the bid price, while other shareholders have all their shares become minority shares with a value lower than the bid price. Consequently, some shareholders, largely unsophisticated investors, end up with considerably less than their pro rata share of the acquisition price. This disproportionate division, I shall suggest, is both inefficient and unfair.

ingly used in negotiated acquisitions because they enable a relatively speedy consummation of an acquisition.

³ For the sake of stylistic convenience, this Article employs male pronouns to refer to all shareholders. Needless to say, shareholders might also be females or legal entities.

⁴ See *infra* Section II.C.

⁵ The view that the current distortions of shareholder choice might justify at least some obstructive tactics is expressed in, for example, Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113-16 (1979), and Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 307-09 (1983). The costs of obstructive tactics are described in Easterbrook & Fischel, *supra* note 1, at 1174-82; Gilson, *supra* note 1, at 852-55.

⁶ See *infra* Section II.D.

A number of legal scholars,⁷ economists,⁸ and legal practitioners⁹ have already discussed various aspects of these two problems. These problems were also recently considered by the SEC's Advisory Committee on Tender Offers¹⁰ and by the SEC.¹¹ This Article seeks to advance our understanding of these problems, and our ability to address them, in the following three ways. First, the Article puts forward a normative framework — based on the objectives of “undistorted choice” and “equal treatment” — for evaluating the performance of takeover rules. Second, the Article analyzes how existing law and the dynamics of takeover bids lead to distorted choice and unequal treatment. Finally, the Article proposes a regulatory arrangement that would attain the objectives of undistorted choice and equal treatment without entailing any significant efficiency costs.

The Article's analysis is organized as follows. Part I of the Article describes the objectives of undistorted choice and equal treatment. According to the undistorted choice objective, a target should be

⁷ The first serious academic discussion of the problems of distorted choice and unequal treatment is in Brudney and Chirelstein's insightful article, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 336-40 (1974). Other discussions of various aspects of these problems include Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1039-41 (1982) [hereinafter cited as Bebchuk, *Facilitating Competing Bids*]; Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 45-46, 48-49 (1982) [hereinafter cited as Bebchuk, *Reply and Extension*]; Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072, 1118-22 (1983); Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, AM. B. FOUND. RESEARCH J. 341 (1983); Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1183-95 (1984); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 710-11 (1982); Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RESEARCH J. 875, 896-98 (1983); Gilson, *supra* note 1, at 859-62; Lowenstein, *supra* note 5, at 307-09.

⁸ See Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 352-56 (1980); DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329 (1983); Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 44-47 (1980); Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J. LAW & ECON. 151, 154-58 (1985); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 31-32 (1983).

⁹ See, e.g., Ballotti & Finkelstein, *“Coercive” Structures in Tender Offers*, 15 REV. SEC. REG. 820 (1982); Lipton, *supra* note 5, at 113-14; Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 676-93 (1984).

¹⁰ See ADVISORY COMMITTEE ON TENDER OFFERS, SEC, REPORT OF RECOMMENDATIONS 24-26 (1983), reprinted in FEDERAL SECURITIES LAW REPORTS No. 1028 (CCH extra ed. July 15, 1983) [hereinafter cited as ADVISORY COMMITTEE REPORT].

¹¹ See Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, before the House Subcommittee on Telecommunications, Consumer Protection, and Finance, [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,511, at 86,679 (Mar. 28, 1984) [hereinafter cited as Statement of Shad]; Securities Exchange Act Release No. 21079 [1984 Decisions] FED. SEC. L. REP. (CCH) ¶ 83,637 (June 21, 1984) [hereinafter cited as SEC Release].

acquired if and only if its shareholders, or at least shareholders holding a majority of its shares, judge the offered acquisition price to be higher than the independent target's value. According to the equal treatment objective, the total acquisition price in an acquisition should be distributed among the target's shareholders in proportion to their holdings. These objectives are capable of providing a unified and consistent normative framework not only for takeovers, but for corporate acquisitions in general.¹²

Part II provides a detailed account of how current takeover rules lead to distorted choice and unequal treatment. While various aspects of these problems have been previously discussed, this Article develops a fuller and more systematic account of them than that provided by the existing literature.¹³ In particular, the Article shows that some common views regarding the current distortions of shareholder choice rest on misconceptions.¹⁴ It thus enables a far better understanding of the nature, scope, and severity of the current problems.

Part II's analysis of the current problems facilitates the subsequent examination of possible remedies. Part III discusses the shortcomings of various remedies that have been suggested in the literature. Part IV then puts forward a regulatory arrangement that would attain the objectives of undistorted choice and equal treatment.

A main element of Part IV's proposed arrangement is a rule that (1) would enable tendering shareholders to indicate whether or not they "approve" a takeover, and (2) would allow a bidder to purchase a controlling interest only if its bid attracts the required number of "approving tenders." Under the proposed regulations, the vast majority of shareholders would tender, either approvingly or disapprovingly. Those who view the offered acquisition price as adequate would make approving tenders; those who view the offered acquisition price as too low, but wish to receive their pro rata share of the acquisition

¹² The SEC's Advisory Committee and the SEC have recently emphasized the need for a consistent treatment of all acquisition methods. See ADVISORY COMMITTEE REPORT, *supra* note 10, at 19, recommendation 10; Statement of Shad, *supra* note 11, at 86,678.

¹³ The Article analyzes many aspects of the current problems that the existing literature ignores. For example, the Article shows that there are two different reasons why shareholders' tender decisions do not reflect their judgment as to whether the expected acquisition price exceeds the independent target's value; that the frequent ability of acquirers to gain effective control of a target by purchasing a substantial plurality of shares also contributes to the current distortions; that the current distortions are not all attributable to target shareholders' inability to coordinate their actions; that ensuring equality between the post-takeover value of minority shares and the bid price would not attain undistorted choice; and that the current distortions affect not only shareholders' choice between selling and not selling their company, but also their choice among competing bids. Furthermore, this Article classifies all the sources of the current distortions and delineates the circumstances in which a distorted outcome is certain and those in which it is only possible. See *infra* Section II.C and Appendix B.

¹⁴ For example, this Article shows that the distorted choice problem is not limited, as many think, to partial bids or to two-tier bids, but rather is present in all bids.

price in the event of a takeover, would make disapproving tenders. Thus, shareholders would be able to express their preferences concerning the bid's success in isolation from their desire to receive their pro rata share in case of a takeover. Enabling shareholders to make approving and disapproving tenders would work, together with the regulatory arrangement's other elements, to attain undistorted choice and equal treatment.¹⁵

Part V explains why the undistorted choice and equal treatment objectives are both desirable and important. It shows that undistorted choice would substantially contribute to an efficient allocation of corporate assets, and that equal treatment is suggested by considerations of both fairness and efficiency. This explanation is deferred to Part V because it relies on the preceding analysis of the current problems and the proposed remedies.

Although this Article focuses on takeovers, Part VI extends the analysis to another acquisition method that is currently used — the accumulation of a controlling interest through open-market or privately negotiated purchases. The Article proposes that prospective buyers be prohibited from acquiring a controlling interest in this way, and that they thus be limited to pursuing a takeover or a merger.

In order to focus on the important problems of distorted choice and unequal treatment, the analysis of Parts I–VI assumes away two other problems that corporate acquisitions might present: distortions of acquirers' choice, and distortions resulting from the existence of private gains (such as gains from tax savings and increased market power) that do not represent net social gains. Part VII discusses these problems and shows that their presence does not weaken the case for the proposed regulations; rather, these problems might require only that the regulations be supplemented with additional measures.

This Article has two appendices. Appendix A compares the proposed regulations with the arrangements prevailing in Britain. The British arrangements are somewhat similar to the proposed regulations, and were at least partly motivated by similar concerns. The British arrangements, however, do not seem to have been drafted with a complete and systematic understanding of the distorted choice and unequal treatment problems. Consequently, as the Appendix shows, the British rules go too far in some respects and not far enough in others.

Appendix B extends the Article's analysis — which for simplicity of exposition limits itself to single-bid situations — to cases involving

¹⁵ The described rule would enable shareholders to express their preferences concerning the bid's success in conjunction with the tendering of shares. An alternative approach would enable shareholders to express their preferences concerning the bid's success in a separate vote, and would allow the bidder to purchase a controlling interest only if it attracts the required number of approving votes. This Article discusses both alternatives, though it suggests that the former would be somewhat preferable.

competing bids. The Appendix describes the additional problems introduced by the presence of competing bids, and it explains how the proposed regulations should be adjusted to address these additional problems.

I. THE OBJECTIVES OF UNDISTORTED CHOICE AND EQUAL TREATMENT

I wish to start by describing the two objectives that I propose for the rules governing corporate acquisitions. By acquisition of a corporation, I mean a purchase of all its shares (or equivalently, of all its assets) or at least of sufficient shares to obtain a controlling interest. It is important to emphasize that this Article will discuss only acquisitions of targets that prior to the acquisition were not controlled by a single shareholder; acquisitions of targets that were previously controlled by a single shareholder pose a special set of problems and require a separate analysis.¹⁶

Before proceeding, a note on terminology is in order. Throughout the Article, a majority of a target's shareholders will mean shareholders holding a majority of the target's shares. Similarly, X percent of a target's shareholders will mean shareholders holding X percent of the target's shares.

A. Undistorted Choice

1. *Corporate Acquisitions in General.* — According to the undistorted choice objective, a company should be acquired if and only if a majority of its shareholders view the offered acquisition price as higher than both the independent target's value and the value of other available offers. The independent target's value refers to the value that the target will have if it remains, at least for the time being, independent; this value of the independent target obviously includes the value of the prospect of receiving higher acquisition offers in the future.

The desirability of the undistorted choice objective will be discussed in detail in Part V. It might be worthwhile at this point, however, to provide a brief description of the efficiency rationale that lies behind the objective. Efficiency requires that corporate assets (as well as other social resources) be allocated to their most productive uses. Some corporate acquisitions would produce efficiency gains from

¹⁶ The rules that should govern acquisitions of companies with a controlling shareholder have been extensively debated for some time. See, e.g., Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965).

improved management or "synergy."¹⁷ Other corporate acquisitions, however, might create no efficiency gains or even produce efficiency losses. From the perspective of efficiency, it is desirable that acquisition attempts succeed if and only if the acquisition would produce efficiency gains. The problem, however, is how to ensure such an outcome of acquisition attempts.

Let us examine this question by considering for a moment the outcome of offers to purchase a sole owner's assets. The law generally conditions the sale of a sole owner's assets upon his consent. Consequently, such a sale will take place if and only if the owner views the offered acquisition price as higher than the value to himself of retaining his assets for the time being (a value that includes the prospect of receiving higher offers in the future).

It is widely thought that enabling sole owners to reject acquisition offers serves efficiency. This mechanism prevents an acquisition whenever the potential buyer is unwilling to pay as much as the sole owner's estimate of the value to himself of retaining his assets. In such cases, efficiency is indeed most likely to be served by having the owner retain his assets. To be sure, this mechanism is not perfect. For one thing, sole owners might make mistakes by over- or underestimating the value to themselves of retaining their assets: they might be overly optimistic, for example, about the assets' productivity or about the chances of receiving higher offers in the future. But this mechanism, though imperfect, appears to be the best available — the one that would bring us closest to an efficient allocation of sole owners' assets.

Let us now return from the sole owner context to that of the public corporation. What the undistorted choice objective suggests is that we should enable a target's dispersed shareholders to act as a sole owner would be likely to act. When the shareholders judge the offered acquisition price to be lower than the independent target's value — and let us assume for a moment that they are unanimous in this judgment — then the acquisition offer should be rejected; in such a case, efficiency would likely be served by having the target remain independent.

Of course, like the corresponding mechanism in the sole owner context, the proposed undistorted choice mechanism is not perfect. For example, like a sole owner, a target's shareholders might be mistaken in their judgment of their value-maximizing course of action. Nevertheless, as Part V will explain, the undistorted choice mechanism is the best we can employ — the one that would bring us closest

¹⁷ The term "synergistic gains" refers to all increases in the combined future profits of the acquirer and the target that an acquisition produces through means other than improvements in management. For example, the acquisition might create economies of scale in production, marketing, or control. See P. STEINER, *MERGERS* 58-69 (1975).

to securing an efficient outcome of acquisition attempts. In particular, I shall suggest, ensuring undistorted choice is clearly superior to a regime facilitating the success of any premium offer, or to a regime enabling the target's management to determine the success of acquisition attempts.¹⁸

While a sole owner obviously has only one view as to whether accepting an offer would be value-maximizing, a target's shareholders might well differ in their judgments of how the offered acquisition price compares with the independent target's value.¹⁹ Thus, it would thus be unrealistic, indeed paralyzing, to require a unanimous agreement among the shareholders about their value-maximizing course of action. It is therefore necessary to specify some fraction of the target's shareholders who must view accepting a given offer as value-maximizing if the offer is to be accepted. According to the undistorted choice objective, we should follow the judgment of the majority of the shareholders — on the ground that the majority is more likely to be right than the minority in its assessment of the shareholders' value-maximizing course of action.²⁰

One objection that is likely to be raised against the proposed objective is based on the fact that acquisition offers are usually made at a premium over the pre-bid market price of the target's shares. This pre-bid market price is supposed to represent investors' pre-bid estimates of the target's value. Therefore, it might be argued, the acquisition price provided by a premium offer necessarily exceeds

¹⁸ Part V discusses two main reasons why the undistorted choice mechanism is not perfect. First, a target's shareholders might make mistakes in their assessment of how the offered acquisition price compares with the independent target's value. For example, they might inaccurately assess the future profitability of the target's assets or the chances of receiving a higher offer in the future. Second, a bidder that attaches to a target's assets a value exceeding the independent target's value might still offer an acquisition price below the independent target's value and consequently fail. Although such a failing bidder might raise its bid, it might also elect not to do so, because of strategic considerations or transaction costs. After examining these problems, which are similar to ones that are present in the sole-owner context, I conclude that the distorted choice mechanism still appears to be the best mechanism we can employ. See *infra* pp. 1770-74.

¹⁹ For one thing, shareholders might well differ in their estimates of the independent target's value. It should be emphasized, however, that the Article's analysis in no way depends on the existence of such a variance: all of the Article's main conclusions are valid both when the shareholders' estimates vary and when they do not.

²⁰ Part V discusses the considerations that are relevant to specifying the decisive fraction, and explains the efficiency rationale underlying my choice of a majority as the decisive fraction. Part V also explains, however, that defining the decisive fraction differently would not affect the relevance of this Article's analysis. This is because the Article's analysis will focus on ensuring that shareholders' tender decisions reflect their judgment as to whether the offered acquisition price exceeds the independent target's value. And the desirability of ensuring such undistorted tender decisions does not depend on how the decisive fraction is defined. Thus, for example, the regulatory arrangement to be proposed could easily be amended to one ensuring that a company will be acquired if and only if a supermajority (rather than a simple majority) views the acquisition as value-maximizing. See *infra* pp. 1774-75.

investors' estimates of the independent target's value. Thus, the argument runs, a target's shareholders can never rationally view rejecting a premium offer as value-maximizing.

The above objection is not justified. When shareholders make their tender decisions (often several weeks after the bid's announcement), their estimates of the independent target's value might significantly differ from their pre-bid estimates. Investors' estimates of a company's value usually vary from month to month — and this is all the more true with respect to takeover targets. A target's shareholders are likely to receive a great deal of new information between the last pre-bid trading time and the time of their tender decisions.²¹ Because this novel information is likely to be on the whole "good news," the shareholders' estimates at the time of their tender decisions might well exceed the pre-bid market price;²² and they might therefore rationally view rejection of the bid as their value-maximizing course of action. For example, at the time of their tender decisions, the shareholders might believe that there is a good chance of receiving higher offers in the future, or that a restructuring plan just proposed by incumbent management will substantially increase the target's value. Indeed, as Part V will explain, there are good reasons to believe that rejecting an acquisition offer would be value-maximizing in a significant number of instances.

Another objection that might be raised against the proposed objective is one based on a concern that while ensuring undistorted choice might produce an efficient outcome of acquisition attempts, it might also involve some substantial efficiency costs. Professors Easterbrook and Fischel, for example, believe that increasing the size of acquisition premiums — as ensuring undistorted choice would likely do — is always undesirable because it would reduce the incentive to search for takeover targets.²³ As Part V will explain, however, ensuring undistorted choice through the regulatory arrangement proposed in this Article would be unlikely to involve any significant efficiency costs.

²¹ See *infra* pp. 1767–68. For example, investors might draw inferences from the very making of the bid and from the bid's terms, or they might revise their estimates in light of disclosures and proposals made by incumbent management. Also, the bid attracts the attention of the investment community, and intensified investigations by market participants are likely to reveal a wealth of new information.

²² It is also worth noting that once a bid is made, the market price might no longer fully reflect investors' estimates of the target's value. The market price during the bid period might be depressed by the anticipated distortions of shareholders' tender decisions, and might be capped by the bid price. Consequently, once a bid is made, the market price might not fully reflect subsequent revisions in investors' estimates of the independent target's value. See *infra* pp. 1726–28.

²³ See Easterbrook & Fischel, *supra* note 1, at 1174–80; Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 3–7 (1982).

Having sketched Part V's argument for the undistorted choice objective, I now turn to evaluate the main acquisition methods — mergers and takeovers — in light of this proposed general objective. For the purposes of that evaluation, it will be helpful to divide the proposed objective into two parts. First, the objective requires that a *necessary condition* of an acquisition attempt's success be the presence of "majority support" — that is, a judgment by a majority of the shareholders that the offer is higher than both the independent target's value and other available offers. Second, the objective requires that such majority support also be a *sufficient condition* of an acquisition attempt's success.

2. *Mergers.* — Consider first mergers, the traditional acquisition method.²⁴ State corporation statutes generally ensure that a target will not be acquired by merger unless the acquisition offer enjoys majority support. These statutes require that a merger receive a vote of approval by the target's shareholders.²⁵ And shareholders presumably will not vote in favor of a proposed merger unless they judge the offered acquisition price to be higher than the independent target's value.²⁶

The problem with the merger method, however, is that it cannot ensure that all acquisition offers that have majority support will indeed be accepted. This problem arises from the possible divergence of interests between shareholders and managers.²⁷ If managers were completely loyal agents of the shareholders, they would submit to a shareholder vote all merger offers possessing a meaningful chance of gaining approval. In a world of perfectly loyal managers, we could use merger as the only permissible method of corporate acquisition, and would have no reason to create alternative acquisition methods; for in such a world we could rely on the merger method to ensure that shareholder support would be sufficient, as well as necessary, for the acceptance of an acquisition offer.

²⁴ By merger I am referring to all forms of acquisition (including consolidation and sale of substantially all assets) that require an approval by both the target's board and a shareholder vote.

²⁵ Most states require approval by a simple majority. See, e.g., DEL. CODE ANN. tit. 8, § 251(c) (1983). But some states require the approval of a supermajority. See, e.g., N.Y. BUS. CORP. LAW § 903(a)(2) (Consol. 1983). The undistorted choice objective implies that a simple majority should be decisive.

²⁶ There is, of course, some question whether shareholders have sufficient incentive to participate in a merger vote. But supposing that a shareholder does vote, his vote will reflect his judgment of how the offered acquisition price compares with the independent target's value. The shareholder's vote will affect his financial position only in the event that it proves to be a pivotal vote. Consequently, when a shareholder does vote, he will vote in favor of the merger proposal if and only if he prefers the merger to take place. Because the total acquisition price in a merger is expected to be distributed pro rata, the shareholder will prefer a merger to occur if and only if he views the offered acquisition price as higher than the independent target's value.

²⁷ See Easterbrook & Fischel, *supra* note 1, at 1199-1201; Gilson, *supra* note 1, at 848-52.

Managers, however, are not perfectly loyal agents. They might be concerned not only with shareholder interests but also with their own private interests. Consequently, management might not submit to a shareholder vote a merger proposal that could well gain shareholder approval. Management might do so in order to maintain its independence, or in order to facilitate an acquisition by another potential buyer offering a deal that is better for management but worse for the shareholders. Thus, because management controls the merger agenda, the presence of shareholder support might be insufficient to ensure that the target will be acquired by a merger. It is therefore desirable to have an alternative acquisition method — the takeover.

3. *Takeovers.* — The objective for the legal rules governing takeovers follows directly from the general objective of undistorted choice. First, since majority support might be insufficient for a merger, such support must be sufficient for a takeover; otherwise, the objective's requirement that majority support be sufficient for an acquisition would not be satisfied. Second, majority support must also be necessary for a takeover; otherwise, the objective's requirement that such support be necessary for an acquisition would be undermined.

Consider first the aim of ensuring that majority support be sufficient for the success of a takeover bid. When the target's shareholders are left free to accept the bid, the presence of majority support generally will ensure that the bidder receives enough tenders to gain control of the target.²⁸ A bid that would otherwise attract a majority of shares, however, might be impeded under current law by incumbent management's use of obstructive defensive tactics (such as litigation or the creation of antitrust obstacles). A self-serving management might currently employ such tactics in order to avoid an acquisition altogether, or to facilitate an acquisition by management's favored acquisition partner. It is for this reason that I support a ban on obstructive defensive tactics: such a ban is necessary if we are to ensure that shareholder support be sufficient for the success of an acquisition attempt.²⁹

Consider now the aim of ensuring that majority support be necessary for the success of a takeover bid. This element of the proposed general objective is the one on which this Article's analysis will focus. As the analysis will demonstrate, a bidder might currently succeed in gaining control of a target even if the bidder's offer does not enjoy majority support. And the Article will therefore put forward a reg-

²⁸ See *infra* Section II.C. The current distortions operate systematically in favor of bidders. Consequently, the presence of shareholder majority support is generally sufficient (but not necessary) for the success of a takeover bid.

²⁹ I have previously expressed my support for a ban on obstructive tactics in Bebchuk, *Facilitating Competing Bids*, *supra* note 7, at 1054-56, and Bebchuk, *Reply and Extension*, *supra* note 7, at 47-48.

ulatory arrangement under which a bidder would not succeed in taking over a target unless its offer enjoys majority support.

Having gone from the objective concerning acquisition attempts in general to the particular objective concerning takeover bids, let us now make a full circle. The regulations proposed in this Article, together with the ban on obstructive tactics that I endorse and with the current rules of merger law, would attain the general objective of undistorted choice. The ban on obstructive tactics would ensure that majority support will be sufficient for an acquisition, whether incumbent management is loyal or self-serving. This Article's proposed regulations, together with the existing requirement that a merger be approved by a shareholder vote, would ensure that majority support be necessary for any acquisition, whether accomplished by takeover or merger. Thus, the regulations to be outlined are an integral part of a suggested general policy — that of ensuring undistorted choice by target shareholders.

B. Equal Treatment

The objective of equal treatment applies only to those instances in which acquisition attempts are successful. According to this objective, the total acquisition price in an acquisition should be divided among the shareholders of the acquired target in proportion to their holdings.

When an independent target is acquired through a merger, the acquisition price is generally divided among the target's shareholders in proportion to their holdings.³⁰ The process that determines whether a merger proposal will be accepted has no bearing on how the acquisition price will be distributed if the proposal is accepted. Once a merger proposal is approved by a shareholder vote and the merger goes through, each shareholder receives his pro rata share of the total acquisition price, regardless of whether or how he voted.

In contrast, when an independent target is currently acquired through a takeover, the target's shareholders might well be subject to unequal treatment. Under current rules, the process that determines whether a takeover bid will succeed also has a substantial bearing on the distribution of the acquisition price in the event that the bid does succeed; and the resulting distribution might be quite disproportionate.³¹ Moreover, a target's shareholders do not all have the same *ex ante* chance of being a victim of the current inequality of treatment; unsophisticated investors are much more likely than are sophisticated

³⁰ As noted earlier, *see supra* p. 1700, this Article limits its analysis to acquisitions of companies that prior to the acquisition did not have a controlling shareholder. In parent-subsidary mergers accomplished under current law, the merged subsidiary's shareholders are often treated unequally, with the parent benefiting at the outsiders' expense. The question of whether such unequal treatment should be allowed is beyond the scope of this Article.

³¹ *See infra* Section II.D.

investors to end up in the event of a takeover with less than their pro rata share of the acquisition price.³² The existing inequality of treatment, it should be emphasized, is a product of current takeover rules; the regulations proposed in this Article would produce a proportionate division of acquisition prices.

Part V will explain why equal treatment is a desirable objective not only for mergers but also for takeovers. One reason for this desirability is that equal treatment is instrumental to attaining undistorted choice. As the analysis will show, the current inequality of treatment distorts shareholders' tender decisions; consequently, attaining undistorted choice would require ensuring a proportionate distribution of acquisition prices.

Equal treatment is desirable, however, not only for its instrumental value but also as an independent objective, an end in itself. This independent value of equal treatment is based on what I view as widely held notions of fairness. These notions of fairness suggest some presumption in favor of pro rata division. The presumption is that, absent some reason to the contrary, fairness requires that two shareholders holding the same number of shares in a company receive the same fraction of the acquisition price in the event of a takeover (or at least that they have *ex ante* the same prospects of sharing in such an acquisition price).

To be sure, this presumption is one that can be refuted if we identify some appropriate reason for deviating from pro rata division.³³ Part V will therefore examine whether there is in the takeover context any justification for such a deviation. To this end, Part V will consider those arguments that are commonly advanced, in a variety of contexts, to justify deviations from equal treatment. It will suggest that in the takeover context neither efficiency considerations, nor notions of entitlement and desert, nor overall distributive goals appear to lend any support for departing from equal treatment. Indeed, some of these considerations will be seen to strengthen rather than undermine the case for equal treatment.

As previously noted, the undistorted choice objective is the one on which a larger share of the analysis will focus. This focus is not meant to detract from the importance of achieving equal treatment, which in my view is a very important objective. Rather, a larger share of the analysis is devoted to the undistorted choice objective for two reasons. First, the analysis of the current distortions of shareholder choice and of the regulations necessary to address them is simply more complicated and requires more space than the corre-

³² See *infra* Subsection V.B.1.

³³ Professors Easterbrook and Fischel, for example, seek to justify unequal treatment of target shareholders by arguing that ensuring equal treatment would involve substantial efficiency losses. See Easterbrook & Fischel, *supra* note 7, at 710-11.

sponding analysis of the current inequality of treatment. Second, since some readers may not accept the equal treatment objective, it is important to demonstrate that the proposed regulations can all be grounded solely on the efficiency-based objective of undistorted choice; the equal treatment objective merely strengthens (in my view, considerably so) the case for these regulations.

II. THE CURRENT PROBLEMS

This Part describes how current takeover rules lead to distorted choice and unequal treatment. For simplicity of exposition, I shall assume in this Part, as well as in Parts III and IV, that the shareholders of every takeover target face a single bid. Although single-bid situations are indeed the most common,³⁴ the assumption does not generally hold true, because bidding contests over targets do occur. Bidding contests are therefore considered in Appendix B, which analyzes the additional problems that the presence of competing bids might introduce.

A. The Post-Takeover Value of Minority Shares

I wish first to examine the expected post-takeover value of minority shares — that is, the post-takeover value that a target's shareholders expect minority shares to have if the bid succeeds.³⁵ The relationship between the expected post-takeover value of minority shares and the bid price³⁶ will play an important role in the analysis to follow.

The expected post-takeover value of minority shares obviously depends on the course of action that the bidder is expected to follow upon gaining control. Under existing state corporate law, an acquirer is usually able to effect a takeout merger between itself and the target — a merger that eliminates the target's independent existence and “freezes out” minority shareholders, requiring them to exchange their shares for either cash or securities of the bidder.³⁷ Thus, a successful

³⁴ See, e.g., Bradley, *supra* note 8; Dodd & Ruback, *Tender Offers and Stockholder Returns*, 5 J. FIN. ECON. 351 (1977).

³⁵ The term “minority shares” will be used to refer to those shares of an acquired target that are not held by the acquirer. The term “post-takeover value” of minority shares will be used to refer to the value that minority shares possess, as indicated by their market price, immediately following the successful bid's expiration.

³⁶ The term “bid price” will be used to refer to the value of the consideration, whether in cash or in securities, exchanged for each share purchased through the bid.

³⁷ Of course, a merger between the target and the acquirer requires a vote of approval by the target's shareholders. The acquirer, however, can legally vote its controlling interest in favor of the merger. The acquirer's votes will usually be sufficient to approve the merger, because most states require approval by a simple majority and the acquirer's controlling interest will commonly encompass a majority of the shares. Even if the acquirer's controlling block falls short of a majority interest, the acquirer will often be able to gain approval of the merger

bidder might proceed upon gaining control in one of two ways. First, the bidder might promptly move to effect a takeout. Alternatively, the bidder might elect not to effect an immediate takeout, but rather to maintain the target, at least for the time being, as a partly-owned subsidiary.

1. *Immediate Takeout.* — Suppose first that upon gaining control the bidder is expected to proceed with an immediate takeout, a takeout occurring within a few months of the takeover. Takeovers are frequently followed by immediate takeouts. Indeed, takeover bids are often accompanied by the bidder's announcement of its plans for an immediate takeout in the event that the bid succeeds.³⁸

When shareholders expect an immediate takeout, they will also expect the post-takeover value of minority shares to be lower than the bid price. Current takeout law allows successful bidders to pay minority shareholders a consideration with a nominal value lower than the bid price. In setting the takeout consideration, acquirers are constrained only by the appraisal rights of the minority shareholders.³⁹ Appraisal statutes are not designed to give a target's shareholders any share of the gains from the target's acquisition: such statutes generally exclude from the required compensation any element of value arising from the expectation or accomplishment of a merger.⁴⁰ Furthermore, in assessing the target's pre-acquisition value, the appraisal process draws substantially on past earnings and stock market prices.⁴¹ Consequently, although appraisal rights usually ensure that

resolution. See Brudney & Chirelstein, *supra* note 7. Once shareholder approval has been obtained and the other technical requirements of a merger have been complied with, courts commonly refuse to grant minority shareholders an injunction against the consummation of a takeout merger. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *David J. Greene & Co. v. Schenley Indus.*, 281 A.2d 30 (Del. Ch. 1971); *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (1962). In *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), the Delaware Supreme Court indicated a willingness to consider injunctive relief in circumstances where the controlling shareholder could show no business purpose for the merger. In *Weinberger*, however, that court reversed itself and practically eliminated the availability of injunctive relief, thus limiting minority shareholders to the appraisal remedy, which will be discussed below. See Berger & Allingham, *A New Light on Cash-Out Mergers: Weinberger Eclipses Singer*, 39 BUS. LAW. 1 (1983).

³⁸ See, e.g., N.Y. Times, Dec. 2, 1981, at D4, col. 1 (giving notice of U.S. Steel's bid for Marathon Oil). Takeovers accompanied by an immediate takeout are referred to in takeover jargon as "two-step" acquisitions.

³⁹ Indeed, some legislatures have even permitted the elimination of appraisal rights when there is an active market in the target's stock. See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(1) (1983); PA. STATE ANN. tit. 15, § 1515(L) (Purdon Supp. 1983); MODEL BUSINESS CORP. ACT § 81 (1977); see also Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal*, 74 MICH. L. REV. 1023 (1976).

⁴⁰ See, e.g., DEL. CODE ANN. tit. 8, § 262(h) (1983); MODEL BUSINESS CORP. ACT § 81 (1971). An exception is the recently reformed New York appraisal statute. See N.Y. BUS. CORP. LAW § 623(a), (c) (McKinney Supp. 1984).

⁴¹ Courts have usually given weight to the target's stock market prices, its current and past earnings, and the sale value of its assets. See, e.g., Chazen, *Fairness from a Financial*

minority shareholders are paid no less than the target's pre-bid price, they are unlikely to require a takeout consideration as high as the price of a premium takeover bid.⁴² Indeed, in recent immediate takeouts, minority shareholders often received securities with a value substantially lower than the bid price.⁴³ Challenges to such pricing structures have been rejected by the courts.⁴⁴

Moreover, even supposing that the bidder announces its intention to pay a takeout consideration with a nominal value equal to the bid price (as has been the case in some friendly takeovers), the expected post-takeover value of minority shares will still be lower than the bid price. Takeouts usually occur at least two months, and often considerably longer, after the takeover.⁴⁵ Therefore, the expected post-takeover value of minority shares will be equal to the nominal value of the expected takeout consideration discounted by the time value of money.

2. *Retention as a Partly-Owned Subsidiary.* — Suppose now that the bidder is expected upon gaining control not to effect an immediate takeout, but rather to maintain the target for the time being as a partly-owned subsidiary. Again, shareholders are likely to expect that, if the bid succeeds, the post-takeover value of minority shares will be lower than the bid price.

Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?, 36 BUS. LAW. 1439 (1981); Note, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453 (1966). In the recent case of *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), however, the Delaware Supreme Court showed a willingness to use a more flexible approach to valuation. See *Berger & Allingham, supra* note 37, at 16-19.

⁴² Furthermore, invoking appraisal rights involves considerable procedural and technical difficulties. In Delaware, for example, a shareholder seeking appraisal rights must (1) file a written objection to the merger prior to the shareholder meeting that approves the merger, (2) vote against the merger in this meeting, (3) give written notice to the corporation promptly after the meeting of his intention to pursue his appraisal remedy, and (4) surrender his shares to the corporation. See DEL. CODE ANN. tit. 8 § 262(a), (d)-(e) (1983). These technical hurdles are one reason why appraisal has been called "a remedy of desperation." Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 85 (1969).

⁴³ For example, U.S. Steel acquired 51% of Marathon Oil's shares at a bid price of \$125 in cash, and then effected an immediate takeout (the terms of which were announced at the time of the bid). In the takeout, minority shareholders received debt securities of U.S. Steel that were estimated at the time of the bid at \$86 per share (and had an even lower value when they were actually paid). See *Wall St. J.*, Feb. 3, 1982, at 2, col. 3.

⁴⁴ See, e.g., *Radol v. Thomas*, 556 F. Supp. 586 (S.D. Ohio 1983).

⁴⁵ Consummating a takeout merger requires substantial time, even when the acquirer tries to speed the consummation, because a vote of shareholder approval is needed. The vote requirement makes it necessary to prepare bulky proxy statements, to file them with the SEC, to wait for and respond to the comments of the SEC's staff, and then to solicit the shareholders' votes. In most cases, materials cannot be mailed to stockholders until one month after filing with the SEC, and another month is usually required for the solicitation of votes. See *Freund & Greene, supra* note 2, at 1499-1500. Furthermore, speeding the immediate takeout is not always in the bidder's interest.

Of course, if minority shareholders in an acquired target could expect to receive their pro rata share of the target's future earnings, the value of their shares would be equal to that of shares in the acquirer's controlling block. Minority shareholders in an acquired target, however, cannot confidently expect to receive their pro rata share of the target's future earnings. The acquirer's control over the target might enable it, in ways described below, to deprive minority shareholders of their pro rata share.

Indeed, when an immediate takeout does not occur, the post-takeover value of minority shares is usually *even lower* than the consideration that would be required in an immediate takeout. This is because an acquirer usually will not decide against an immediate takeout unless it has other means of taking advantage of minority shareholders, and unless it believes that these means will leave the minority shareholders with even less than the consideration required in an immediate takeout.

To understand the acquirer's reasoning, suppose that an immediate takeout would require it to pay \$80 per share; and suppose that $\$M$ is the per-share value that investors would attach to minority shares if they expected no takeout to occur until at least, say, three years following the takeover. If $\$M$ were higher than \$80, then the acquirer would likely profit from an immediate takeout — even if the acquirer does not wish to remain the owner of all the target's shares. For the acquirer could effect an immediate takeout at \$80 and then resell the acquired minority shares to public investors, committing itself not to effect another takeout within three years. Given this commitment, the acquirer would be able to sell the shares for $\$M$ per share and hence make a profit of $\$(M-80)$ per share (less the relatively small transaction costs involved in the purchase and reissue of shares). Thus, because an immediate takeout would likely be profitable if $\$M$ exceeded \$80, it follows that the acquirer would decide against an immediate takeout only if $\$M$ were likely to be lower than \$80.

There are two ways that an acquirer can take advantage of minority shareholders without effecting an immediate takeout. First, the acquirer might operate the target's business in such a fashion as to divert to itself part of the target's profits.⁴⁶ For example, the acquirer might engage in self-dealing, transacting with the target on terms favorable to itself,⁴⁷ or might allocate to itself business opportunities belonging to the target.⁴⁸ Although such practices might be unlawful, engaging in them is often possible because of the obvious problems

⁴⁶ See, e.g., Brudney, *Efficient Markets and Fair Values in Parent Subsidiary Mergers*, 4 J. CORP. L. 63, 69-70 (1978).

⁴⁷ See, e.g., *Schlick v. Penn-Dixie Cement, Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

⁴⁸ See, e.g., *Swanson v. American Consumer Indus.*, 415 F.2d 1326 (7th Cir. 1969); *Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427 (Del. 1968).

involved in detecting and challenging them. The potential for such diversions of earnings is especially great when the acquirer and the target have similar or complementary lines of business, as is frequently the case when either the acquirer or the target are conglomerates.

Second, the acquirer might be able to take advantage of minority shareholders by effecting a takeout later on (a "distant takeout"). When an acquirer decides against an immediate takeout, it presumably keeps in mind, or even relies upon, the possibility of a distant takeout. Postponing a takeout might benefit the acquirer in two ways. One way that such postponement might be beneficial is that, by waiting, the acquirer might obtain inside information that will improve its ability to predict whether a takeout will prove profitable. This consideration might be especially important when the target's prospects are substantially uncertain. The acquirer might expect that its access to inside information will in time enable it to make an estimate of the target's prospects that will be substantially better than the market's estimate. If the inside information suggests that the target's prospects are good, the acquirer will effect a takeout before the information becomes reflected in the market price.⁴⁹ And if the inside information is unfavorable, the acquirer will let minority shareholders retain their shares. Thus, the acquirer will fully expose minority shareholders to the downward side of the target's uncertain prospects, while denying them the potential benefits of the upward side.

The second way that postponing the takeout might benefit the acquirer is by enabling it to influence the size of the takeout consideration that minority shareholders would be entitled to receive on appraisal. As the Delaware Supreme Court noted, the timing of a takeout might be controlled by the acquirer "to favor the majority only, based upon the status of the market and the elements of an appraisal."⁵⁰ For example, because earnings and market price are common elements of the appraisal formula, the acquirer might time the takeout to occur when earnings are abnormally low or when the market price is substantially below the value suggested by the acquirer's inside information.⁵¹ Moreover, the acquirer might also manage the target's operations so as to lower further the elements of the appraisal formula. For example, the acquirer might depress the target's earnings in the period prior to the takeout; or the acquirer might

⁴⁹ Although the acquirer is legally required to disclose all material information when proposing the takeout merger, this requirement can hardly be expected to preclude the concealment of such information, due to the ambiguity of the term "material information" and to the difficulty of identifying the kind of knowledge about the future that management knows and must disclose. See Brudney, *supra* note 46, at 71.

⁵⁰ *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032, 1037 (Del. 1979).

⁵¹ See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Berkowitz v. Power/Mate Corp.*, 135 N.J. Super. 36, 342 A.2d 566 (1975).

depress the target's market price in that period by using its control over both the target's dividend policy and its release of information.⁵² Finally, it is worth noting that the prospect of a future takeout might by itself depress the market price of minority shares. Even supposing that the informational efficiency of capital markets is perfect, the threat of an impending takeout might lead the market to price minority shares at a considerable discount below the market's estimate of the shares' pro rata portion of the target's future earnings.⁵³

Thus, an acquirer that does not effect an immediate takeout usually has available to it other effective means of taking advantage of minority shareholders. A recent study by the SEC's Chief Economist found that the post-takeover value of minority shares is usually higher when a takeover is followed by an immediate takeout than when it is not.⁵⁴ The preceding analysis explains this pattern: those instances in which the acquirer decides against an immediate takeout are exactly the instances in which the acquirer expects that, by diverting earnings or effecting a distant takeout, it will leave minority shareholders with even less than it would have to pay them in an immediate takeout.⁵⁵

3. *Minority Shares' Value versus the Bid Price.* — In sum, under current rules, the expected post-takeover value of minority shares is generally lower than the bid price *both* when the bidder is expected to effect an immediate takeout upon gaining control and when the bidder is expected not to do so. It of course follows that this will also be the case when investors are uncertain which course of action the bidder will take upon gaining control.

Finally, the analysis of this Section is confirmed by the empirical evidence. Studies by both Professor Michael Bradley and the SEC found that the post-takeover market price of minority shares is indeed significantly lower than the bid price.⁵⁶

⁵² See, e.g., *Marsh v. Armada Corp.*, 533 F.2d 978 (6th Cir. 1976), *cert. denied*, 430 U.S. 954 (1977); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967); *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969). Again, although it is unlawful for the acquirer to deliberately manipulate the elements of appraisal, there are obvious difficulties in monitoring and enforcing the acquirer's compliance with this legal standard.

⁵³ The size of the discount depends on investors' expectations concerning the acquirer's strategy. Different discounts, as well as no discount, are all consistent with investor rationality. Suppose, for example, that the per-share value of the acquired target's future earnings is \$100. Suppose also that investors believe that the acquirer is committed to a strategy of paying no dividends until it will be able to effect a takeout at \$50 per share. In this case, the value that investors will rationally attach to minority shares is \$50 per share, and this valuation will be immediately reflected in the market price. Of course, different expectations concerning the acquirer's strategy will lead to different discounts, or even to no discount at all.

⁵⁴ See SEC Release, *supra* note 11.

⁵⁵ While I accept the Chief Economist's empirical findings, I disagree with his inference that prohibiting takeouts below the bid price would hurt minority shareholders. See *infra* Subsection III.B.1.

⁵⁶ See Bradley, *supra* note 8; SEC Release, *supra* note 11.

B. *The Acquisition Price in a Takeover*

Before proceeding to examine the current problems, it is necessary to clarify the concepts of "the (total) acquisition price" and "the per-share acquisition price" in a takeover. These concepts are important to defining undistorted choice and equal treatment, and thus also to examining deviations from these objectives.

1. *The Presence of Unacquired Shares.* — In a merger, defining the acquisition price is simple because the acquirer purchases all of the target's shares: the total acquisition price equals the amount paid for each of the target's shares multiplied by the total number of the target's shares. Defining the total or per-share acquisition price in a takeover is more problematic, however, because a successful bidder generally does not acquire through its bid all of the target's shares.

There are two reasons for the common presence of unacquired shares in takeovers. First, although a successful bidder by definition attracts enough tenders to gain control, it usually does not attract tenders from all of the target's shareholders. I shall discuss later in this Part the reasons why many shareholders usually fail to tender to an eventually successful bidder.⁵⁷ At this stage, it is sufficient to note that as a matter of fact there is currently a substantial and widespread incidence of such non-tendering: commonly, a substantial fraction of an acquired target's shareholders — frequently as much as twenty or thirty percent — fail to tender their shares.⁵⁸

The second reason for the presence of unacquired shares is that in many takeovers the acquirer does not purchase all of the tendered shares. There are two kinds of bids — "for all shares" and "partial." In bids for all shares, the offeror commits itself, at least if the bid is successful, to purchase all tendered shares. In partial bids, which are often used,⁵⁹ the offeror does not commit itself to purchase more than a specified fraction (say, 51%) of the target's shares. When a partial bid is oversubscribed, the acquirer may, and usually does, refuse to purchase more shares than the number sought. In such a case, the

⁵⁷ See *infra* pp. 1733-34. Non-tendering shareholders in successful bids fall roughly into three groups: first those who did not tender because they lacked the opportunity to do so, because they were either unaware of the bid or unable to deliver their shares in time; second those who did not tender because they viewed the independent target's per-share value as higher than the bid price and hoped that the bid would fail; and third, those who did not tender for tax reasons.

⁵⁸ See Study by the Office of the Chief Economist, SEC, *The Economics of Any-or-All, Partial, and Two-Tier Tender Offers*, table 9 (Apr. 19, 1985). There is a substantial incidence of non-tendering in successful bids of all kinds — that is, whether the bid is for all shares or partial and whether or not it is expected to be followed by an immediate takeover.

Even in U. S. Steel's takeover of Marathon Oil, where shareholders expected an immediate takeout at a price dozens of dollars lower than the bid price, 10% of Marathon's shareholders did not tender. See *Radol v. Thomas*, 534 F. Supp. 1302, 1305 (S.D. Ohio 1982).

⁵⁹ See, e.g., Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183, 188 (1983).

Williams Act requires that shares be taken pro rata, so that each tendering shareholder will have the same fraction of his shares rejected.⁶⁰

2. *Defining the Actual Acquisition Price.* — Purchasing a controlling interest through a takeover bid is in an important sense equivalent to acquiring the whole target. To understand this equivalence, it may be useful to consider an illustrative example. Suppose that a bidder gains control of a 100-share target by purchasing 70 shares for a bid price of \$100 per share, and that the post-takeover value of the remaining 30 minority shares is \$80 per share. At first blush, it might seem that this takeover does not involve the target as a whole, but involves only the purchase of 70 shares for \$100 each. This view is mistaken, however, because it ignores the consequences of acquiring a controlling interest.

Acquiring a controlling interest in a target with a previously dispersed ownership is fundamentally different from acquiring a non-controlling block. The acquisition of a non-controlling block, say 5% of the target's shares, ordinarily affects only the parties to the transaction — the selling shareholders and the buyer. Shares do change hands, but the value of the target's shares and the position of non-selling shareholders are unlikely to be affected.

In contrast, when a bidder acquires a controlling interest in a target, the target's value might well change, and the position of non-selling shareholders is clearly changed.⁶¹ The takeover is likely to affect the value of unacquired shares in substantial and varied ways.⁶² Consequently, a share in the acquired target generally will have a different value — whether higher or lower — than a share in the independent target. In a sense, the two shares are different assets, each representing a different stream of future earnings. The takeover thus transforms the nature and value of unacquired shares. It terminates the asset known as “a share in the independent target” and replaces it with “a minority share in the acquired target.”

Therefore, we should not view the takeover in our example as involving only 70 shares. Rather, we should view the bidder as having purchased all 100 shares of the independent target, with each of 70 shares purchased for the bid price of \$100, and with each of 30 shares exchanged for a minority share worth \$80. We should thus regard

⁶⁰ See 15 U.S.C. § 78n(d)(6) (1976).

⁶¹ “A change in control can result in what amounts to a new, or at least vastly changed, company.” Address by Manuel Cohen, SEC Chairman, before the American Society of Corporate Secretaries, Inc. (excerpted in V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 720–22 (2d ed. 1979)).

⁶² First, the takeover might change the allocation and management of the target's assets and hence the value of the target's future earnings. Second, by creating the possibilities of a takeover and a diversion of earnings, the takeover might reduce the fraction of the target's future earnings that holders of unacquired shares can expect to capture.

the bidder as having acquired the target for a total acquisition price of $(70 \times \$100) + (30 \times \$80) = \$9400$, or a per-share acquisition price of \$94.

This characterization of the takeover is clearly accurate from the perspective of the target's shareholders. As a result of the takeover, the shareholders, as a group, have lost all of their 100 shares in the independent target. Instead, they find themselves with \$7000 in cash and with 30 minority shares worth \$2400.

This characterization of the takeover is also accurate from the bidder's perspective. The value of the minority shares — 30 shares worth \$80 each, or \$2400 — represents the part of the target's future earnings that the minority shareholders can expect to capture. The bidder, in turn, can expect to capture all of the acquired target's future earnings less \$2400. Hence, from the bidder's perspective, the takeover is equivalent to a transaction in which the bidder would first purchase all of the target's shares for \$9400 and then sell to public investors 30 minority shares worth \$2400.

3. *Defining the Expected Acquisition Price.* — Having thus far considered the actual acquisition price in a takeover, let us now examine the acquisition price that was expected when the bidder made its offer and the shareholders made their tender decisions. The expected acquisition price is important because it best reflects the bidder's valuation of the target; this valuation is in turn important, as Part V will explain, to determining the efficient allocation of the target's assets.

Consider again our example but now from the perspective of the time in which the bidder makes its bid. Suppose that at this time the expected number of shares that the bidder will purchase in the event of a takeover is estimated at 70. In this case, I suggest, the expected acquisition price is \$9400; for if the bid succeeds and the number of shares acquired for the bid price turns out to be 70, then, according to our previous calculations, the actual acquisition price will be \$9400.

No one would presumably dispute this calculation if the reason for the expected presence of unacquired shares is that the bid is partial. Some might dispute that calculation, however, if the bid is for all shares. They would argue that, after all, the bidder's offer will obligate it to purchase all of the target's shares for \$100 per share if all the shareholders tender; it is only because some shareholders might fail to tender that the total acquisition price might fall below \$100 per share. This argument, however, ignores the improbability of tendering by all of the shareholders. The bidder is presumably well aware that even the most successful bids usually do not attract tenders from all the shareholders. Consequently, in evaluating the profitability of an acquisition, the bidder will base its estimate of a takeover's expected acquisition price not on the extreme possibility of tendering

by all shareholders, but rather on the expected number of tendered shares.

Thus, the expected acquisition price is the expected value — estimated before the bid's outcome is determined — of the actual acquisition price that the bidder would pay in the event of a takeover. Although the expected acquisition price might sometimes differ from the actual one, I shall rarely distinguish between the two and shall refer to both as the acquisition price.⁶³

4. *The Acquisition Price versus the Bid Price.* — The per-share acquisition price in a takeover is thus a weighted average of the bid price (multiplied by the fraction of the target's shares acquired at that price) and the post-takeover value of a minority share (multiplied by the fraction of the target's shares that become minority shares). Because successful bidders generally do not purchase all of the target's shares at the bid price, and because the post-takeover value of minority shares is generally lower than the bid price, the per-share acquisition price is also generally lower than the bid price. This gap exists in both partial bids and bids for all shares. The larger the fraction of unacquired shares, and the greater the gap between the bid price and the post-takeover value of minority shares, then the greater the gap between the bid price and the per-share acquisition price.⁶⁴

C. *The Current Distorted Choice*

I now turn to describe the problem of distorted choice.⁶⁵ Under current rules, the outcome of a takeover bid might be distorted — that is, might deviate from the one required by the undistorted choice objective.⁶⁶ The main reason for distorted outcomes is that share-

⁶³ In referring to the acquisition price, I shall usually refer to the expected acquisition price in the context of the distorted choice issue, and to the actual acquisition price in the context of the unequal treatment issue. It should be clear from the context which of the two possible meanings is intended.

⁶⁴ The gap between the bid price and the per-share acquisition price is probably greater on average in successful partial bids than in successful bids for all shares. Whenever a partial bid is oversubscribed, as frequently happens, the fraction of unacquired shares is greater than it would be if the bid were for all shares. Still, a significant gap does usually exist in successful bids for all shares, because of the usually substantial presence of non-tendering shareholders.

⁶⁵ A mathematical, game-theoretic analysis of the current distorted choice is presented in sections III & IV of L. BECHUK, *A MODEL OF THE OUTCOME OF TAKEOVER BIDS* (Discussion Paper No. 11, Program in Law and Economics, Harvard Law School) (forthcoming Sept. 1985). I shall make frequent references below to that Discussion Paper for a formal derivation or fuller treatment of some of this Section's points.

⁶⁶ Referring to a bid's outcome — and to the tender decisions leading to it — as distorted is not meant to imply that these decisions are involuntary or illegitimately forced. Rather, the outcome, and the tender decisions leading to it, are distorted only in the sense that they deviate from the baseline established by the undistorted choice objective.

holders might tender their shares even if they consider the offered acquisition price to be lower than the independent target's value. The second reason, with which this Section begins, is that the bidder might gain effective control even if it does not attract tenders from a majority of the target's shareholders.

1. *Gaining Effective Control Without Majority Ownership.* — Let us suppose for the moment, unrealistically as we shall later discover, that shareholders tender their shares if and only if they view the offered acquisition price as higher than the independent target's value. Given this supposition, a bid's success in attracting a majority of the target's shares would mean that a majority of the shareholders viewed accepting the bid as value-maximizing. Thus, if acquiring a majority interest were both necessary and sufficient to a takeover, the undistorted choice objective would be attained.

Assuming that targets have no special anti-takeover provisions in their charters,⁶⁷ a majority interest is generally sufficient to exercise control over a target; a majority interest generally enables the acquirer both to elect the target's directors and to effect a takeout merger between the target and itself.⁶⁸ While majority ownership is generally a sufficient condition for control, it is not generally a necessary condition. When the ownership of a target is substantially divided, a bidder might well be able to gain effective control by purchasing a substantial plurality, say 40%, that falls short of a majority interest. Such a block will usually enable the bidder to elect the target's directors and, if it so desires, to effect a takeout merger. Thus, acquiring such a block will usually result in a takeover and will turn unacquired shares into "minority shares" with a post-takeover value lower than the bid price.⁶⁹

The ability of bidders to gain control without majority ownership can lead to distorted outcomes. Consider, for example, a case in which 40% of the shareholders view the offered acquisition price as higher than the independent target's value, while 60% hold the contrary view. According to the undistorted choice objective, the bid should fail. But if 40% of the shareholders tender, as we suppose they will, the bidder might well succeed in gaining control over the target.

The distortion resulting from the ability of bidders to gain control without attracting a majority of shares, however, could by itself be easily remedied. Standing alone, this problem could be addressed by

⁶⁷ Some anti-takeover charter provisions (for example, "supermajority" provisions) might increase the control threshold beyond a majority interest. Such charter provisions, which might be viewed as a possible remedy for the distorted choice problem, will be discussed in Section III.E. As will be explained, such charter provisions are incapable of ensuring that the outcome of future bids for the company will be undistorted.

⁶⁸ See *supra* note 37.

⁶⁹ Literally, of course, the unacquired shares will constitute not a numerical minority, but a powerless majority.

prohibiting bidders from acquiring a controlling interest unless they attract tenders from a majority of the shareholders. Assuming that shareholders' tender decisions reflect their judgments as to whether the offered acquisition price exceeds the independent target's value, this measure would be sufficient to attain the undistorted choice objective. Therefore, let us now put aside the problem of effective control without majority ownership, and focus on a more difficult problem: the fact that shareholders' tender decisions might well deviate from those suggested by the undistorted choice objective.

2. *The Distortion of Shareholders' Tender Decisions.* — In analyzing shareholders' tender decisions, I shall assume that these decisions are all made at the "moment of truth" — the time just prior to the bid's closing.⁷⁰ Although shareholders often tender at earlier stages, this assumption is reasonable for two reasons. First, early tenders can commonly be withdrawn until the moment of truth and hence become final and irrevocable only at that moment. Consequently, at the moment of truth, shareholders who made early tenders make a decision (at least implicitly) whether to withdraw their shares — a decision that is equivalent to a tender decision. Second, because shareholders can always postpone tendering until the moment of truth, a shareholder will not tender early unless he expects that at the moment of truth he will probably still prefer to tender. Therefore, for our purpose — that of understanding how a bid's outcome is determined — the critical question is what determines shareholders' explicit or implicit tender decisions at the moment of truth.

(a) *Shareholders' Undistorted Tender Decisions.* — The undistorted choice objective suggests that shareholders should tender their shares if and only if they estimate the independent target's value to be lower than the offered acquisition price. It is therefore important to state precisely what is meant by a shareholder's estimate of the independent target's value.

A shareholder's estimate of the independent target's value refers to his estimate of the value that the target would have if he could determine the bid's fate and if he used this power to order that the target remain independent. Shareholders might of course differ in their estimates of the independent target's value — for the independent target's value depends on various imperfectly known factors, such as the profitability of the target in an indefinite independent existence and the prospect of receiving other acquisition offers in the future.

Furthermore, a shareholder's estimate of the independent target's value refers to the estimate that he has at the time of his tender

⁷⁰ More precisely, I shall assume that all tender decisions are made at the last moment in which it is still possible to tender and receive the same treatment as earlier tenderers. In a bid for all shares, that moment will be just prior to the bid's closing; in a partial bid, it will be just before the closing of the proration pool.

decision — that is, the estimate he can make with the information he has at that time. Note that at the moment of decision, the shareholder ordinarily has only imperfect information about the other shareholders' estimates. The shareholder is unlikely to know the exact distribution of the others' estimates around his own, and indeed might even be unable to completely rule out the possibility that the others' estimates are all higher (or lower) than his own. Consequently, the shareholder might revise his estimate if he were to make a further assumption concerning others' estimates (that is, an assumption beyond those warranted by the information he has at the time). For example, a shareholder who has a \$100 estimate and believes that others' estimates are just as likely to be above as below his, might revise his estimate upwards if he were to make the further assumption that all the other shareholders actually have an estimate above \$100. An estimate revised in light of such assumptions will be referred to as an estimate "conditional" on such assumptions.⁷¹

(b) *Shareholders' Considerations Under the Current Rules.* — In making a tender decision under current takeover rules, a shareholder will presumably realize that his decision is unlikely to determine the bid's success. This is true not only for small shareholders, but also for relatively large ones who hold, say, one percent of the target's stock. First, in the spectrum from a small, non-controlling block to a majority block, there is no magic point where the purchase by the bidder of an additional one percent of the target's shares would significantly change the degree of control that the bidder would have. Second, even if there were such a magic threshold — if, for example, a majority interest were not only sufficient but also absolutely necessary for control — the shareholder's decision would still have a very small likelihood of determining whether or not that magic threshold would be crossed.

Thus, the shareholder will pay little attention to the question of how his decision will affect the probabilities of the two possible outcomes of the bid — the bidder gaining control over the target and the bidder failing to do so.⁷² Rather, for each of the two possible out-

⁷¹ A shareholder's conditional estimate might differ from his unconditional estimate, of course, only if the shareholders differ in their unconditional estimates. The ways in which the difference between conditional and unconditional estimates might affect tender decisions are discussed in my Discussion Paper more fully than they will be discussed below. See L. BEBCHUK, *supra* note 65, secs. III-VII.

The possible difference between conditional and unconditional estimates is relevant not only to understanding the current distortions, but also to designing adequate measures to attain undistorted choice. In particular, it will be shown that, because of this difference, one seemingly promising approach — ensuring that the expected post-takeover value of minority shares be equal to the bid price — would not attain undistorted choice. See *infra* Section III.C.

⁷² There are of course intermediate cases where the bidder gains partial control. Incorporating such cases into the analysis to follow would not significantly affect any of its conclusions.

comes, the shareholder will examine whether he would be better off tendering or holding out.

Consider first the case in which the bid succeeds and the bidder gains control. In this case, if the shareholder does not tender, all of his shares will become minority shares with a post-takeover value lower than the bid price. In contrast, if the shareholder does tender, he will have all of his shares — or, in the case of an oversubscribed partial bid, a major fraction of them — acquired for the bid price. In comparison to his holding out, then, tendering will produce a gain for each of his shares that the bidder will acquire. Thus, if the bid is going to succeed, the shareholder will always be better off tendering, no matter how high his estimate of the independent target's value.⁷³

Consider now the case in which the bidder fails to gain control and the target remains independent. Because bidders usually retain the option not to purchase tendered shares if they fail to gain control, a failing bidder usually can proceed in either of two ways: it may return tendered shares to the tenderers, or it may elect to purchase these shares and thus obtain a possibly significant, though non-controlling, block of the target's shares.⁷⁴ If the bidder returns tendered shares, the shareholder's tender decision will make no difference: whether he tenders or holds out, he will end up with his original shares in the independent target. If the failing bidder elects to purchase tendered shares, however, the shareholder's decision will matter: if he holds out he will retain his shares in the independent target, whereas if he tenders he will have his shares acquired for the bid price. Therefore, assuming that the bid is going to fail, and that there is some likelihood that the failing bidder will elect to purchase tendered shares, the shareholder will be better off tendering if and only if the bid price exceeds the per-share value that the independent target will have.

Thus, whereas the shareholder will wish to have his shares acquired in the event of a takeover, he might or might not wish to have

⁷³ Because of special tax circumstances, some shareholders might prefer retaining minority shares in the acquired target to selling their shares at the bid price. Retaining minority shares — and accepting a lower pre-tax wealth — might benefit these shareholders by reducing their tax liability. See *infra* pp. 1734–35. In analyzing the tender decisions of a representative shareholder, this Section assumes that the shareholder does not face such special tax circumstances.

⁷⁴ A failing bidder might wish to acquire a non-controlling block because it entertains the possibility of making another bid in the future, or because it views the target's stock as a good investment (possibly because of the prospect of a future offer by another bidder). The failing bidder might choose to purchase tendered shares even if the bid price exceeds the market price of the independent target's shares following the bid's failure; for an attempt to purchase a substantial block in the market might drive the market price up.

The failing bidder might on the other hand elect to return tendered shares because it has abandoned the idea of acquiring the target and it does not view the acquisition of a non-controlling block as the best way to invest its funds.

his shares acquired in the event that the target remains independent. What, then, will he elect to do? Clearly, if he concludes that he would like to have his shares acquired for the bid price even if the bid fails, then he will certainly tender. If, however, he concludes that he would like to retain his shares in the event that the bid fails, then he will have to weigh the costs and benefits of tendering. In doing so, he will compare the probability of the bid's success with that of the bid's failure, and the expected gain from tendering in case the bid succeeds with the expected loss from tendering in case the bid fails. In assessing the probabilities of the bid's success and failure, the shareholder will use whatever information he has about other shareholders' estimates and beliefs to try to predict their likely tender decisions.⁷⁵

(c) *The Nature of Shareholders' Current Considerations.* — The considerations that currently shape shareholders' tender decisions are quite different from those that, according to the undistorted choice objective, should determine these decisions. Consider first a shareholder's examination of his best course of action if the bid is going to succeed. The shareholder's best course of action in this case will be determined by the expectation that the post-takeover value of minority shares will be lower than the bid price: if the bid is going to succeed, the shareholder will be better off tendering, no matter how high his estimate of the independent target's value. Thus, as long as the bid has some chance of success, the prospect of a takeover will pressure the shareholder to tender his shares. The greater the probability that the shareholder attaches to a takeover, and the larger the gap between the bid price and the expected post-takeover value of minority shares, then the stronger will be the pressure to tender.

This pressure exists whether the bid is partial or for all shares, and whether or not the takeover is expected to be followed by an immediate takeout. This point is worth emphasizing because many seem to believe that, to the extent distortions of shareholder choice exist, they are rooted in the practices of partial bids and immediate takeouts.⁷⁶ A pressure to tender is present, however, whenever there is a gap between the bid price and the expected post-takeover value

⁷⁵ In section III of my Discussion Paper, see L. Bebchuk, *supra* note 65, I present a game-theoretic analysis of how a shareholder will reach his tender decision. In particular, I analyze how a shareholder will assess the likelihood of the bid's success — given his beliefs concerning other shareholders' estimates of the independent target's value, and his recognition that other shareholders reason in a way similar to his. This analysis is then used to derive the shareholder's likely tender decision as a function of the bid's terms, the expected post-takeover value of minority shares, the shareholder's estimate of the independent target's value, and his beliefs concerning the distribution of others' estimates. This result is in turn used to derive a bid's likely outcome as a function of the bid's terms, the expected post-takeover value of minority shares, the distribution of shareholders' estimates, and the level of the effective control threshold.

⁷⁶ See *infra* Sections III.A–B.

of minority shares; and such a gap is usually present in bids of all kinds.

Consider now a shareholder's determination of his best course of action if the bid is going to fail. The shareholder's best course of action in this case depends on how the bid price compares with the per-share value that he expects the independent target's shares to have. This comparison differs in two respects from the comparison suggested by the undistorted choice objective — that is, from a comparison of the expected per-share acquisition price with the shareholder's estimate of the independent target's per-share value. First, the shareholder will be taking into account not the expected per-share acquisition price but rather the bid price, which will generally be higher. Second, the shareholder will be taking into account not his (unconditional) estimate of the independent target's per-share value, but rather an estimate that is conditional on enough shareholders resisting the pressure to tender — and the latter, conditional estimate might well differ from the former.

In sum, shareholders' tender decisions under current law are significantly distorted: they are in no way determined by the shareholders' judgments as to how the expected acquisition price compares with the independent target's value. It still remains, however, to identify the direction of the current distortions.

(d) *The Direction of the Current Distortions.* — Predicting a bid's outcome with certainty might sometimes be difficult or indeed impossible.⁷⁷ Nonetheless, it is possible to identify clearly the direction in which the current distortions operate. In comparison to the benchmark established by the undistorted choice objective, the current distortions operate systematically and strongly in favor of bidders.

To see the direction of the current distortions, let us study the expected outcome of bids under the simplifying assumption that all the shareholders of a given target maintain the same estimate of the independent target's value, and that each of them knows that the others share his estimate. For an illustrative example, suppose that the shareholders of a target face a bid (which might be either partial or for all shares) with a bid price of \$100 per share and with an expected post-takeover value of minority shares of \$80 per share; and suppose that the shareholders' common estimate of the independent target's value is $\$V$ per share.

⁷⁷ For one thing, shareholders' tender decisions might well depend on the probability that each of them attributes to the bid's success; and this probability depends not only on a shareholder's estimate of the independent target's value, but also on his belief concerning the distribution of the other shareholders' estimates, on his beliefs concerning others' beliefs concerning the distribution of estimates, and so forth. Furthermore, as we shall see below, even with a complete specification of shareholders' estimates and shareholders' beliefs concerning others' information, different outcomes might still result.

Suppose first that $\$V$, the shareholders' common estimate, is lower than the $\$100$ bid price. In this case, any given shareholder will tender his shares; for, whether the bid is going to succeed or fail, the shareholder will prefer selling his shares at the bid price to retaining them.⁷⁸

Thus, if $\$V$ is lower than the bid price, all the shareholders will tender, and the target will be acquired. This result by itself suggests that bids' outcomes are currently distorted in favor of bidders. For, according to the undistorted choice objective, the target should not be acquired unless $\$V$ is lower than the expected per-share acquisition price, which is generally lower than the bid price. Thus, whenever $\$V$ is lower than the bid price but higher than the expected per-share acquisition price, an undesirable outcome — a takeover — will surely result.⁷⁹

Suppose now that $\$V$, the shareholders' common estimate of the independent target's per-share value, exceeds the $\$100$ bid price. In this case, the target may or may not be acquired. A given shareholder will wish, as always, to have his shares acquired in the event of a takeover. But he will also wish to retain his shares in the event that the target remains independent, because he expects that in such a case the independent target's per-share value will exceed $\$100$. Consequently, he may or may not tender. The greater the probability that he attributes to the bid's success, and the greater the gap between the bid price and the expected post-takeover value of minority shares ($\$20$ in our example), then the greater the likelihood that the shareholder will tender. Similarly, the greater the probability that he attributes to the bid's failure, and the larger the gap between $\$V$ and the $\$100$ bid price, then the greater the likelihood that the shareholder will hold out.

It might be asked why a shareholder would attribute any positive probability to the possibility of a takeover when he knows that he, as

⁷⁸ No matter what $\$V$ is, the shareholder will always wish to have his shares acquired in the event of a takeover. And, since $\$V$ is lower than the $\$100$ bid price, the shareholder would like to sell his shares for the bid price even in the event that the bid fails. (This latter case is a purely hypothetical one: the shareholder, recognizing that all other shareholders reason in a way identical to his, will attach a zero probability to the bid's failure.)

⁷⁹ To illustrate, suppose that the bid in our example is partial and that in the event of a takeover the bidder is expected to purchase 50% of the target's shares at the $\$100$ bid price. In this case, the expected per-share acquisition price is $\$90$; thus, according to the undistorted choice objective, the target should be taken over only if $\$V$ is lower than $\$90$. But since a takeover will surely occur as long as $\$V$ is lower than the $\$100$ bid price, a distorted outcome will take place whenever $\$V$ is between $\$90$ and $\$100$.

Alternatively, suppose that the bid in our example is for all shares, and that the expected fraction of non-tendering shareholders (say, shareholders who lack an opportunity to tender) is 20%. In this case, the expected per-share acquisition price is $\$96$, and, according to the undistorted choice objective, the target should be taken over only if $\$V$ is lower than $\$96$. But again, a takeover will surely occur if $\$V$ is lower than $\$100$. Thus, if $\$V$ is between $\$96$ and $\$100$, a distorted outcome will certainly take place.

well as all other shareholders, estimate the independent target's per-share value to be higher than the bid price. There are two reasons why a rational shareholder might do so. First, while we assume that each shareholder knows with certainty that other shareholders' estimates are uniform and equal to his own, a shareholder might still be uncertain as to what other shareholders' beliefs are. He might be unsure whether all other shareholders know that the distribution of estimates is uniform, or he might be unsure whether all other shareholders know that all other shareholders know that the distribution of estimates is uniform, and so forth. Any uncertainty of this kind might lead a rational shareholder to attribute a positive probability to the possibility of a takeover.⁸⁰

Second, and more important, even assuming that shareholders face no uncertainty of the kind just discussed, a rational shareholder might still attach a significant likelihood to the possibility of a takeover. To be sure, if the shareholders could coordinate their actions, they would all agree not to tender their shares, and a rational shareholder would thereupon view the bid's failure as certain. But the shareholders presumably cannot conclude such an agreement, and each shareholder must consequently make his tender decision without assurance as to how the others will act. His decision will depend on his expectations concerning the others' actions, expectations that he will form with the recognition that others reason in a similar fashion. In such a situation, it might be perfectly rational for some, many, or indeed most shareholders to attach a significant likelihood to the possibility of a takeover. For such initial expectations might well be self-fulfilling — they could lead to tenders in a sufficient number for the bidder to gain control. And since such initial expectations might be self-fulfilling, it might be rational to adopt them in the first place. To be sure, it is also possible that all or most shareholders would adopt initial expectations that the bid will fail, and such expectations might also be self-fulfilling. Thus, shareholders' initial expectations can go either way; and, because these initial expectations are likely to be self-fulfilling, the bid's outcome can also go either way.⁸¹

The conclusions of the above analysis, which employed the simplifying assumption that all shareholders have the same $\$V$ estimate

⁸⁰ The described reason for viewing a takeover as possible will not be present only when the uniformity of shareholders' estimates is what economists call "common knowledge." That the information be "common knowledge" is a very strong requirement. Shareholders must all know about the uniformity of their estimates, must all know that all the shareholders know about the uniformity, must all know that all the shareholders know that all the shareholders know about the uniformity, and so forth, ad infinitum. On the concept of "common knowledge," see Aumann, *Agreeing to Disagree*, 4 ANNALS OF STATISTICS 1236 (1976).

⁸¹ In the language of economics, even if it is "common knowledge" that all the shareholders have the same high estimate of the target's value, the equilibrium is not unique: both the bid's failure and the bid's success are possible rational expectations equilibria.

of the independent target's per-share value, can thus be summarized as follows. If the shareholders' estimate of $\$V$ is lower than the expected per-share acquisition price — that is, if a takeover is socially desirable — the bid will indeed succeed. If the shareholders' estimate of $\$V$ is higher than the expected per-share acquisition price — that is, if a takeover is socially undesirable — the target might still be acquired: if $\$V$ is between the expected per-share acquisition price and the bid price, the target will surely be acquired; and even if $\$V$ is higher than the bid price, the target might still be acquired if enough shareholders attach a sufficiently significant likelihood to the possibility of a takeover. The bid is likely to fail only if (1) the shareholders' estimate of $\$V$ is higher not only than the expected per-share acquisition price but also than the bid price, and (2) there is a widespread confidence among shareholders that the bid will fail (say, because the offered acquisition price is widely perceived as ludicrously low). Thus, the above analysis suggests that the current distortions operate systematically and substantially in favor of bidders.⁸²

(e) *The Current Distortions and Market Trading.* — The analysis thus far, it might be argued, is flawed because it has paid no attention to the existence of market trading throughout the period in which the bid is open. Trading in the target's shares is commonly active during that period, usually with a heavy participation by arbitrageurs.⁸³ The ability of the target's shareholders to sell their shares in the market, it might be argued, protects them from the pressure to tender created by the prospect of a takeover.

The market price of the target's shares, so the argument goes, will reflect shareholders' estimates of the independent target's value. For example, if all the shareholders estimate the independent target's per-

⁸² My Discussion Paper analyzes the current distortions without employing the simplifying assumption that all the shareholders of a target share the same estimate of the independent target's value. See L. BEBCHUK, *supra* note 65, secs. III & IV. Dropping this assumption introduces a new distorting factor that works *against* bidders. As the Discussion Paper shows, however, this new factor is likely to be outweighed by the other distorting factors discussed in this Section. The Discussion Paper therefore reaches the same conclusion as this Section — that the current distortions are likely to operate systematically and strongly in favor of bidders.

The new factor that is introduced when the simplifying assumption is dropped might be briefly described as follows. In reaching a tender decision, a shareholder will consider what his best course of action will be if the bid is going to fail. This course of action depends on how the bid price compares with the shareholder's estimate of the independent target's value *conditional* on the assumption that the bid is going to fail. If the shareholder knows for sure that all of the others' estimates are equal to his own, then his conditional estimate will be no different from his unconditional estimate. If the shareholders' estimates differ, however, the shareholder's estimate conditional on the bid's failure (the estimate that he will use in identifying his best strategy supposing that the bid is going to fail) will be higher than his unconditional estimate (the estimate that defines his undistorted tender decision). The difference between the shareholder's conditional estimate and his unconditional estimate works against the bidder.

⁸³ See Henry, *Activities of Arbitrageurs in Tender Offers*, 119 U. PA. L. REV. 466 (1971); Rubin, *Arbitrage*, 32 BUS. LAW. 1315 (1977).

share value at $\$V$, the market price will not fall below $\$V$. Thus, if $\$V$ exceeds the per-share value that tendering shareholders can expect to receive in case of a takeover,⁸⁴ the market price will also exceed this per-share value; consequently no shareholder will tender, since tendering will be clearly inferior to selling into the market. Hence, the argument concludes, a target will never be acquired if most shareholders view its independent per-share value as higher than the per-share value that tendering shareholders can expect to receive in case of a takeover.⁸⁵

This market trading objection, however, is invalid. The Article's analysis has correctly focused on "the moment of truth" (the time just prior to the bid's expiration). No matter how many times the target's shares have changed hands since the bid's announcement, at the moment of truth they are all necessarily owned by someone. At this point in time, the shares' ultimate owners face only two alternatives — tendering their shares to the bidder, and retaining their shares beyond the offer's expiration. Thus, the Article's analysis of shareholder choice is perfectly applicable to the decisions that the shares' ultimate owners must make at the moment of truth. Fearful of ending up with minority shares, they might tender even if they consider the independent target's per-share value to be higher than the per-share value they expect to receive in the event of a takeover.

Because a bid's outcome is determined by the shareholders' decisions at the moment of truth, showing that these decisions are distorted is sufficient to refute the market trading objection. Still, it is worth noting that the objection also relies on mistaken assumptions concerning the market price of the target's shares during the bid period. In particular, in contrast to what the objection mistakenly assumes, this market price might not fully reflect investors' estimates of the independent target's value.

Because shareholders are expected to be under pressure to tender at the moment of truth, this looming pressure might affect the market

⁸⁴ In a bid for all shares, the per-share value that tendering shareholders can expect to receive in the event of a takeover is equal to the bid price. In a partial bid, however, that per-share value is commonly lower than the bid price, since tendering shareholders commonly expect only a fraction of their shares to be purchased at the bid price (with the rest of their shares becoming minority shares).

⁸⁵ Note that even if the market trading objection were valid, it would not imply that no distortions exist, but would imply only that the distortions are more limited than my analysis suggests. As will be explained later, (1) the per-share value that tendering shareholders can expect to receive in the event of a takeover is higher than (2) the expected per-share acquisition price. The reason for the difference between (1) and (2) is that, because not all shareholders are expected to tender, tendering shareholders can expect to receive in the event of a takeover more than their pro rata share of the acquisition price. See *infra* pp. 1729-31. Thus, even supposing that the market trading objection is valid, a socially undesirable acquisition might still occur in those cases where a majority of the shareholders view the independent target's value as higher than (2) but not higher than (1).

price of the target's shares during the bid period.⁸⁶ Investors who buy the target's shares during this period are aware that they (or, if they resell the shares, those who will buy the shares from them) will be ultimately subject to pressure to tender. The price that investors will be willing to pay for the target's shares will inevitably reflect this awareness. Indeed, in calculating the price that they are willing to pay for the target's shares, arbitrageurs and other potential buyers usually assume that, because of the current distortions of shareholder choice, the bid will likely succeed unless it is superseded by a higher bid or impeded by obstructive tactics. Thus, when the shareholders' estimate of the independent target's per-share value exceeds the per-share value that tendering shareholders would receive in the event of a takeover, the prospect of a takeover might push the market price below the shareholders' estimate of the independent target's per-share value. Indeed, when the bid's success seems certain, the market price will be capped by the per-share value that tendering shareholders would receive in the event of a takeover.⁸⁷

To be sure, the market price of the target's shares during the bid period is sometimes set at a substantial premium over the per-share value that tendering shareholders would receive in the event of a takeover. Such a premium might exist because of widespread expectations that the present bid will be superseded by a substantially higher one. In this case, however, the premium will disappear if the higher bid has not materialized by the time the moment of truth arrives. Such a premium might also exist because of widespread confidence that shareholders will not tender and the bid will fail, and that the subsequent market price of the independent target's shares will substantially exceed the per-share value that tendering shareholders would receive in the event of a takeover. In this latter case, of course, the high market price only reflects — rather than brings about — the bid's expected failure.

Finally, it should be noted that, because the market price during the bid period might not accurately reflect shareholders' estimates of the independent target's value, this market price cannot be used as evidence for the social desirability of a takeover. In particular, when a bid succeeds, the fact that during the bid period the target's market price did not exceed the eventual per-share acquisition price does not

⁸⁶ For an illustration of this point in a formal model, see L. Bebchuk, *supra* note 65, sec. VIII.

⁸⁷ To illustrate, suppose that the pre-bid market price of a target's shares was \$75; that the bidder made a \$100 per-share bid for all shares; that the expected post-takeover value of minority shares is \$80 per share; and that, subsequent to the making of the bid, new information leads shareholders to increase their estimate of the independent target's value to \$105. In this case, the market price might not rise to \$105, but stay at \$100. Investors might believe that the pressure to tender will enable the bid to succeed, and consequently might be unwilling to pay more for the target's shares than \$100 per share.

imply that most shareholders indeed viewed the independent target's per-share value as lower than that per-share acquisition price.

(f) *The Current Distortions and Coordination Costs.* — It is worth examining the extent to which the distortions of shareholders' tender decisions are related to shareholders' inability to coordinate their actions. In particular, I wish to show that if shareholder coordination were possible, then some distorted outcomes would be avoided, but others would not.⁸⁸

Consider again the example of a target's shareholders who face a bid price of \$100 per share and expect the post-takeover value of minority shares to be \$80 per share. Assuming that the bid is for 60% of the target's shares, and that this is indeed the number of shares that the bidder is expected to purchase in case of a takeover, the expected per-share acquisition price is \$92. As before, suppose that all the shareholders have the same $\$V$ estimate of the independent target's per-share value. Let us add, however, a new fact: 20% of the target's shareholders lack the opportunity to tender, because they are unaware of the bid or unable to deliver their shares in time.⁸⁹ Thus, in the event of a takeover, the fraction of non-tendering shareholders will be at least 20%. In particular, if all the shareholders able to tender do so, the proration ratio will be 75%, and they will all end up with a per-share value of \$95.

Now, according to the undistorted choice objective, the target should remain independent if $\$V$, the shareholders' common estimate of the independent target's per-share value, exceeds the \$92 expected per-share acquisition price. As we have seen, however, as long as $\$V$ is lower than the \$100 bid price, all shareholders able to tender will do so, and the target will certainly be acquired; and even if $\$V$ exceeds \$100, the target might still be acquired. Thus, a distorted outcome might well occur. Further examination of this possible distortion reveals that one can distinguish between two classes of cases: those in which cooperation among shareholders would prevent a distorted outcome, and those in which it would not.

Suppose first that $\$V$ exceeds \$95, the per-share value that tendering shareholders would receive in the event of a takeover in which all shareholders able to tender do so. In this case, a takeover would be avoided if coordination were possible, because all the shareholders who are able to tender would conclude an agreement to hold out. These shareholders would all desire such an agreement because they

⁸⁸ Previous discussions of the distorted choice problem have assumed, explicitly or implicitly, that distortions of shareholders' tender decisions must all be attributed to the inability of tendering shareholders to coordinate their actions.

⁸⁹ As will be later explained, *see infra* pp. 1733-34, ignorance of the bid is only one reason among several for the presence of non-tendering shareholders in successful bids. For the purposes of the present analysis, however, what is important is that, whatever the reason, not all shareholders are expected to tender in the event of a takeover.

would all rightly expect to be worse off if it is not concluded and a takeover takes place.⁹⁰

Suppose now that $\$V$ is lower than $\$95$ but exceeds the $\$92$ expected per-share acquisition price. In this case, a distorted outcome would not be avoided if shareholders could coordinate their actions — a takeover would still take place. For in this case all the shareholders who have an opportunity to tender will correctly expect to benefit from a takeover. Because 20% of the shareholders will not tender, the takeover's proration ratio will be 75%, and the tendering shareholders will end up with a per-share value of $\$95$ ($\$3$ more than the per-share acquisition price). Consequently, since $\$V$ is lower than this per-share value of $\$95$, all the shareholders who are able to tender will prefer the bid to succeed.⁹¹ Therefore, even if they could coordinate their actions, they would not conclude an agreement to hold out, but rather would still elect to tender.

To be sure, the resulting takeover will make non-tendering shareholders worse off: all of their shares will become minority shares with a value of $\$80$ each, a value substantially lower than $\$V$. Indeed, the fact that $\$V$ is higher than the $\$92$ per-share acquisition price implies that the losses the takeover will impose on non-tendering shareholders will exceed the gains it will confer on tendering shareholders. Although the tendering shareholders realize that the takeover will reduce the wealth of the target's shareholders as a group, they still prefer the takeover to take place because it will enhance their own wealth. Of course, if the acquisition price were expected to be divided pro rata, the tendering shareholders would not wish the bid to succeed. But the tendering shareholders expect to receive more than their pro rata share of the acquisition price, and this expectation leads them to want the bid to succeed.

The general lesson to be drawn from the above analysis is the following. At present, tendering shareholders can generally expect to receive in the event of a takeover more than their pro rata share of the acquisition price. As a result, tendering shareholders' judgment of whether they would benefit from a takeover might differ from their judgment of whether the expected acquisition price exceeds the independent target's value. In particular, tendering shareholders might estimate the independent target's per-share value to be higher than

⁹⁰ If $\$V$ exceeds $\$100$, then any given shareholder will clearly be made worse off by a takeover — even if he could have all of his shares acquired for the $\$100$ bid price. If $\$V$ is between $\$100$ and $\$95$, then, without coordination, all the shareholders able to tender will do so. Consequently, each tendering shareholder will have only 75% of his shares acquired at the bid price; he will thus end up with a per-share value of $\$95$ and will be made worse off by the takeover.

⁹¹ I assume that the bidder is unlikely to purchase tendered shares if the bid fails. This assumption is reasonable because the $\$100$ bid price substantially exceeds $\$V$, which will be the market price of the target's shares if the bid fails.

the expected per-share acquisition price but lower than the per-share value they expect to receive in the event of a takeover; in such a case, they would prefer a takeover to take place even though they expect it to reduce the combined wealth of the target's shareholders. A situation of this kind can occur in all bids, whether partial or for all shares.⁹²

3. *Classifying the Sources of Distorted Outcomes.* — I now wish to propose a classification of the reasons for the current deviations from the undistorted choice objective. This classification will later prove useful in designing a remedy to attain that objective.

The outcome of bids would always conform to the undistorted choice objective if the following two conditions were satisfied: (1) that bidders succeed in gaining control if and only if a majority of the target's shareholders prefer the bid to succeed; and (2) that shareholders prefer a bid to succeed if and only if they view the expected acquisition price as higher than the independent target's value. The two conditions together imply that a takeover will occur if and only if a majority of the target's shareholders consider the expected acquisition price to be higher than the independent target's value.

At present, however, neither condition is satisfied. The first condition, that a takeover never occur unless a majority of the shareholders prefer the bid to succeed, is violated in two ways. First, a bidder might gain effective control without attracting a majority of the target's shares; hence, even if shareholders' tender decisions perfectly reflected their preferences concerning the bid's success, the condition might still be violated. Second, and more important, shareholders' tender decisions might not reflect their preferences concerning the bid's success; as we have seen, a bidder might well receive tenders from shareholders who prefer the target to remain independent.

The second condition, that shareholders never prefer a bid to succeed unless they view the expected acquisition price as higher than the independent target's value, also is not currently satisfied. As we have seen, tendering shareholders can currently expect to receive in the event of a takeover more than their pro rata share of the acquisition price, and they might therefore prefer a takeover even if they view the expected acquisition price as lower than the independent target's value.

In sum, the conditions that would ensure an undistorted choice are currently violated for three reasons: (1) a bidder might gain control

⁹² To see how such a situation might arise in the context of a bid for all shares, let us suppose that our hypothetical \$100 per-share bid is for all shares. Because 20% of the shareholders are assumed to lack an opportunity to tender, tendering by all shareholders able to do so will produce a takeover with a per-share acquisition price of \$96. In such a takeover, however, tendering shareholders will receive a per-share value of \$100. Thus, supposing that SV is between \$96 and \$100, a socially undesirable takeover would occur even if the tendering shareholders had the ability to coordinate their actions.

even if less than a majority of the shareholders tender their shares; (2) shareholders might tender their shares even if they do not prefer the bid to succeed; and (3) tendering shareholders might prefer the bid to succeed even if they view the independent target's value as higher than the expected acquisition price.

Each of these three problems would be sufficient by itself to produce deviations from undistorted choice. And all three operate in favor of bidders. Although problem (2) appears to be the most significant one,⁹³ it should be emphasized that eliminating it alone would not ensure undistorted choice.⁹⁴

4. *Conclusion.* — Under current rules, the outcome of bids does not conform to the undistorted choice objective. Indeed, distorted outcomes can currently occur in bids of all kinds — that is, whether the bid is partial or for all shares, and whether or not it is expected to be followed by an immediate takeout. For one thing, a bid's outcome might be distorted whenever there is a gap between the bid price and the expected post-takeover value of minority shares, and such a gap is generally present in all bids.⁹⁵

To be sure, I do not claim that the current distortions are irresistible and that a bid might never fail. A bid might well fail, for

⁹³ The second problem is also the only one to which commentators have previously paid attention. See sources cited notes 7–9.

⁹⁴ The regulatory arrangement proposed in Part IV would attain undistorted choice by ensuring that the two conditions stated above would both be satisfied. First, under the proposed regulations a takeover would occur if and only if a majority of the shareholders prefer it to take place. This first condition would be satisfied because shareholders would express their preferences concerning the bid's success by making approving and disapproving tenders, and because bidders would be allowed to purchase a controlling interest only if they attract a majority of approving tenders. Second, under the proposed regulations, shareholders would prefer a takeover to occur if and only if they view the expected acquisition price as higher than the independent target's value. This second condition would be attained by virtue of the fact that, under the regulations, tendering shareholders (or shareholders making approving tenders) would never expect to receive in the event of a takeover more than their pro rata share of the acquisition price. See *infra* Sections IV.A and IV.B.

⁹⁵ In Section IV of my Discussion Paper, see L. BEBCHUK, *supra* note 65, I compare partial bids and bids for all shares in terms of the magnitude of the distortions involved. That analysis suggests that, contrary to common perceptions, partial bids cannot be shown to involve systematically greater distortions than those involved in bids for all shares. On the one hand, compared to a bid for all shares, a partial bid increases the magnitude of the distortions by increasing the gap between the bid price and the expected per-share acquisition price; for, as is explained in note 64, making the bid partial is likely to reduce the expected per-share acquisition price by decreasing the number of shares that the bidder is expected to purchase in the event of a takeover. On the other hand, compared to a bid for all shares, a partial bid diminishes the magnitude of the distortions by lowering the penalty that a takeover is expected to impose on non-tendering shareholders: making the bid partial creates the expectation that in the event of a takeover tendering shareholders will not have all of their shares acquired at the bid price; and it thus reduces the gap between tendering and non-tendering in terms of their expected consequences for the shareholder's financial position in the event of a takeover.

example, if a large majority of the target's shareholders view the independent target's per-share value as substantially higher than not only the expected per-share acquisition price but also the bid price, and if there is also a widespread confidence that the bid will fail. Indeed, recent empirical work by Professors Bradley, Desai, and Kim identified several dozen instances in which, in the face of a takeover bid, a target's shareholders did not tender their shares, and the target remained independent at least for some time.⁹⁶ In these instances, remaining independent indeed turned out to be value-maximizing: following the bid's rejection, the market price of the independent target's shares was significantly higher than the bid price; and the independent target often received a higher acquisition offer later on.

My claim is not that the current distortions are irresistible, but rather that they are substantial. Although bids are not bound to be successful, a bid might well succeed even if it is socially desirable that it fail. There is a significant likelihood that a bid will fail only when the shareholders' estimates of the independent target's per-share value exceed the expected per-share acquisition price by a considerable margin. By the same token, a bidder can currently offer a per-share acquisition price considerably lower than the shareholders' estimates of the independent target's per-share value — and still enjoy a high likelihood of success.⁹⁷

D. The Current Inequality of Treatment

A takeover's total acquisition price is often unequally distributed among the target's shareholders. This inequality of treatment is rooted in the common presence of a gap between the post-takeover value of minority shares and the bid price. Because of this gap, a shareholder's portion of the total acquisition price depends on the proportion of his shares, if any, that are acquired by the successful bidder at the bid price. Whereas tendering shareholders have their shares, or most of them, acquired at the bid price, the shares of non-tendering shareholders are all converted into minority shares. Consequently, these non-tendering shareholders, who are commonly present in substantial numbers, receive significantly less than their pro rata share of the acquisition price.

Because the disparity between the bid price and the post-takeover value of minority shares can be anticipated, the question naturally

⁹⁶ See Bradley, Desai & Kim, *supra* note 59.

⁹⁷ The analysis of this Section has thus demonstrated that, when a majority of the target's shareholders view rejecting the bid as their value-maximizing course of action, the bid might well still succeed. The question remains, however, whether it often happens that a majority of the shareholders will view remaining independent as value-maximizing. This question is addressed in Part V, which explains why there is in all likelihood a significant number of such cases. See *infra* pp. 1766–70.

arises why shareholders ever fail to tender to a successful bidder. There are three reasons for the substantial incidence of such non-tendering. First, some shareholders simply lack a genuine opportunity to tender, either because they are unaware of the bid or because they are unable to deliver their shares in time.⁹⁸ Market professionals learn about a bid very shortly after it is made, but some unsophisticated investors may not learn about a bid or may learn about it too late. Market professionals are often able to deliver their share certificates within hours, but some unsophisticated investors might need a substantial time to make such delivery. Thus, because bids are generally open only for a rather limited period, it is inevitable that a significant number of unsophisticated shareholders are left unaware of a bid or unable to deliver their shares in time.

Second, some shareholders do not tender to an eventually successful bidder because they view the bid price as lower than the independent target's per-share value and hope that the bid will fail. As we have seen, a shareholder who views the bid price as lower than the independent target's per-share value might still tender out of fear that the bid will succeed. Yet, such a shareholder might also decide against tendering if he attaches a sufficient likelihood to the bid's failure. The second group of non-tendering shareholders, then, is composed of shareholders who did not tender because they hoped that the bid would fail — a hope later frustrated by the actions of their fellow shareholders.

Third, some shareholders do not tender to an eventually successful bidder for tax reasons. These shareholders prefer retaining their shares as minority shares (with a per-share value lower than the bid price) to selling them at the bid price. A sale of the shares would constitute a taxable event, and postponing tax liability might be beneficial for some shareholders, especially for shareholders who bought their shares at a very low price.⁹⁹

The unequal treatment problem is closely linked to the distorted choice problem. The current inequality of treatment distorts shareholders' tender decisions in two ways. First, it threatens shareholders with a stick if they decide to hold out — the penalty of receiving less than their pro rata share of the acquisition price. Second, it offers

⁹⁸ See Securities Exchange Act Release No. 19,366, [1982-1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,306, at 85,651 (Dec. 15, 1982); SEC Exchange Act Release No. 18,761, 47 Fed. Reg. 24,338, at 24,340 (1982); Nathan & Volk, *Developments in Acquisitions and Acquisition Techniques Under the Williams Act*, in TWELFTH ANNUAL INSTITUTE ON SECURITIES REGULATIONS 159, 181-82 (1981); Welles, *Inside the Arbitrage Game*, INSTITUTIONAL INVESTOR, Aug. 1981, at 41, 46-51; Pozen, *Extended Proration Time for Tender Offers Proposed*, Legal Times of Wash., July 12, 1982, at 15, col. 3.

⁹⁹ On the intricate issue of taxation of target shareholders, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.01-57 (4th ed. 1979).

shareholders a carrot if they decide to tender — the reward of receiving more than their pro rata share of the acquisition price (at the expense of non-tendering shareholders).

As Part V will explain, however, unequal treatment is undesirable not only because it distorts tender decisions but also because it is unfair. In examining this dimension of the unequal treatment problem, I shall focus on the first two groups of non-tendering, unequally treated shareholders: those who had no opportunity to tender and those who hoped that the bid would fail. Given that a takeover occurs as a result of other shareholders' tender decisions, the shareholders in these two groups would like to receive from the successful bidder treatment equal to that received by tendering shareholders; for they would prefer selling their shares at the bid price to having them become minority shares. Had these shareholders had both the knowledge that the bid would succeed and the opportunity to tender, they would have tendered their shares.¹⁰⁰

Thus, in explaining the unfairness of the current distribution, I shall not rely on the claims that might be made by those shareholders who did not tender to a successful bidder for tax reasons. These shareholders do prefer retaining minority shares to having their shares acquired at the bid price. They therefore do not wish to receive a treatment equal to that accorded tendering shareholders. Of course, one might still wonder whether shareholders who did not tender for tax reasons are treated fairly; while they prefer retaining minority shares to receiving the treatment accorded tendering shareholders, the choice imposed upon them might itself be unfair.¹⁰¹ But I shall ignore the controversial claims that such shareholders might make, and shall focus instead on the much stronger claims that can be made by shareholders who did not tender for non-tax reasons.

III. SOME UNSATISFACTORY REMEDIES

Before putting forward in Part IV a regulatory arrangement to address the problems of distorted choice and unequal treatment, I wish to examine alternative approaches that have been suggested in the literature. This Part discusses these approaches and shows that none of them is capable of adequately addressing the current problems.

¹⁰⁰ As Part V will explain, unsophisticated investors are much more likely than sophisticated investors to belong to the above two groups of non-tendering, unequally treated shareholders. In other words, unsophisticated investors face systematically higher chances of losing from the current inequality of treatment. See *infra* pp. 1781-82.

¹⁰¹ Cf. Brudney, *supra* note 7, at 1126-31 (discussing the problem of deciding which corporate action is most fair to all shareholders when the shareholders have conflicting preferences due to different tax circumstances).

A. Prohibiting Partial Bids

In considering the possible existence of distorted choice and unequal treatment, the SEC's Advisory Committee and subsequently the SEC limited their examination to partial bids.¹⁰² Their view that these problems are rooted in the use of partial bids is also shared by many commentators and practitioners.¹⁰³ This view naturally leads its adherents to consider a ban on such bids. The Advisory Committee decided against recommending such a ban, however, because it believed that partial bids serve valuable economic functions.¹⁰⁴ Instead, the Committee recommended discouraging such bids by requiring that they remain open longer than bids for all shares.¹⁰⁵ Some commentators, accepting the Committee's premise that partial bids serve valuable economic functions, nonetheless criticized the proposed regulatory disincentive as too weak.¹⁰⁶ The SEC stated that it was sensitive to the Committee's concern regarding partial bids but was unsure that the Committee's proposal was the best way to deal with this concern.¹⁰⁷

Although I agree that allowing partial bids does sometimes lead to efficiency gains, I believe that these gains are much less frequent and sizeable than is commonly thought.¹⁰⁸ I would therefore support

¹⁰² See ADVISORY COMMITTEE REPORT, *supra* note 10, at 24-26; SEC Release, *supra* note 11, at 86, 914-15.

¹⁰³ See, e.g., Greene & Junewicz, *supra* note 9, at 676-84. The British City Code also reflects a similar view — that partial bids pose different and more severe problems than do bids for all shares. See *infra* Appendix A, Section D.

¹⁰⁴ See ADVISORY COMMITTEE REPORT, *supra* note 10, at 24-26.

¹⁰⁵ *Id.* One member of the Committee, however, expressed disappointment that the committee did not do "anything meaningful" to regulate partial bids. See *id.* at 144-45 (statement of Jeffrey B. Bartell).

¹⁰⁶ See Greene & Junewicz, *supra* note 9, at 691-93, 738. They proposed that managers should be allowed to obstruct partial bids but not bids for all shares.

¹⁰⁷ See Statement of Shad, *supra* note 11, at 86,679; SEC Release, *supra* note 11, at 86,917.

¹⁰⁸ It is often suggested that allowing partial acquisitions is necessary because potential buyers might lack sufficient funds to purchase all of the target's shares. Existing regulations discourage the use of offers in securities (exchange offers) and lead bidders to make cash tender offers. See ADVISORY COMMITTEE REPORT, *supra* note 10, at 20. A bidder might have limited liquidity and find it difficult or costly to raise cash. Consequently, the bidder might be able to make a partial cash bid, but be unable to make a cash bid for all shares. This argument for allowing partial acquisitions will, however, lose much of its force in the near future. The SEC's Advisory Committee recommended facilitating exchange offers, and the SEC stated that it will follow this recommendation. See Statement of Shad, *supra* note 11, at 86,677-78. Once exchange offers are made easier, bidders will be able to finance an acquisition by issuing their own securities. Indeed, by issuing an appropriate mix of securities, a bidder will be able to finance an acquisition without any change in the bidder's debt-equity ratio.

Moreover, a structure of partial ownership might often involve efficiency costs. In running the target as a partly-owned subsidiary, the acquirer will be concerned not only with maximizing the target's value, but also, and to a large extent, with diverting value from minority shareholders

a ban on partial bids if such a ban could address the problems of distorted choice and unequal treatment. Such a ban would be unable to address these problems, however, because they are not limited to — nor even especially acute in — partial bids; the popular view to that effect rests on a misperception of the current problems.

The current problems are largely rooted in the presence of a gap between the bid price and the expected post-takeover value of minority shares, a gap that is generally present in *all* bids. Consequently, as Part II has demonstrated, the problems of distorted choice and unequal treatment are substantially present in bids for all shares.¹⁰⁹ First, the outcome of a bid for all shares might be distorted: for one thing, the prospect of ending up with low-value minority shares creates a strong pressure on shareholders to tender. Second, when a bid for all shares succeeds, those who did not tender — and there is currently a significant incidence of such non-tendering — are left with less than their pro rata share of the acquisition price. In sum, requiring that bids be for all shares would do very little to ensure undistorted choice and equal treatment.

B. Prohibiting Immediate Takeouts at Less Than the Bid Price

The gap between the bid price and the expected post-takeover value of minority shares is most conspicuous when a takeover is expected to be followed by an immediate takeout at a price lower than the bid price. Such takeouts have therefore attracted the attention of commentators and regulators. In particular, Professors Brudney and Chirelstein proposed that courts enjoin immediate takeouts at less than the bid price.¹¹⁰ Brudney and Chirelstein's proposal has received wide attention,¹¹¹ but has not been adopted by the courts.¹¹²

to itself. The acquirer's desire to take advantage of minority shareholders will be likely to produce various inefficiencies.

Thus, it does not appear likely that there are many instances in which a partial ownership can produce substantial efficiency gains in comparison to a total ownership. But, in any event, prohibiting partial bids would not preclude a partial ownership structure. Supposing that there were some special efficiency advantages to a bidder's owning only part of the target, the bidder could still buy all of the target's shares, resell a fraction of them to public investors, and end up with any fraction of the target's shares that it wishes to hold. Such a resale of shares would admittedly involve some wasteful transaction costs. But the possibility of such resale indicates that the social cost of prohibiting partial bids would in no case exceed the size of these limited transaction costs.

¹⁰⁹ Indeed, as is explained in note 95, and demonstrated in L. Bebchuk, *supra* note 65, sec. IV, partial bids cannot be shown to involve systematically greater distortions than bids for all shares.

¹¹⁰ See Brudney & Chirelstein, *supra* note 7, at 336–40; Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1361–65 (1978).

¹¹¹ See, e.g., Easterbrook & Fischel, *supra* note 7; Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 955 (1978); Toms, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548 (1978).

¹¹² See, e.g., *Tanzer v. International Gen. Indus.*, 402 A.2d 382, 393–95 (Del. Ch. 1979).

The SEC's Advisory Committee expressed concern about the "coercive elements" of bids followed by immediate takeouts below the bid price. The Committee considered, but decided against, recommending a regulatory ban on such takeouts.¹¹³ The Committee believed that, in takeovers not followed by an immediate takeout, minority shareholders fare even worse than in takeovers followed by an immediate takeout below the bid price. Hence, the Committee reasoned, allowing such immediate takeouts benefits minority shareholders and increases the post-takeover value of minority shares.

Following the Advisory Committee's report, the SEC stated that the issue requires further examination¹¹⁴ and initiated an empirical study by the SEC's Chief Economist.¹¹⁵ The Chief Economist's findings confirmed the Advisory Committee's suggestion: the post-takeover value of minority shares is indeed lower in takeovers unaccompanied by an immediate takeout than in takeovers followed by an immediate takeout below the bid price. From these facts, the Chief Economist drew the same inference that the Advisory Committee did: he concluded that allowing immediate takeouts below the bid price reduces the gap between the post-takeover value of minority shares and the bid price.

As Section C of this Part will point out, eliminating the gap between the bid price and the post-takeover value of minority shares is not altogether the right approach to addressing the current distortions. First, however, it is worth resolving the disagreement concerning the expected impact that a ban on immediate takeouts below the bid price would have on the gap between the bid price and the post-takeover value of minority shares. Below I explain that, contrary to the views of the SEC's Advisory Committee and the SEC's Chief Economist, such a ban would operate to reduce that gap. I then go on to show, however, that the ban would not eliminate that gap (a showing that by itself indicates that the ban would not adequately address the current problems).

1. *The Ban Would Narrow the Gap.* — The problem with the analysis of the Advisory Committee and the SEC's Chief Economist is that they drew an incorrect inference from an accurate empirical observation. To see the flaw in their analysis, consider the choice that a successful bidder makes between effecting an immediate takeout and refraining from doing so. An immediate takeout below the bid price provides the acquirer with one way of taking advantage of minority shareholders. Refraining from an immediate takeout, however, might enable the acquirer to take advantage of minority shareholders in

¹¹³ See ADVISORY COMMITTEE REPORT, *supra* note 10, at 24–25.

¹¹⁴ See SEC Release, *supra* note 11, at 86,914–15; Statement of Shad, *supra* note 11, at 86,679.

¹¹⁵ See SEC Release, *supra* note 11, at 86,920–42.

other ways — through a distant takeout or through a diversion of the target's earnings. The acquirer will presumably follow the strategy that will enable it to take maximum advantage of minority shareholders.

Thus, those instances in which the acquirer decides against an immediate takeout are exactly the instances in which the acquirer expects that — by diverting earnings, effecting a distant takeout, or both — it will succeed in leaving minority shareholders with even less than it would have to pay them in an immediate takeout. This conclusion explains the empirical evidence considered by the Advisory Committee and the Chief Economist — that minority shareholders fare worse in instances where an immediate takeout does not occur than in instances where it does. By the same logic, however, those instances in which the acquirer currently effects an immediate takeout below the bid price are exactly the instances in which the acquirer views such a takeout as the best means of taking advantage of minority shareholders.

It follows that a ban on immediate takeouts below the bid price would be likely to enhance the post-takeover value of minority shares in those instances where such takeouts currently occur. And the ban would obviously have no effect on the post-takeover value of minority shares in those instances where the acquirer currently does not effect an immediate takeout. Hence, the ban would clearly operate to narrow the average gap between the bid price and the expected post-takeover value of minority shares.

2. *The Ban Would Not Eliminate the Gap.* — Although prohibiting immediate takeouts at less than the bid price would often narrow the gap, it usually would not eliminate it. The expected post-takeover value of minority shares would frequently remain below the bid price, because acquirers would still be able to take advantage of minority shareholders in other ways than by effecting an immediate takeout.

Even at present, when acquirers can effect an immediate takeout at less than the bid price, there are many instances where they elect not to effect an immediate takeout. In these instances, the post-takeover value of minority shares is generally lower than the bid price because of the possibility that the acquirer will effect a distant takeout or divert to itself some of the target's earnings; indeed, as explained earlier, the post-takeover value of minority shares in these instances is even lower than the consideration which is currently required in an immediate takeout. In all the instances in which the acquirer currently decides against an immediate takeout, the ban would of course leave intact the present substantial gap between the bid price and the expected post-takeover value of minority shares.

Moreover, the ban would greatly increase the proportion of instances in which an immediate takeout does not take place. Such an increase would occur because the ban would usually convert an im-

mediate takeout into the acquirer's inferior strategy. Instead of effecting an immediate takeout and paying minority shareholders a consideration equal to the bid price, most acquirers would presumably elect to rely on the possibilities of effecting a distant takeout and diverting earnings. They would effect a takeout, if at all, only after the passage of that period during which takeout terms would be strictly regulated. Thus, once the ban is adopted, instances in which an immediate takeout does not occur would be likely to constitute the great majority of cases. Consequently, although the ban would reduce the average gap between the bid price and the post-takeover value of the minority shares, its effect would be much more limited than might be initially thought.

In sum, the ban would not generally eliminate the gap between the bid price and the expected post-takeover value of minority shares. It follows that the ban would not ensure either undistorted choice or equal treatment.

*C. Ensuring that Minority Shares Have Value Equal
to the Bid Price*

While prohibiting immediate takeouts below the bid price would not ensure equality between the post-takeover value of minority shares and the bid price, one might still seek to ensure such an equality by adopting supplemental or alternative measures. Such equality could be ensured, for example, by providing minority shareholders in the aftermath of a takeover with the option of redeeming their shares at the bid price.

It should first be noted that ensuring equality between the post-takeover value of minority shares and the bid price would be likely to involve some efficiency costs. Providing an option to redeem minority shares at the bid price, for example, would all but preclude partial acquisitions, since most minority shareholders would be likely to use their redemption rights. Similarly, it appears that any alternative measure that would secure equality between the post-takeover value of minority shares and the bid price would also practically preclude partial acquisitions.¹¹⁶ Thus, because a partial acquisition

¹¹⁶ Consider, for example, measures aimed at limiting the extent to which an acquirer that does not effect an immediate takeout can, by diverting earnings or by effecting a distant takeout, take advantage of minority shareholders. Because of the nature of the activities regulated, such measures cannot ensure that, whenever an immediate takeout does not occur, the value of minority shares will be *exactly* equal to the bid price. Consequently, if the measures are stern enough to ensure that the post-takeover value of minority shares *never* falls below the bid price, then they will in *most* instances drive that post-takeover value above the bid price. Such a result would force bidders always to commit themselves to effecting an immediate takeout upon gaining control; for if an immediate takeout is not expected, and if minority shares are expected in this case to have a post-takeover value exceeding the bid price, then shareholders might hold out even if they view the bid price as higher than the independent target's value.

might sometimes be the most efficient form of a given transaction,¹¹⁷ adopting measures that would secure this equality would entail some efficiency costs.

The main problem with the approach under consideration, however, is not that it would preclude partial acquisitions, but that it would not attain undistorted choice.¹¹⁸ In particular, if we were to adopt regulations ensuring equality between the post-takeover value of minority shares and the bid price, the outcome of bids would be systematically distorted *against* bidders — that is, in a direction opposite to the current distortions.

Suppose that such regulations were adopted and that a target's shareholders receive a \$100 per-share bid. Because the regulations ensure that in the event of a takeover the per-share value of minority shares will be equal to the \$100 bid price, the offered per-share acquisition price is also \$100. Suppose additionally that shareholders' estimates of the independent target's per-share value range between \$84 and \$99; each shareholder knows that the estimates are distributed within a \$15 range, but does not know the boundaries of that range and, hence, the ranking of his own estimate in the distribution of estimates. According to the undistorted choice objective, all shareholders should tender and the bid should succeed. As explained below, however, some shareholders might well elect to hold out.

Consider the tender decision of a shareholder whose estimate of the independent target's per-share value is, say, \$95. The shareholder will realize that, if a takeover occurs, tendering and holding out will have the same results for him. Therefore, the shareholder will ask himself only what his best course of action will be *assuming* that the bid is going to fail. Assuming that the bid is going to fail, the shareholder will reason, implies that most shareholders are likely to have estimates higher than his own and perhaps even higher than the bid price. Therefore, to determine his best course of action under the assumption that the bid is going to fail, the shareholder will revise his estimate of the independent target's value upwards; his estimate *conditional* on the bid's failure might thus exceed \$100, in which case he would not tender his shares.

In other words, by limiting shareholders' considerations to the scenario in which the bid fails, the regulations would lead shareholders to focus on the contingency that others' estimates exceed their own and to ignore the contingency that the opposite is true. As a result, all shareholders would revise their estimates upwards to make their tender decisions, and this revision would distort the outcome of bids against bidders.¹¹⁹

¹¹⁷ See, e.g., ADVISORY COMMITTEE REPORT, *supra* note 10, at 24–26.

¹¹⁸ For a demonstration of this point in a formal model, see L. BEBCHUK, *supra* note 65, sec. VI.

¹¹⁹ There is another way to demonstrate that the regulations would not ensure undistorted

Finally, since completely eliminating the current gap between the bid price and the expected post-takeover value of minority shares would distort outcomes *against* bidders, it might be suggested that we could attain undistorted choice by curtailing the current gap to some low "optimal" level. Unfortunately there is no level that would generally ensure outcomes conforming to the undistorted choice objective. True, for any particular case, there might exist an optimal level of inequality that would cancel out the opposite distorting factors. This level, however, depends on such factors as the height of the effective control threshold and the extent to which the distribution of shareholders' estimates is widespread. Consequently, this level is not only hard to identify in any particular case, but also might vary with the target and the bid. Thus, it appears impossible to design any general rules concerning the post-takeover treatment of minority shareholders that would uniformly ensure outcomes conforming to the undistorted choice objective.

D. Allowing Obstructive Defensive Tactics

Target managements often use obstructive defensive tactics, such as litigation or creating antitrust obstacles, to prevent a bid, at least temporarily, from reaching shareholders. The courts have thus far tolerated such tactics, merely subjecting them to the liberal test of the business judgment rule. In recent years, however, commentators have persuasively argued that such tactics should be prohibited and that management should never prevent shareholders from making their own decisions whether to accept a takeover bid.¹²⁰

The only plausible argument that can be made for allowing obstructive tactics is based on the current distortions of shareholder

outcomes — by first assuming that the regulations would attain undistorted choice, and then showing that this assumption creates a contradiction. Assuming that the regulations would attain undistorted choice implies that shareholders in our example would hold out only if they view the independent target's per-share value as higher than the \$100 bid price. Hence, the target would remain independent only if most shareholders view the independent target's per-share value as higher than \$100. This proposition in turn implies that, if the bid fails and the target remains independent, the market price of the independent target's shares will be likely to exceed the \$100 bid price. But this latter proposition means that a shareholder might well find it in his interest to hold out even if his own estimate of the independent target's per-share value is lower than \$100. And this possibility contradicts the initial assumption that shareholders' tender decisions would be undistorted.

Finally, it is worth noting that the problem discussed above would not impair the effectiveness of this Article's proposed regulations. Under these regulations, a deciding shareholder would not focus on the scenario in which most other shareholders have unconditional estimates exceeding his; rather, he would focus on the scenario in which others' unconditional estimates are split above and below his. See *infra* Subsection IV.B.1.

¹²⁰ See Easterbrook & Fischel, *supra* note 1; Gilson, *supra* note 1. I have expressed my support for a ban on obstructive tactics in Bebchuk, *Facilitating Competing Bids*, *supra* note 7, and Bebchuk, *Reply and Extension*, *supra* note 7.

choice. Because the tender decisions of a target's shareholders might be distorted, it might be desirable to prevent the bid from reaching the shareholders. As we have seen, the problem of distorted choice results from the diffusion of ownership of takeover targets. Allowing obstructive tactics, it might be argued, gives management some degree of veto power and thus enables it to bargain with potential acquirers as a sole owner would. Management, it might be hoped, will obstruct bidders that do not offer an adequate acquisition price.¹²¹

Allowing obstructive tactics, however, is a very costly and inadequate method of dealing with the problem of distorted choice. First, even if managers were perfectly loyal agents of the shareholders, allowing obstructive tactics would still be a highly imperfect remedy. To begin with, obstructive tactics are socially wasteful. Litigation, for example, involves large wasteful expenditures, and creating anti-trust obstacles can produce an inefficient allocation of assets. More important, obstructive tactics cannot always give management the ability to block bids whose acceptance is not value-maximizing. Although obstructive tactics create a substantial nuisance and often provide a delay, they can rarely stop a persistent bidder.¹²² Moreover, the factors that determine whether obstructive tactics can stop a bid — such as the likelihood of obtaining an antitrust injunction — are unrelated to the factors that determine whether rejection of the bid would be value-maximizing.

Second, managers are not, in fact, perfectly loyal agents of the shareholders, and they might well abuse their power to obstruct bids. The interests of a target's managers are unlikely to coincide perfectly with those of the shareholders, and the managers may pursue their own private interests. Thus, managers might refrain from obstructing an inadequate offer by their favored acquisition partner. Even worse, management might decide to obstruct a bid whose acceptance would be the shareholders' value-maximizing course of action. Management might do so in order to avoid a takeover and retain its independence, or to extract side payments from the obstructed bidder, or to facilitate an acquisition by a rival bidder offering a lower acquisition price to shareholders but a better deal for the managers.

Thus, allowing obstructive tactics not only cannot ensure undistorted outcomes, but also distorts outcomes that would otherwise

¹²¹ Several commentators have indeed argued that the possible distortions of shareholder choice justify obstructive tactics, or at least some such tactics. See Greene & Junewicz, *supra* note 9; Lipton, *supra* note 5; Lowenstein, *supra* note 5. These authors differ in the extent of their support for obstructive tactics. Mr. Lipton would allow such tactics subject only to the liberal test of the business judgment rule. Professor Lowenstein would allow such tactics subject to a shareholder vote of approval. Mr. Greene and Mr. Junewicz would allow such tactics only in partial bids, the bids to which they believe the distorted choice problem is limited.

¹²² See, e.g., Austin & Mandula, *Tender Offer Trends in the 1980's*, MERGERS & ACQUISITIONS, Fall 1981, at 46, 46.

conform to the undistorted choice objective. Without obstructive tactics, a bid would usually succeed whenever a majority of the shareholders view the offered acquisition price as higher than the independent target's value. Such an outcome would be desirable according to the undistorted choice objective, which requires that shareholder majority support be sufficient for an acquisition. Because self-serving managers might choose to obstruct adequate bids, however, shareholder majority support might not be sufficient for a bid's success.

In sum, allowing obstructive tactics leads to wasteful expenditures and falls far short of attaining undistorted choice — indeed, it might even move us further from attaining that objective. Obstructive tactics should therefore be prohibited, and we should seek other ways to address the problem of distorted choice.

E. Relying on Charter Amendments by Potential Targets

In recent years, many companies have adopted amendments to their articles of incorporation that make acquisition of the company more difficult or costly. Such amendments have become known as "anti-takeover" or "shark repellent" amendments.¹²³ Some commentators advance such charter amendments as a remedy for the problems of distorted choice and unequal treatment.¹²⁴ These problems, they argue, can be addressed by, and should be left to, shareholders' adopting appropriate charter amendments. As explained below, however, the charter amendment solution has significant shortcomings.

First, charter amendments have to be initiated by management. The managers are likely to be concerned not only with the problems of distorted choice and unequal treatment, but also with their own private interests. As a result, management might not propose the optimal charter arrangements for ensuring undistorted choice and equal treatment. In choosing amendments to initiate, management might be strongly influenced by a desire to make a takeover simply less likely or by a desire to strengthen its ability to extract side benefits from a potential buyer.¹²⁵

Second, companies cannot adopt through their charters those arrangements that would best deal with the problems of distorted choice and unequal treatment. These optimal arrangements, which are iden-

¹²³ For a comprehensive survey and analysis of anti-takeover amendments, see Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982).

¹²⁴ See, e.g., Carney, *supra* note 7; Y. Amihud, *The Case Against a Mandatory Delay Period and Other Constraining Rules in Tender Offers* (Feb. 1985) (unpublished manuscript on file at the Harvard Law Library); see also DeAngelo & Rice, *supra* note 8, 335-44 (discussing the hypothesis that anti-takeover amendments are aimed at addressing the distortions of shareholder choice).

¹²⁵ See Gilson, *supra* note 123 (proposing a prohibition of anti-takeover amendments); see also Coffee, *supra* note 7, at 1183-92.

tified and outlined in Part IV, would involve certain restrictions on the transferability of shares and on the process through which shares are transferred. The New York Stock Exchange and the American Stock Exchange, however, generally prohibit listed companies from including such restrictions in their charters.¹²⁶ Consequently, even if managers were perfectly loyal, we could not expect companies to adopt the optimal arrangements outlined in Part IV.¹²⁷

To be sure, companies can adopt various charter provisions that would make acquisitions more difficult. Undistorted choice cannot be attained, however, simply by making acquisitions more difficult. Ensuring undistorted choice involves a far more complicated task — preventing all those acquisitions, but only those acquisitions, in which the offered acquisition price is lower than the independent target's value. An analysis of all the commonly used anti-takeover amendments suggests that none of them can perform that task.

Consider first those amendments that protect minority shareholders in the aftermath of a takeover, for example, amendments that ensure a "fair price" in a takeout. As explained earlier, undistorted choice cannot be attained by guaranteeing a certain post-takeover value for minority shares. Ensuring that minority shares have a post-takeover value equal to the bid price would distort the outcome of future bids against the bidder. More generally, there is no "optimal" level for the post-takeover value of minority shares (or for the gap between this post-takeover value and the bid price) that would ensure that the outcome of any future bid for the company would not be distorted either in favor of or against the bidder.¹²⁸

¹²⁶ This prohibition has been the general and consistent policy of the exchanges. The exchanges have made exceptions — for example, in the case of some savings and loan associations — only when the adopted restrictions on transferability were required by some external regulatory body because of the particular nature of the company's business. Telephone interviews with Mr. Edward Lucas of the New York Stock Exchange and Mr. David Rope of the American Stock Exchange (Mar. 1 and Mar. 14, 1985).

¹²⁷ It would of course be desirable if the Exchanges were to amend their policies and allow companies to adopt the optimal arrangement outlined in Part IV. Even then, however, there would still be some advantages to providing this arrangement by law, while allowing companies to opt out of the prescribed arrangement by adopting appropriate charter provisions. *See infra* pp. 1755–56.

¹²⁸ *See supra* Section II.C; *see also* L. BEBCHUK, *supra* note 65, sec. VI (demonstrating this point in a formal model). True, for any particular situation, there may exist a level of the expected post-takeover value of minority shares that would ensure an outcome conforming to the undistorted choice objective. This level, however, depends on various features of the situation (for example, the extent to which the distribution of shareholders' estimates is widespread). Consequently, this level is not only very hard to identify for a particular situation, but, more importantly, also might vary from situation to situation. Therefore, no amendment that guarantees a certain post-takeover value for minority shares could be designed to ensure an undistorted outcome in future situations — whose particular features are unknown at the time of adopting the amendment.

A similar problem afflicts amendments that increase the threshold of ownership needed for effective control, for example, amendments requiring "supermajority" approval of a takeout. There is no "optimal" level of the control threshold that could be specified and would ensure that the outcome of any future bid for the company would not be distorted either in favor of or against the bidder.¹²⁹ Common supermajority amendments might fail to prevent an undesirable acquisition and might prevent a desirable one.¹³⁰

Finally, consider those amendments that delay or impede the process by which an acquirer can replace the board of directors, for example, amendments that stagger the tenure of board members. Such amendments, which entrench management's position and give it some veto power, suffer from the same problem that afflicts obstructive tactics: there is no reason to expect incumbent managers to use their veto power solely to ensure undistorted choice. In sum, all of the familiar anti-takeover amendments would have limited effectiveness in attaining undistorted choice and would entail some significant costs. These shortcomings presumably provide one of the reasons why companies have not uniformly adopted such amendments.

The evolution of appropriate charter amendments, then, cannot be relied on to address the problems of distorted choice and unequal treatment. Instead, we should identify the optimal arrangements for

¹²⁹ This point is clear from the analysis in L. BEBCHUCK, *supra* note 65, secs. IV and VI. Increasing the level of the control threshold obviously makes it more difficult for a given bid to succeed, because the bid's success would require attracting a larger number of shares. For any particular situation, there might exist a level of the control threshold that would cancel out the various distorting factors and ensure an undistorted outcome. Even when such a level exists, however, it depends on various features of the situation, such as the extent to which the distribution of shareholders' estimates is widespread. Therefore, this level is hard to identify for any particular situation, and, moreover, it varies across situations. Therefore, no supermajority amendment could be designed that would ensure an undistorted outcome in any future bid for the company.

¹³⁰ To illustrate, consider an amendment that increases the control threshold to 75%. To see that the amendment might fail to prevent an undesirable acquisition, consider an offer that is viewed as inadequate by a majority of the shareholders. As Part II has shown, the fact that a majority of the shareholders view the offered acquisition price as too low in no way rules out the possibility that 80% — or even 100% — of the shareholders will tender out of concern that the bid will succeed.

To see that the amendment might prevent a desirable acquisition, consider an offer that is viewed as adequate by shareholders holding between 50% and 75% of the target's shares. Because of the amendment, the tenders of this group of shareholders alone would be insufficient to ensure the bid's success. Although the pressure to tender might produce a sufficient number of additional tenders, this need not be the case.

Finally, it is worthwhile to note an effect that a supermajority amendment might have when the target's management has a significant stake in the target. In such a case, a substantial increase in the level of the control threshold might give management a veto power. As Section C of this Part has explained, however, giving management such power would in no way ensure outcomes conforming to the undistorted choice objective, because management might use its veto power in a self-serving way.

ensuring undistorted choice and equal treatment — a task to which I shall now turn — and we should prescribe these arrangements through regulation.

IV. A PROPOSED REGULATORY ARRANGEMENT

This Part puts forward a regulatory arrangement that would remedy the current problems of distorted choice and unequal treatment. Section A outlines the proposed regulations, and Section B demonstrates that they would attain undistorted choice and equal treatment. Section C then comments on the design and performance of the proposed regulations. A discussion of the costs of these regulations is deferred to Part V, which will show that the regulations would be unlikely to involve any significant social costs.¹³¹

A. The Proposed Regulations

The proposed regulations would apply to all offers aimed at acquiring a controlling interest in a target. The regulations therefore must specify the fraction of a target's shares that would be assumed to provide a buyer with a "controlling interest." This crucial threshold should be determined so as to ensure that shareholders holding less than the threshold block would be generally unable to exercise any substantial measure of effective control. There might of course be disagreement concerning the precise level at which the threshold should be set. For the sake of concreteness, however, the following analysis assumes that this level would be specified at 20% ownership.¹³² This figure is used only as an example, and further analysis might suggest a different figure.¹³³

1. *The Treatment of Tendering Shareholders.* — The first and central element of the proposed regulations would concern the treatment of tendering shareholders. To understand the operation of this element, recall the analysis of shareholders' current tender decisions. At present, each shareholder realizes that his tender decision will have little or no effect on the likelihood of the bid's success. A shareholder's tender decisions will therefore be little influenced by — and hence

¹³¹ See *infra* pp. 1775–80.

¹³² The SEC's Advisory Committee suggested a figure of 20% for the control threshold. The Committee reported, however, that there was "strong disagreement" concerning this figure, and that there was some support for a figure of 15% or even 10%. See ADVISORY COMMITTEE REPORT, *supra* note 10, at 23. The British City Code on Take-Overs and Mergers assumes that 30% ownership gives de facto control. See CITY CODE ON TAKE-OVERS AND MERGERS 11 (City Working Party 1976).

¹³³ Such an analysis might also suggest specifying different threshold levels for targets of different sizes. See Greene & Junewicz, *supra* note 9, at 671 (suggesting that the fraction of a target's shares necessary for effective control decreases as the size of the target increases).

will not reflect — his preference concerning the bid's success. Furthermore, at present shareholders are unable to condition their acceptance of the bidder's offer on a particular outcome of the bid. Tendering by a shareholder enables the bidder to purchase his shares whether the bid succeeds or fails; holding out, on the other hand, requires the shareholder to retain his shares in both cases.

The proposed regulations would enable shareholders to better express their preferences. First, the regulations would enable shareholders to express their preferences concerning the bid's success in isolation from their desire to receive their pro rata share of the acquisition price in the event of a takeover; the preferences that shareholders would express concerning the bid's success would determine the bid's fate. Second, the regulations would enable shareholders to better specify the conditions under which they are willing to have their shares acquired; specifically, shareholders would be able to permit the bidder to purchase their shares in the event of a takeover but not in the event that the bid fails.

The medium through which shareholders would be able to express their preferences would be the letter of transmittal ("tender form") which must accompany tendered shares. At present, tender forms generally provide the bidder with unconditional permission to purchase the tenderer's shares. The regulations, however, would require that tender forms be formulated so as to enable a tendering shareholder to express fully his preferences concerning the following three issues: (1) whether he would like to sell his shares in the event that the bid succeeds; (2) whether he would like to sell his shares in the event that the bid fails; and (3) whether he would like the bid to succeed or fail.

Because all tendering shareholders can be presumed to wish to have their shares acquired in the event of a takeover,¹³⁴ tender forms could start with a statement permitting the bidder to purchase the tenderer's shares in case of a takeover. Following this statement, tender forms would have to include a question eliciting the tenderer's preference concerning the bid's success. To this end, the shareholder might simply be asked to indicate by marking an appropriate box whether or not he approves the takeover. Tendering shareholders' responses to this question — responses that would determine the bid's fate — would divide these shareholders into two groups: those who made "approving tenders" (that is, gave an affirmative answer to the question) and those who made "disapproving tenders."

¹³⁴ Because the expected post-takeover value of minority shares is generally lower than the bid price, shareholders will by and large wish to have their shares acquired in the event of a takeover. The only reason why a shareholder might wish to retain his shares in the event that the bid succeeds is to avoid some adverse tax consequences of selling his shares. But such a shareholder will presumably also wish to retain his shares in the event that the bid fails, and hence will not tender his shares altogether.

In addition, a bidder that would want the option of purchasing a non-controlling block if its bid fails would have to include in its tender form a second question. The tenderer would be asked to indicate, by marking an appropriate box, whether or not he permits the bidder to purchase his shares in the event that the bidder fails to acquire a controlling interest. The tenderer's answer would of course determine how his shares would be treated if the bid fails.

As Section B will explain, under the proposed regulations, shareholders who are aware of the bid would by and large tender their shares. Under the regulations, however, the number of tendered shares would not by itself determine the bid's success. The bid's success would instead depend on shareholders' choices between tendering approvingly and disapprovingly. The bidder would be allowed to purchase a controlling interest in the target only if its bid attracts the specified, crucial number of approving tenders. I shall assume at this stage that the bidder would be required to attract approving tenders from a majority of the target's shareholders, and I shall later discuss possible refinements of the required number of approving tenders.

To ensure that shareholders' choices between tendering approvingly and disapprovingly indeed reflect their preferences concerning the bid's success, the regulations would preclude the bidder from penalizing disapproving tenders. Thus, upon receiving a majority of approving tenders, a successful bidder would have to treat all tendering shareholders equally, whether they tendered approvingly or disapprovingly. In a bid for all shares, the bidder would have to purchase all tendered shares; in a partial bid, the bidder would have to use the same proration ratio for all tendering shareholders.¹³⁵

Although a bidder that fails to attract the required number of approving tenders would be prohibited from purchasing a controlling interest, such a bidder might still be able to use its bid to purchase a non-controlling block. The bidder would be allowed to acquire such a block by purchasing shares of those tendering shareholders who, by answering affirmatively the tender form's second question, permitted the bidder to purchase their shares even if the bid fails. The bidder would have to treat all such tendering shareholders equally: if more

¹³⁵ To illustrate how a bid's outcome would be determined, suppose that 90% of a target's shareholders tendered, 70% approvingly and 20% disapprovingly. In this case, the bidder would be allowed to purchase a controlling interest, provided that it treats all tendering shareholders equally, and a takeover would thus occur. Suppose, however, that 70% of the shareholders tendered disapprovingly and only 20% tendered approvingly. In this latter case, the bidder would be prohibited from purchasing a controlling interest, and the target would remain independent.

As Appendix A discusses, the proposed arrangement for determining a bid's fate is similar to one that the British City Code applies to partial bids. In bids for all shares, however, the Code establishes a different arrangement, which distorts outcomes against bidders. See *infra* pp. 1796-98.

shares are available to the bidder than it wishes or is able to purchase for its non-controlling block,¹³⁶ a proration would take place.

2. *The Treatment of Non-Tendering Shareholders.* — Although the proposed regulations would substantially reduce the incidence of non-tendering in successful bids, some shareholders (in particular, those without an opportunity to tender) would still fail to tender. The second, supplementary element of the proposed regulatory arrangement would regulate the treatment of non-tendering shareholders by successful bidders. This second element, though much less important than the first,¹³⁷ would serve to perfect the regulations' effectiveness in attaining undistorted choice and equal treatment.

As described below, the proposed regulations would enable the non-tendering shareholders of an acquired target to receive something close to their pro rata share of the acquisition price. It should be emphasized that the regulations would not provide these non-tendering shareholders with exactly their pro rata share of the acquisition price, but rather with slightly less than that. Maintaining such a small gap is necessary to provide shareholders who are aware of a bid with an incentive to tender, whether approvingly or disapprovingly.

(a) *Regulating Immediate Takeouts.* — When a successful bidder proceeds to effect an immediate takeout, the proposed regulations would ensure that the value of the takeout consideration would be close to the bid price. An immediate takeout would be required to take place within three months after the takeover, and the takeout consideration would be required to have a *nominal* value equal to the bid price. As a result, the real value of the takeout consideration would be slightly lower than the value of the consideration paid for shares acquired on tender; for a delay of three months in receiving a nominally identical consideration involves a loss of interest, which under current rates amounts to about two or three percentage points.

Once the proposed regulations take effect, minority shareholders should be precluded from demanding, on the basis of appraisal rights or otherwise, a takeout consideration higher than the one prescribed by the regulations. Thus, the regulations would not merely establish a floor, but rather completely determine the value of the takeout consideration. As already noted, non-tendering shareholders should have no reason to expect that in the event of a takeover they will be

¹³⁶ It is possible that the bidder would fail to attract the required majority of approving tenders, but that more than 20% of the shareholders would permit the bidder to purchase their shares even if the bid fails. In such a case, the bidder would of course be prevented from purchasing all the shares of these shareholders, and would have to limit its purchases to at most 20% of the target's shares.

¹³⁷ As will be clear from the analysis of Section B of this Part, the proposed regulations concerning the treatment of tendering shareholders would by themselves go a long way toward attaining undistorted choice and equal treatment.

better off than, or even on a par with, tendering shareholders. Otherwise, shareholders might have no incentive to tender, whether approvingly or disapprovingly.

(b) *Providing Redemption Rights.* — When a successful bidder decides against an immediate takeout, the proposed regulations would provide non-tendering shareholders with redemption rights. These rights would ensure that non-tendering shareholders would be able, if they so wish, to receive something close to their pro rata share of the acquisition price. Again, maintaining a slight gap between the rewards of non-tendering and tendering shareholders would be needed to provide shareholders with an incentive to tender.

To exercise their redemption rights, non-tendering shareholders would have to submit their shares to the acquirer within three months of the takeover.¹³⁸ At the end of this three-month period, the acquirer would pay the prescribed redemption consideration for those submitted shares that it would be required to redeem. Whether the bidder would have to redeem all or only some submitted shares would depend, as is explained below, on whether the bid is partial or for all shares. In either case, the consideration paid for each redeemed share would be required to have a nominal value equal to the bid price, and its real value would thus be slightly lower than the value of the bid's consideration.

In a bid for all shares, where the bidder expressed a willingness to purchase all of the target's shares, non-tendering shareholders would have the option to redeem all of their shares for the prescribed redemption consideration. Note that in a successful bid for all shares, tendering shareholders would have all their shares purchased at the bid price. Therefore, non-tendering shareholders must be able to redeem all their shares if they are to receive a per-share value close to that received by tendering shareholders.

In contrast, a bidder that made a successful partial bid would not have to redeem all submitted shares. In particular, the bidder would not be forced to acquire a larger number of shares than it originally sought. The regulations would only require equality between (1) the "redemption ratio," that is, the fraction of shares submitted by non-tendering shareholders that the bidder would redeem, and (2) the "bid ratio," that is, the fraction of tendered shares that the bidder would purchase. Requiring equality between the redemption ratio and the bid ratio would ensure that non-tendering shareholders would be able to receive a per-share value close to that received by tendering share-

¹³⁸ The rules concerning redemption rights should be designed to ensure that all non-tendering shareholders have a genuine opportunity to take advantage of these rights. To this end, the acquirer should be required to send all minority shareholders (say, within six weeks of the takeover) written notice of the takeover and the redemption option available to them. This notice, and the three-month period for exercising redemption rights, would enable virtually all minority shareholders to take advantage of their redemption rights.

holders. The bidder, however, would be free to set the common level of these two ratios, and would thus be able to control the number of shares that it would ultimately acquire.¹³⁹

B. Effectiveness in Attaining Undistorted Choice and Equal Treatment

1. *Undistorted Choice.* — I now turn to demonstrate the regulations' effectiveness in attaining the proposed objectives, and I begin with the objective of undistorted choice.¹⁴⁰ Under the proposed regulations, the vast majority of a target's shareholders would tender their shares, either approvingly or disapprovingly. Any particular shareholder who has an opportunity to tender, and has no tax reasons for avoiding a sale of his shares, could only profit by tendering. No matter how high the shareholder's estimate of the independent target's value, holding out would be inferior to tendering disapprovingly with an indication of unwillingness to sell shares in the event that the bid fails. These two courses of action would produce different results for the shareholder only if a takeover occurs. And in that case holding out would bring clearly inferior results: although the regulations would provide some protection for shareholders who fail to tender to a successful bidder, such shareholders would still lose three-months' interest.¹⁴¹

Given that shareholders would by and large tender, the important issue becomes how a tendering shareholder would decide between

¹³⁹ Because of the required equality between the bid ratio and the redemption ratio, the bid ratio might not be finalized until the total number of tendered shares and shares submitted for redemption is established. To illustrate, consider a partial bid for 60% of a target's shares. Until the deadline for submitting shares for redemption passes, it cannot be determined with precision which bid ratio will lead to the bidder's purchasing 60% of the target's shares. Although the bid ratio will not be finalized until the rights of redemption expire, it will certainly be at least 60%. Therefore, upon the bid's expiration, the bidder should purchase at least 60% of the tendered shares.

The successful bidder's purchase and payment schedule will consequently look as follows. Upon the bid's expiration, the bidder will purchase at least 60% of all the shares that were tendered (approvingly or disapprovingly) and will hold the rest of the tendered shares until the common level of the bid ratio and proration ratio is finalized. The common level of these two ratios will be determined at the end of the three-month period for exercising redemption rights. Assuming that the tendered shares and the shares submitted for redemption add up to 90% of the target's shares, the bid ratio and the redemption ratio will be set at 66.6%. At this point, the bidder will purchase 66.6% of all the shares submitted for redemption, and will also purchase an additional 6.6% of the originally tendered shares (bringing the bid ratio up to 66.6%). The bidder will then return all the shares that it will not purchase.

¹⁴⁰ For a formal demonstration of the regulations' effectiveness in attaining undistorted choice, see L. Bebchuk, *supra* note 65, sec. V.

¹⁴¹ The risk of losing three-months' interest in the event of a takeover seems a sufficiently strong incentive to induce tendering. Of course, this loss could be increased if such an increase were considered necessary to strengthen incentives to tender. In general, the loss should be set at the lowest level sufficient to induce tendering from virtually all shareholders with an opportunity to tender and no tax reasons to avoid a sale of their shares.

making an approving tender and making a disapproving tender. Under the regulations, the shareholder's decision will affect his position only if his decision proves pivotal and determines the bid's outcome. The shareholder's decision would therefore turn on his judgment of whether — assuming his decision is going to be pivotal — he would prefer the bid to succeed or fail.

If the shareholder's decision is going to be pivotal and he makes an approving tender, then a takeover will occur, and he will end up with his pro rata share of the acquisition price. To be sure, under current rules, tendering shareholders can expect to receive in a takeover more than their pro rata share of the acquisition price. Under the proposed regulations, however, tendering shareholders would no longer have such expectations because the regulations would ensure a pro rata division of acquisition prices.

On the other hand, if the shareholder's decision is going to be pivotal and he makes a disapproving tender, then he will end up with shares in the independent target. It should be emphasized that to evaluate this scenario, the shareholder would be unlikely to use an estimate of the independent target's value that is significantly different from his own unconditional estimate. In other words, the shareholder's estimate conditional on his decision being pivotal would probably be very similar, if not equal, to his unconditional estimate of the independent target's value. The reason for this similarity is that the shareholder's choice will be pivotal only if the other shareholders are roughly split on the question of whether the offered acquisition price exceeds the independent target's value; and in focusing on such a case, the shareholder would have little reason to revise his own judgment significantly in either direction.¹⁴²

Thus, assuming that a shareholder's choice between tendering approvingly and disapprovingly is going to be pivotal, he would prefer the bid to succeed — and would hence tender approvingly — if and only if he views the expected acquisition price as higher than the independent target's value.¹⁴³ It follows that the proposed regulations

¹⁴² Thus, the effectiveness of the proposed regulations would not be impaired by the problem, discussed in Section III.C, that would afflict measures ensuring equality between the post-takeover value of minority shares and the bid price. Under such measures, shareholders would determine their tender decisions using upwardly-biased estimates of the independent target's value, and the outcome of bids would consequently be distorted against bidders. See *supra* pp. 1741-42.

¹⁴³ This proposition holds true for all tendering shareholders — including those shareholders, like arbitrageurs, who in no case wish to hold shares in the target for a long time. It might be suggested that such shareholders would always wish to have their shares acquired by the bidder, and therefore would always prefer the bid to succeed. This suggestion is wrong, however, because the bid's failure does not mean that these shareholders would have to retain their shares in the target. Following the bid's failure, the market price of the target's shares would reflect investors' estimates of the independent target's value. Therefore, when a shareholder's estimate of the independent target's value (conditional on his choice proving pivotal) would exceed the

would bring us fairly close to attaining the undistorted choice objective.¹⁴⁴

2. *Equal Treatment.* — The proposed regulations would also attain the equal treatment objective. In a takeover, all the shareholders who wish to receive their pro rata share of the acquisition price would be able to get it, or at least something close to it. The proposed regulations would increase the proportion of tendering shareholders in successful bids, and these tendering shareholders would all be treated with perfect equality. As to the remaining non-tendering shareholders, the regulations would ensure that they would be able to receive, if they so wish, something close to their pro rata share of the acquisition price.

Another way to show the regulations' effectiveness in attaining equal treatment is by reference to the current inequality of treatment. As we have seen, in takeovers accomplished under current law, there are two significant groups of non-tendering shareholders who would like to receive their pro rata share of the acquisition price but nonetheless have all their shares become minority shares: (1) shareholders who hoped that the bid would fail and wished to retain their shares in such a case; and (2) shareholders who had no opportunity to tender. As to shareholders who hope that the bid will fail, the regulations would enable them to tender without having to sell their shares in the event that the bid does fail; consequently, these shareholders would receive in a takeover the same per-share value as all tendering shareholders. As to shareholders who lack an opportunity to tender, the regulations concerning non-tendering shareholders would enable them to secure, if they so wish, something close to their pro rata share of the acquisition price.

Finally, it is important to note the link between the equal treatment that the proposed regulations would ensure and the undistorted choice that they would attain. As we have seen, the current inequality of treatment distorts shareholders' tender decisions because it creates both a stick, threatening non-tendering shareholders with receiving less than their pro rata share of the acquisition price, and a carrot, rewarding tendering shareholders with more than their pro rata share of the acquisition price. By securing equal treatment, the proposed

offered per-share acquisition price, he would always prefer the bid to fail. For the shareholder would expect that, if the bid fails, he would be able to sell his shares in the market at a price above the offered per-share acquisition price.

¹⁴⁴ Although the proposed regulations, as thus far outlined, would bring us close to attaining undistorted choice, they might not do a "perfect" job. One reason for this imperfection is that although most target shareholders would tender their shares, some would not. Another reason is that, in choosing between tendering approvingly and disapprovingly, some tendering shareholders might be guided by goals other than maximizing the value of their shareholdings. Section C.3 of this Part will discuss these problems, and will propose two modifications of the required number of approving tenders aimed at perfecting the regulations' effectiveness. See *infra* pp. 1759-61.

regulations would ensure that neither a stick nor a carrot would be present to distort shareholders' choices between tendering approvingly and disapprovingly: shareholders who make disapproving tenders would not receive in a takeover less than their pro rata share of the acquisition price, nor would those who make approving tenders expect to receive in a takeover more than their pro rata share.

C. Remarks on the Design and Performance of the Proposed Regulations

The remarks below highlight and discuss several significant issues concerning the design, operation, effectiveness, and possible modification of the proposed regulations.

1. *The Need for External Intervention.* — Whenever one proposes a regulatory intervention, the question naturally arises whether the proposed arrangement could be adopted through private ordering. In the present context, the question is whether companies could adopt the proposed arrangement by including appropriate clauses in their charters. If companies could do so, then one could object to regulatory intervention on two grounds. First, it might be argued, the fact that companies could have adopted the proposed arrangement but did not, casts some doubt on the efficiency of the proposed arrangement. Second, even supposing that the arrangement is efficient, it might still be argued that there is no reason why its adoption cannot be left to private parties.

These potential objections are invalid. As previously noted, the stock exchanges prohibit listed companies from adopting charter clauses that would impose arrangements of the kind that I propose.¹⁴⁵ Therefore, since companies have been precluded from adopting such arrangements, the fact that they have not adopted them in no way weakens the case for the desirability of the proposed arrangement. Furthermore, so long as the exchanges' restrictions remain, the adoption of the proposed arrangement in the future cannot be left to private parties: the arrangement must be provided by law. Of course, companies might be allowed to opt out of the arrangement — that is, to adopt charter clauses exempting bids for their shares from the prescribed restrictions. Such opting out should be acceptable, though it is unlikely to be used by a significant number of companies.

Moreover, even if the exchanges were to amend their policies and enable companies to adopt the proposed arrangement through appropriate charter clauses, there would still be advantages to providing the arrangement through regulation. Private solutions are most advantageous when private parties face varied situations that do not lend themselves to a uniform optimal solution, and when these parties

¹⁴⁵ See *supra* p. 1745 & note 126.

have superior information about their particular circumstances and needs. In the present context, however, the problems and their remedy can be analyzed in a general way. Since the proposed arrangement appears to be optimal across targets, adopting it in a centralized regulatory fashion (while allowing companies to opt out) has obvious advantages over adoption through numerous private initiatives. Such centralized adoption would save transaction and information costs, reduce uncertainty, and make planning easier.

2. *The Knife's Edge Problem.* — Under the proposed regulations, a shareholder's choice between tendering approvingly and disapprovingly would affect his financial position only in the event that his choice proves decisive for the bid's success. Indeed, as explained earlier, it is this feature of the regulations that would ensure that the shareholder's choice would be undistorted. Because of the small likelihood that a shareholder's choice would affect the bid's outcome, however, one might worry that shareholders would have no incentive to make that choice, or at least no incentive to make it in an informed way.

Consider first the concern that shareholders would have no incentive to indicate on their tender forms whether they tender approvingly or disapprovingly. This concern is similar to ones that are expressed in other contexts, such as the concern that shareholders have no real incentive to vote in proxy contests, or the concern that citizens have no real incentive to vote in political elections. Although this kind of concern may be valid in these latter contexts, it is clearly inapplicable to the proposed regulations.

Voting in a proxy contest or in a political election involves non-negligible transaction costs. Coupled with the low likelihood of affecting the outcome, these transaction costs lead some potential voters to refrain from participating. In contrast, under the proposed regulations, tendering shareholders would have to bear no extra transaction costs in order to register their approval or disapproval of a takeover. These shareholders would not be tendering to register their approval or disapproval, but rather to ensure that their shares will be acquired in case of a takeover. For these tendering shareholders — who would be sending their shares with an accompanying tender form anyway — registering approval or disapproval would involve only marking an appropriate box on the tender form.¹⁴⁶

Having concluded that tendering shareholders would have no reason to refrain from registering their approval or disapproval of a takeover, a second concern still remains — that shareholders would

¹⁴⁶ And if one is still concerned that shareholders would not bother to answer the tender form's question of whether they approve the takeover, it is possible to prescribe that tender forms would not be valid (that is, the accompanying shares would not be considered to be tendered) unless they contain an answer to this question.

have no real incentive to form a serious, informed judgment as to how the independent target's value compares with the offered acquisition price. Clearly, a shareholder would have no real incentive to devote time and resources for the sole purpose of improving the quality of his choice between tendering approvingly and disapprovingly. Thus, the concern under consideration would be justified if improving this choice were the only reason why a shareholder would wish to form a judgment about the independent target's value. This is, however, not the case.

The question of the target's value is of great interest to all the target's shareholders. It is critical not only to their initial decision to buy the target's stock, but also to their continuous decision to retain, rather than sell, their shares. Of course, sophisticated investors might invest substantially more resources than other investors in studying the target's value and updating their estimate. But all shareholders have some guiding estimates of the target's value, and they would naturally use these estimates in deciding between tendering approvingly and disapprovingly.

In particular, under the regulations, investors with no direct information about the independent target's value would be able to base their choice between tendering approvingly and disapprovingly on the market price of the target's shares prior to the bid's closing. At present, this market price might not accurately reflect the estimates of the independent target's value that market participants have, because the market price might be depressed by the anticipated distortions of shareholders' tender decisions.¹⁴⁷ Under the regulations, however, such distortions would no longer be expected, and the market price would therefore fairly reflect the estimates of market participants. When most market participants estimate the independent target's value to be higher than the offered acquisition price, the market price would reflect their high estimates and would exceed the offered per-share acquisition price. Observing this market price, investors with no direct information about the independent target's value would correctly elect to tender disapprovingly.

3. *The Separate Vote Alternative.* — Under the proposed regulations, shareholders would express their preferences concerning the bid's success in conjunction with the tendering of shares. An alternative approach would enable shareholders to express their preferences in a separate vote, and would allow a bidder to purchase a controlling interest only if its bid obtains a majority approval in such a separate vote.¹⁴⁸ I wish now to explain why the proposed regulations are

¹⁴⁷ See *supra* pp. 1726–28.

¹⁴⁸ Such a separate vote arrangement should be designed as follows. A bidder would have to submit his bid to a vote by the target's shareholders and obtain majority approval of the takeover. The vote's result would become known before the deadline for shareholders' tender

somewhat preferable to an arrangement based on a separate vote requirement.

First, many shareholders who are aware of a bid might choose not to participate in a separate vote, whether or not they prefer the bid to succeed. A shareholder might refrain from participating in the vote because his participation would be unlikely to affect the vote's outcome and would involve non-negligible transaction costs. As explained above, however, such a problem would not afflict the operation of the proposed regulations. Under the regulations, shareholders would by and large tender, and tendering shareholders' expression of their preferences concerning the bid's success would entail no transaction costs beyond those already involved in tendering.¹⁴⁹

Second, shareholders' choices between tendering approvingly and disapprovingly would likely be better informed than their choices under a separate vote arrangement between voting in favor of a takeover and voting against it. Under the proposed regulations, tendering shareholders would choose between approving and disapproving a takeover at the same time that they would choose whether to permit the bidder to purchase their shares in the event that the bid fails. Unlike the former choice, the latter choice would have a significant likelihood of affecting the deciding shareholder's financial position. Consequently, in deciding whether to permit the bidder to purchase their shares if the bid fails, shareholders would carefully examine the independent target's per-share value. This examination would inform, and hence improve, the quality of their concurrent choice between tendering approvingly and disapprovingly.

Finally, requiring a separate vote would make the acquisition process more cumbersome, less economical, and unnecessarily slow.

decisions. When the bidder fails to obtain the necessary majority approval, it would be prohibited from using its bid to purchase a controlling block. Shareholders might then still tender their shares if they wish to have them acquired in the event that the bidder elects to purchase a non-controlling block. When the bidder succeeds in obtaining the necessary majority approval, it would be allowed to acquire a controlling interest. Shareholders aware of the bid would then correctly assume that a takeover would take place, and therefore would by and large tender their shares. As to non-tendering shareholders, regulations concerning immediate takeouts and redemption rights would enable them to secure something close to their pro rata share of the acquisition price.

A separate vote requirement was recently adopted in Ohio. See OHIO REV. CODE. ANN. § 1701.831 (Page Supp. 1984). The Ohio statute, however, might well be unconstitutional in light of *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

¹⁴⁹ The expected failure of many shareholders to participate in a separate vote would be a significant shortcoming, however, only if the bidder were required to obtain approving votes from a majority of the target's shareholders (rather than from a majority of the voting shareholders). Under such a requirement, the failure of many shareholders to participate in the vote would distort outcomes against bidders. This problem could be largely addressed, however, by requiring the bidder to obtain approving votes from a majority of the *voting shareholders*. Cf. *infra* pp. 1759-61 (discussing how the required number of approving tenders should be refined for outcomes to best conform to the undistorted choice objective.)

Under the proposed regulations, shareholders would have to act only once, as the expression of approval or disapproval of a takeover would be done in conjunction with the tendering of shares. In contrast, a separate vote might require shareholders to act twice — once to cast a vote, and again to tender their shares. This two-stage process would involve not only higher transaction costs but also substantial delays in consummating acquisitions. And as long as the choice of the target's shareholders is undistorted, prompt consummation of acquisitions is desirable.

Although the proposed regulations appear somewhat preferable to a separate vote arrangement, their superiority is not that substantial and should not be overstated. Adopting a separate vote arrangement would move us a long way toward attaining undistorted choice and equal treatment — and would be very much in the spirit of this Article's approach. The essential tasks are first, to enable shareholders to express their preferences concerning the bid's success separately from their desire to have their shares acquired in the event of a takeover, and, second, to ensure a pro rata division of the acquisition price in the event that the majority prefers the bid to succeed. A separate vote arrangement, carefully designed, would be able to accomplish these tasks.

4. *The Required Number of Approving Tenders.* — Thus far I have assumed that the regulations would require bidders to attract approving tenders from a majority of the target's shareholders. Although the precise specification of the required number of approving tenders is not central to my thesis, I wish to propose two refinements of the required number of approving tenders. These refinements are aimed at perfecting the regulations' effectiveness in attaining undistorted choice. In particular, these refinements are suggested by an analysis of two issues: (1) the possible presence of non-tendering shareholders; and (2) the possible presence of shares held by the bidder and by other "interested" shareholders.

(a) *Non-Tendering Shareholders.* — Suppose that 10% of a target's shareholders did not tender, 48% tendered approvingly, and 42% tendered disapprovingly. While those who tendered approvingly constitute 53% of the tendering shareholders, they fall short of a majority of all the target's shareholders. Thus, requiring the bidder to attract approving tenders from a majority of the shareholders would lead to the bid's failure. Whether we should view this failure as consistent with the undistorted choice objective, however, depends on our assumptions concerning the non-tendering shareholders' estimates of the independent target's value. The bid's failure would be consistent with the undistorted choice objective, for example, if all the non-tendering shareholders view the bid's failure as value-maximizing.

Under the proposed regulations, however, a high estimate of the independent target's value would by itself lead a shareholder not to

hold out, but rather to tender disapprovingly. That 10% of the shareholders did not tender is therefore due either to lack of an opportunity to tender or to special tax circumstances. Thus, there is no reason to assume that the distribution of estimates of the independent target's value among the non-tendering shareholders is significantly different from the distribution of estimates among the tendering shareholders.

It follows that requiring bidders to receive approving tenders from a majority of the target's shareholders (i.e., from 56% of the tendering shareholders in our example) would be likely to introduce a slight bias against the bidder. Instead, we should require bidders to attract approving tenders from only a majority of the *tendering* shareholders (i.e., from 45% of the target's shareholders in our example). Assuming that the distribution of estimates among tendering shareholders is fairly representative of the distribution of estimates among all of the target's shareholders, such a modification would produce outcomes that are most consistent with the undistorted choice objective.

(b) *Shares Held by the Bidder and Other "Interested Shareholders."* — Whether a shareholder tenders approvingly or disapprovingly would depend on whether he prefers the bid to succeed or fail. In discussing the regulations' operation, I have thus far implicitly assumed that every shareholder is "disinterested" — in the sense that his preference concerning the bid's success is determined solely by the effect that a takeover would have on the value of his shareholdings. As was shown, a disinterested shareholder's choice between tendering approvingly and disapprovingly would be determined by his judgment of how the expected acquisition price compares with the independent target's value.

In fact, however, some shareholders might be "interested" — in the sense that their preferences concerning a takeover are shaped by considerations other than the takeover's expected effect on the value of their shareholdings. In particular, the bidder might own, directly or through subsidiaries, some initial stake in the target. The bidder would presumably prefer the bid to succeed whether or not it views acceptance of the bid as the shareholders' value-maximizing course of action.

If all approving tenders were to count toward the critical number of such tenders, the bidder would of course use the shares it already owns to make approving tenders. Counting such approving tenders would distort the outcome, however, because the bidder would make them regardless of whether it views the offered acquisition price as higher than the independent target's value. Therefore, the bidder should be required to attract approving tenders not from a majority of the tendering shareholders, but rather from a majority of the *disinterested* tendering shareholders.¹⁵⁰

¹⁵⁰ Although approving tenders made by the bidder would not count for the purpose of determining whether the bidder would be allowed to purchase a controlling interest, it would

In addition to the bidder and its subsidiaries, the category of interested shareholders should include other classes of shareholders who can be identified as interested. In particular, it seems appropriate to classify the target's managers as interested shareholders; for the managers might prefer the target to remain independent — and consequently might tender their shares disapprovingly — even if they view the offered acquisition price as higher than the independent target's value. Interested shareholders who tender their shares would of course be entitled to have the same fraction of their shares acquired as would all other tendering shareholders. But the approving and disapproving tenders of interested shareholders would not count for the purpose of determining whether the bidder would be allowed to cross the control threshold.

5. *The Proposed Regulations and Partial Acquisitions.* — As previously noted, many believe that partial acquisitions serve valuable economic functions, and that prohibiting or discouraging such acquisitions would thus produce substantial efficiency costs.¹⁵¹ Although the social desirability of enabling partial acquisitions has in my view been overstated,¹⁵² I agree that a partial acquisition might sometimes be more efficient than a complete acquisition. It is therefore important to point out that the proposed regulations would neither penalize nor in any way discourage partial acquisitions.

Under the proposed regulations, bidders would be free to set any limit they wish on the number of shares that they would acquire. The regulations would require only (1) that the bidder attract the specified number of approving tenders, and (2) that all shareholders be able to have the same fraction of their shares purchased at the bid price (or something close to it). Consequently, the proposed regulations would not prevent any socially beneficial partial acquisitions. A bidder would fail to purchase the partial interest that it seeks only if a majority of the target's shareholders view the bidder's purchase of such a block as value-decreasing. In such a case the bid's failure would indeed be socially desirable.

Conversely, under the proposed regulations, bidders would make partial bids whenever a partial acquisition is more efficient than a complete acquisition. When a partial acquisition would be more ef-

still be quite profitable for a prospective bidder to make secret pre-bid purchases of the target's shares. (Under the Williams Act, a prospective bidder can purchase up to 5% of the target's shares without being required by the Williams Act to disclose its purchases. See 15 U.S.C. § 78n(d)(1) (1982).) To be sure, such pre-bid purchases would not increase the likelihood of the bid's success (nor should they). But the purchases would in all likelihood produce a substantial gain for the bidder whether its bid succeeds (in which case the bidder would save the acquisition premium on the stock it already owns) or fails (in which case the market price of the target's shares would probably be significantly higher than the pre-bid price). See Bebchuk, *Facilitating Competing Bids*, *supra* note 7, at 1035 & nn.40-42.

¹⁵¹ See *supra* p. 1736.

¹⁵² See *supra* note 108.

ficient, the bidder would be able to offer a higher per-share acquisition price in a partial bid than it would be able to offer in a bid for all shares. Consequently, because under the regulations the bidder's chances of success would be enhanced by an increase in the offered acquisition price, the bidder would elect to make a partial bid.

6. *The Proposed Regulations and Shareholders' Freedom To Sell Their Shares.* — The free transferability of shares is an important feature of the modern public corporation. I therefore wish to show that the restrictions on alienation that the proposed regulations would entail would be limited and, more importantly, clearly justified.

In order to lend concreteness to the discussion below, let us suppose that the control threshold were set at 20% of the target's shares, and that the required fraction of approving tenders were set at 50% of the target's shares. As explained below, the proposed regulations would constrain alienation only when the shareholders who made approving tenders constitute more than 20% but less than 50% of the target's shareholders. In such a case, the bidder would be prohibited from buying more than 20% of the shares, and those who made approving tenders would be prevented from selling all of their shares to the bidder.

When more than 50% of the target's shareholders made approving tenders, the regulations would of course entail no restrictions on alienation, because they would allow the bidder to purchase as many shares as it wishes, provided only that it treats all tendering shareholders equally. Note that in this case the majority would in effect force the minority who made disapproving tenders to sell their shares. To be sure, the shareholders who made disapproving tenders would receive their pro rata share of the acquisition price. These shareholders, however, would desire most of all to retain shares in the independent target, an option ruled out by the majority's decision.

Similarly, when less than 20% of the target's shareholders made approving tenders, the regulations would again involve no restrictions on alienation. Although the bidder would have to stay below the 20% threshold, it would be allowed to purchase shares from those tendering shareholders who indicated their willingness to sell their shares even if the bid fails. And the number of shareholders who made approving tenders indicates that there is no group of shareholders who together hold a block of more than 20% of the shares and who would wish to enable the bidder to acquire such a block.

Thus, restrictions on alienation would exist under the regulations only because the required fraction of approving tenders was specified at a level higher than the effective control threshold. Hence, all such restrictions would be eliminated if we were to allow bidders to cross the 20% threshold whenever 20% or more of the shareholders make approving tenders. But, as the following analysis suggests, such a modification of the regulations would be undesirable.

Recall the previously emphasized distinction between the acquisition of a non-controlling block and the acquisition of a controlling one.¹⁵³ An acquisition of a non-controlling block does not change the nature of the target's ownership, and it is unlikely to affect the allocation of the target's assets or the position of non-selling shareholders. Thus, when a buyer seeks to acquire a non-controlling block, the case for freedom of transfer is compelling. There is no reason to prevent a transaction between a willing buyer and a willing seller when it would not adversely affect the position of non-selling shareholders (or some other third parties). The selling shareholders' freedom to sell their shares does not conflict with the other shareholders' wish to retain shares in an independent target.

In contrast to acquiring a non-controlling block, acquiring a controlling block transforms the independent target into a company with a controlling shareholder. The acquisition is likely to affect the way in which the target is run and the allocation of the target's assets. It affects not only the position of the selling shareholders but also that of the non-selling shareholders.

Bearing in mind the consequences of acquiring a controlling interest, consider a case in which 40% of the target's shareholders make approving tenders while 60% of the shareholders make disapproving tenders. Thus, 40% of the shareholders would like the bidder to acquire a controlling interest — and would be willing to contribute their shares for that purpose — while 60% of the shareholders would like the target to remain independent. Whatever the bid's outcome, all the shareholders would be treated equally. The two groups of shareholders, however, differ in their judgments as to which outcome of the bid would maximize the collective wealth of the target's shareholders. The minority group views the expected acquisition price as higher than the independent target's value, whereas the majority group holds the contrary view.

Clearly, the two groups cannot both have their way. The desire of the minority to sell a controlling block to the bidder is incompatible with the wish of the majority to retain shares in an independent target. Prohibiting the bidder from acquiring a controlling block would clearly limit the freedom of the minority group to sell their shares; such a prohibition would force upon this minority the majority's opinion that the offered acquisition price is too low. Yet it is equally clear that allowing the bidder to purchase a controlling interest would force the minority's opinion on the majority. To be sure, if the bidder is allowed to gain control and a takeover occurs, the shareholders in the majority group will all receive their pro rata share of the acquisition price. But these shareholders view this pro rata share as lower than the

¹⁵³ See *supra* pp. 1715–16.

value of their shares in the independent target, and they would like most of all to continue holding such shares.

Which group's opinions and wishes should the law follow? As Part V will explain, efficiency considerations suggest that we should follow the judgment of the majority. For the majority is more likely than the minority to be correct in its assessment of the shareholders' value-maximizing course of action — that is, in its assessment of how the offered acquisition price compares with the independent target's value.

Thus, when a majority of the shareholders made approving tenders, or voted in favor of a merger proposal, the bidder should be allowed to gain control, even though that result will in effect force those who made disapproving tenders, or voted against a merger proposal, to sell their shares. But when only a minority made approving tenders, or voted in favor of a merger proposal, then the minority view should not prevail and the target should remain independent.

V. THE DESIRABILITY OF UNDISTORTED CHOICE AND EQUAL TREATMENT

Thus far this Article has shown how far we currently are from attaining undistorted choice and equal treatment and has explained how these two objectives could be achieved. I still owe the reader, however, a systematic and detailed explanation as to why these two objectives are both desirable and important. This Part undertakes that task.

A. *Undistorted Choice*

The undistorted choice objective is desirable for reasons of economic efficiency.¹⁵⁴ In Subsection One I shall describe the substantial

¹⁵⁴ Another argument which might be made in support of the objective, and which many might find appealing, is one based on entitlement considerations. The entitlement argument would assert that ensuring undistorted choice is necessary to protect the property rights that a target's shareholders have in the assets they own. The shareholders, it would be argued, should not be put in a position that would lead them to sell their assets for an acquisition price that they judge to be lower than the value to themselves of retaining their assets.

The above argument is not one that I wish to make, however, because I do not find it convincing. The protection that the legal system gives to owners of property is rarely perfect; it is usually one whose contours are shaped by various policy considerations. Many owners, for example, are protected only by a liability rule — their assets might be "taken" by others provided only that some prescribed consideration be paid. See Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). Therefore, if efficiency required a legal regime in which target assets could be taken provided only that the target's shareholders receive a compensation exceeding the target's pre-bid market price, I would not rule out such a regime. As explained below, however, the regime that is required by efficiency is that of undistorted choice.

efficiency gains that would result from ensuring undistorted choice. Then, in Subsection Two, I shall show that ensuring undistorted choice would be unlikely to involve any significant efficiency costs.

1. *The Efficiency Gains from Ensuring Undistorted Choice.* — (a) *The Proposed Mechanism.* — It is in society's interest that corporate assets, as well as all other resources, be put to their most productive uses. The productivity of given assets might well depend on the identity of the corporation that controls them; the identity of the controlling corporation determines what managerial resources will be brought to bear upon these assets and what other resources will be used in combination with them. Thus, at any given time there are likely to be some companies whose acquisition by other companies would produce efficiency gains by creating "synergy" or improving management.

While the acquisition of some companies might produce efficiency gains, there are many other companies whose assets are employed most efficiently under their existing, independent mode of operation. Moreover, even where the acquisition of a company is likely to produce efficiency gains, the size of these gains might well still depend on the acquirer's identity: the magnitude of synergistic gains clearly depends on the "fit" between the acquirer and the target, and acquirers may differ in their ability to improve the management of the target's assets. Thus, choosing the mechanism that will determine whether a given company will be acquired, and, if so, by which potential acquirer, presents an important question of social policy.

Part I has already discussed the mechanism that we employ to determine the outcome of offers to acquire a sole owner's assets. The acquisition of such assets is conditional on the owner's consent, and such acquisitions consequently take place if and only if the offered acquisition price is viewed by the owner as higher than the value to himself of retaining his assets. According to the undistorted choice objective, the guiding principle for corporate acquisitions should parallel the principle followed in the sole owner context. Assuming for the time being that a target's shareholders all have the same judgment as to whether accepting a given offer would be value-maximizing,¹⁵⁵ the undistorted choice objective suggests that we follow the shareholders' judgment: the target should be acquired if and only if the shareholders view the offered acquisition price as higher than the independent target's value. This mechanism, I propose, appears to be the best feasible mechanism for determining the outcome of acquisition offers, at least if we limit ourselves to private market mechanisms.

¹⁵⁵ The implications of divergent judgments among the shareholders are discussed below, see *infra* pp. 1774-75.

Before proceeding to examine further the proposed mechanism's operation, it should be noted that the mechanism would contribute not only to efficient allocation of target assets, but also to efficient pricing of potential targets. For society to induce a socially optimal level of investment in a given company, investors must be able to capture the social gains that result from their investment. Ensuring undistorted choice by target shareholders would preclude a bidder from acquiring a target for less than the competitive price. Consequently, shareholders of potential targets would expect to capture those social gains that are attributable to the existence of their companies. Such expectations would in turn help to induce efficient levels of investment in potential targets.¹⁵⁶

(b) *Why Rejecting a Premium Bid Might Be Value-Maximizing.* — As previously noted, the undistorted choice objective might be divided into two elements: (1) ensuring that shareholder support (that is, a judgment on the shareholders' part that acceptance of the offer would be value-maximizing) is necessary for the success of any acquisition attempt; and (2) ensuring that shareholder support is sufficient for the success of any acquisition attempt. Most of this Article, however, has focused on the objective's first element. Any endorsement of this element of the objective is necessarily based on an implicit factual assumption — that there might be acquisition offers that do not enjoy shareholder support. If there were no such offers, then there would of course be no practical significance to the question of whether their failure is socially desirable. It is therefore important to respond to the objection that shareholders can never have a rational reason to view the rejection of a premium acquisition offer as value-maximizing.¹⁵⁷

(i) *Might Shareholders Rationally View the Rejection of a Premium Bid as Value-Maximizing?* — Acquisition offers usually include a premium over the pre-bid market price of the target's shares. The pre-bid market price reflects investors' pre-bid estimates of the independent target's value; indeed, it is believed by many that the pre-bid market price reflects all the information concerning the independent target's value that is publicly available at that time.¹⁵⁸ Therefore, it might be argued, shareholders can never rationally view the independent target's per-share value as higher than the target's pre-bid market price; and they thus can never rationally view the independent target's value as higher than the acquisition price offered by

¹⁵⁶ See Bebchuk, *Reply and Extension*, *supra* note 7, at 42–44.

¹⁵⁷ Note that no one is likely to argue that the objective's second element — that shareholder support be sufficient for an acquisition offer's success — is of no practical significance. Clearly, shareholders can often have a good reason to view the acceptance of a premium acquisition offer as value-maximizing.

¹⁵⁸ See Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (surveying the literature on the informational efficiency of capital markets).

a premium bid. Hence, the argument proceeds, the undesirability of acquisitions that do not enjoy shareholder support is a moot issue, because shareholder rationality implies that all premium acquisition offers enjoy shareholder support. Moreover, even if a target's shareholders happen to view the rejection of a premium bid as value-maximizing, we should disregard their view — because their high estimates of the independent target's value are bound to be inferior to the lower estimate implicit in the pre-bid market price.

The above reasoning, however, is flawed. It ignores the ever-changing nature of investors' estimates and the fact that shareholders' tender decisions are usually made several weeks after their company becomes a takeover target. In general, the value that investors attach to a given company at a given point in time might well vary from month to month. The market's estimate of a company's value is continuously revised as new information about the company and the world is revealed. In the case of takeover targets, the flow of new information and the resulting revision of estimates are likely to be especially substantial.

For example, investors might well draw inferences concerning the target's value from the very fact that a bid was made and from the bid's terms. Investors might also revise their estimates, especially in a hostile bid, in reaction to disclosures by the target's management concerning future plans, proposed structural changes, and previously undisclosed facts. Finally, a bid attracts the investment community's attention, and intensified investigations by financial analysts and other market participants are likely to reveal a wealth of new information concerning the target.

All this new information is likely to lead shareholders to hold, at the time of their tender decisions, an estimate of the independent target's per-share value that is quite different from the target's pre-bid market price. Because most of this new information is likely to be "good news," investors' estimates at the time of their tender decisions are likely to exceed the pre-bid market price. Indeed, these estimates might exceed not only the pre-bid market price but also the market price during the bid period. As previously explained,¹⁵⁹ the market price in the bid period might be affected by the looming pressure to tender and might be capped by the per-share value that tendering shareholders can expect to receive in the event of a takeover. Thus, once a bid is made, the market price might not fully reflect subsequent revisions in investors' estimates of the independent target's value.

In sum, at the time they make their tender decisions, a target's shareholders might estimate the independent target's value to be higher than the acquisition price offered by a premium bid. Moreover,

¹⁵⁹ See *supra* pp. 1726–28.

in cases in which they hold such an estimate, their estimate is likely to be superior to that implicit in the pre-bid market price. While some shareholders' information might be limited, all the shareholders are presumably aware of the pre-bid market price. Therefore, assuming minimal rationality on their part, they will adopt a revised estimate only if, on the basis of new developments and new information, they have a good reason to do so.

That rejecting a premium bid might sometimes be value-maximizing is also indicated by the empirical evidence. As previously noted, a study by Bradley, Desai, and Kim identified several dozen instances in which shareholders rejected a premium bid.¹⁶⁰ In these instances, rejecting the bid indeed proved to be value-maximizing. Once the bid was rejected, the market price of the target's shares was significantly higher than the bid price, which in turn was presumably higher than the offered per-share acquisition price. The high stock market price that followed the bid's rejection in these instances must have been a result of the new information that investors had acquired since the announcement of the bid.

(ii) *How Often Do Shareholders View the Rejection of a Premium Bid as Value-Maximizing?* — At the time of their tender decisions, then, investors might rationally view the rejection of a premium bid as value-maximizing. Among the various reasons they might have for holding such a view, several are likely to be important and deserve specific mention.

First, the target's shareholders might expect that another bidder, who can put the target's assets to a more valuable use than can the present bidder, will come forward later on with a higher offer. The empirical evidence indicates that such expectations are often reasonable: in the previously noted study by Bradley, Desai, and Kim, many of the targets that remained independent were later acquired through a higher bid.¹⁶¹ To be sure, the Williams Act provides a delay period that often enables competing bidders to come forward before shareholders have to make irrevocable decisions concerning the initial bid.¹⁶² But the prescribed delay period might in many instances fall short of the time necessary for a competing bid to materialize; and, since the resolution of bids should not be delayed unnecessarily, adopting a long mandatory delay period would be undesirable. Ensuring undistorted choice would provide target shareholders with the necessary flexibility: the mandatory delay period would remain quite limited, but when further delay would seem beneficial, the shareholders

¹⁶⁰ Bradley, Desai & Kim, *supra* note 59, at 187–98.

¹⁶¹ See *id.* at 188–89.

¹⁶² See 15 U.S.C. § 78n(d)(5) (1982); Bebchuk, *Facilitating Competing Bids*, *supra* note 7, at 1051–54.

would be able to choose freely to remain independent for the time being.

Second, the shareholders might judge the present bidder to be the highest-valuing user of the target's assets, but expect that rejection of the present bid would lead the bidder to make a higher offer. Under current takeover rules, the distortions of shareholder choice might enable a bidder to acquire a target for less than the competitive price — that is, the price that other potential buyers would be willing to pay. The threat of competing bids might be insufficient to secure a competitive price because the competition in the market for corporate acquisitions is far from perfect. In particular, if other potential buyers view the present bidder as the one that places the highest value on the target, they will not enter a costly bidding contest — which they are bound to lose — even if the present bid is below the competitive price.¹⁶³ Enabling a target's shareholders to exercise an undistorted choice, however, would ensure that a target would not be acquired for less than the competitive price.

Third, the shareholders might believe that the bidder's motive for making the bid was not the expectation of efficiency gains, but rather the possession of private information that the target's shares were undervalued by the market;¹⁶⁴ and the shareholders might conclude that the target's accurate value exceeds the offered acquisition price. While undervaluation by the market might not be the dominant motive for most takeover bids, it might well be the motive in a non-trivial number of cases. The recent wave of takeovers of oil companies, for example, was widely regarded as motivated by the undervaluation of these companies' stock.¹⁶⁵

Fourth, the shareholders might raise their estimates of the independent target's value as a result of proposals and plans that the incumbent management puts forward subsequent to the bid. Such proposals and plans might have been formulated as a direct response to the bid, or might have been formulated earlier but revealed as such a response. Management might, for example, put forward a plan for a financial or economic restructuring of the target,¹⁶⁶ and such a plan might lead investors to raise significantly their estimates of the target's value.

How often are targets acquired even though their shareholders view remaining independent as value-maximizing? Although one cannot be certain, there are grounds to believe that there is a substantial

¹⁶³ See Bebchuk, *Facilitating Competing Bids*, *supra* note 7, at 1036 n.45.

¹⁶⁴ See Grossman & Hart, *The Allocational Role of Takeover Bids in Situations of Asymmetric Information*, 36 J. FIN. 253 (1981).

¹⁶⁵ See Lowenstein, *supra* note 5, at 277.

¹⁶⁶ See Hicks, *Zellerbach Rejects Goldsmith's Offer*, N.Y. Times, Apr. 12, 1985, at D5, col. 1 (Zellerbach's management proposed a major restructuring of the company in response to a tender offer by Sir James Goldsmith).

number of such instances. As the analysis of Part II has demonstrated, at present a target is likely to remain independent only if the independent target's per-share value exceeds the offered per-share acquisition price *by a considerable margin*; the instances of bid rejection identified in the study by Bradley, Desai, and Kim presumably belong to that category. Because bidders wish to pay as little as possible, they presumably attempt to set the acquisition price at or just above the minimal level that, given the current distortions, would be sufficient for the bid's success. The current instances of bid rejection are thus those in which the bidder undershoots even that minimal level. Thus, there are likely to be many instances in which the bidder offers less than the independent target's per-share value — but not by a sufficiently large margin for shareholders to overcome the current distortions and reject the bid.

Finally, a target's shareholders might view rejecting a bid as value-maximizing not because they attach a high value to remaining independent for the time being, but rather because they view the acceptance of another available bid as value-maximizing. As Appendix B demonstrates, the current distortions afflict not only shareholders' choice between selling their company and remaining independent for the time being, but also their choice among rival bids. Consequently, a bidder might currently win a bidding contest and gain control even though its rival, which can put the target's assets to a more valuable use, is offering a higher acquisition price. Thus, enabling shareholders to make an undistorted choice among competing offers — which, as the Appendix shows, the proposed regulations could be extended to do — is necessary for ensuring an efficient allocation in the many instances of current bidding contests.

(c) Is the Proposed Mechanism Perfect? — Allowing sole owners to accept or reject offers to purchase their assets is not a perfect mechanism that ensures an efficient outcome in every instance. Nor would the proposed undistorted choice mechanism ensure an efficient outcome in every instance. In both cases, the imperfection is measured by comparison to the allocation of assets that could be obtained in an imaginary world in which public officials had all the information available to private parties and thus could prescribe the allocation that would be most efficient. Although the undistorted choice mechanism — and the corresponding mechanism in the sole owner context — cannot create this perfect world, they appear to be the best feasible mechanisms for the world that we inhabit. The two main reasons why the undistorted choice mechanism is imperfect are discussed below.¹⁶⁷

¹⁶⁷ It is important to remind the reader that, to focus on the problems that result from the diffusion of ownership of takeover targets, the analysis of Parts I–V assumes away two other problems presented by corporate acquisitions — distortions of acquirers' choice, and distortions

(i) *Mistaken Judgment by a Target's Shareholders.* — Like a sole owner, a target's shareholders might misjudge their value-maximizing course of action. In particular, they might inaccurately assess the independent target's value.

It is important to distinguish two senses in which the shareholders' judgment might be mistaken. First, the shareholders might regret their decision in light of events subsequent to it, even though their decision was correct at the time they made it (that is, in light of the information available at that time). To understand this type of regret, consider a sole owner who rejects an offer to purchase his assets because he believes that there is a sixty percent chance that he will later be able to employ the assets very productively or at least receive a higher offer. As things turn out, however, neither contingency occurs, and the sole owner wishes he had sold his assets. Obviously, these disappointing developments do not imply that, given the information available at the time, the sole owner's decision to retain his assets was the wrong one to make. Assuming that his assessment of the sixty percent likelihood was accurate, his decision was correct: on an expected-value basis, retaining his assets was his value-maximizing course of action.

Similarly, a target's shareholders might conclude that remaining independent would be value-maximizing on the basis of some uncertain prospects — for instance, the prospect of receiving a higher bid in the future. Indeed, any estimate of a company's value must include the appropriately discounted capitalization of uncertain prospects. Assuming that the shareholders accurately assess the expected value of uncertain prospects, then their estimate of the independent target's value is the correct one to use — from both their point of view and society's — even though the shareholders might later regret their decision.

In the study by Bradley, Desai, and Kim, there were instances in which the shareholders rejected a bid apparently because they believed that there was some probability that a higher bid would be made later on.¹⁶⁸ Immediately following the bid's rejection, the target's stock market price in these instances exceeded the bid price. As the uncertainty about a higher bid was later resolved, the market price either advanced further or declined, according to whether the higher bid materialized or failed to materialize. Whether or not a higher bid

resulting from the existence of private gains to acquirers and targets that do not represent net social gains. These two problems constitute another reason why the undistorted choice mechanism would not by itself achieve a perfectly efficient allocation of targets' assets. As Part VII will explain, however, the presence of these two problems in no way weakens the case for this Article's proposed regulations, and only suggests that some supplementary measures might be desirable. See *infra* pp. 1792-94.

¹⁶⁸ See Bradley, Desai & Kim, *supra* note 59, at 204-05.

materialized, however, the decision to reject the bid was clearly correct in each instance: on an expected-value basis, and given all information publicly available at the time, the decision to reject was the value-maximizing decision — as indicated by the market price following the rejection.

In sum, regrets caused by the unfolding of subsequent events are irrelevant to determining the efficient outcome of acquisition attempts. The relevant estimate of the independent target's value is that which can be reached on the basis of the information available at the time of the shareholders' tender decisions. Thus, in evaluating the performance of the undistorted choice mechanism, our concern should be limited to the second sense in which the shareholders' judgment might be mistaken — their estimate of the independent target's value might be inaccurate in light of the information available at the time of their tender decisions. Such a mistaken estimate might of course lead to an inefficient outcome: an upward-biased estimate might prevent a desirable acquisition, whereas a downward-biased estimate might enable an undesirable acquisition. Nonetheless, the possibility of such a mistaken estimate does not justify opposing the undistorted choice mechanism, just as the possibility of a mistaken estimate by sole owners does not justify denying them the power to accept or reject offers.

Clearly, assessing the independent target's value is critical to determining the efficient outcome of an acquisition offer. Therefore, the possibility of a mistaken estimate by shareholders should lead us to reject the undistorted choice mechanism only if we can identify another mechanism for determining the outcome of acquisition offers that would utilize systematically better estimates. No such mechanism, however, appears available.

In particular, an undistorted choice regime is superior to a regime that would enable any acquisition attempt to succeed provided only that a premium is offered over the target's pre-bid market price. Although some shareholders' information might be quite limited, all shareholders are presumably aware of the target's pre-bid market price. As explained earlier, shareholders will adopt an estimate different from the pre-bid price only if they see, in light of new developments and new information, some good reason to do so. Their decisions to revise their pre-bid estimate might sometimes be wrong, but there is every reason to expect that such decisions are more likely to be right than wrong.

Similarly, ensuring undistorted choice by shareholders is superior to enabling the target's managers to determine the bid's outcome. To be sure, the managers' estimate of the independent target's value might commonly be more accurate than the shareholders' estimate. The managers' preference concerning the bid's fate, however, might be greatly affected by considerations other than their judgment as to how

the offered acquisition price compares with the independent target's value. In contrast, the shareholders' preference will be determined solely by their judgment as to how these two values compare. Although the shareholders' judgment might occasionally be incorrect, we can do no better than follow their judgment.

(ii) *Strategic Behavior and Transaction Costs.* — The second main reason that the undistorted choice mechanism might be imperfect is that the acquisition price offered by a buyer might well be lower than the value that the buyer attaches to the target's assets. Consequently, that the independent target's value exceeds the offered acquisition price does not necessarily imply that it exceeds the value that the target's assets would have in the buyer's hands.

To understand the nature of this problem, it will be helpful to examine it first in the sole owner context. When a sole owner attaches a value of \$135 to an asset and a potential buyer attaches a value of \$150 to it, the buyer's acquisition of the asset is socially desirable. But if the buyer offers a price of \$132, seeking a gain of \$18, the owner will reject the offer. To be sure, the acquisition might ultimately take place, for the buyer might increase its offer above \$135; after all, an acquisition at any price below \$150 would make the buyer better off. But the acquisition might also not occur. First, strategic considerations — such as a desire to establish a reputation for toughness in bargaining, or a hope that the other side will capitulate — might lead the buyer to stick to its initial offer. Second, the buyer might sometimes be unwilling to bear the transaction costs of making an increased offer, especially if such an offer might be again rejected. Thus, enabling sole owners to reject offers might occasionally prevent a socially desirable acquisition.

Similarly, undistorted choice by target shareholders might on occasion prevent a desirable acquisition. Such an outcome might result when the independent target's value exceeds the offered acquisition price but not the value that the target's assets would have in the bidder's hands. Of course, assuming that the bidder correctly appreciates the value of the target's assets to itself, the bidder might raise its offer beyond the independent target's value. Yet, the bidder might also walk away, due to strategic considerations or to the transaction costs involved in raising its offer.

Note that the danger of deadlock caused by strategic behavior is no more severe in the takeover context — and indeed might well be less severe — than in the sole owner context. In bargaining between a sole owner and a buyer, each party can at any time make a new offer or accept an outstanding one. At any given stage of the bargaining, uncertainty about what might happen in subsequent stages might lead to a strategic deadlock. In contrast, in the takeover context the “bargaining procedure” is certain — only the bidder can make offers, which after a specified delay period must be accepted or re-

jected by the target's shareholders. This greater certainty might well decrease the probability of strategic deadlock.

Furthermore, the danger that a socially desirable takeover will be prevented by the transaction costs involved in raising a bid appears to be very small. The cost of raising an existing bid is much smaller than the cost of making an initial bid, which in turn is very small compared to the value of the bid itself. It is thus extremely unlikely that transaction costs would prevent a failing bidder from raising its offer if the bidder indeed places on the target's assets a value exceeding the independent target's value.

Thus, the imperfections introduced by strategic behavior and transaction costs in the takeover context are qualitatively similar to, and perhaps quantitatively less severe than, the corresponding problems in the sole owner context. Therefore, these problems no more suggest that target shareholders should be denied an undistorted choice than they suggest that sole owners should be denied the power to reject offers. For in both cases there appears to be no feasible mechanism that would on the whole perform in a more satisfactory fashion.

(d) *The Decisive Fraction.* — The analysis thus far has assumed that the shareholders of any given target all share the same judgment as to how the offered acquisition price compares with the independent target's value. In such a case, the guiding principle is simple: the shareholders' judgment should be followed. Shareholders, however, might differ in their estimates of the independent target's value and of the offered acquisition price. When shareholders hold opposing views as to how these two values compare, the question of which view should prevail naturally arises. According to the undistorted choice objective, the decisive fraction, the fraction whose view should prevail, is a majority of the shareholders.

The selection of a majority as the decisive fraction is based on efficiency considerations. From the perspective of efficiency, the desirable outcome of an acquisition offer depends on how the offered acquisition price compares with the independent target's value. Because the majority's judgment concerning this issue is more likely to be correct than the minority's, efficiency is more likely to be served by following the view of the majority.

Throughout this Article, a majority of the shareholders has meant not a numerical majority, but rather a group of shareholders who together hold a majority of shares. Thus, the proposed definition of the undistorted choice objective weighs each shareholder's judgment in proportion to the number of shares he holds. The rationale for this approach is that the more shares a shareholder holds, the greater his incentive to seek information about the target, and hence the more informed his judgment as to whether the offered acquisition price exceeds the independent target's value. Therefore, in aggregating shareholders' views, we should attach an increased weight to the

judgment of a shareholder with a larger number of shares, though the size of the desirable increase in weight is by no means clear. Finding the optimal weighting formula is clearly very complicated, and it would require more information than is currently available concerning the connection between the size of a shareholder's block and the amount of information that he will gather. Therefore, defining undistorted choice by reference to shareholders who together hold a majority of shares seems the best definition to use at this stage.

In any event, most of this Article's analysis in no way depends on how one defines the decisive fraction. First, the Article's analysis of the current distorted choice has focused on the fact that shareholders' tender decisions might not reflect their views as to how the offered acquisition price compares with the independent target's value; this feature of shareholders' tender decisions might produce a distorted outcome no matter how the decisive fraction is defined. Second, with respect to the proposed regulations, a different specification of the decisive fraction in defining the undistorted choice objective would only require a different specification of the crucial fraction of approving tenders that a bidder would have to attract to gain control.

2. *Would Ensuring Undistorted Choice Involve Any Significant Efficiency Costs?* — Having seen that ensuring undistorted choice would produce substantial efficiency gains, it remains to examine whether it would involve any significant efficiency costs. As the following analysis demonstrates, ensuring undistorted choice through the proposed regulations would be unlikely to involve any such costs.

Because ensuring equal treatment is a necessary instrument for ensuring undistorted choice, the efficiency costs of the latter include those of the former. Therefore, the conclusion that attaining undistorted choice would involve no significant efficiency costs will also apply to attaining equal treatment.

(a) *Wasteful Transaction Costs.* — Ensuring undistorted choice would in all likelihood produce no increase in the wasteful transaction costs involved in consummating acquisitions. At first blush, it might seem that ensuring undistorted choice would frequently lead to the failure and subsequent increase of initial bids, thus producing a longer and costlier takeover process. This impression, however, is wrong. It fails to recognize that ensuring undistorted choice would produce its efficiency benefits mainly by affecting the terms of initial bids, rather than by causing initial bids to fail. Under the proposed regulations, bidders would realize that shareholders are no longer subject to a pressure to tender, and would therefore design their initial bids to have a good chance of being accepted by shareholders exercising undistorted choice. Consequently, bidders would offer higher prices in their initial bids than they would if shareholders' decisions were still distorted. Moreover, potential bidders who would estimate the independent target's value as higher than any price they could offer

would no longer bid — which would of course be socially desirable. Thus, the beneficial operation of the proposed regulations would not usually involve a more drawn-out bidding process.

Indeed, the overall wasteful transaction costs in an undistorted choice regime would likely be lower than those in the existing regime. The dominant source of wasteful transaction costs in the existing regime is incumbents' use of obstructive tactics and bidders' response to such tactics. The ban on obstructive tactics, which would be part of the undistorted choice regime, would eliminate this dominant source of wasteful costs.

That ensuring undistorted choice would not increase wasteful transaction costs, however, does not necessarily imply that it would involve no efficiency costs. After all, ensuring undistorted choice would have a substantial impact on the size of acquisition prices and on their distribution among target shareholders. Although these consequences would themselves constitute mere wealth transfers, they might have efficiency costs if they led some parties to behave inefficiently. Therefore, I shall now turn to examine whether ensuring undistorted choice would have any adverse effect on the various socially beneficial activities undertaken by prospective acquirers, sophisticated investors, and arbitrageurs.

(b) *The Search for Potential Targets.* — Prospective acquirers often look for targets whose acquisition might be profitable. Professors Easterbrook and Fischel have emphasized in their recent writings that for the corporate acquisitions market to operate efficiently, it is necessary to provide prospective buyers with an incentive to search for potential targets.¹⁶⁹ Easterbrook and Fischel's view is that to encourage the search for potential targets we should seek to maximize searchers' returns, and to this end we should seek to minimize the premium that is necessary to acquire a discovered target. On this view, ensuring undistorted choice would be undesirable because it would increase takeover premiums.

The need to reward search, however, does not undermine the undistorted choice objective. As I explained elsewhere,¹⁷⁰ curtailing takeover premiums is not at all necessary to induce an adequate level of search: competitive acquisition prices are consistent with providing searchers with substantial rewards relative to search costs. For example, prior to making a bid for an identified target, a searcher can and often does make secret market purchases of the target's stock. Whether or not the searcher ultimately acquires the target, the

¹⁶⁹ See Easterbrook & Fischel, *supra* note 1, at 1177–80; Easterbrook & Fischel, *supra* note 23. In the economic literature, the issue of search for targets has been emphasized by Grossman and Hart. See Grossman & Hart, *supra* note 8, at 57–58.

¹⁷⁰ See Bebchuk, *Facilitating Competing Bids*, *supra* note 7, at 1034–38; Bebchuk, *Reply and Extension*, *supra* note 7, at 31–33.

searcher will usually make a substantial profit on its secret pre-bid purchases.¹⁷¹

Furthermore, even assuming that an increase in rewards for search is deemed desirable, such an increase can be accomplished by raising the limit on the amount of the target's shares that a searcher can secretly purchase before being required to disclose its purchases. As long as the searcher is required to stay below the effective control threshold, an increase in the disclosure threshold would be consistent with ensuring undistorted choice. Thus, since the existing disclosure threshold of five percent is far below any reasonable specification of the effective control threshold, the existing substantial rewards for search could be greatly enhanced without sacrificing undistorted choice.

Even more important, sacrificing undistorted choice to magnify further searchers' rewards might lead to a socially excessive level of search. Search is socially beneficial only to the extent that searchers look for targets whose acquisition would produce efficiency gains. In a regime of distorted choice, under which targets might be acquired for less than the independent target's value, bidders would often go after targets whose acquisition would profit the bidder but not produce efficiency gains. Thus, since searchers would not limit themselves to looking for potential efficiency gains, they would make socially wasteful investments in search.

¹⁷¹ If the searcher acquires the target, then its pre-bid purchases will enable it to save the acquisition premium on the stock it already owns. If another buyer acquires the target, the searcher will earn on its stock the acquisition premium paid by that buyer. Finally, if the target's shareholders reject all available bids, the searcher will still make a substantial gain, because in such a case the market price of the independent target's shares will probably be substantially higher than the pre-bid price for which the searcher bought its shares. The gain that a searcher can make on its pre-bid purchases often approaches two to three percent of the target's value. See Bebchuk, *Facilitating Competing Bids*, *supra* note 7, at 1035-36.

In addition to making a profit on pre-bid purchases, searchers can also gain in other ways. In particular, even in a regime of undistorted choice, a searcher that acquires an identified target would often not have to pay as much as its valuation of the target. Of course, the searcher would have to pay at least the competitive price — that is, the price that other potential buyers would be willing to pay. The searcher, however, might place a higher value on the target's assets than do other potential buyers; potential buyers vary substantially in the amount of efficiency gains that they can produce by acquiring the target. In such a case, the searcher would usually capture a substantial fraction of those gains from the acquisition that other buyers would be unable to produce. Indeed, the searcher would likely capture the lion's share, if not all, of these gains: the searcher would have a substantial advantage in the "bargaining" over the division of these gains between itself and the target's shareholders — because in the takeover context, unlike a standard buyer-seller situation, only the bidder can make offers.

Finally, it is worth noting that search costs do not appear to be all that large. Because prospective buyers often lack appropriate in-house resources, the search is frequently done for them by investment bankers. In such cases, the search costs are a fraction of the investment bankers' total fees. These total fees, in turn, are often less than one percent of the target's value. See Bebchuk, *Facilitating Competing Bids*, *supra* note 7, at 1036-37.

In sum, the need for incentives to search in no way warrants forgoing the substantial efficiency gains that ensuring undistorted choice would produce. Even assuming that existing incentives are inadequate, which is by no means clear, the remedy that should be advocated is that of raising the ceiling on secret pre-bid purchases. Indeed, sacrificing undistorted choice to increase search further would not only forgo the substantial efficiency benefits that undistorted choice would produce, but might also have an undesirable effect on the search activity itself.

(c) *Beneficial Acquisitions of Discovered Targets.* — Having seen that ensuring undistorted choice would not have a significant adverse effect on the search for targets, let us now consider whether it might prevent some desirable acquisitions of identified targets. Professors Easterbrook and Fischel suggest that the current pressure to tender might be necessary for bids to succeed.¹⁷² If such pressure did not exist, they warn, shareholders would have a strong incentive not to tender their shares even if they prefer that the bid succeed; therefore, Easterbrook and Fischel argue, the existence of such pressure is in the interest of target shareholders and society.

This Article's analysis, however, indicates that the above concern is unwarranted. As has been shown, it is quite possible to eliminate the current pressure to tender without creating any undue incentives to hold out. Under the proposed regulations, the only acquisition attempts that would be prevented from succeeding are those that indeed should fail — those in which a majority of the target's shareholders view the independent target's value as higher than the offered acquisition price.

(d) *Information-Seeking Activities by Target Shareholders.* — When a takeover is accomplished under current law, shareholders who did not tender because they were unaware of the bid or because they hoped that the bid would fail receive considerably less than their pro rata share of the acquisition price. Conversely, shareholders who were aware of the bid and foresaw that it would succeed end up with more than their pro rata share. Because sophisticated investors have better information about the presence and expected outcome of bids, they are disproportionately represented in this latter group. One might therefore be concerned that ensuring equal treatment in order to attain undistorted choice would eliminate investors' incentives to seek information about available bids and their expected outcome.¹⁷³

¹⁷² See Easterbrook & Fischel, *supra* note 7, at 705, 710–11. See also Grossman & Hart, *supra* note 8 (discussing the extent to which the value of minority shares must be “diluted” for takeovers to be possible).

¹⁷³ The SEC's Advisory Committee has alluded to this possibility. See ADVISORY COMMITTEE REPORT, *supra* note 10, at 52.

This concern in no way weakens the case for undistorted choice. Consider first the issue of shareholders' incentive to learn whether a bid has been made for a company in which they own stock. The proposed regulations would leave investors with a strong incentive to learn this information. Shareholders who are unaware of an eventually successful bid — and hence fail to tender — would lose three-months' interest. Although this penalty appears quite sufficient to induce the great majority of shareholders to seek such information, it could of course be increased if necessary. Thus, under the regulations, investors would by and large continue to seek information about the availability of bids for companies in which they own stock.

Consider now the issue of shareholders' incentive during the bid period to seek information about the bid's expected outcome. Under the proposed regulations, investors would continue to seek such information, because it would be necessary for assessing the market price of the target's shares and would thus be relevant to investors' trading decisions. To be sure, the current inequality of treatment strengthens the incentive to seek such information, and this incentive might therefore be stronger in the existing regime than it would be in an undistorted choice regime. Investors' search for information about the expected outcome of bids is socially desirable, however, only to the extent that the information improves the efficiency of the outcome of bids. A regime should therefore be evaluated not on the basis of how much information investors collect about the expected outcome of bids, but on the basis of how efficient these bid outcomes are. While shareholders might have in the existing regime a substantial incentive to seek information about the expected outcome of bids, their tender decisions are subject to substantial distortions that would be eliminated by the proposed regulations. Consequently, there can be no doubt that ensuring undistorted choice would lead to more efficient outcome of bids.

(e) *Arbitrage Activity.* — Arbitrageurs are market professionals who purchase target shares in the market during the bid period. During that period, the target's shareholders face considerable uncertainty over the fate of the bid and the target. The arbitrageurs play a socially beneficial role by enabling risk-averse investors to sell their shares in the target and pass the risk to parties who are better able to bear it. It would thus be a cause for concern if the proposed regulations were expected to discourage arbitrage activity and reduce it to a suboptimal level.¹⁷⁴

One way in which ensuring undistorted choice might reduce arbitrage activity is by eliminating some sources of uncertainty. For

¹⁷⁴ A concern that ensuring equal treatment might have such an effect on arbitrage activity is expressed in DeMott, *Current Issues in Tender Offer Regulation: Lessons from the British*, 58 N.Y.U. L. REV. 945, 1003 (1983).

example, the proposed ban on obstructive tactics would eliminate the risk of bids being impeded by such tactics, and the proposed regulations would eliminate the risk of ending up with minority shares. But even assuming that the proposed regulations would indeed decrease the overall level of uncertainty and thereby reduce the level of arbitrage activity,¹⁷⁵ that effect would provide no reason for opposing undistorted choice. Arbitrage activity is desirable only to the extent that it eliminates risk-bearing costs. Therefore, any reduction in arbitrage activity induced by a decrease in the level of potential risk-bearing costs would not be socially undesirable.

Another way in which the proposed regulations would affect arbitrageurs is by preventing them from capturing in a takeover more than their pro rata share of the acquisition price. Again, however, this effect would not reduce arbitrage activity to a suboptimal level. Maintaining a desirable level of arbitrage activity does not require providing arbitrageurs with rewards that have nothing to do with their useful economic function: that of bearing risk. Under the proposed regulations, all desirable arbitrage transactions — that is, all transactions that could produce efficiency gains by transferring shares to parties better able to bear risk — would continue to take place. In sum, ensuring undistorted choice through the proposed regulations would have no adverse effect on arbitrage activity — and, as we have previously seen, it would be unlikely to have such an effect on any other socially beneficial activity.

B. Equal Treatment

I wish now to explain why equal treatment is proposed not only as an instrument for attaining undistorted choice but also as an independent objective. Unequal treatment, I suggest, is unfair.

In discussing the unfairness of unequal treatment, I shall focus on the claims that might be made in case of a takeover by two groups of non-tendering shareholders: those who lacked an opportunity to tender and those who did not tender because they hoped that the bid would fail. Given that the tender decisions of other shareholders led to a takeover, these non-tendering shareholders would wish to receive — but under current rules do not receive — their pro rata share of the target's acquisition price.¹⁷⁶

¹⁷⁵ The proposed regulations might not decrease the overall level of uncertainty, because they would also introduce a new source of uncertainty — uncertainty over whether the bidder would succeed in attracting the required number of approving tenders.

¹⁷⁶ A third group of non-tendering shareholders — those who do not tender for tax reasons — also receives less than its pro rata share of the acquisition price. As explained in Section D of Part II, however, I do not claim that the non-tendering shareholders in this group are unfairly treated. These shareholders do not wish to be equally treated — they prefer retaining minority shares in the acquired target to selling their shares for the bid price. Therefore, the claims that

1. *Shareholders are Unequally Treated Both Ex Post and Ex Ante.*

— The claim that the current inequality of treatment is unfair faces a preliminary objection. This objection denies that shareholders are at present unequally treated. It asserts that all of a target's shareholders are always treated equally from some ex ante perspective — either from the perspective of the time before the bid's outcome is resolved, or at least from the perspective of the time before the bid is made.¹⁷⁷

This objection is based on an assumption that the identities of the beneficiaries and victims of the current inequality of treatment are determined in a perfectly random fashion. Every shareholder, it is assumed, has the same chance as any other shareholder of ending up in one of these two groups. Consequently, when some shareholders end up ex post with less than their pro rata share of the acquisition price, this fact does not imply that they have been treated unequally: they were equally treated ex ante, in that they had the same chance as anyone else to benefit from a possible inequality of treatment.

The above objection is invalid, however, because shareholders' fortunes in the existing regime of unequal treatment are not determined by pure chance. Rather, some shareholders can expect to be favored — and others can expect to be disfavored — by the inequality of treatment. Whether a shareholder of an acquired target ends up with more or less than his pro rata share of the acquisition price might well depend on his professionalism, his resources, and his access to the market and to market information. The following analysis refers to these characteristics as “sophistication” and correspondingly refers to investors as “sophisticated” and “unsophisticated.”

There are two reasons why, under current law, a shareholder's sophistication might affect his chances of receiving more than his pro rata share of the acquisition price in the event of a takeover. First, sophisticated investors rarely lack an opportunity to tender, because they are usually aware of available bids and capable of tendering their shares in time. In contrast, unsophisticated investors are much more likely to lack an opportunity to tender. Second, when a bid is successful, sophisticated investors are much less likely than unsophisticated ones to have chosen not to tender because of a false hope that the bid would fail. Sophisticated investors have access to information that better enables them to determine a given bid's chances of success, and they are capable of tendering at the last moment, just before the

these shareholders might advance against the current distribution of acquisition prices appear much weaker than those that might be made by shareholders from the two groups on which the following analysis will focus.

¹⁷⁷ The distinction between the ex ante and ex post perspectives is one that has recently been emphasized by Easterbrook and Fischel. See Easterbrook & Fischel, *supra* note 7, at 703-04.

bid is closed, on the basis of the most recent information available about the bid's chances.¹⁷⁸

Thus, some sophisticated shareholders have ex ante very favorable chances, if not a virtual certainty, of benefiting from the existing regime of unequal treatment. Conversely, unsophisticated investors have systematically higher chances of losing from the current inequality of treatment. Shareholders are thus subject to unequal treatment not only ex post but also ex ante.

2. *The Presumption in Favor of Equal Treatment.* — It is a widely held moral principle that, absent any reason to the contrary, individuals in like situations should be treated alike.¹⁷⁹ This presumption, shared by many political theories, is rooted in a view that individuals are equal in some fundamental sense and that claims of natural superiority must be rejected.

The presumption is a fairly weak one; indeed, its weakness explains how it can be shared by so many people who sharply disagree with each other on many, if not most, political issues. What the presumption dictates depends crucially on what one recognizes as a like situation and on what one acknowledges as an appropriate reason for deviating from identical treatment. Having accepted the presumption, one can nevertheless argue for unequal treatment in any given context by alleging some relevant difference between parties' situations or some appropriate reason for overriding the presumption. Yet, the presumption is not meaningless. Although it does not determine one's conclusions, it provides a starting point for one's moral reasoning and forces that reasoning to proceed in a certain way.¹⁸⁰

What does the general presumption in favor of equal treatment imply for the distribution of the acquisition price in a takeover? Consider two shareholders who hold the same number of shares in a given corporation. At first blush, the two shareholders appear to be similarly situated with regard to the distribution of the acquisition price in the event of a takeover. Their holdings represent identical capital contributions to the corporation. If the corporation were to remain independent, the two shareholders would be entitled to the same fraction of its distributed earnings. Thus, absent some adequate reason to the contrary, fairness requires that the two shareholders

¹⁷⁸ Sophisticated investors have good access to general market information, and some of them may also have the opportunity to monitor customers' tender decisions. See ADVISORY COMMITTEE REPORT, *supra* note 10, at 52.

¹⁷⁹ See, e.g., J. FEINBERG, SOCIAL PHILOSOPHY 99-100 (1973); W. FRANKENA, *Some Beliefs about Justice*, in PERSPECTIVES ON MORALITY 93 (K. Goodpaster ed. 1976); Berlin, *Equality*, 56 PROC. OF THE ARISTOTELIAN SOC. 301, 302-03 (1956); Williams, *The Idea of Equality*, in PHILOSOPHY, POLITICS AND SOCIETY 110-31 (P. Laslett & W. Runciman eds. 2d Series 1972).

¹⁸⁰ For a good discussion of the weakness — but meaningfulness — of this presumption, see Williams, *supra* note 179.

receive the same fraction of the acquisition price in a takeover — or at least that they have *ex ante* the same prospects of sharing in such an acquisition price.

When an independent target is acquired under current law through merger, the acquisition price is generally distributed *pro rata* among the shareholders; shareholders receive the same per-share value regardless of whether and how they voted on the merger proposal. Thus, the law's implicit judgment is that, at least in the case of a merger, there exists no adequate justification for a disproportionate division. The question, then, is whether for our purposes a takeover differs from a merger in any significant way. Do takeovers present any special considerations — presumably ones absent in the merger context — that justify unequal treatment?

This critical question might alternatively be formulated as a choice between alternative legal regimes. The distribution of the acquisition price in a takeover is the product of the prevailing takeover rules. Thus, we may view our choice not as one between a disproportionate and a proportionate division but rather as one between the unequal treatment regime created by the existing takeover rules and the equal treatment regime that the proposed regulations would establish. The presumption in favor of equal treatment implies that we should adopt the latter regime unless we can identify some justification for adopting the former.

As I explain below, there appears to be no justification for the existing regime of unequal treatment in corporate takeovers. My position is not, I wish to emphasize, that there generally exists no justification for rules that enable sophisticated investors to fare better than unsophisticated ones. On the contrary, there are very good reasons for adopting certain such rules. For example, sophisticated investors engage in several socially valuable activities — their search for undervalued securities, for example, contributes to efficient market pricing. These socially beneficial activities of sophisticated investors are and should be rewarded. In the takeover context, however, there is no reason to adopt rules that systematically provide sophisticated investors with more than their *pro rata* share of the acquisition price.

Clearly, I can offer no proof that, as a matter of logic, one could never find an adequate justification for unequal treatment in corporate takeovers. Rather, the aim of the following analysis is to convince readers that there appears to be no justification that they would find acceptable. To this end, I shall examine those considerations that are commonly advanced to justify deviations from equal treatment in a variety of contexts, and I shall suggest that none of them appears to lend any support to unequal treatment in the context of takeovers. The conclusion that none of these familiar justifications is applicable to the takeover context, coupled with the absence of any plausible

alternative justification for an unequal treatment of target shareholders, should lead the reader to view such unequal treatment as arbitrary and unfair.

3. *Unequal Treatment Cannot Be Justified by Efficiency Considerations.* — In the various contexts where a deviation from equal treatment is considered, the argument that is most frequently advanced in favor of such a deviation is based on the efficiency gains that unequal treatment would allegedly produce. In the takeover context, Professors Easterbrook and Fischel have made an efficiency argument to justify a disproportionate division of acquisition prices.¹⁸¹

There are two ways in which the alleged efficiency gains from a disproportionate division might be thought to justify such unequal treatment. First, it might be suggested that these efficiency gains trickle down, so that even those who seem to be hurt by the unequal treatment are in reality made better off by it.¹⁸² Alternatively, it might be argued that even if a disproportionate division were to produce some losers, the overall efficiency gains that it produces would justify it.¹⁸³

Whatever form the efficiency argument takes, it obviously hinges on demonstrating that deviating from a proportionate division indeed produces efficiency gains. Such efficiency gains, however, cannot be demonstrated. The equal treatment regime of the proposed regulations would produce substantial efficiency gains by contributing to the attainment of undistorted choice. Moreover, as Section A of this Part has shown, ensuring equal treatment through these regulations would be unlikely to entail any significant efficiency costs. Thus, efficiency considerations do not provide a reason for deviating from equal treatment, but rather strengthen the case for an equal treatment regime.

4. *Unequal Treatment Cannot Be Justified by Entitlement and Desert Notions.* — Under current rules, the reason why two shareholders who own the same number of shares in a target might receive different fractions of the acquisition price is that their actions differed. It might be argued that this difference in their actions is morally significant, and that the two shareholders are therefore not in like situations that would trigger the equal treatment presumption. Because the disproportionate distribution results from shareholders' voluntary actions, so

¹⁸¹ See Easterbrook & Fischel, *supra* note 7, 703-14.

¹⁸² Easterbrook and Fischel use this version of the efficiency argument: they suggest that a deviation from a proportionate division is so essential to the efficient operation of takeovers that even investors who appear to be hurt by unequal treatment should ex ante prefer a regime of unequal treatment to one of equal treatment. See *id.* at 711-15.

¹⁸³ In particular, it might be suggested that a consistent policy of adopting efficient rules would on the whole work to everybody's benefit, even though its application in particular instances would produce losers. Or it might be argued that the efficiency gains that unequal treatment would produce are in themselves sufficiently desirable to override parties' claims for equal treatment.

the argument goes, this distribution is the one that shareholders are entitled to or deserve.¹⁸⁴ In examining this general argument, two particular claims should be considered: (a) that, because of their actions, sophisticated investors are entitled to, or deserve, what they currently receive; and (b) that, because of their inaction, unsophisticated investors are not entitled to, or do not deserve, more than what they currently receive.

(a) *The Claim that Sophisticated Investors Have a Right to What They Currently Receive.* — The claim that sophisticated investors are entitled to, or deserve, what they currently receive is analytically different from the claim that it is efficient to reward sophisticated investors in this way to encourage their socially beneficial activities. As explained earlier, this latter claim is invalid — ensuring equal treatment would not have a socially undesirable effect on the information-seeking and arbitrage activities that sophisticated investors might undertake during the bid period. Rather, the claim under consideration is that, efficiency considerations aside, sophisticated investors simply have a right to the disproportionate share that they receive under the existing regime of unequal treatment.

To determine whether such a claim is plausible in the takeover context, let us examine the structure of familiar entitlement and desert arguments that are made in a variety of other contexts to support the proposition that a given party has a right to a particular object. Such arguments commonly use some version of one or more of the following three claims.

First, it might be suggested that a given person has a right to a particular object because he has made an essential contribution to creating that object. For example, it might be argued that a person who builds a machine is entitled to own it because the machine would not exist but for his labor and talent. Such an assertion, however, cannot be made in the takeover context. The activities that enable sophisticated investors to receive more than their pro rata share of a target's acquisition price are in no way essential to providing the target's shareholders with the takeover premium: as we have seen, in the equal treatment regime of the proposed regulations, target shareholders would still realize all the potential premiums from value-maximizing acquisitions of their companies.

Second, it might be suggested that a given person has a right to a particular object because the distribution that assigns that object to him is in some sense "natural," a distribution that should not be tinkered with but rather left intact. In the takeover context, however,

¹⁸⁴ I do not attempt to offer here a precise definition of the terms "entitlement" and "desert." Although the meanings of these terms often overlap, they are not necessarily synonymous. I use them here together to indicate a whole cluster of arguments that are raised to justify or support someone's right to a given treatment.

it cannot be maintained that the disproportionate division under current rules is a "natural" distribution, an integral part of the way in which takeovers must by their nature proceed. The advantage that sophisticated investors currently have is simply a product of the existing takeover rules. Under the proposed regulations, investors' sophistication would play no role, and the distribution that would "naturally" emerge out of the takeover process would be a proportionate one.

Third, it might be suggested that, given a system of rules, a person has a right to whatever he obtains in following these rules. Clearly, given the existing takeover rules, sophisticated investors have a right to whatever they obtain by "playing by the rules." This right, however, is irrelevant to our question — which is what set of rules should be adopted in the first place, and, in particular, whether one can justify adopting a regime in which sophisticated investors have an advantage. For an entitlement or desert argument to be relevant to this question, it must claim that sophisticated investors are entitled to or deserve a system of rules in which sophistication matters.

In sum, while it cannot be proved that no plausible entitlement or desert argument for an unequal treatment regime could ever be offered, no such argument appears available. The notions on which familiar entitlement and desert arguments are based — those of "essential contribution," "natural distribution," and "playing by the rules" — are inapplicable. What seems to remain is only the unacceptable claim that, simply by virtue of their being sophisticated, sophisticated investors are entitled to or deserve a system of rules that favors them; this last claim, however, is as morally arbitrary as the claim that, by virtue of their being tall, tall investors are entitled to or deserve a system of rules that would systematically favor them.

(b) The Claim that Unsophisticated Investors Have No Right to More Than They Currently Receive. — Conceding that sophisticated investors do not have a right to receive more than their pro rata share, one might still argue that unsophisticated investors cannot oppose unequal treatment as unfair because they do not deserve more than what they currently receive. This claim is based on the notion that it is possible for unsophisticated investors to escape from the consequences of their lack of sophistication. Such investors can put their money in professional hands by, for example, investing through a mutual fund.¹⁸⁵ Therefore, the argument proceeds, unsophisticated investors who do not act in such a way have no right to complain about their exposure to unequal treatment. They have only them-

¹⁸⁵ Note that unsophisticated investors who invest their money themselves cannot escape their disadvantage under current rules by diversifying their holdings. An unsophisticated investor who holds a diversified portfolio is likely to fare less well than a sophisticated investor holding the same portfolio — for the unsophisticated investor would on average do worse than the sophisticated investor in takeovers of companies whose stock is part of the portfolio.

selves to blame, and there is no reason to be concerned about their lot.

Many unsophisticated investors, as a matter of fact, do not put their money in professional hands. They presumably prefer for some reason — say, to avoid money management fees — to invest their money themselves. Do such investors have any right to complain about the unequal treatment produced by current rules? The answer is clearly affirmative. The disadvantage that unsophisticated investors face at present is not an inherent feature of the takeover process, but rather a product of current takeover rules. Therefore, the fact that some unsophisticated investors may escape or diminish their current disadvantage does not justify putting them at such a disadvantage in the first place.

As previously noted, the relevant question is not what investors are entitled to given the existing system of takeover rules. Given this system, every investor is of course only entitled to that which he obtains by playing by the rules. The question we confront, however, is which system of rules we should adopt in the first place. Is there any justification for maintaining a system that forces unsophisticated investors either to buy into mutual funds (at a cost) or to face a disadvantage? As explained earlier, such a system is not required by efficiency considerations or by the rights of sophisticated investors. Thus, since no plausible justification for such a system appears to be available, unsophisticated investors have a right to oppose such a system as unfair.

5. *Unequal Treatment Cannot Be Justified by Overall Distributive Goals.* — It is a widely held moral view that the distribution of income arising out of the market should be corrected, and that income should be redistributed to some extent from the well-off to the less well-off. The last kind of argument for unequal treatment that I wish to consider is one that seeks to justify unequal treatment by reference to some overall distributive goals.¹⁸⁶

There is a substantial disagreement as to whether overall distributive goals should affect the design of legal rules or rather should be left to the tax system.¹⁸⁷ Whatever position one takes on this question, however, such overall distributive goals clearly cannot jus-

¹⁸⁶ One form that this argument might take would suggest that differences in wealth among shareholders are morally relevant to the distribution of acquisition prices, and that shareholders with different levels of wealth should therefore not be viewed as being in like situations. Another form of the argument would accept that the shareholders are in like situations, but would claim that the presumption of equal treatment is overridden because certain unequal treatment (in favor of the less well-off) would serve a deeper and more comprehensive ideal of equality.

¹⁸⁷ The view that overall distributive goals should affect the design of legal rules is expressed, for example, in Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 498-510 (1980). The opposite view is expressed, for example, in Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 502-06 (1980).

tify a disproportionate division of acquisition prices. For the effect that the disproportionate division under current law has on the overall distribution of income is likely to be regressive. This disproportionate division favors sophisticated investors, and sophistication in investment appears to be positively correlated with wealth and income.¹⁸⁸ Thus, since the effect of the current inequality of treatment is likely to be regressive, the goal of redistributing income provides no support for this inequality of treatment, but rather adds to the strength of the case against it.

VI. ACQUISITIONS THROUGH OPEN-MARKET OR PRIVATELY NEGOTIATED PURCHASES

The undistorted choice and equal treatment objectives should guide us in regulating all acquisition attempts. Under current rules, a prospective buyer can attempt to gain control over a target not only through a takeover or a merger, but also through a third method — acquiring a controlling interest through open-market or privately negotiated purchases. This Part extends the Article's analysis to this third mode of corporate acquisition.¹⁸⁹

A. *The Current Problems*

Current law imposes few restrictions on a prospective buyer's attempt to gain control over a target through open-market or privately negotiated transactions.¹⁹⁰ The main requirement is one of disclosure: section 13(d)(1) of the Williams Act requires disclosure of the identity and intention of any buyer that acquires more than five percent of a company's stock.¹⁹¹ As will be explained below, the current ability of prospective buyers to acquire a controlling interest through open-market or privately negotiated purchases leads to distorted choice and unequal treatment.

These problems can best be understood with the aid of an illustrative example. Suppose that a prospective buyer seeks a controlling block of 40% of a target's shares, and that to this end the buyer privately approaches various shareholders and offers to buy their

¹⁸⁸ See M. Feldstein & S. Yitzhaki, Are High Income Individuals Better Stock Market Investors? (Discussion Paper No. 918, Harvard Institute of Economic Research, Sept. 1982).

¹⁸⁹ It is important to remind the reader that this Article's analysis is limited to attempts to gain control of companies that prior to the attempt were not controlled by a single shareholder (or a group of shareholders acting in concert). See *supra* p. 1700. Thus, the analysis below will not apply to cases where a prospective buyer acquires a controlling interest by purchasing the shares of a single shareholder who previously controlled the target. The analysis will apply only to cases where a prospective buyer purchases many non-controlling blocks (on the open market or through private negotiations) and combines them to form a controlling block.

¹⁹⁰ See Greene & Junewicz, *supra* note 9, at 662-70; SEC Release, *supra* note 11, at 86,918.

¹⁹¹ 15 U.S.C. § 78n(d)(1) (1982).

shares for \$100 per share.¹⁹² Suppose also that if the prospective buyer succeeds in acquiring the controlling block that it seeks, the value of shares not held by the buyer will be \$80 per share. Thus, the acquisition price that the buyer will pay if it succeeds in acquiring the block will be \$88 per share. Therefore, according to the undistorted choice objective, the acquisition attempt should succeed only if a majority of the target's shareholders view the independent target's per-share value as lower than \$88. In fact, however, the attempt might be successful even if the majority does not hold such a view.

The main reason for this possibility of a distorted outcome is that shareholders approached by the buyer might agree to sell their shares even if their estimate of the independent target's per-share value exceeds \$88. For one thing, an approached shareholder will certainly sell his shares as long as his estimate of the independent target's per-share value is lower than the \$100 price offered by the buyer: the shareholder will view the acquisition as making him better off, and he will be indifferent to the fact that an acquisition will make non-selling shareholders worse off.¹⁹³

Furthermore, even assuming that shareholders would not sell their shares unless they judge the independent target's per-share value to be lower than \$88, the outcome might still be distorted because of the buyer's ability to gain effective control without acquiring a majority ownership.¹⁹⁴ Suppose that 40% of the shareholders judge the independent target's value to be lower than \$88, while the other 60% judge it to be higher than \$88. Then, even if all the latter shareholders refuse to sell, the buyer will still succeed in purchasing a 40% block and gaining control. This outcome is of course undesirable according to the undistorted choice objective, which requires that acquisition attempts fail if they lack majority support.

Turning to the unequal treatment problem, observe that if the acquisition attempt in our example were to succeed, the acquisition price would be distributed among the target's shareholders quite disproportionately. Shareholders who sold their shares to the buyer would receive \$100 per share, whereas those who were not approached by the buyer or were approached but refused to sell would end up with shares in the acquired target worth \$80 per share. Indeed, this

¹⁹² The analysis below would be largely applicable if the buyer sought to gain control through open-market purchases rather than through privately negotiated transactions.

¹⁹³ Moreover, a shareholder approached by the buyer might sell his shares even if his estimate of the independent target's per-share value exceeds the offered price of \$100 per share. The shareholder might know or suspect that the buyer is seeking to gain control. He might thus fear that, if he does not agree to sell, other shareholders might still sell and the buyer might gain control, in which case he will be left with low-value minority shares.

¹⁹⁴ Cf. *supra* pp. 1718-19 (discussing how the outcome of takeover bids might be distorted because of bidders' frequent ability to gain effective control by acquiring a substantial plurality of the target's shares).

inequality of treatment would probably be even greater than the inequality that would result if the buyer gained control through a partial bid for 40% of the target's shares; for a successful partial bid would probably attract tenders from more than 40% of the shareholders, and more than 40% of the shareholders would thus have some of their shares acquired for \$100 per share.

B. *The Proposed Prohibition*

Because attempts to acquire targets through open-market or privately negotiated purchases might lead to distorted choice and unequal treatment, I propose that this acquisition method be banned: open-market and privately negotiated purchases should be prohibited from exceeding the specified threshold of a controlling interest. A prospective buyer seeking to cross that threshold and acquire a controlling interest should be limited to using the avenue of a takeover or a merger.

The above proposal, which follows from the Article's theoretical framework, is a familiar one. Such a prohibition was proposed by the SEC several years ago,¹⁹⁵ and has been endorsed by commentators.¹⁹⁶ Such a prohibition was also recently recommended by the SEC's Advisory Committee,¹⁹⁷ but the SEC subsequently expressed serious reservations about the Advisory Committee's recommendation.¹⁹⁸

The proposed prohibition, together with the other elements of the regulatory framework proposed in this Article, would ensure undistorted choice and equal treatment. The prohibition would eliminate the possibility that open-market or privately negotiated purchases would lead to deviations from these objectives. And the regulatory framework's other elements — the proposed takeover rules and the existing merger law — would ensure that whenever one of the two remaining acquisition methods is used, undistorted choice and equal treatment would obtain.

Some might be concerned that the effectiveness of the proposed prohibition would be undermined by buyers' purchasing shares up to the specified limit and then seeking control by making a bid for an

¹⁹⁵ See S. 3188, 96th Cong. 2d Sess., 126 CONG. REC. 28,792-99 (1980); Securities Exchange Act Release No. 16384, 44 Fed. Reg. 70,326 (1979). In the end, however, the proposed prohibition was not adopted.

¹⁹⁶ See, e.g., Greene & Junewicz, *supra* note 9, at 674-76. Such a prohibition has also been recently proposed by a leading practitioner in the field. See Testimony of Martin Lipton before the Subcommittee on Securities of the United States Senate Committee on Banking, Housing, and Urban Affairs (Apr. 3, 1985), at 11. The legislation proposed by Mr. Lipton would prohibit a buyer from accumulating more than five percent of a target's shares through open-market or privately negotiated purchases.

¹⁹⁷ See ADVISORY COMMITTEE REPORT, *supra* note 10, at 22-23.

¹⁹⁸ See Statement of Shad, *supra* note 11, at 86,679; SEC Release, *supra* note 11, at 86,919.

additional small block. To see that this concern is unwarranted, consider the following example. Suppose that the control threshold is set at 20% and that a buyer makes open-market and privately negotiated purchases until it accumulates just below 20%. Suppose also that the buyer then makes a bid for an extra 20% at \$160 per share (an amount, let us suppose, substantially higher than the independent target's per-share value); and suppose that if the buyer's bid succeeds, the buyer will gain control and the value of minority shares will be \$80 per share. The important point to demonstrate is that, under the proposed regulations, the success of the buyer's bid would in no way be assured — despite the very high price that the bidder is willing to pay for the limited number of extra shares it needs to gain control.

Under the regulations, the bid would attract tenders from almost all the shareholders, but its success would still depend on receiving a majority of approving tenders. All the tendering shareholders would recognize that if the bid succeeds they would not have all their tendered shares acquired for \$160 per share; rather, only a quarter of their tendered shares would be acquired for \$160 each, and the remaining three quarters would become minority shares worth \$80 each. Tendering shareholders would thus expect to receive in the event that the bid succeeds an average per-share value of \$100, and they would therefore tender approvingly only if they view the independent target's per-share value as lower than \$100. The bidder would thus gain control only if a majority of the shareholders hold such a view — which is the outcome required by the undistorted choice objective.

Having described the benefits of the proposed prohibition, it remains only to point out that it would involve no significant efficiency costs. This conclusion follows logically from the general demonstration in Part V that a regime of undistorted choice and equal treatment would involve no such costs. Still, it is worthwhile to address specifically a concern that the SEC expressed with respect to such a prohibition.¹⁹⁹ The SEC was worried that such a prohibition would often increase the cost of purchasing blocks larger than the specified threshold — whether the buyer seeks to purchase the block for control purposes or for other reasons, such as investment or technology transfer.

That the prohibition might often increase the price necessary to acquire blocks larger than the specified threshold, however, provides no reason to oppose it. As previously noted, increased prices do not by themselves represent a social cost; they are socially undesirable only to the extent that they lead parties to behave inefficiently and preclude the realization of efficiency gains. The proposed prohibition, however, would not eliminate any socially beneficial acquisition of a block. The only instances in which the prohibition would prevent the

¹⁹⁹ See SEC Release, *supra* note 11, at 86,919.

acquisition of a block — whether sought for the purpose of control, investment, technology transfer, or any other reason — would be those in which a majority of the target's shareholders view the price offered for the block as lower than what they are asked to give up. And in such instances the acquisition of the block indeed should not take place.²⁰⁰

VII. BEYOND UNDISTORTED CHOICE AND EQUAL TREATMENT

The Article's analysis has thus far focused on the closely related problems of distorted choice and unequal treatment. These two problems are rooted in the divided and often dispersed ownership of acquisition targets. Corporate acquisitions, however, present two additional problems which have nothing to do with the structure of ownership in acquisition targets. Because these additional problems might lead to inefficient acquisitions, addressing them is an additional objective for acquisition rules — beyond the proposed objectives of undistorted choice and equal treatment. As explained below, however, these additional problems in no way weaken the case for the Article's proposed regulations, but rather suggest that these regulations might have to be supplemented by some additional measures.

To understand the full range of potential problems that corporate acquisitions present, note the three conditions that would ensure an efficient operation of the market for corporate assets: (1) undistorted choice by targets; (2) undistorted choice by acquirers, in that an acquirer will never offer an acquisition price that exceeds the value of the target's assets to the acquirer; and (3) the absence of externalities, so that the private gains to the acquirer's and the target's shareholders from an acquisition will represent net social gains, rather than gains made at the expense of some third parties (such as consumers, taxpayers, or employees).

The Article's analysis has focused on ensuring that condition (1) be satisfied — that is, on attaining undistorted choice by targets. In order to focus on that issue, I have implicitly assumed that conditions (2) and (3) are currently satisfied. Given this assumption, the proposed regulations would by themselves bring us as close as possible to an efficient allocation of targets' assets. While the assumption has been

²⁰⁰ While this Article proposes that buyers be prohibited from acquiring targets through open-market or privately negotiated purchases, another approach is worth noting. Under this approach, a buyer would be allowed to gain control of a target through open-market or privately negotiated purchases, but would then be required to extend an offer to all remaining shareholders at the same price that it paid for the shares in its controlling block. Such an approach, which is followed by the British City Code, was recently examined by the SEC. See SEC Release, *supra* note 11, at 86,919. As Appendix A shows, such a mandatory offer requirement would secure equal treatment, but would not ensure undistorted choice. See *infra* p. 1801.

a useful tool of analysis, it is not generally borne out in the real world of corporate acquisitions.

First consider condition (2), that acquirers' choices be undistorted. This condition requires that an acquirer never offer an acquisition price exceeding the value of the target's assets to the acquirer. This condition might not be satisfied because the interests of an acquirer's managers might not perfectly overlap with those of the acquirer's shareholders. Whereas an acquirer's shareholders are interested solely in maximizing the value of the company's shares, its managers might also be interested in expanding the size of the enterprise under their control.²⁰¹ Thus, an acquirer's management might sometimes be willing to acquire a target for a price exceeding the target's value to the acquirer. Consequently, ensuring undistorted choice by target shareholders would not rule out an acquisition of a target whose independent value exceeds its value to the acquirer; for the acquirer's managers might still raise the offered acquisition price above the independent target's value, and the socially undesirable acquisition might hence occur.

Now consider condition (3), that the private gains that an acquisition confers on the shareholders of the acquirer and the target represent net social gains. Any acquisition consummated under the conditions of undistorted choice by both the target and the acquirer would increase the combined value of the two corporations and thus benefit their shareholders. But such an increase in combined value would not by itself imply that the acquisition is efficient; such an inference would be necessarily valid only if the gains to the acquirer's and the target's shareholders represented net social gains. At present, however, the private gains conferred by an acquisition on the acquirer's and the target's shareholders need not reflect net social gains. To be sure, the increase in the combined value of the target and the acquirer might be the result of improved management or synergy, in which case the private gains will indeed represent net social gains. But the increase in combined value might also result from tax savings²⁰² or enhanced market power,²⁰³ in which case the private gains will come at the expense of tax revenues or consumers, respectively. Furthermore, the increase in combined value might sometimes reflect gains made at the expense of the companies' employees. Thus, some current acquisitions might be socially undesirable even though they increase the combined value of the acquirer and the target.

²⁰¹ See, e.g., W. BAUMOL, BUSINESS BEHAVIOR, VALUE, AND GROWTH 45-52 (rev. ed. 1967); R. MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM 122-24 (1964); Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LITERATURE 32, 41-45 (1980).

²⁰² See, e.g., P. STEINER, *supra* note 17, at 75-95.

²⁰³ *Id.* at 69-74, 218-87.

Thus, because conditions (2) and (3) might not be satisfied, the proposed regulations would not be sufficient to generally ensure an efficient outcome of acquisition offers. By eliminating the problem of distorted choice by target shareholders, the proposed regulations would achieve only that level of efficiency that would be attained if the shares of any given target were concentrated in a sole owner's hands.

Various measures might be proposed to attain conditions (2) and (3). For example, to address the problem of distorted choice by acquirers, one might consider requiring that acquisition offers, or at least some of them, be approved by the shareholders of the prospective acquirer.²⁰⁴ To address the problem of private gains that do not represent net social gains, one might seek to design measures that would prevent or at least discourage acquisitions that are motivated by tax savings, increased market power, or gains made at the expense of employees. Identifying the best way to address these two problems is of course a complex task beyond the scope of this Article.

The important point for our purposes, however, is that the presence of the above two problems does not weaken the case for the Article's proposed regulations. The effect of the proposed regulations would be to prevent some acquisitions — those in which the offered acquisition price is viewed by the target's shareholders as lower than the independent target's value. The presence of the two problems considered above in no way implies that the acquisitions prevented by the proposed regulations might ever be socially desirable. Rather, the presence of these problems only suggests that the proposed regulations would not prevent *all* socially undesirable acquisitions; the incidence of acquisition might be too high even after the reduction produced by the proposed regulations. It follows that the presence of these problems does not counsel against the proposed regulations, but only suggests that it might be desirable to supplement them with some additional measures.

VIII. CONCLUSION

This Article has proposed two objectives — undistorted choice and equal treatment — for the legal rules governing corporate takeovers. These objectives are desirable and important for reasons of both efficiency and fairness. The Article has shown that current takeover rules lead to substantially distorted choice and to significantly unequal treatment, and it has put forward a set of takeover rules that would attain undistorted choice and equal treatment without entailing any significant efficiency costs.

²⁰⁴ See Coffee, *supra* note 7, at 1269–72.

Although the Article has focused on takeovers, the objectives of undistorted choice and equal treatment should guide us in the design of all acquisition rules. The Article has pointed out that existing merger law is at least roughly consistent with these objectives. It has also shown that the objectives require limiting prospective buyers to pursuing a takeover or a merger — such buyers should be prohibited from acquiring a controlling interest through open-market or privately negotiated purchases.

The Article has thus provided a general normative framework for evaluating acquisition rules, and has outlined several important elements of the acquisition rules that this framework suggests. A number of significant issues remain to be considered, however, before we can put forward a complete set of desirable acquisition rules. First, although merger law has been seen to be roughly consistent with the proposed objectives, it is still necessary to conduct a systematic and detailed analysis of the objectives' implications for the various aspects of merger law. Second, although the undistorted choice objective has been shown to require a ban on managers' use of obstructive defensive tactics, there remains a need to examine carefully the objectives' precise implications for the rules governing the role of a target's management. Third, because this Article's analysis has been limited to acquisitions of corporations that do not have a controlling shareholder prior to their acquisition, that analysis must be extended to acquisitions of corporations that do have a controlling shareholder. Finally, as explained in Part VII, corporate acquisitions might present, in addition to the problems of distorted choice and unequal treatment, two other problems — distortions of acquirers' choice, and distortions resulting from private gains to acquirers and targets that do not represent net social gains. Although these two problems do not weaken the case for the Article's proposed regulations, they might require supplementing these regulations with some additional measures. All these issues must be examined before the task that this Article has pursued — putting forward a complete set of desirable acquisition rules — is brought to completion.

APPENDIX A: COMPARISON TO THE BRITISH ARRANGEMENTS

In Britain, takeovers are subject to both governmental regulation and industry self-regulation. The main body of takeover rules is the City Code on Take-Over and Mergers, which was drafted (and is administered and enforced) by the Panel on Take-Over and Mergers, a non-governmental entity that functions under the auspices of the Council for the Securities Industry.²⁰⁵ This Appendix compares the regulations proposed in this Article with some of the arrangements prevailing in Britain.

A. The Determination of a Bid's Success

Under the proposed regulations, a bid's success would be determined by whether it attracts the required number of approving tenders. This proposed rule should be compared with two British arrangements, one applying only to partial bids and the other applying to all bids.

1. *The Approval Requirement for Partial Bids.* — The City Code discourages partial bids, and such bids are much less popular in Britain than they are in the United States.²⁰⁶ When a partial bid is made, however, the City Code imposes an approval requirement that is very similar to the one that I propose for all bids. The Code prohibits the purchase of any shares through a partial bid unless the bid has been approved by a majority of the target's shareholders.²⁰⁷ Approval is signified by an entry in a separate box on the tender form, where a tendering shareholder can indicate whether he approves the partial bid. The City Code thus ensures that a partial bid will be successful only if a majority of the shareholders indeed prefer it to succeed.

The limitation of the Code's approval requirement to partial bids is a result of the drafters' belief that partial bids pose different and more serious problems than do bids for all shares. As we have seen, however, this belief is mistaken.²⁰⁸ According to a leading British treatise, the British approach to partial bids is motivated by "the realization that British company law provides inadequate remedies for minority shareholders who feel that those in control of a company are abusing their position."²⁰⁹ But this rationale is in no way limited to partial bids: the ability of an acquirer to take advantage of minority

²⁰⁵ For a general discussion of the City Code, see A. JOHNSTON, *THE CITY TAKE-OVER CODE* (1980); DeMott, *supra* note 174.

²⁰⁶ See *infra* Section D of this Appendix.

²⁰⁷ CITY CODE ON TAKE-OVERS AND MERGERS, Rule 27 (City Working Party 1976).

²⁰⁸ See *supra* Part II & Section III.A.

²⁰⁹ M. BLANK & A. GREYSTOKE, *WEINBERG AND BLANK ON TAKE-OVERS AND MERGERS* para. 902 (4th ed. 1979); see also Johnston, *supra* note 205, at 254 (expressing a similar view).

shareholders might distort the outcome of any bid, whether it is partial or for all shares.

Because the British approval requirement is limited to partial bids, it does not address the problem of distorted choice in bids for all shares, which constitute the majority of bids in Britain. Indeed, the requirement leads bidders to make bids for all shares even when a partial acquisition would be more efficient than a complete acquisition. Thus, because the British approval requirement is limited to partial bids, it cannot make a substantial contribution to attaining undistorted choice.

2. *Providing a Second Opportunity to Tender.* — The City Code prohibits a bidder from purchasing any tendered shares unless it has attracted tenders from a majority of the target's shareholders.²¹⁰ Thus, attracting a majority of tenders is a necessary condition for a takeover. When a bidder succeeds in attracting the necessary majority, the Code requires it to leave its offer open for an additional two weeks.²¹¹ Thus, once it becomes clear that a takeover is going to take place, the required "second round" provides non-tendering shareholders with an opportunity to tender and receive the same treatment as all tendering shareholders. This rule, which applies to all bids, might appear to facilitate undistorted choice, because it enables shareholders who prefer the bid to fail to safely hold out, knowing that if the bid succeeds they will have a second opportunity to tender.

Before examining the rule's effect on shareholder choice, it is worth noting that the drafters of the British rule do not appear to have aimed at addressing the distorted choice problem or to have had an adequate understanding of that problem. The rule allows a successful bidder to deny shareholders a second opportunity to tender (exercise a "shut-off") if the bidder has given the shareholders an advance notice that no second opportunity to tender would be provided in the event that the bid succeeds.²¹² Clearly, a rule seeking to ensure undistorted choice should not allow bidders to exempt themselves from the rule's application by giving shareholders advance notice. Notifying an individual that a gun will be pointed to his head the next day will not enable the individual to make an undistorted choice on that next day when (as notified) the gun is pointed at his head. Similarly, notifying shareholders that they will not have a second opportunity to tender in the event of a takeover in no way protects them from the pressure to tender.

Even supposing, however, that bidders were not allowed to exercise a "shut-off," the British rule is not the right way to address the

²¹⁰ See CITY CODE ON TAKE-OVERS AND MERGERS, Rule 21 (City Working Party 1976). For simplicity I am assuming here that the bidder holds no shares in the target.

²¹¹ See CITY CODE ON TAKE-OVERS AND MERGERS, Rule 23 (City Working Party 1976).

²¹² See *id.*

distorted choice problem. To be sure, under the rule, shareholders who prefer the bid to fail will not tender. The problem, however, is that shareholders who prefer the bid to succeed might not bother to tender either, and the outcome of bids might be consequently distorted *against* bidders: a bid might well fail even if a majority of the shareholders would prefer it to succeed.

Consider how a shareholder who prefers a bid to succeed will decide whether to tender in the "first round." If the bid is going to succeed regardless of his decision, then his tender decision will not matter, since shareholders who tender in the "first round" and those who will tender in the "second round" will be equally treated. If the bid is going to fail regardless of his decision, the shareholder will be somewhat better off holding out: since the City Code requires failing bidders to return all tendered shares, tendering would lead only to unnecessary transaction costs. Consequently, the shareholder might elect to hold out in the "first round" and save the transaction costs involved in tendering. To be sure, if the shareholder's decision is going to determine the bid's fate, he will be better off tendering and bringing about a takeover, which is his preferred outcome. But since the likelihood of his decision being pivotal is very small, the shareholder might well hold out even though he prefers the bid to succeed.

The problem with the second round requirement might be alternatively described as follows. The requirement turns the "first round" into the equivalent of an approval vote, because a shareholder's decision whether to tender in that round matters only in the event that his decision proves pivotal for the bid's fate. To express a preference for the bid's success, a shareholder has to tender his shares in the first round; to express a preference for the bid's failure, he has to hold out in that round. The problem is that expressing a preference for the bid's success might involve extra transaction costs in comparison to expressing a preference for the bid's failure. This transaction cost differential creates a significant bias against expressing a preference for the bid's success.²¹³

²¹³ It is worth recalling how the proposed regulations concerning tendering shareholders would avoid the above problem. Under the proposed regulations, shareholders would express their approval or disapproval of a takeover in conjunction with the tendering of shares. Their choice between tendering approvingly and disapprovingly would thus involve no transaction costs differential, and would therefore be determined solely by their preferences concerning the bid's success.

Recall also that the problem considered above played a role in the design of the proposed regulations concerning non-tendering shareholders. In order to ensure that shareholders aware of the bid would have an incentive to tender, the proposed regulations would provide non-tendering shareholders in a takeover not with their pro rata share of the acquisition price, but rather with slightly less than that.

B. The Treatment of Tendering Shareholders in Unsuccessful Bids

Under the City Code, a failing bidder may not buy any tendered shares and must return all such shares to the tenderers.²¹⁴ In contrast, under the regulations proposed in this Article, a failing bidder may use its bid to purchase a non-controlling block: the bidder may purchase the shares of those tendering shareholders who specifically indicated their willingness to sell their shares even in the event that the bid fails.

The approach of the proposed regulations is somewhat preferable to that of the City Code. When some shareholders are willing to sell their shares to a failing bidder, there is no reason to prohibit this transaction, provided that the bidder is limited to purchasing a non-controlling block. Of course, a British bidder that fails to gain control may subsequently make a bid aimed at, and limited to, purchasing a non-controlling block. But the approach taken by the proposed regulations would save the transaction costs that such an additional bid would involve.

C. The Treatment of Non-Tendering Shareholders in Successful Bids

The proposed regulations would enable non-tendering shareholders in successful bids to secure something close to their pro rata share of the acquisition price. To this end, the regulations would restrict the terms of immediate takeouts and provide redemption rights when an immediate takeout does not occur.

Consider first the treatment of non-tendering shareholders in immediate takeouts. In Britain, a successful bidder is often able to effect a compulsory acquisition of the outstanding minority shares,²¹⁵ though it is generally more difficult to effect a takeout in Britain than in the United States.²¹⁶ When a successful British bidder proceeds to effect a takeout, the takeout consideration must be equal to the bid's consideration.²¹⁷

²¹⁴ See CITY CODE ON TAKE-OVERS AND MERGERS, Rule 21 (City Working Party 1976).

²¹⁵ The bidder might be able to effect a compulsory acquisition of minority shares by using section 209(1) of the 1948 Companies Act, by effecting a scheme of rearrangement pursuant to section 206 of the Companies Act, by following a certain procedure to reduce the target's capital, or, finally, by altering the articles of association to permit expropriation of minority shares. See Companies Act of 1948, 11 & 12 Geo. 6, ch. 38 §§ 206, 209(1); M. BLANK & A. GREYSTOKE, *supra* note 209, paras. 801-18.

²¹⁶ For example, section 209(1) requires the bidder to have received tenders from at least three fourths of the persons who are shareholders, those three-fourths owning at least 90% of the target's shares.

²¹⁷ Section 209(1)(a) of the 1948 Companies Act specifically requires that, in a compulsory acquisition pursuant to that section, the bidder must provide minority shareholders with the bid's consideration. See *In re Carlton Holdings Ltd.* [1971] 1 W.L.R. 918, 925. The other procedures to effect a takeout either require court approval of the takeout consideration or are

Consider now the treatment of non-tendering shareholders when an immediate takeout does not occur. According to section 209(2) of the British Companies Act of 1948, a successful bidder that has acquired more than 90% of the target's shares must allow the remaining minority shareholders to redeem their shares for the bid price within four months following the takeover.²¹⁸ The problem with the British rule is, of course, that it limits redemption rights to takeovers in which the remaining minority shares constitute less than 10% of the target's shares. This Article's analysis, which has shown that redemption rights are desirable on grounds of both undistorted choice and equal treatment, has revealed no reason for imposing the above limitation.²¹⁹ Redemption rights should be provided in all takeovers — as the proposed regulations would do.²²⁰

D. The Treatment of Partial Bids

The City Code's implicit view is that partial bids are of questionable desirability and pose more serious problems than do bids for all shares.²²¹ Consequently, the Code discourages partial bids. Every partial bid requires the consent of the Panel on Take-Overs and Mergers.²²² While such consent is frequently granted to bids for more than 50% of a target's shares, it is given only in exceptional circumstances to bids for more than 30% but less than 50%.²²³ Moreover, as already noted, a partial bid must be approved by a majority of the target's shareholders, but a bid for all shares does not face such a requirement.

subject to court intervention. There appear to be no cases in which a successful bidder effected a takeout with a consideration lower than the bid's consideration.

²¹⁸ See M. BLANK & A. GREYSTOKE, *supra* note 209, at paras. 1461-73.

²¹⁹ See *supra* Sections IV.A & IV.B. A British Committee (the Jenkins Committee) considered abolishing the limitation, but rejected this possibility. The Committee said that abolishing the limitation would have the effect of turning every partial bid into a bid for all shares. See M. BLANK & A. GREYSTOKE, *supra* note 209, at para. 1473. As Part IV explained, however, the proposed regulations concerning redemption rights would not require a bidder that makes a successful partial bid to purchase more than the fraction of shares it seeks. See *supra* pp. 1151-52.

²²⁰ In connection with the provision of redemption rights, it is also worthwhile to recall the British rule requiring successful bidders to leave their bids open for an extra two weeks. See *supra* Section A.2 of this Appendix. This rule does not ensure that all shareholders will be able to secure their pro rata share of the acquisition price. Because the required option remains open only for two weeks, and because shareholders are not notified about it, some shareholders are unable to take advantage of it. In contrast, the proposed regulations would ensure that all non-tendering shareholders would have the opportunity to take advantage of their redemption rights.

²²¹ Early versions of the Code even prefaced the provisions governing partial bids with the statement that such bids are undesirable. In 1974, however, this statement was deleted and the Code adopted a more ambiguous position. See A. JOHNSTON, *supra* note 205, at 254.

²²² See CITY CODE ON TAKE-OVERS AND MERGERS, Rule 27 (City Working Party 1976).

²²³ See *id.*; M. BLANK & A. GREYSTOKE, *supra* note 209, at paras. 985, 991.

As we have seen, however, the problems posed by partial bids and bids for all shares are essentially the same. The proposed regulations would therefore leave bidders free to choose the terms of their offers, while ensuring that shareholders exercise an undistorted choice concerning the acceptance or rejection of offers made to them. Consequently, under the proposed regulations, bidders would make partial bids whenever a partial acquisition would be most efficient. Because a partial acquisition might sometimes be more efficient than a complete acquisition, it is an advantage of the proposed regulations over the British rules that they would in no way discourage or penalize partial bids.

E. Acquisitions Through Open-Market or Privately Negotiated Purchases

The proposed regulatory framework would prohibit a buyer from gaining control of a target through open-market or privately negotiated purchases. In Britain, however, prospective buyers may gain control through such purchases. The City Code requires only that a buyer who crosses the specified threshold of effective control extend an offer to buy all the remaining shares at the same price it has paid for the shares in its controlling block.²²⁴

The British rule clearly ensures equal treatment. The rule also eliminates some possible distortions of shareholder choice. Without the rule, a shareholder approached by a buyer might sell his shares even if he views the independent target's per-share value as higher than the offered per-share price; the shareholder might elect to do so out of concern that if he does not sell and the buyer nonetheless gains control, he will end up with low-value minority shares. The mandatory offer requirement eliminates this possible pressure to sell.

The British rule, however, falls short of attaining undistorted choice. Under the rule, a buyer will succeed in gaining control whenever it is willing to pay a per-share acquisition price that exceeds the independent target's value in the view of a sufficiently large plurality of the shareholders. According to the undistorted choice objective, however, the buyer should gain control only if such a view is held by a *majority* of the shareholders.²²⁵

²²⁴ See CITY CODE ON TAKE-OVERS AND MERGERS, Rule 34 (City Working Party 1976). When the buyer has paid different per-share prices, the mandatory offer must be at the highest price paid by the buyer in the twelve months preceding the date of its crossing the specified threshold of effective control. The Code sets this threshold at 30% of the target's shares.

²²⁵ Cf. *supra* pp. 1761-64 (discussing why the minority's view should not prevail over the majority's).

APPENDIX B: DISTORTED AND UNDISTORTED CHOICE IN BIDDING CONTESTS

In analyzing the outcome of takeover bids, this Article has thus far assumed that a given target's shareholders face a single bid, rather than competing bids. This assumption has enabled us to set aside the choice that shareholders might face between rival bids and to focus entirely on their choice between selling their company and remaining independent. This Appendix extends the analysis to cases in which competing bids are present. The Appendix shows that shareholders' choice among rival bids might currently be distorted, and explains how the proposed regulations could be designed to facilitate undistorted choice among such bids.

A. The Current Distorted Choice

1. *The Paradigmatic Situation.* — In examining a paradigmatic situation of a bidding contest over a target, the following analysis uses two simplifying assumptions. First, it assumes that there are only two competing bidders, *A* and *B*; without loss of generality, *A*'s offer is assumed to expire prior to *B*'s offer.²²⁶ Second, in order to focus on the shareholders' choice between *A*'s offer and *B*'s offer, the analysis assumes that all of the shareholders (who are all assumed to be aware of both bids) view the independent target's value as lower than both *A*'s and *B*'s offered acquisition prices. Section C considers the additional complications that will be introduced once these two assumptions are dropped.

What is the socially desirable outcome in this situation? According to the undistorted choice objective, a takeover by *A* and a takeover by *B* are both superior to the target's remaining independent, because the independent target's value is lower in the shareholders' view than both *A*'s and *B*'s offered acquisition prices. Thus, the target should be acquired, and the only question remaining is whether it should be acquired by *A* or by *B*. The acquirer's identity might be important from the perspective of efficiency because potential buyers might differ substantially in the amount of efficiency gains that they can produce by acquiring the target.

According to the undistorted choice objective, the winning bidder should be the one whose offered acquisition price is viewed by a majority of the target's shareholders as the higher one. Efficiency would be served if the target is acquired by the bidder that places the highest value on the target and is therefore willing to pay the most

²²⁶ This assumption does not imply that bidder *A* was the first one to make a bid for the target. The considered bids might, for example, be the final ones in a long contest started by *B*.

for it. And when the shareholders differ in their judgment as to how the two offered acquisition prices compare,²²⁷ the majority's judgment should be followed because it is more likely to be correct.²²⁸

Thus, according to the objective of undistorted choice, it is desirable that a shareholder tender to *A* if he judges *A*'s offered acquisition price to be the higher one, and to *B* if he has the opposite view. Under current rules, however, shareholders' tender decisions might well deviate from this standard.

2. *Shareholders' Current Considerations.* — Consider the tender decision of a given shareholder in the situation described above. The shareholder presumably will tender his shares, as will all other shareholders,²²⁹ and the only question is whether the shareholder will tender to *A* or to *B*. As will be demonstrated below, the shareholder's choice will be substantially affected by considerations other than his judgment as to whether *A*'s offered acquisition price exceeds *B*'s.

The shareholder will realize that his tender decision is unlikely to affect the contest's outcome. He therefore will consider each of the two possible outcomes of the contest: a takeover by *A* and a takeover by *B*.²³⁰ For each of the two possible cases, the shareholder will examine whether he would be better off tendering to *A* or to *B*.

Assuming that (as commonly happens) both bidders retain the option not to purchase tendered shares if they fail to gain control, then, whichever bidder loses, it may return the shares tendered to it. Consequently, as we shall soon see, if *A* is going to win, the shareholder's best course of action will be to tender to *A*, and if *B* is going to win, the shareholder's best course of action will be to tender to *B*. That is, a victory by either bidder might impose a penalty on those who tendered to the losing bidder. Therefore, in deciding whether to tender to *A* or to *B*, the shareholder will compare the two bids in terms of two factors: (1) the bid's likelihood of success; and (2) the expected penalty that the bid's success will impose on tendering to the competing bid. Let us therefore examine these two factors, and let us begin with factor (2).

²²⁷ For each of the two bids, shareholders might differ in their estimates of the value that minority shares will have in the event of a takeover, in their estimates of the expected number of shares that will be acquired at the bid price in case of a takeover, and (in an exchange offer) in their estimates of the value of offered securities.

²²⁸ For a discussion of the choice of a majority of the shareholders as the decisive fraction, see pp. 1774-75.

²²⁹ I assume that shareholders have no compelling tax reasons for avoiding a sale of their shares. Consequently, since any given shareholder is assumed to view the independent target's per-share value as lower than both *A*'s bid price and *B*'s bid price, holding out altogether will never be his preferred strategy.

²³⁰ The analysis below ignores for simplicity the possibility that the tendering shareholders will divide themselves roughly equally between the two bids so that the contest will be deadlocked.

(a) *The Penalty that a Bid's Success Will Impose on Tendering to the Rival Bid.* — To focus on factor (2), suppose that the shareholder attributes the same probability to *A*'s success as to *B*'s success. Consequently, the shareholder's decision will be determined by his judgment as to whether *A*'s success would impose a higher cost on tendering to *B* than the cost that *B*'s success would impose on tendering to *A*.

Assume first that shares tendered to the failing bidder are always expected to be returned to the tenderers and to become minority shares. In this case, the shareholder will compare (i) the gap between *A*'s bid price and the expected value of minority shares in case of a takeover by *A*, with (ii) the gap between *B*'s bid price and the expected value of minority shares in case of a takeover by *B*. The shareholder will tender to *A* if (i) exceeds (ii), and to *B* if the opposite is true. Thus, the bidder best able to take advantage of minority shareholders upon gaining control has an advantage — because a victory by this bidder would impose a higher penalty on tendering to its losing rival.

The discussion thus far has assumed that all shares tendered to the losing bidder will become minority shares. This assumption clearly holds true when the winning bidder is *A*, the one whose offer closes earlier. In such a case, *B* will have no reason to purchase any tendered shares, and the shares tendered to *B* will all become minority shares. But if the failing bidder is *A*, shares tendered to *A* might not always become minority shares — and this possibility might give *A* an advantage in the contest with *B*.

To see this advantage, suppose that *A*'s bid closes with an insufficient number of shares for a takeover, and that it is therefore expected that *B* will receive enough tenders to gain control. Although the shareholders who tendered to *A* might end up with minority shares, they also might not. First, *A* might promptly return all tendered shares to the tenderers, enabling them to tender their shares to *B* before *B*'s bid closes. Second, if *B* bids for all shares at a bid price exceeding *A*'s bid price, then *A* will probably purchase tendered shares in order to resell them at a profit to *B*. These two possibilities imply that shareholders who tendered to *A* might suffer either no loss or a loss smaller than the gap between *B*'s bid price and the post-takeover value of minority shares. The possibility of this small or non-existent penalty gives *A* an advantage in the contest with *B* over the target.

In sum, one consideration that will influence the shareholder's tender decision is his judgment of how the two bids compare in terms of the expected gap between the bid price and the expected value of minority shares upon the bid's success. This consideration favors the bidder that would be best able to take advantage of minority shareholders upon gaining control. Another consideration, which would favor *A*, is the possibility that, in a takeover by *B*, shares tendered

to *A* might not become minority shares but instead might be purchased by *A* or returned in time to be tendered to *B*. Clearly, these considerations have very little to do with the consideration that should determine the shareholder's decision — his judgment as to how *A*'s offered acquisition price compares with *B*'s offered acquisition price.

(b) *The Likelihood of a Bid's Success.* — Thus far the analysis has assumed that the probability of *A*'s victory is equal to the probability of *B*'s victory. Once this assumption is dropped, we recognize the presence of another consideration that might play a role in the shareholder's tender decision — his judgment as to how these two probabilities compare. The greater the likelihood of a given bidder's success, then the greater the likelihood that the shareholder will tender to that bidder rather than to its rival.

It might be thought that the shareholder would predict certain success for the bidder whose offered acquisition price the shareholder views as higher than that of the rival bidder. This supposition, however, is incorrect. The shareholder's estimate of a bid's likelihood of success might well be shaped by considerations that have little to do with his judgment of how the bidders' offered acquisition prices compare.

In comparing the bids in terms of their likelihood of success, one factor the shareholder will take into account is his judgment as to how the two bids compare in terms of the expected penalty that their success would impose on tendering to the rival bid. The shareholder knows that this comparison might well affect other shareholders' tender decisions and hence the outcome of the contest. Another important consideration that the shareholder will take into account is his assessment of other shareholders' expectations concerning the contest's outcome. Indeed, any pervasive expectations among the shareholders that a given bidder will win might be self-fulfilling. That any initial expectations might be self-fulfilling implies by itself that, consistent with perfect shareholder rationality, the contest might end with a victory by the bidder whose offered acquisition price is lower.

B. Attaining Undistorted Choice

The preceding discussion has demonstrated that under current rules the contest between *A* and *B* might end in a takeover by the bidder whose offered acquisition price is viewed by a majority of the shareholders as lower than that of the rival bidder. This Article's proposed regulations can be extended, however, in either of two alternative ways, to ensure undistorted choice between the bids of *A* and *B*.

One possible and somewhat preferable extension would allow shareholders to tender their shares to both *A* and *B*. This approach would require rival bidders to have one, centralized depository. Al-

though shareholders would be able to tender to both *A* and *B*, they would not be allowed (and indeed would not want) to make an approving tender to more than one of the rival bidders. Thus, a shareholder who would make an approving tender to one of the bidders would also be able to make a disapproving tender to the rival bidder, thereby ensuring that he will receive his pro rata share of the acquisition price if the rival bidder wins. As before, a bidder would be allowed to purchase a controlling interest only if it attracts approving tenders from a majority of the shareholders.

To see that the above approach would work, note first that any rational shareholder would take advantage of the right to tender to both *A* and *B*; the only question is to which bidder he would make his approving tender. Because the shareholder's choice between the rival bidders would affect his financial position only if his decision proves pivotal for the contest's outcome, he would make an approving tender to *A* rather than to *B* if and only if he prefers a takeover by *A* to a takeover by *B*. Because all shareholders would be expected to tender to both *A* and *B*, the shareholder would expect the acquisition price to be divided pro rata in case of a takeover by either bidder. Consequently, the shareholder would prefer *A*'s takeover to *B*'s takeover if and only if he views *A*'s offered acquisition price as higher than *B*'s offered acquisition price. Thus, since the winning bidder would be the one who receives approving tenders from a majority of the shareholders, the winner would be the one whose offered acquisition price is judged by the majority to be the highest available.

The alternative way in which the proposed regulations could be extended would allow shareholders to tender to only one bidder at a time. The regulations, however, would require *A*, the bidder whose offer is the first to close, to return all tendered shares that it would not purchase in time for the tenderers to tender their shares to *B*. This approach would of course necessitate requiring rival bidders to maintain a sufficient period of time between the closings of their bids.

To show that this alternative approach would work, note first that it would eliminate the risk that tendering to *A* might lead to ending up with minority shares in case of a victory by *B*. Consequently, all rational shareholders would tender (approvingly or disapprovingly) to *A*. If *A* fails to attract the required number of approving tenders and returns the shares tendered to it, then all shareholders would presumably tender approvingly to *B*, which would then succeed in gaining control. Thus, the contest's outcome would depend on whether or not *A* succeeds in attracting the required number of approving tenders. Because a shareholder's choice between tendering approvingly to *A* and tendering disapprovingly would affect his position only if his choice proves pivotal for the outcome of *A*'s bid, the shareholder would elect to tender approvingly to *A* if and only if he prefers a takeover by *A* to a takeover by *B*. Because the shareholder would

expect the acquisition price to be divided pro rata in a takeover by either *A* or *B*, the shareholder would prefer *A*'s takeover to *B*'s takeover if and only if he views *A*'s offered acquisition price as higher than *B*'s. Therefore, *A* would win the contest if and only if a majority of the target's shareholders hold such a view — which is the outcome required by the undistorted choice objective.

C. Undistorted Choice Among Three or More Outcomes

The preceding analysis has assumed that a given target's shareholders face only two bidders, and that all the shareholders view the independent target's value as lower than the acquisition price offered by either bidder. These assumptions imply that there are only two possible candidates for the desirable outcome — a takeover by *A* and a takeover by *B*. Once these assumptions are dropped, however, there might be three or more candidates for the desirable outcome, each of which is viewed by some of the target's shareholders as the value-maximizing outcome.

Suppose, for example, that some of the target's shareholders view the independent target's value as higher than both *A*'s offered acquisition price and *B*'s offered acquisition price. Thus, there are three outcomes that could be socially desirable — a takeover by *A*, a takeover by *B*, and remaining independent. In this situation, a new problem might arise. The problem is not one of ensuring that the desirable outcome would take place, but rather one of defining what the desirable outcome is. There might be no outcome that in the view of a majority of the target's shareholders is superior to the other two possible outcomes. It might so happen that the independent target's value is viewed by a majority of the shareholders as lower than *A*'s offered acquisition price; that *A*'s offered acquisition price is viewed by a (different) majority as lower than *B*'s offered acquisition price; and, finally, that *B*'s offered acquisition price is viewed by a (still different) majority as lower than the independent target's value.²³¹

How should we define the desirable outcome in such problematic situations? Social choice theory suggests that this problem cannot be perfectly solved — any definition that we adopt is bound to have some arbitrary and imperfect element.²³² The undistorted choice objective, as I have defined it, requires that a bidder gain control if and

²³¹ To see how this result might occur, let *X* and *Y* represent the offered acquisition prices of *A* and *B*, respectively, and let *V* represent the independent target's value. The above situation will arise if, for example, the distribution of estimates is as follows: one third of the shareholders view *X* as higher than *Y* and *Y* as higher than *V*; one third of the shareholders view *Y* as higher than *V* and *V* as higher than *X*; and one third of the shareholders view *V* as higher than *X* and *X* as higher than *Y*.

²³² The seminal work on the problems involved in aggregating different individual rankings over three or more alternatives is K. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (2d ed. 1963). For an accessible survey of the literature, see D. MUELLER, *PUBLIC CHOICE* (1979).

only if, in the view of a majority of the target's shareholders, the bidder's offered acquisition price exceeds the independent target's value as well as the acquisition prices offered by other bidders. The imperfection in this definition is its slight bias in favor of the target's remaining independent. When there is no outcome that a majority of the target's shareholders view as superior to all others, the objective as defined requires that the target remain independent.

The proposed regulations (including the extensions outlined in Section B of this Appendix) would ensure that, in situations in which no single outcome is viewed by a majority of the shareholders as superior to all other possible outcomes, the outcome would be that which is required by the undistorted choice objective — that is, the target will remain independent. If we choose to define differently the desirable outcome in such problematic situations, we will have to modify slightly the proposed regulations — specifically, the formula of the required number of approving tenders. But, in any event, defining the desirable outcome in such problematic situations is not an issue of much practical importance. Such situations are presumably quite rare; and when they do occur, the difference in efficiency between the three or more candidates for the desirable outcome is likely to be quite small.