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ANTITAKEOVER CHARTER PROVISIONS: DEFENDING SELF-HELP FOR TAKEOVER TARGETS

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The historical transition from substantive to enabling corporation statutes¹ did not anticipate the emergence during the last decade of the tender offer as a widespread means of corporate acquisition.² One consequence is a seeming absence of statutory provisions aimed at protecting minority interests following a shift in control from public stockholders in general to a single controlling stockholder that results from a successful tender offer.³ This vulnerability of the minority interest reveals tension in the corporation statutes with respect to balancing the competing interests of majority stockholders, minority stockholders and management, which must somehow deal with scrupulous fairness toward all stockholders as well as the corporation itself. When opposing interests divide the ranks of stockholders, management's dilemma is merely compounded.⁴ Appropriate judicial and corporate responses to the lack of protection for minority stockholders in the tender offer context remain in the development stage.⁵

Increasingly, corporations have responded by proposing a variety of charter or bylaw amendments designed to impede abrupt changes in man-

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¹ See Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 BUS. LAW. 1031, 1038-51 (1976); Lynch, *A Concern for the Interest of Minority Stockholders Under Modern Corporation Laws*, 3 J. CORP. L. 19, 21-31 (1977) [hereinafter cited as Lynch]. See also Katz, *The Philosophy of Midcentury Corporation Statutes*, 23 LAW & CONTEMP. PROB. 177 (1958); Latty, *Why Are Corporation Laws Largely "Enabling"?*, 50 CORNELL L.Q. 599 (1965).

² The tender offer, long popular in England, emerged in the late 1960's as a popular acquisition technique in the United States. Steinberg, *The Contested Cash Tender Offer: Practical, Economic, and Legal Considerations of the Offeror*, [1978] 5 CORP. PRAC. SERV. (BNA) ¶A-1 (1978); E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* v-vi (1973) [hereinafter cited as ARANOW & EINHORN]. It is today the preferred method of acquiring control of a corporation. See Note, *Commerce Clause Limitations Upon State Regulation of Tender Offers*, 47 S. CAL. L. REV. 1133, 1136 (1974). See generally BUS. WEEK, Nov. 14, 1977, at 176-84.

³ Lynch, *supra* note 1, at 22, 25.

⁴ In cases where the stockholders are divided over a tender offer, management seems always beset by two opposing factions, those who believe that the tender offer should be opposed and those who object to any effort that may jeopardize their chance to sell their shares at a premium. Compare *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), *rev'g* 367 A.2d 1349 (Del. Ch. 1976) with *Berman v. Gerber Products Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978).

⁵ See A. FLEISCHER, JR., *TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING* (1978) [hereinafter cited as TENDER OFFERS]; 1 M. LIPTON & E. STEINBERGER, *TAKEOVERS & FREEZEOUTS* 263-325 (1978) [hereinafter cited as TAKEOVERS & FREEZEOUTS]; Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978); Weiss, *Tender Offers and Management Responsibility*, 23 N.Y.L. SCH. L. REV. 445 (1978).

agement.⁶ These provisions, frequently referred to as "shark repellent" or "porcupine" provisions because of their antitakeover effect, have become increasingly sophisticated. Relatively commonplace internal management devices, such as the staggered board and a simple greater than majority vote requirement, have begun to give way to variants such as fair price and right of redemption provisions.⁷ The broad enabling type corporation statutes serve to legitimize both the traditional and innovative antitakeover provisions. However, these provisions have become defensive weapons in intercorporate battles in ways apparently not anticipated by the draftsmen of the corporation laws.⁸ By inhibiting the exercise of control by a simple majority of stockholders or by limiting the otherwise broad powers of management, the adoption of antitakeover provisions runs counter to the public policy inherent in the typical enabling corporation code.⁹ At the same time, however, these provisions may be in consonance with competing

⁶ See E. ARANOW, H. EINHORN & G. BERLSTEIN, *DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL* 193-96 (1977); Hochman & Folger, *Deflecting Takeovers: Charter and Bylaw Techniques*, 34 *BUS. LAW.* 537 (1979); Fleischer, *Defensive Tactics in Tender Offers*, 9 *REV. SEC. REG.* 853 (1976); Mullaney, *Guarding Against Takeovers—Defensive Charter Provisions*, 25 *BUS. LAW.* 1441 (1970); Smith, *Fair Price and Redemption Rights: New Dimensions in Defensive Charter Provisions*, 4 *DEL. J. CORP. L.* 1 (1978).

⁷ See text accompanying notes 66-70 *infra*.

⁸ The development in Delaware of the authority to prohibit stockholder action by written consent offers one instructive example of unforeseen results of statutory legitimization of antitakeover provisions. Prior to 1917, Delaware prohibited action of stockholders by written consent. In that year, with the adoption of § 64A (now § 271 of the Delaware General Corporation Law), action by written consent of a majority of stockholders was authorized in connection with the vote on a sale of all assets. 29 *Del. Laws*, Ch. 113, § 17 (1917). In 1937, the forerunner of present § 228 was adopted and provided generally for action by unanimous written shareholder consent (except for the majority consent allowed in a sale of assets). 41 *Del. Laws*, Ch. 131, § 6 (1937). The 1967 general revision of the Delaware statute authorized corporations to provide in the certificate of incorporation for a less than unanimous consent. 56 *Del. Laws*, Ch. 50, § 228 (1967). In 1969, the legislature amended § 228 to permit action by written consent of the holders of stock having not less than the minimum number of votes necessary to take the action at a meeting. 57 *Del. Laws*, Ch. 148, § 228 (1969). In addition, the words "[u]nless otherwise provided in the certificate of incorporation" was added to the beginning of § 228, thereby giving corporations the authority under Delaware law to eliminate by charter provision stockholder action by written consent.

It is unlikely that the drafters of § 228 saw the "unless otherwise provided" language as anything more than authority to require a higher vote, or even unanimous vote, for action by written consent. The possibility of eliminating action by written consent was recognized in 1972 by Professor Folk. E. FOLK, *THE DELAWARE GENERAL CORPORATON LAW* 278 (1972). At the time, however, the 1969 amendment was seen as simply taking the final steps of extending the old sale of assets rule to all stockholder action. Arsht & Stepleton, *Delaware General Corporation Law: 1969*, 25 *BUS. LAW.* 287, 293-94 (1969). Since Delaware from 1937 to 1969 made no provision for elimination of action by written consent, it would seem that if the drafters had in mind permitting corporations to do away with action by written consent to protect against takeovers, some mention would have been made.

⁹ The fundamental policy underlying enabling corporation statutes is to place maximum discretion in management and permit fundamental corporate changes by mere majority vote. See Folk, *supra* note 1, at 1039-51; Lynch, *supra* note 1, at 24-27. Also, see the discussion of § 228 of the Delaware General Corporation Law at note 8 *supra*.

public policies, such as that favoring fair treatment of the minority at the hands of a controlling stockholder.¹⁰ Thus, the use (some might say abuse) of the broad authority under state corporation laws to adopt prophylactic provisions against tender offers pits public policy against public policy and one faction of stockholders against another. These conflicts demonstrate again the difficulty in balancing the variety of interests involved in the corporate form of enterprise.

Antitakeover provisions are in substance corporate self-help mechanisms for thwarting a perceived threat to the interests of management and stockholders alike, although those interests may differ in nature. Whether they seriously impede tender offers is open to question.¹¹ More importantly,

¹⁰ The public policy that requires controlling stockholders to treat the minority fairly finds expression in the cases developing the fiduciary duties of management and control stockholders in freezeout mergers. *See, e.g.,* *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Najjar v. Roland International, Inc.*, 387 A.2d 709 (Del. Ch. 1978), *rev'g*, 367 A.2d 1349 (Del. Ch. 1976); *Young v. Valhi*, 382 A.2d 1372 (Del. Ch. 1978); *Kemp v. Angel*, 381 A.2d 241 (Del. Ch. 1977). *See generally Note, Assuring Fairness In Corporate Mergers: Recent State Trends*, 35 WASH. & LEE L. REV. 927 (1978).

¹¹ *See e.g.,* Steinbrink, *supra* note 5, at 905; TAKEOVERS & FREEZEOUTS, *supra* note 5, at 265; TENDER OFFERS, *supra* note 5, at 6. The commentators generally premise the ineffectiveness of antitakeover provisions on the basis of several factors. Initially, they rely on the ability of the successful offeror to invalidate the provisions and the unwillingness of institutional investors to vote for such provisions. Moreover, they question whether incumbent management would continue to fight a majority stockholder. Finally, because the antitakeover provision has such low visibility following its adoption, it may not be discovered by the offeror until after it has already determined to attempt the acquisition. Nevertheless, the adoption of antitakeover charter provisions apparently has, in fact, contributed to the outcome of some struggles for control. For example, the adoption by PSA, Inc. of a broad spectrum of shark repellent charter provisions appears to have been the determining factor in fending off the attempted takeover by Valhi, Inc.'s Harold Simmons. *Wall Street Journal*, Feb. 23, 1979, p. 14, col. 1. Through Valhi, Simmons had acquired some 21% of PSA's stock. In response PSA management obtained stockholder approval of, among other defensive provisions, an 80% vote requirement for business combinations with a holder of 20% or more of PSA's stock. Although Simmons attacked the adoption, *see Valhi, Inc. v. PSA, Inc.*, No. 7530 (Del. Ch., Oct. 30, 1978), the acquisition attempt was abandoned before any judicial resolution, with Simmons pointing to the antitakeover provisions as a reason for calling off the chase. Simmons' response to adoption of the antitakeover provisions by PSA may have been prompted in part by the earlier unsuccessful attempt to merge Valhi with Contran Corporation. There, Contran, of which Harold Simmons was a 40% stockholder, had acquired control of Valhi and attempted a merger which would eliminate the minority interest. Because Valhi had a pre-existing 80% vote requirement for mergers with 5% or more stockholders, Contran attempted to merge Valhi into a newly created wholly-owned subsidiary of Valhi, and thereby eliminate the 80% vote requirement. The Delaware Chancery Court, however, saw this action as an attempt to evade a high vote provision designed to benefit Valhi's minority stockholders and enjoined the merger. *Young v. Valhi, Inc.*, 382 A.2d 1372, 1378 (Del. Ch. 1978). The existence of a number of other lawsuits in which defensive charter provisions have been attacked attests to the fact that at least some offerors find such provisions a cause for concern. *See, e.g.,* *Lee Nat'l Corp. v. Deramus*, 313 F. Supp. 224 (D. Del. 1977); *Monogram Indus., Inc. v. Royal Indus., Inc.*, No. 76-3356-R (C.D. Cal. 1976); *UV Indus. Inc. v. Globe-Union, Inc.*, No. 5563 (Del. Ch., Mar. 31, 1978). Moreover, there is no way to know how many tender offers have been scratched in the planning stage when the potential offerors' lawyers discovered class vote or other problems in assessing the impact of the provisions of the target's charter on the offerors' future plans for the target.

however, they may be an expression by public stockholders of a need for greater protection of their investment opportunity.¹² The pace at which corporations are adopting antitakeover provisions,¹³ the attempts through litigation to block their adoption, and the recently announced position of the SEC's Division of Corporation Finance¹⁴ suggest a need for more considered attention to the usefulness and propriety of such measures. Important questions also arise as to whether new rules or legislation might be beneficial to delineate properly their scope.

As starting points for such a debate, four discrete aspects of the anti-takeover provision trend will be examined: (1) the Division of Corporation Finance's release on disclosure, as it is the SEC's first public reaction to the trend; (2) a brief overview of current antitakeover provisions; (3) an analysis of the validity of defensive charter provisions; and (4) some reflections on the usefulness of new legislation to control adoption of defensive charter provisions.

I. THE SEC POSITION ON DISCLOSURE

In Exchange Act Release No. 15230 (Release)¹⁵ the SEC's Division of Corporation Finance made public its concern over the adequacy of disclosure with respect to charter or bylaw amendments that, by design or effect, tend to discourage tender offers. Although officially the Release represents only instructions for the guidance of the SEC staff,¹⁶ it obviously is designed to put issuers on formal notice that in the Division's view antitakeover proposals are inherently suspect and will be scrutinized accordingly for completeness of disclosure. Precisely what has prompted the warning at this point in time is unclear.¹⁷ The original instructions to the

¹² It is argued that antitakeover provisions are harmful because they make stockholders' investments less liquid. Yet the apparent willingness of stockholders to adopt antitakeover provisions suggests that some members of the investing public wish to protect their investment from the risk of a takeover that would preclude them from sharing in the future benefits of the enterprise. Thus, one commentator has suggested that the ease with which investors may be taken out by a tender offer may actually deter investment. See Steinbrink, *supra* note 5, at 901.

¹³ There is little firm statistical data addressing the popularity of antitakeover provisions. Based on information from the New York Stock Exchange (NYSE), it appears that there has been a marked increase. For example, in 1973, only 12 NYSE listed companies adopted supermajority vote provisions. In 1977, the number was 45. There is no sign that the trend is abating, and the announcement of the proposal of antitakeover provisions is a regular notation in the financial press. See Wall Street Journal, July 10, 1979, P. 16, col. 3 (antitakeover provisions proposed or adopted by Southwest Airlines, MacDonald's Corp., Kerr Glass Manufacturing Corp., Ozark Airlines, and United Missouri Bancshares, Inc.); Wall Street Journal, Oct. 11, 1979, p. 16, col. 2 (antitakeover provisions proposed by Bache Group, Inc.).

¹⁴ SEC Exchange Act Release No. 15230, Oct. 13, 1978, *reprinted in* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,748 [hereinafter cited as Release].

¹⁵ *Id.*

¹⁶ "The Division stresses, moreover, that these instructions are merely for the guidance of the staff and are subject to revision without formal notice." *Id.* at 80,984.

¹⁷ The ostensible purpose for the Division's avowal to scrutinize antitakeover proposal

staff, on which the Release is based, were drafted in 1978 in response to a specific recommendation of the Advisory Committee on Corporate Disclosure¹⁸ that the Division should screen management antitakeover proposals carefully to insure adequate disclosure to stockholders of the disadvantages of such provisions.¹⁹ However, the Division indicates in the Release that it

materials is to assist issuers in the preparation of proxy materials in the 1978-79 proxy season.
Id.

¹⁸ HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95th Cong., 1st Sess., REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 39 (Comm. Print 1977). The Advisory Committee's Digest of its report summarizes the discussion of antitakeover provisions as follows:

The Advisory Committee believes that the disclosures in proxy statements about management proposals, particularly those where management may have a conflict of interest, such as option and other similar type plans, anti-takeover proposals, and plans for going private, are not always adequate. The Commission should closely review proxy materials on management proposals and assure that there is adequate discussion of their disadvantages.

Digest of the Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, (Nov. 3, 1977), *reprinted in* [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,357, at 88,669. Significantly, perhaps, the specific recommendation is less forceful:

The Commission should direct the SEC staff to review intensively proxy materials which contain certain management proposals, with a view to requiring more uniform and adequate disclosure of the advantages and disadvantages of proposals which may substantially affect the interests of shareholders, including disclosure of estimated costs of any option or similar type of plan and the possible impact such plan may have on the behavior of management.

Id. at 88,674.

¹⁹ The Release states:

The Advisory Committee on Corporate Disclosure in its report urged the Commission staff to review closely proxy materials containing anti-takeover proposals in order to ensure that there is adequate discussion of their disadvantage as well as advantages. In February of 1978, the Commission responded with an indication that the suggestion would be implemented administratively and would be the subject of specific instructions to the staff of the Division of Corporate Finance [footnotes omitted].

Release, *supra* note 14, at 80,984. In February 1978, the SEC issued the following statement of implementation of the Advisory Committee's recommendation:

The Committee also urges the Commission to review closely proxy materials containing management proposals, particularly those where management may have a conflict of interest, such as option and other similar type plans, anti-takeover proposals, and plans for going private, in order to assure that there is adequate discussion of their disadvantages.

.
These recommendations are being evaluated for possible Commission consideration in the context of the Commission's re-examination of rules relating to shareholder communications, shareholder participation in the corporate electoral process, and corporate governance generally. In addition, the recommendation relating to review of management proposals, to the extent not already implemented, will be implemented administratively and will be the subject of specific instructions to the staff of the Division of Corporation Finance.

SEC Securities Act Release No. 5906, (Feb. 15, 1978), SEC Docket, Vol. 14, No. 4, p. 140, 145. Arguably, the SEC suggests in Securities Act Release No. 5906 that the Advisory Com-

was addressing the problem as early as 1969,²⁰ and there is no explanation of why the Division had not reacted publicly until now.

Although the Advisory Committee recommendation provides a convenient explanation for the adoption of a formal position, the Division unfortunately appears to have missed an opportunity to make a meaningful comment on antitakeover provisions as responses to anticipated or incipient tender offers. Moreover, the Division indicates it has considerable experience with such proposals,²¹ the Release does not reflect much of that experience. Rather, it has all the markings of a hastily conceived internal response to the Advisory Committee's recommendation which has been made public without thoughtful revision. Consequently, the Release does little more than confirm the Divisions's bias against defensive charter provisions²² and present in laundry-list fashion²³ charter provisions that the

mittee's recommendations were to some extent already implemented. However, it does not explain in what way, nor does Exchange Act Release No. 15,230 indicate that the staff had received any specific instructions prior to the guidelines responding to the Advisory Committee's recommendation. Appropriate disclosure was required as early as 1969, however. See ARANOW & EINHORN, *supra* note 2, at 264.

²⁰ Specifically, the Release states that since 1969 the Division's position has been that: when management sponsors anti-takeover proposals and other devices to insulate management from removal, the issuer's proxy material or information statements should disclose in a prominent place that the over all effect of the proposal is to render more difficult the accomplishment of mergers or the assumption of control by a principal stockholder, and thus to make difficult the removal of management.

Release, *supra* note 14, at 80,985.

²¹ In the Release, the Division states that it has "reviewed many proxy and information statements containing antitakeover measures," thereby gaining a "great deal of experience" in dealing with the disclosure issues raised by such measures. Release, *supra* note 14, at 80,985. The Release also indicates that a monitoring system has been established to compile statistical data on antitakeover provisions in proxy statements. The system is designed:

- (1) to evaluate the disclosure being made by companies proposing such measures;
- (2) to determine whether more specific disclosure requirements should be published concerning the purpose and/or effect of such proposals; and (3) to collect data on the frequency of use of such proposals which may serve as an empirical basis for Congressional proposals or testimony, or rulemaking action by the Commission.

Id. at 80,986 n. 7.

²² See Comments of Leonard M. Leiman, (Nov. 15, 1978), *reprinted in* 478 SEC. REG. L. REP. (BNA) A-16 to A-17.

²³ The defensive charter and bylaw maneuvers specifically noted in the Release as being of an antitakeover nature are:

- (1) classification of directors or staggering of boards;
- (2) provisions to abolish cumulative voting;
- (3) provisions establishing supermajority approval requirements for certain corporate transactions including, but not limited to, any proposed merger or sale of assets;
- (4) provisions requiring a supermajority vote to cancel a supermajority provision as described in category 3 above, but not to adopt one;
- (5) provisions requiring a supermajority vote to amend the corporate charter in any relevant respect;
- (6) provisions which reduce the supermajority required for a merger to a lesser majority unless the other party to the transaction is a "related corporation" (such as one owning more than 5% of any class of voting securities of the issuer) in which case a merger would require

Division has deemed to have antitakeover purposes, effects, or both.

One unfortunate consequence of the Release is that in presenting a list of antitakeover proposals, the Division has created a presumption that all such proposals are motivated by antitakeover purposes. While the Division maintains that the need for disclosure may vary depending upon the circumstances of a particular proposal,²⁴ by branding a proposal "antitakeover" the Division inevitably places a burden on the issuer to disclose potential disadvantages of a proposed charter amendment in the tender offer context. This will be true even when the purpose behind the proposal bears no relation to defensive maneuvering. The Division apparently disregards the fact that many of the "antitakeover" actions have been statutorily sanctioned for many years prior to the development of tender offers as a significant method of corporate acquisition.²⁵ Presumably, the statutory provisions permitting classified boards, greater than majority votes, and similar internal structuring of the rights of stockholders, reflect a public policy that such arrangements serve some legitimate corpo-

supermajority approval of the common stock as a class in addition to approval by the holders of the voting power to all securities of the issuer entitled to vote;

(7) the creation of a privately placed class of equity securities, the favorable vote of which is necessary to approve any tender offer, merger, sale or exchange of assets or other extraordinary corporate transaction;

(8) provisions which prevent the removal of directors without cause or by a supermajority vote;

(9) provisions prohibiting the removal from office for any reason of a director elected for a term longer than one year, notwithstanding any change in control due to tender offers, mergers or other transactions;

(10) provisions prohibiting the calling of special shareholder meetings altogether or allowing them only upon the request of a holder or holders of a supermajority of the shares outstanding;

(11) provisions establishing the maximum permissible number of directors;

(12) provisions providing for stand-by successor directors, to be elected at the same time who will fill a position upon the death or resignation of a regular director, as the regular directors;

(13) reincorporation of the issuer in a state with an antitakeover statute;

(14) creation of an Employee Stock Ownership Plan which, because of its size, percentage of total outstanding securities of the issuer which it may own, voting or other provisions, may be used in defense in a contested takeover attempt;

(15) provisions requiring the consideration for any merger following a tender offer to be no less than the highest total consideration offered pursuant to the tender offer;

(16) shareholder approval of long term "sweet-heart" employment contracts with executive officers of the issuer which cannot be abrogated or rescinded. Release, *supra* note 14, at 80,988-89.

²⁴ In the Release, the Division stated that the "facts and circumstances underlying particular proxy or information statements or other filings must be given great weight and that the importance and effect of these instructions will vary as the context requires." Release, *supra* note 14, at 80,984. Nevertheless, the Division's emphasis on effect rather than purpose seems to undercut the importance of the foregoing qualification. See text accompanying notes 31, 34-37 *infra*.

²⁵ For example, Delaware has provided for staggered boards since 1899. 21 Del. Laws Ch. 273 (1899). The concept was not invented by Delaware or by drafters of corporation laws. The United States Senate is a classic example of a staggered board.

rate end wholly removed from any antitakeover purpose or effect. Requiring disclosure of the possible antitakeover effect of such routine proposals, in addition to adding clutter to proxy statements, may hinder necessary corporate action by injecting irrelevant factors into the decision making process. For example, management may determine that an increase in the authorized number of an existing class of stock is advisable in anticipation of some corporate transaction wholly unrelated to any tender offer threat. However, because the increase in stock provides a potential weapon for use in deflecting a hypothetical tender offer, the antitakeover effect is to be disclosed.²⁶ Management must thus advise stockholders that adoption of the increase will arm management with an antitakeover device. Further, management must review and disclose every other charter or bylaw provision that may also have an antitakeover effect.²⁷ This concentrated antitakeover disclosure may serve only to make it difficult for management to convince stockholders of the bona fides of the proposal.

Other aspects of the Release reveal a similar shortsightedness. Where a conditional supermajority vote is proposed with respect to mergers or other business combinations, the Release indicates that the proxy materials should disclose that once adopted the proposal would empower management to veto a merger and retain its position even when a majority of stockholders support the transaction.²⁸ This misconstrues most such supermajority vote provisions, which operate only with respect to business combinations involving a controlling stockholder. Moreover, few, if any, such provisions purport to grant to management an absolute veto power over mergers. Rather, management's option is to endorse the transaction and thereby reduce the supermajority vote to the statutory vote needed to approve the proposed transaction in the first place.²⁹ Hence, the required disclosure seems a bit heavy-handed.

The Division's disclosure requirements pose additional problems for management proposals that are not clearly antitakeover measures.³⁰ Since the Division takes the position that many rather ordinary proposals requiring stockholder approval of corporate action have an antitakeover effect, every proposal requiring stockholder approval must be assessed to deter-

²⁶ See text accompanying note 38 *infra*.

²⁷ See text at pp. 708-09 *infra*.

²⁸ See text at p. 710 *infra*.

²⁹ See text accompanying notes 51-53 *infra*; DEL. CODE ANN. tit. 8, § 251(c) (1974). Where management does have an effective veto it arises not because of a charter provision but because most corporation laws expressly provide that the board of directors must propose mergers and similar corporate action in the first instance. Perhaps the Division's objection is to requiring a supermajority vote of directors to reduce the supermajority vote of stockholders, thus giving a minority of directors (obviously those not installed by the controlling stockholder) a veto power in the sense of permitting them to preserve the supermajority stockholder vote.

³⁰ See Rose & Collins, *Porcupine Proposals*, 12 REV. SEC. REG. 977 (1979). Not long ago few would have perceived the antitakeover effect of several of the provisions now viewed as defensive charter provisions. This could become a trap for unwary management in the event the antitakeover effect of a provision is not discovered until after its adoption.

mine its antitakeover effect independent of whether it is intended to function as a defensive provision. The Division has exacerbated the problem by speaking in some instances of "purpose" and in other instances of "effect."³¹ Intent is necessarily a subjective matter while effect is more objective, and issuers probably would not rely on lack of antitakeover purpose to justify a failure to disclose antitakeover effects. The net result will undoubtedly be to disclose routinely any potentially antitakeover effect of any proposal submitted to the stockholders.

A. Summary of Disclosure Requirements

The disclosure requirements set forth in the Release relate to the placement in the disclosure materials of antitakeover proposals, the general content of the materials, and specific proposals required to be disclosed. Antitakeover proposals must be prominently disclosed in a list of all proposals in the forepart of the materials. Further, all such antitakeover proposals must be presented as a group uninterrupted by unrelated proposals. This latter requirement may create some difficulty where the reason for a specific proposal is not defending against takeovers but the proposal nevertheless may have an antitakeover effect.

Like the Division's suggestions regarding placement of the antitakeover proposals in the disclosure materials the guidance it offers in the Release with respect to the content in seven areas of disclosure is deemed generally applicable to all antitakeover proposals. Both the "reasons" for a proposed antitakeover provision and the "bases" of such reasons are to be disclosed. The term "bases" is defined to mean "an explanation of the factors and/or principles supporting or serving as a foundation for the reasons stated." This appears to represent an attempted expansion of Item 20 of Schedule 14A,³² which presently requires only that the reasons for a charter or bylaw amendment be given along with a brief description of the effects of the proposed amendment.³³

³¹ *Id.* at 979.

³² 3 FED. SEC. L. REP. (CCH) ¶ 24,051 (1979).

³³ Item 20 of Schedule 14A provides as follows:

If action is to be taken with respect to any amendment of the issuer's charter, bylaws or other documents as to which information is not required above, state briefly the reasons for and general effect of such amendment.

Instruction. Where the matter to be acted upon is the classification of directors, state whether vacancies which occur during the year may be filled by the board of directors to serve only until the next annual meeting or may be so filled for the remainder of the full term.

3 FED. SEC. L. REP. (CCH) ¶ 24,051 (1979). Heretofore, it has generally been considered sufficient to disclose the effects of antitakeover provisions without attempting to explore the subjective reasons underlying their proposal. See *Selk v. St. Paul Ammonia Prods., Inc.*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,847 (8th Cir. April 27, 1979); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *Blanchette v. Providence & Worcester Co.*, 428 F. Supp. 347 (D. Del. 1977); *Elgin Nat'l Indus., Inc. v. Chemetron Corp.*, 299 F. Supp. 367 (D. Del. 1969); TENDER OFFERS, *supra* note 5, at 22.

The Division suggests that there be specific disclosure if a proposal is the result of management's knowledge of any effort to obtain control of the issuer. Conversely, if a proposed antitakeover provision is not the result of any specific takeover attempt, management is to so state and explain why the measure is then being proposed. Such disclosure is likely even without Division prompting, however, in light of Item 20 of Schedule 14A.

Whenever an antitakeover proposal is presented to stockholders, disclosure should be made as to whether the corporation's charter or bylaws contain other provisions having an antitakeover effect. Similarly, any plan by management to adopt a series of such amendments and its intention to propose similar measures in future proxy solicitations should be disclosed. This particular requirement may present some difficulty because it requires a corporation to review its charter and bylaws to determine whether any existing provisions have an antitakeover effect, even though the provision was not adopted in contemplation of thwarting takeover attempts. Thus, any corporation proposing an antitakeover provision (or one having such an effect), must now review in the proxy statement all charter and bylaw provisions that might be construed to have an antitakeover effect. In this respect, the Division suggests that it may be appropriate to use a chart or table to list the charter or bylaw provisions which may be used as defensive provisions in a takeover context. The chart "may" include disclosure concerning a class of authorized but unissued securities with respect to which the board of directors retains the power to determine voting rights, and should indicate whether or not cumulative voting is provided under the corporation's charter or bylaws or pursuant to state law. Further, management must make some inquiry into whether it intends to propose for adoption any antitakeover provisions in the future. Proposals that would have ancillary antitakeover effects would have to be disclosed along with purposeful antitakeover proposals. Management also would have to consider and disclose whether or not it would defend against a future takeover by exercising presently existing powers such as the power to amend the bylaws.

Closely related to the purpose disclosure is the requirement that issuers reveal the overall effect of any antitakeover proposal in the event of its adoption. The Division points particularly to disclosure of any proposals' impact on management's tenure,³⁴ and issuers are to indicate whether the overall effect of the proposal, if adopted, may or would be to render more difficult or to discourage a takeover, assumption of control or removal of incumbent management. If appropriate, a statement should be made to the effect that the proposal would make certain transactions, such as mergers, more difficult even if beneficial to shareholder interests. The Release

³⁴ No mention is made of disclosing the effect of the provisions on management's ability to negotiate more favorable terms for continued employment following a takeover. This typically is disclosed, however. See Proxy Statement, Management of Universal Leaf Tobacco Co. (Dec. 24, 1976) (for special meeting of stockholders on Jan. 21, 1977), reprinted in TENDER OFFERS, *supra* note 5, at 475.

thus emphasizes the need for disclosure of increased difficulty of removing management and of limitations on stockholder approval of transactions even where management favors the transaction.³⁵

The one area of disclosure emphasized by the Advisory Committee was informing stockholders of the disadvantages attending the adoption of antitakeover provisions.³⁶ Accordingly, the Division indicates that information should be included concerning the advantages and disadvantages of an antitakeover proposal, both to incumbent management and to stockholders generally.

Regardless of their relative advantages and disadvantages, the complexity of many antitakeover provisions,³⁷ may make them difficult for shareholders to understand. Consequently, the Division justifiably takes the position that issuers should explain the operation of an antitakeover proposal to assist stockholders in their understanding of what they are being asked to approve. Such explications are already common in proxy materials proposing defensive charter provisions.

Two of the Division's content disclosure requirements relate to procedural matters during the promulgation and adoption of a proposal. First, whether a proposal was or was not the subject of a vote of the issuer's board of directors must be disclosed. If the board voted on the proposal, the results of the vote must be set forth. Since most charter amendments must be approved by the board of directors in the first instance, the Division's vote disclosure requirement is most properly seen as a means to call specific attention to any dissenting votes. The Release specifically recommends that consideration be given to identifying any dissenting directors and stating the reasons given for their dissent if available. The second procedural disclosure must address certain limitations on adoption of the antitakeover proposal. The rules or practices of a stock exchange may provide for the refusal to list or the delisting of stock possessing unusually restrictive voting provisions. The Division's Release indicates that the issuer must disclose the extent to which its securities are subject to such stock exchange rules.³⁸

The final disclosure requirement of general applicability adheres if a proposed antitakeover measure pertains to a matter specifically addressed under state corporation law. Under those circumstances, disclosure materials should furnish a comparison of the corporation law provision with the

³⁵ Typically, however, where incumbent management favors the transaction, the antitakeover provision is inoperative. It is only when control is acquired by an offeror that a transaction favored by management may nonetheless be difficult to consummate. But that, of course, is the whole purpose of the antitakeover provision. Thus, the disclosure required here is not likely to be neglected by management since it is a selling point.

³⁶ See note 18 *supra*.

³⁷ See text accompanying notes 50-70 *infra*.

³⁸ In this context, it may also be appropriate to disclose that to date, notwithstanding the many antitakeover provisions adopted, it does not appear that any exchange has refused to list or to continue to list a company's stock because of such provisions. See TENDER OFFERS, *supra* note 5, at 19-21; Hochman & Folger, *supra* note 6, at 546.

proposed antitakeover measure.³⁹ This requirement obviously would apply in connection with antitakeover proposals such as removal of directors only for cause, elimination of action by written consent, and ability to call special meetings. Thus, the requisite comparison should accompany any takeover proposal that varies the provisions of state laws that apply when the charter or bylaws are silent.

In addition to the foregoing general matters, the Division calls for specific disclosures in connection with the proposal of three popular antitakeover provisions: supermajority vote, classified board, and increase in or authorization of so-called "blank" stock. The Division urges issuers, when proposing a supermajority voting provision, specifically to disclose whether management may thereby obtain a veto power over the subject transactions despite the desires of a majority of shareholders to approve the deals. If the proposal creates a veto power, management must disclose whether or not it is assisted thereby in retaining its present position. Similarly, if the supermajority voting provision would give a shareholder minority the power to veto a merger approved by management and/or a majority of the stockholders, that feature of the proposal would warrant disclosure. In connection with that disclosure, the company is to report information on the percentage of voting stock beneficially owned by management, the board of directors, and principal stockholders. Finally, disclosure is to be made with respect to whether a supermajority vote is needed to adopt or repeal the provision. If a supermajority is not required for these purposes, the issuer should disclose the reasons why not.⁴⁰

In the case of proposals adopting a classified board, the Release evidences the Division's concern with the continuing effect of staggered terms for directors. Thus, stockholders are to be informed that the staggered board is applicable to every election of directors. In addition, disclosure is required contrasting the number of annual meetings necessary to change the majority of directors under the classified system to the number of annual meetings necessary for change under the existing structure. If the staggered board is designed to limit the voting power of a particular block of common stock or to frustrate accumulations of such blocks, disclosure of those facts is called for. Anticipating the kind of boiler plate description that usually accompanies proposals for staggered director terms, the Division indicates that when one reason for the staggered board is to insure continuity of the board or management, there should be disclosure with respect to any problems regarding continuity in the past and a description of any such problems.

The final provision that the Release singles out for special mention as an antitakeover measure is the authorization of a class of stock as to which

³⁹ Specifically, the Release calls for a comparison between supermajority vote provisions and any minimum vote requirement of state law. Release, *supra* note 14, at 80,987.

⁴⁰ *Id.* The reason why supermajority approval is not required to adopt the provision usually will be simply that neither the company's certificate of incorporation nor its bylaws requires or permits a vote on the amendment in excess of the statutory minimum.

the directors may determine voting rights or which has voting rights with respect to extraordinary corporate transactions. If these shares could be privately placed, the issuer must disclose the fact, and its relationship to purchasers in any contemplated private placement. Similarly, disclosure is called for where there is a proposal to increase the amount of authorized stock of a class of voting securities if the increase may have an antitakeover effect.⁴¹

B. Relation to Tender Offer Rules

Because the Release bears on changes in corporate structure affecting the balance between tender offerors and subject companies, one might expect some correlation between the Release and existing⁴² or proposed tender offer rules.⁴³ Such is not the case. At most, the Release provides guidelines that opponents may find useful in challenging the adequacy of issuer disclosure in proxy statements. Given its expressed concern over maintaining the proper balance between bidders and subject companies,⁴⁴ the Division's failure to respond more strongly to what it evidently perceives as attempts to strengthen incumbent management's hand in the tender offer arena is surprising. Nonetheless, the Release indicates the Division's clear antipathy for antitakeover charter and bylaw provisions and may suggest a willingness, should such provisions continue to proliferate notwithstanding increased disclosure, to take affirmative action to curtail their implementation.⁴⁵ The SEC's position regarding its authority to implement its going private rules⁴⁶ suggests the outline of the argument that it has power to adopt substantive rules concerning antitakeover provisions. Like Section 13(e)⁴⁷ upon which the proposed going private rules are

⁴¹ *Id.* at 80,988. Almost by definition an increase in a class of voting securities will have an anti-takeover effect. Even where all the newly authorized stock is to be widely distributed (e.g., a stock dividend or a public issue to raise capital), its issuance will increase the amount of stock in the market and will have a deterrent effect on potential offerors, although it may be slight. Where the stock is authorized for future issuance, the increase may have an anti-takeover effect in all cases since it could be issued in privately negotiated transactions to persons friendly to management.

⁴² 17 C.F.R. § 240.14d-1 to .14f-1 (1978).

⁴³ SEC Exchange Act Release No. 15,548, (Feb. 5, 1979), *reprinted in* [Current] FED. SEC. L. REP. (CCH) ¶ 81,935. The new proposed rules replace earlier proposed rules. *See* SEC Exchange Act Release No. 12,676, 41 Fed. Reg. 33,004 (Aug. 6, 1976).

⁴⁴ SEC Exchange Act Release No. 15,548, *supra* note 43, at 81,209.

⁴⁵ The possibility that the SEC will undertake to actively restrict the implementation of antitakeover provisions finds expression in the reasons given by the Division of Corporation Finance for establishing a system for monitoring antitakeover proposals, including the collection of data that may serve as a basis for rulemaking action by the SEC or as a basis for congressional proposals or testimony. *See* note 21 *supra*.

⁴⁶ *See* SEC Exchange Act Release No. 14,185, (Nov. 17, 1977), *reprinted in* [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366. Rule 13e-3 regulating going-private transactions was adopted in revised form on August 2, 1979, effective September 2, 1979. 2 FED. SEC. L. REP. (CCH) ¶ 23,703A.

⁴⁷ Section 13(e)(1) provides:

predicated, Section 14(e)⁴⁸ speaks in terms of fraudulent acts and practices and grants the Commission the authority to define such acts and practices and to adopt rules designed to prevent them. At least one court has enjoined implementation of various antitakeover proposals on the ground that they would violate Section 14(e).⁴⁹ Such decisions could convince the SEC that it is authorized to regulate directly the substance and timing of antitakeover provisions.

Hopefully, the SEC will not go beyond the expanded disclosure requirements contained in the Release. Consideration and adoption of antitakeover provisions, as internal corporate matters, are properly the subject of state law. Where state law permits the stockholders should be allowed to insulate their company and, incidentally or by design, their management from unwanted takeovers. Significantly, the most popular and widely adopted proposals are aimed at protecting minority interests from post-acquisition abuses. The more sophisticated antitakeover proposals not

It shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 78l of this title, or which is a closed-end investment company registered under the Investment Company Act of 1940, to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices. Such rules and regulations may require such issuer to provide holders of equity securities of such class with such information relating to the reasons for such purchase, the source of funds, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and such additional information, as the Commission deems necessary or appropriate in the public interest or for the protection of investors, or which the Commission deems to be material to a determination whether such security should be sold.

15 U.S.C. § 78m(e)(1) (1976).

⁴⁸ Section 14(e) provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purpose of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e) (1976).

⁴⁹ See *Monogram Indus., Inc. v. Royal Indus., Inc.*, No. 76-3356-R (C.D. Cal. Nov. 17, 1976 and Dec. 13, 1976). In *Monogram*, the court preliminarily enjoined Royal from, among other things, holding a meeting of stockholders to vote on a proposed 90% vote requirement on business combinations with a person owning 30% or more of Royal's stock. Cf. *Hyer v. Gibson-Homans Co.*, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,537 (E.D.N.Y. April 22, 1976) (questioning staggered board proposal intended to inhibit 15% stockholder's cumulative voting power). But see *Lee Nat'l Corp. v. Deramus*, 313 F. Supp. 224 (D. Del. 1970) (refusing to enjoin special meeting called to consider defensive charter provisions). The Supreme Court decision in *Sante Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977), casts doubt on whether § 14(e) is an appropriate basis for enjoining antitakeover charter amendments where there is full disclosure of the antitakeover effect of the provisions.

only strengthen incumbent management but also are aimed at protecting minority interests once an offeror successfully gains control. This subsequent protection is closely analogous to the interests the SEC has pursued through its proposed rules on going private transactions. Thus, in expressing its distaste for antitakeover proposals, the Division exhibits an internal tension with its approach toward going private transactions. Consequently, even if the SEC believes that it has the power to adopt substantive rules regulating the adoption of defensive charter and bylaw provisions, it may not wish to do so.

II. THE PRESENT ARRAY OF ANTITAKEOVER PROVISIONS⁵⁰

The supermajority vote is the most popular antitakeover charter provision,⁵¹ and it appears in great variety. Some versions are no more than a simple greater than majority vote requirement for approval of various "business combinations." The requisite vote may range anywhere from 66 2/3% to as high as 95%, with the most common vote appearing to be 80%. For many reasons, however, the supermajority vote is rarely a simple high vote, unlimited in its application. Rather than unduly hampering incumbent management, use of a supermajority generally is conditioned on the existence or absence of certain circumstances. Typically, the board must not have approved the transaction, the third party must own more than a specified percentage of stock in the corporation, and the transaction must

⁵⁰ For more comprehensive discussions of defensive charter and bylaw provisions, including sample provisions, see Hochman & Folger, *supra* note 6, and Smith, *id.* For discussions of defensive tactics beyond charter and bylaw provisions, see TENDER OFFERS, *supra* note 5; TAKEOVERS & FREEZEOUTS, *id.* See also ARANOW & EINHORN, *supra* note 2, at 219-276; E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 193-206 (1977); Brudney, *A Note on Chilling Tender Solicitations*, 21 *RUTGERS L. REV.* 609 (1967); Cary, *Corporate Devices Used to Insulate Management From Attack*, 25 *BUS. LAW.* 839 (1970); Goolrick, *Purchases on the Market of Target Company Stock*, 26 *BUS. LAW.* 457 (1970); Hayes and Taussig, *Tactics of Cash Takeover Bids*, 45 *HARV. BUS. REV.* 135, 142-147 (1967); Jaqua, *Defenses Against Uninvited Tender and Exchange Offers*, 59 *ILL. B.J.* 106 (1970); Kennedy, *Defensive Take-over Procedures Since the Williams Act*, 19 *CATH. U. L. REV.* 158 (1969); Mullaney, *Guarding Against Takeovers—Defensive Charter Provisions*, 25 *BUS. LAW.* 1441 (1970); O'Boyle, *Changing Tactics in Tender Offers*, 25 *BUS. LAW.* 863 (1970); Schmults & Kelly, *Cash Take-Over Bids—Defense Tactics*, 23 *BUS. LAW.* 115 (1967); Yoran, *Advance Defensive Tactics Against Takeover Bids*, 21 *AM. J. COMP. L.* 531 (1973); Panel, *Defending Target Companies*, 32 *BUS. LAW.* 1349-64 (1977); Panel, *Tender Offer Litigation*, 32 *BUS. LAW.* 1433-54 (1977); Note, *Defensive Tactics Employed By Incumbent Managements in Contesting Tender Offers*, 21 *STAN. L. REV.* 1104 (1969); Comment, *Corporation Defenses to Takeover Bids*, 44 *TUL. L. REV.* 517 (1970).

⁵¹ According to information obtained from the New York Stock Exchange, between 1972 and November, 1978, 199 NYSE listed companies adopted supermajority voting provisions of one kind or another. Some 153 companies adopted staggered board provisions, 32 adopted removal for cause only provisions, 20 eliminated stockholder action by written consent, 12 eliminated cumulative voting, 10 adopted cumulative voting, 6 eliminated or made more difficult the stockholders' right to call a special meeting, 1 adopted a social/economic effects provision, and 1 provided for an independent expert to pass on the fairness to minority stockholders of certain business combinations.

involve an entity that is not a controlled subsidiary of the company adopting the proposal.⁵²

Prior director approval, either by the normal majority vote of the directors or some higher percentage, such as a two-thirds vote, ordinarily serves to increase the leverage of the board in negotiating with prospective offerors, both in the first instance and as to the terms of the second step business combination which the offer contemplates. Thus, where the board approves the transaction, the supermajority vote is made inapplicable, thereby greatly facilitating stockholder approval. The second limitation on supermajority voting, the degree of ownership of stock in the corporation by the other party to the transaction, serves the purpose of facilitating legitimate arm's-length transaction. The protection afforded by the supermajority vote is necessary only in connection with a business combination with a stockholder having a significant or controlling interest. Therefore, its application typically is limited to transactions with a party who, prior to the transaction, holds directly or indirectly more than 5% or 10% of the outstanding stock of the corporation. Finally, for obvious reasons, an exception is usually carved out for transactions involving a party that is controlled by the corporation itself.⁵³

To avoid circumvention by unorthodox transactions, supermajority vote provisions generally go beyond those transactions for which stockholders' approval is statutorily required.⁵⁴ Thus, charter provisions typically define the "business combinations" to which supermajority vote provisions apply to include not only mergers and consolidations, sales, leases, exchanges or other dispositions of assets, but also other less common activities. "Business combinations" may include the corporation's purchase of all or substantially all of the assets of any other corporation other than in the ordinary course of business and the issuance, reclassification or purchase of shares of stock of the corporation generally possessing voting rights in elections for directors, or securities convertible into such shares.

⁵² For examples of conditional supermajority vote provisions, see 2 TAKEOVERS & FREEZEOUTS, *supra* note 5, at L-1. A recent innovation is to require in addition to the high vote the approval of a majority of the minority. See Proxy Statement, Management of PSA, Inc. (Oct. 23, 1978) (for special meeting of stockholders on Nov. 20, 1978). However, this type of provision may violate the rule against discriminating among holders of the same class of stock. See TENDER OFFERS, *supra* note 5, at 15 n.49.

⁵³ Caution is needed in providing this loophole. Even where the business combination is with a controlled subsidiary, it may be structured to freeze out minority stockholders. See *Young v. Valhi, Inc.*, 382 A.2d 1372 (Del. Ch. 1978). To avoid that possibility, it may be provided that a greater than majority vote is required unless the minority stockholders retain their proportionate voting and equity interests in the surviving entity. See Hochman & Folger, *supra* note 6, at 550.

⁵⁴ Under Delaware law, mergers and consolidations, the sale, lease, exchange, or other disposition of all or substantially all of the assets of the corporation, and a reclassification of shares all require prior shareholder approval. DEL. CODE ANN. tit. 8, §§ 242(c)(1), (2), 251(c),(p), 271 (1974). By contrast, no stockholder vote is required for the acquisition by a corporation of another entity, for the purchase by a corporation of its own stock, or for the issuance of stock generally possessing voting rights in elections for directors.

Many variations and refinements have emerged from the basic supermajority framework. A common provision withdraws the supermajority vote on an acquisition or sale of property or securities having some specified value, and gives the board of directors the authority to make a binding determination of value. Another requires approval of any business combination by either the unanimous vote of directors, or the unanimous vote of what are frequently termed "continuing directors."⁵⁵ Continuing directors are those who were elected prior to the acquisition of a certain percentage of shares (generally 10%) by the other party to the transaction. The term also may include nominees of such directors to assure continued control over a second step merger or consolidation even when a successful offeror dominates the board.

The classified board follows the supermajority vote in popularity as an antitakeover provision.⁵⁶ By spreading the election of the full board over a period of three years, the classified board forces the successful offeror to wait, in theory at least, two years before assuming working control of the board of directors.⁵⁷ However, the continued effectiveness of the classified board as a deterrent depends on the presence of a number of ancillary charter provisions. Many corporations have inserted a provision that first prohibits removal except for cause and then defines cause in narrow terms. The most stringent provisions typically define cause as a felony conviction which is no longer subject to appeal or an adjudication that the director to be removed is liable for negligence or misconduct in the performance of

⁵⁵ Ordinarily, only a majority vote of directors is required for the board to take action. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(b) (1974); N.Y. BUS. CORP. LAW § 708(d) (McKinney Supp. 1971); MODEL BUS. CORP. ACT § 40. However, either the certificate of incorporation or the bylaws usually may require the voting of a greater number. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 102(b)(4), 141(b) (1974); N.Y. BUS. CORP. LAW § 709 (McKinney Supp. 1978); MODEL BUS. CORP. ACT § 40 (1976).

⁵⁶ *See* note 47 *supra*. Delaware is one of many states that permit classified boards of directors. The board of directors of a Delaware corporation may be classified into as many as three classes, with each class standing for election only once every three years. *See* DEL. CODE ANN. tit. 8, § 141(d) (1974). *See also* N.Y. BUS. CORP. LAW § 704 (McKinney 1963); MODEL BUS. CORP. ACT § 37 (1976). The classified board grew out of an attempt to dilute the effect of cumulative voting. *See* C. WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 48 (1951). Although elimination of cumulative voting has been cited as a defensive charter provision, *see, e.g.*, E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 193 (1977), many corporations retain cumulative voting while adopting other defensive provisions. The reason may be that cumulative voting potentially provides continued board representation for minority stockholders where the acquiring entity obtains little more than a bare majority. Cumulative voting also creates restrictions on removal. *See* DEL. CODE ANN. tit. 8, § 141(k) (1974); N.Y. BUS. CORP. LAW § 706 (McKinney 1963); MODEL BUS. CORP. ACT § 39 (1976).

⁵⁷ As a practical matter, the wait may be shorter. Following a successful tender offer, incumbent directors may not desire to continue as directors and face the problems of conflicting fiduciary duties that may be represented by a proposed business combination or the almost inevitable derivative or class action suits that follow. Consequently, such directors may resign shortly after the acquisition of control by the offeror, thus opening the way for the offeror to install its nominees.

his duty to the corporation which is no longer appealable. Removal may also be made subject to a supermajority vote of stockholders. The nonremoval provision could be made slightly stronger by requiring an adjudication of gross negligence as opposed to mere negligence in conduct. However, no corporation as yet appears to have gone this far.

Corporation laws generally do not define cause. Case law suggests that acts such as disclosure of trade secrets to a competitor, embezzlement of corporate funds, or a plan of harrassment to the detriment of the corporation constitute cause sufficient to entitle stockholders to remove a director.⁵⁸ Whether stockholders by appropriate charter or bylaw provision may deprive themselves of the right to remove a director for cause remains an open issue.⁵⁹ Indeed, a stringent nonremoval provision that required a felony conviction or an adjudication of negligence or misconduct before stockholders could remove a director may be contrary to public policy.⁶⁰

Control sometimes can be obtained by forcing an increase in the number of directors and electing sympathetic individuals to the new posts. Companies often preclude the use of this technique by inserting in the charter an upper limit on the number of directors, usually fixing it at or slightly above the number then in office.⁶¹ Frequently the numerical limit is coupled with a charter provision authorizing the designation of alternative directors to succeed to any vacancy on the board. The existence of substitute directors discourages the successful offeror from engineering vacancies and voting in its own nominees.⁶²

Two other defensive charter provisions complete the list of common antitakeover measures. First is one that eliminates the stockholders' power

⁵⁸ See, e.g., *Campbell v. Loew's, Inc.*, 37 Del. Ch. 17, 134 A.2d 852 (1957).

⁵⁹ *Id.* at 24, 134 A.2d at 858. See also E. FOLK, *THE DELAWARE GENERAL CORPORATION LAW* 58-59 (1972).

⁶⁰ It seems questionable whether a court would sustain a provision that precluded removal except under circumstances that may be difficult or impossible to establish. For instance, what would be done with a director who, although clearly guilty, is never prosecuted or is granted immunity in return for his testimony? In any event, management may be willing to risk the possibility of a court nullifying a provision predicating removal on an adjudication of director wrongdoing in light of such a provision's strong deterrent effect against unwanted takeovers.

⁶¹ Section 141 of the Delaware General Corporation Law permits the certificate of incorporation to fix the number of directors. DEL. CODE ANN. tit. 8, § 141(b) (1974). New York and the Model Business Corporation Act have similar provisions. N.Y. BUS. CORP. LAW § 702 (McKinney Supp. 1977); MODEL BUS. CORP. ACT § 36 (1976).

⁶² Absent a provision to the contrary in the certificate of incorporation or bylaws, the board of directors of a Delaware corporation is authorized to fill any vacancy or any newly created directorship. DEL. CODE ANN. tit. 8, § 223(a) (1974). See also N.Y. BUS. CORP. LAW § 705 (McKinney Supp. 1977); MODEL BUS. CORP. ACT § 38 (1976). Although such charter provisions could logically extend to the designation of individuals to fill newly-created directorships, they generally do not do so for the obvious reason that the existing directors do not want to be obligated to install one of the designated alternative directors should they themselves decide to create a new directorship. The validity of provisions authorizing designated alternative directors is questionable. See *Chapin v. Benwood Found., Inc.*, 402 A.2d 1205 (Del. Ch. 1979).

to call a special meeting,⁶³ and vesting that authority exclusively in the board of directors, thereby forcing the successful offeror to wait until the next annual meeting before installing directors or causing other corporate action to be taken. Second, is a provision precluding action by stockholders except at an annual or special meeting. This precludes the offeror from acting on written consent without a meeting⁶⁴ to circumvent the effect of the elimination of the power to call a special meeting.

Finally, the substantive antitakeover charter provisions always are protected against alteration by a successful offeror by a requirement that they not be altered, amended or repealed without the consent of a greater than majority vote of stockholders. Absent such a provision, the certificate of incorporation may generally be amended by the lowest vote sanctioned by statute,⁶⁵ and its antitakeover protections repealed.

All of the foregoing antitakeover measures may be deemed "traditional" in the sense that they have a "found" defensive effect, but were not invented in response to the takeover phenomenon experienced in recent years. More refined antitakeover provisions have emerged, designed specifically to make prospective bidders look elsewhere. Although the deterrent effect of these modern provisions lends to them a management entrenching aspect, their principal thrust is to make any subsequent business combination between the bidder and the subject company so difficult or expensive that a takeover is unattractive from the outset. These novel defensive measures also protect the interests of minority shareholders remaining after a bidder successfully acquires control.

The so-called "fair price" provision is the most frequently used of these newer defensive charter measures.⁶⁶ The mechanism is keyed to a superma-

⁶³ The Delaware General Corporation Law provides the authority for limiting the power to call a special meeting of stockholders to the board of directors, as do the Model Business Corporation Act and the New York Business Corporation Law. Compare DEL. CODE ANN. tit. 8, § 211(d) (1974) with MODEL BUS. CORP. ACT § 28 (1976) and N.Y. BUS. CORP. LAW § 602(c) (McKinney Supp. 1977).

⁶⁴ Subsection (a) of § 228 of the Delaware General Corporation Law permits a provision in the certificate of incorporation eliminating the right to take action by written consent without a meeting. DEL. CODE ANN. tit. 8, § 228(a) (1974). Neither the Model Business Corporation Act nor the New York Business Corporation Law permits elimination of the right to take action by written consent. MODEL BUS. CORP. ACT § 145 (1976); N.Y. BUS. CORP. LAW § 615 (McKinney 1963).

⁶⁵ For example, § 242 of the Delaware General Corporation Law requires only a majority vote of the stockholders to amend the certificate of incorporation to delete almost all types of defensive provisions. DEL. CODE ANN. tit. 8, § 242(c) (1974). Nevertheless, subsection (c)(4) of § 242 does provide that where a provision of the certificate of incorporation requires a greater than majority vote, that provision may not be altered, amended or repealed except by such greater vote. Subsection (c)(4), however, affords no protection to defensive charter provisions that do not involve voting matters.

⁶⁶ The term "fair price" is somewhat of a misnomer. The provisions establish a fair price only in the sense that minority stockholders may not be forced out at a price lower than that offered in the tender offer leading to control. The tests for fair price may bear little relation to the intrinsic value of a share of stock. For an example of a fair price provision, see Hochman & Folger, *supra* note 6, at Appendix F, p. 570. The fair price provision is typically in addition

jority vote for business combinations, making supermajority approval unnecessary if shareholders will receive a specified consideration in the business combination. The specified consideration often is stated in relation to the market price for the shares just prior to the business combination. Supermajority approval thus is unnecessary when the ratio between offer price and last market price before the offer equals or exceeds the ratio between the offeror's highest priced presently held shares and the market price just prior to the tender offer.

If the post-tender offer market price for the corporation's stock drops below the pre-tender offer price, then the foregoing percentage relationship test provides no protection. In anticipation of that possibility, a second fair price test sometimes is imposed. Under this second test, the consideration to be received in the business combination must be at least equal to the highest price per share, including applicable commissions and fees, paid by the offeror in acquiring any of its holdings of the corporation's stock. This simplistic approach insures that the reluctant minority stockholders will receive at least the amount paid to stockholders who tendered in response to the original tender offer.

Both the percentage relationship and the highest price per share tests are artificial, somewhat arbitrary, and probably bear little relation to true value. Significantly, neither test appreciably accounts for the value of continued participation in the enterprise or affords any measure of the value or benefit to the offeror of the business combination. In an apparent attempt to take such factors into account, the fair price charter provisions typically include a price/earnings ratio test for fair price. The test's first step is to multiply the company's earnings per share for the four fiscal quarters immediately preceding the tender offer by the current price/earnings multiple as customarily computed in the financial community. The consideration to be received by the stockholders must exceed this figure in order for it to be considered a fair price.

Some fair price provisions go one step further in their attempts to protect stockholders by requiring the offeror to add a certain amount to the price/earnings ratio's "fair price." The requisite "premium" per share is tied to a percentage of the corporation's highest consolidated balance of domestic and foreign cash, cash equivalents and marketable securities during the period between the offeror's first acquisition of the corporation's shares and the fifteenth or twentieth day prior to the date on which a proxy statement is mailed to stockholders. The premium provision thus forces a partial liquidation of the corporation's assets and assures that the minority stockholders will have some share of the corporation's assets.

The second protective provision recently emerging is the "right of re-

to and not in substitution for whatever defensive charter provisions currently exist. Frequently, it must be integrated with existing charter provisions relating to the rights of preferred stockholders. This may create some problems with the vote required to adopt the provision. See Hochman & Folger, *supra* note 6, at 555.

demption."⁶⁷ This type of provision becomes operative if any person or entity who is the beneficial owner of more than 5% or 10% of the company's stock either acquires additional shares in a tender offer or becomes the beneficial owner of more than 50% of the stock and any such shares were acquired in a tender offer. If those circumstances arise, the other stockholders and holders of rights, options, warrants, and securities then exercisable or convertible into common stock, are entitled for a limited period to demand payment by the corporation of a specified price for any or all of their shares.⁶⁸ The provision may exempt shares acquired in a tender offer expressly recommended by the board of directors for acceptance by the stockholders. The company thereby retains the option of negotiating a friendly tender offer or arranging for a competing offer that management can endorse. Such negotiations likely will be fruitful for the company since the power it has to endorse an offer and remove the prospect of giving all minority stockholders a put will add a significantly powerful dimension to its bargaining position.

Another recent development in the protection of minority stockholders in a tender offer, is what might be called "social and economic concerns" charter provisions.⁶⁹ These require the board of directors to specifically consider the social and economic effects on the community or communities in which the corporation operates when it evaluates the advisability of any business combination or its response to any takeover attempt. By requiring the board of directors to consider such factors, presumably the directors are given more subjective latitude in responding to takeover attempts. Thus, even in the face of a tender offer's undeniable direct benefits to stockholders, the directors may be able to predicate opposition on perceived adverse social or economic consequences without breaching fiduciary duties.

Provisions requiring the appointment of independent experts to assess the fairness of a business combination before the company consummates

⁶⁷ For a sample right of redemption provision, see 2 TAKEOVERS & FREEZEOUTS, *supra* note 5, at L-2. The right of redemption may have its antecedents in the Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 209(2)(b) which provides that where an acquiring company obtains 90% of the shares of the target, notice must be given to minority stockholders, who may within three months thereafter compel the corporation to purchase their shares at the tender offer price, an agreed price, or on such terms as a court may order.

⁶⁸ For a discussion of some problems respecting the validity and operation of the right of redemption provision, see Smith, *supra* note 6, at 25-27.

⁶⁹ Control Data proposed a "social and economic concerns" provision which illustrates the focus of such provisions generally. The provision read:

The Board of Directors of the Corporation, when evaluating [certain takeover and related transactions], shall . . . give due consideration to all relevant factors, including without limitation the social and economic effects on the employees, customers, suppliers and other constituents of the Corporation and its subsidiaries and on the communities in which the Corporation and its subsidiaries operate or are located.

Proxy Statement, Management of Control Data Corp. (March 20, 1978) (for annual meeting of stockholders on May 3, 1978).

the transaction benefit minority stockholders more directly. Here, the deterrent effect obviously arises from the loss of control over the consideration paid in the course of cashing out minority stockholders. Moreover, such provisions may not define fairness, leaving it to the independent experts to determine what is fair.

In addition to the defensive charter provisions, more attention is now being paid to the bylaws as an effective line of defense. Defensive bylaw provisions might establish qualifications for directors, require nomination prior to meetings to preclude surprise nominations, mandate notice of intention to use cumulative voting, and impose high vote provisions for amendments in order to protect against bylaw changes by a majority stockholder that would impede incumbent management.⁷⁰

III. CHALLENGES TO VALIDITY

Although commentators have questioned the effectiveness of antitakeover provisions,⁷¹ attempts to prevent their adoption or to have them declared invalid at least evidence their nuisance value.⁷² These challenges typically are mounted by active bidders where the provisions are proposed or adopted in response to their bid for control.⁷³ Bidders may successfully seek to enjoin their adoption as violative of federal tender offer regulations, although it may be questionable whether such injunctions are warranted.⁷⁴ Quite apart from the federal law questions, there are issues under state law that deserve consideration. Chief among these are the intrinsic validity of such provisions and the fiduciary duty of management in proposing them for adoption.

A. Per se Validity

The courts have not addressed the intrinsic validity of antitakeover charter provisions to any appreciable extent. Attacks on the validity of such provisions under state corporation statutes have, however, generally taken two approaches. While some arguments are based on the provisions' alleged failure to comply with the corporation statutes, others are predicated on public policy considerations.

Arguments that the provisions fail to comport with statutory provisions

⁷⁰ See generally Hochman & Folger, *supra* note 6; TENDER OFFERS, *supra* note 5.

⁷¹ See note 10 *supra*.

⁷² See, e.g., the complaints in Valhi, Inc. v. PSA, Inc., No. 78-0913 GT (S.D. Cal. Oct. 30, 1978); Monogram Indus., Inc. v. Royal Indus. Inc., No. 76-3356-R (C.D. Cal. Nov. 17, 1976 and Dec. 13, 1976); Valhi, Inc. v. PSA, Inc., No. 5730 (Del. Ch. Oct. 30, 1978); UV Industries, Inc. v. Globe-Union, Inc., No. 5563 (Del. Ch. Mar. 31, 1978), reprinted in TENDER OFFERS, *supra* note 5, Exhibit 40 at 583.

⁷³ Of course, stockholders who anticipate a premium price in a tender offer also might object to the adoption of defensive provisions. See complaints in Abella v. Jennings, No. 77-56 (S.D.N.Y. Nov. 21, 1977), reprinted in TENDER OFFERS, *supra* note 5, Exhibit 19 at 455; Seibert v. Gulton Indus., Inc., No. 5631 (Del. Ch. June 20, 1978).

⁷⁴ See note 46 *supra*.

are likely to be fruitless for two reasons. Some charter provisions, such as the staggered board and greater than majority vote, are expressly authorized by statute.⁷⁵ Other provisions with antitakeover effect nevertheless are not designed to have that effect, and have been used successfully in the past for other purposes without violating corporation laws. However, more sophisticated variations, such as conditional supermajority voting, fair price and right of redemption provisions, may be more vulnerable.

The principal attack on conditional supermajority vote provisions is that the conditional aspect unlawfully delegates to the board of directors the authority to establish the vote necessary to approve the transaction, as opposed to setting forth the required vote in the charter itself.⁷⁶ A second ground advanced for invalidity is that under some governing statutes the stockholder vote may not be made dependent on extrinsic facts. The conditions requiring a supermajority vote, such as an amount of the company's stock owned by the other party to the transaction, the value of the consideration to stockholders in the proposed transaction or the number of directors voting in favor of the proposed transaction, might constitute facts made inapposite by the statutes.⁷⁷ Here, the focus shifts from the discretionary aspect of director approval to facts that may be beyond their control. Underlying both lines of attack is whether the statute authorizing the high vote permits a corporation to establish a different vote requirement for the same basic transaction. Both positions may be argued from the statutes.⁷⁸

⁷⁵ Of the popular defensive charter provisions, the staggered board, a simple supermajority vote on business combinations and charter and bylaw amendments, a limitation on the number of directors, elimination of the right to call a special meeting or to act by written consent, and the creation of blank stock are typically the subject of express statutory authority. See Hochman & Folger, *supra* note 6. It is difficult to imagine a court setting such provisions aside or enjoining their adoption in the absence of material nondisclosure as to their purpose and effect.

⁷⁶ See, e.g., the complaint in *UV Indus. v. Globe-Union, Inc.*, No. 5563 (Del. Ch. Mar. 31, 1978).

⁷⁷ See, e.g., the complaint in *Valhi, Inc. v. PSA, Inc.*, No. 5730 (Del. Ch. Oct. 30, 1978).

⁷⁸ For example, § 102(b)(4) of the Delaware General Corporation Law provides:

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

.....
 (4) Provisions requiring for any corporate action, the vote of a larger portion of the stock or of any class or series thereof, or of any other securities having voting power, or a larger number of the directors, than is required by this chapter

.....
 DEL. CODE ANN., tit. 8, § 102(b)(4) (1974). "Any corporate action" may refer generally to those classes of transactions as to which a vote is specified by statute, the authority for a higher vote contemplating a high vote for all transactions within the class. Alternatively, the statute may indicate that the classes may be subdivided, as the conditional voting provisions attempt to do. The latter position is suggested by § 242 of the Delaware General Corporation Law, which itself differentiates among charter amendments, providing a class vote for classes or series of a class of stock under certain conditions, but not in every instance. See DEL. CODE ANN., tit. 8, § 242 (1974).

Recently, the Delaware Court of Chancery, in *Seibert v. Gulton Industries, Inc.*,⁷⁹ upheld a conditional supermajority vote provision of the type commonly adopted today as an antitakeover measure.⁸⁰ The plaintiff in *Gulton Industries* sought to have declared null and void a charter provision adopted by a 54% vote of Gulton's stockholders that required an 80% vote of stockholders to approve a business combination with a 5% or greater stockholder. An exception obviated the need for 80% approval where the business combination was approved by Gulton's directors prior to the stockholder's acquisition of its 5% interest. In those circumstances, only a majority vote of stockholders was required to approve the transaction. The challenge to validity was premised on the theory that Section 102(b)(4) of the Delaware General Corporation Law does not permit a charter provision authorizing a shifting vote requirement dependent on both the percentage of stock ownership of the other party to the business combination and the determination of the board of directors. Noting both the express authority in Section 102(b)(4) and the provision in Section 102(b)(1) that the certificate of incorporation may contain provisions defining, limiting and regulating the powers of the directors and stockholders "if such provisions are not contrary to the laws of this State," and finding no convincing public policy against such a conditional supermajority vote provision, the Court of Chancery dismissed the action for failure to set forth a claim upon which relief may be granted.

Not all types of antitakeover provisions may fare so well, however. In *Chapin v. Benwood Foundation, Inc.*,⁸¹ the Delaware Court of Chancery cast considerable doubt on the use of designated alternative directors as an antitakeover device. That case involved issues of whether the board of trustees of a Delaware non-profit charitable corporation might bind itself by the written agreement of its individual trustees to limit the composition of the board to a number of trustees less than that authorized by the certificate of incorporation and to bind itself in advance to fill vacancies on the board of trustees as such vacancies occurred with designated persons. The Court of Chancery answered both questions in the negative. Of particular interest is the Court's emphasis on the duties owed by the trustees in connection with filling vacancies. The court reasoned as follows:

⁷⁹ No. 5631 (Del. Ch. June 21, 1979).

⁸⁰ There were some early indications that the conditional supermajority vote provision was valid. See *Tankersley v. Albright*, 374 F. Supp. 538, 542 (N.D. Ill. 1974), *aff'd in part, rev'd in part*, 514 F.2d 956, 963 (7th Cir. 1975). In dictum, both the district court and the court of appeals in *Tankersley* indicated that under Delaware law a charter provision requiring an 80% vote of stockholders to approve certain business combinations with any person holding 10% or more of the stock of the corporation was *prima facie* valid. More recently, the Delaware Chancery Court gave tacit approval to a similar conditional supermajority vote. See *Young v. Valhi, Inc.*, 382 A.2d 1372 (Del. Ch. 1978). Moreover, there is no practical reason to distinguish a supermajority vote conditional upon the status of the other party to the transaction from a supermajority vote conditioned upon the vote by which the directors of the corporation approve the transaction. See also Mullaney, *Guarding Against Takeovers—Defensive Charter Provisions*, 25 Bus. Law 1441 (1970).

⁸¹ 402 A.2d 1205 (Del. Ch. 1979).

All things considered, I am convinced that the facts of this situation impose upon the trustees of Benwood a duty to use their best judgment in filling a vacancy on the board of trustees as of the time the need arises. To commit themselves in advance—perhaps years in advance—to fill a particular board vacancy with a certain named person, regardless of the circumstances that may exist at the time that the vacancy occurs, is not the type of agreement that this court should enforce, particularly when it is an agreement made between persons who have no personal interest at stake but who owe a duty to those intended to be benefited by the charitable corporation they are charged with managing.⁸²

Although *Chapin* involved a non-profit charitable organization and is likely to be distinguishable on its facts from most cases that might arise respecting stock corporations, the reasoning of the court appears equally applicable to directors of a stock corporation with respect to their fiduciary duty in filling vacancies on the board of directors. Thus, the use of “standby directors” as an antitakeover measure where such standby directors are designated by the board of directors itself is of questionable validity. However, where standby directors are elected by the stockholders as an exercise of their right to fill vacancies, the reasoning of the court in *Chapin* is of significantly less application.

The defensive charter provisions, including those designed specifically to fend off takeovers, at times stretch the limits of what state corporation laws will permit with regard to the internal structuring of a corporation’s affairs. Nevertheless, the challenges to intrinsic validity predicated on technical arguments lack persuasive force. The arguments challenging validity on the basis of lack of proper corporate purpose and on public policy grounds, while interesting, are no more persuasive. Their proponents contend that the antitakeover provisions, taken as a whole, are unlawful and unreasonable because they transcend any reasonable or proper corporate purpose. Moreover, they believe the provisions violate the public policy implicit in the typical enabling corporation law that the rights of the majority are not to be subjected to the will of any unreasonably small minority.

The corporate purpose for which the typical array of antitakeover provisions is adopted is to protect the stockholders from the adverse consequences perceived to flow from the acquisition of control by a single stockholder.⁸³ A collateral effect, if not purpose, is to protect incumbent management. Even in the most extreme case, when management proposes to the stockholders that they adopt antitakeover provisions in order to protect

⁸² *Id.* at 1211.

⁸³ See, e.g., Proxy Statement, Management of PSA, Inc. (Oct. 23, 1978) (for special meeting of stockholders on November 20, 1978); Proxy Statement, Management of Globe-Union, Inc. (May 10, 1977) (for special meeting of stockholders on June 14, 1977); Proxy Statement, Management of Universal Leaf Tobacco Co. (Dec. 24, 1976) (for special meeting of stockholders on Jan. 21, 1977).

incumbent management, it is questionable whether a lack of corporate purpose argument really exists. It is at times difficult to distinguish a corporate purpose from a purpose serving the stockholders. Clearly, stockholders may vote their stock to serve their own purposes notwithstanding the fact that the action may not be tied to any particular benefit to the corporation itself.⁸⁴ Accordingly, where a majority of stockholders determine to vote their shares to protect their own interests as stockholders from the perceived detrimental effects of a takeover, the stockholders have a legitimate right to do so. Under those circumstances, it should not be necessary to demonstrate that the corporation itself will receive a benefit.⁸⁵

The other public policy argument advanced, that the will of the majority may not be subjected to the will of the minority, is no more persuasive. In order for the theory to be valid, one must accept the view that the state statute's legislative history, insofar as it may reveal a liberalizing trend towards control by a simple majority, establishes a public policy against greater than majority vote provisions and similar defensive techniques that may place a veto power in the hands of a minority. However, where the statutory scheme also clearly authorizes a corporation to impose a greater than majority vote, it is difficult to argue convincingly that a veto power in the hands of a minority of stockholders violates the public policy underlying the statutory scheme.⁸⁶

B. Fiduciary Duty of Management

Although most defensive charter provisions do not appear to be invalid per se, questions have been raised regarding management's fiduciary duty to respond generally to takeover attempts.⁸⁷ The act of proposing anti-

⁸⁴ *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121, 1124 (Del. 1977); *Ringling Bros.—Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441, 447 (Del. Ch. 1947).

⁸⁵ The shareholders' right to protect their interests without necessarily creating a corporate benefit comports with the law generally respecting mergers, sales of all assets, and dissolution. So long as a single controlling stockholder does not force the transactions on an unwilling minority, there is no requirement that the fundamental change serve some corporate purpose apart from the interests of the majority of stockholders voting in favor of the corporate action. See *Tanzer v. Internatinal Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977); 5 W. FLETCHER, *CYCLOPEDIA OF CORPORATIONS* § 2031 (perm. rev. ed. 1976).

⁸⁶ There is an interesting argument on public policy grounds that the maximum vote permissible is limited to the percentage provided for in the short form merger statute, if any, of the jurisdiction. For example, in Delaware, a 90% owner may effect a merger without the consent of the minority stockholders, subject of course to the fiduciary duty not to take such action solely to exclude the minority. See *Najjar v. Roland Int'l Corp.*, 387 A.2d 709 (Del. Ch. 1978), *aff'd*, ___ A.2d ___ (Del. 1979); *Kemp v. Angel*, 381 A.2d 241 (Del. Ch. 1977); DEL. CODE ANN. tit. 8, § 253 (1974). To the extent that the short form merger statute expresses a policy to permit a 90% stockholder to exercise absolute control, it may be argued that a 95% vote, which would place a veto power in the hands of barely more than 5% of the stockholders, violates the public policy expressed in the short form merger statute. See *TENDER OFFERS*, *supra* note 5, at 15-16 n.49.

⁸⁷ *TENDER OFFERS*, *supra* note 5, at 19; *Steinbrink*, *supra* note 5, at 882. See *Weiss*, *supra* note 5.

takeover provisions for adoption, however, has received surprisingly little careful analysis. Instead, the propriety of recommending such proposals has been lost in the general discussion of management's duty not to act solely to perpetuate itself in office.⁸⁸

In analyzing the fiduciary duty of management in connection with defensive charter provisions, two situations should be distinguished. The first is where management takes action by virtue of existing authority; the second is where management puts the issue of antitakeover provisions to stockholders for their approval. In the former, the directors have the burden of demonstrating that they acted after making a bona fide judgment that there was a legitimate threat of harm to the corporation in the event of a takeover.⁸⁹ This requirement reflects the policy that management may not use its power solely to preserve itself in office.⁹⁰ Although it may well be unjust to attribute automatically an improper motive to all such actions,⁹¹ on balance this remains a salutary approach.

However, when management seeks stockholder approval for antitakeover provisions, the situation is significantly altered. Admittedly, there may be good reason to suspect management's motives whenever it proposes to stockholders that they adopt antitakeover charter provisions, particularly when done in the context of an announced takeover attempt. However, the determination of whether proposing such defensive charter provisions constitutes a breach of fiduciary duty arguably should rest on whether management has made full and candid disclosure to the stockholders with respect to the proposals and their effects.⁹² Once disclosure is effected, the decision to adopt or reject the proposal rests with the stockholders and they should be permitted to attempt by such means to protect the corporation from a takeover.⁹³ Indeed, putting the matter to the stockholders may be the safest course for management to follow in order to fulfill

⁸⁸ See, e.g., Weiss, *supra* note 5, at 447-450.

⁸⁹ See Kaplan v. Goldsamt, 380 A.2d 556 (1977); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 549 (1964); Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960).

⁹⁰ See generally Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971); Petty v. Penntech Papers, Inc., 347 A.2d 140 (Del. Ch. 1975); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967); Canada Southern Oils, Ltd. v. Manabi Exploration Co., Inc., 33 Del. Ch. 537, 96 A.2d 810 (1953); see also Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962).

⁹¹ Authorities have noted the anomalous situation in which management may be trusted to negotiate a merger, sale of all assets, or similar transaction, any of which affect their continuation in office, and yet a tender offer immediately creates a presumption that these same individuals cannot be trusted to respond with the best interests of the stockholders and corporation foremost in their minds. See Steinbrink, *supra* note 5, at 892.

⁹² At worst, disclosure made in connection with antitakeover proposals would reveal that the provisions are tantamount to self-dealing transactions. If self-dealing may be ratified by the stockholders, however, there is no apparent reason why adoption by the stockholders should not remove any entrenchment aspects from the proposal of defensive charter provisions.

⁹³ Since the decision of whether or not to adopt a defensive provision rests with the shareholders, it should make no difference whether the provisions are adopted in advance of any takeover or are proposed in response to a threatened or existing takeover attempt.

their fiduciary duty, for it removes doubt as to the desires of at least a majority of the stockholders.⁹⁴

On the other hand, whether management's disclosure and stockholder approval should so insulate management where a tender offer is pending or expected is less clear. Certainly management has the right, if not the duty, to resist takeover attempts that it views as detrimental to the corporation and its stockholders.⁹⁵ Does this permit management to propose charter provisions that will tend to ward off all tender offers, regardless of merit?⁹⁶ Further, must management guard the rights of the minority of stockholders who would want to tender and are thus injured by the adoption of defensive charter and bylaw provisions?⁹⁷ If one accepts the premise that corporate democracy translates into majority rule (or at least disinterested majority rule), these concerns must be viewed as groundless. Defensive charter amendments are simply corporate changes that, like a merger, sale of assets, or charter amendment altering a preferred stock dividend, may legitimately be imposed by the majority on the minority.

Where the defensive maneuvers are not approved by the stockholders, there is no insulating effect to shield management from claims of improper entrenchment. This is well illustrated in the recent decision of the Delaware Court of Chancery in *Telvest, Inc. v. Outdoor Sports Industries, Inc.*⁹⁸

⁹⁴ Where management actively and successfully opposes a tender offer, it is exposed to potential liability to stockholders who had planned to tender. Liability is generally predicated on breach of fiduciary duty in resisting the tender offer. See, e.g., *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978); *Maris v. Sunshine Mining Co.*, No. 77-4020 (S.D. N.Y. Aug. 16, 1977); *Krasner v. Palmer*, No. 5658 (Del. Ch. July 20, 1978). See also McIntyre, *Shareholders' Recourse Under Federal Securities Law Against Management for Opposing Advantageous Tender Offers*, 34 BUS. LAW. 1283 (1979). Accordingly, stockholder approval of antitakeover provisions should assist management in defending breach of fiduciary duty claims by the disappointed minority who wished to tender. Where a majority of stockholders have so indicated their approval of the resistance to the takeover attempt, it should be difficult to hold management liable on breach of fiduciary duty grounds to the minority.

⁹⁵ See, e.g., *Heit v. Baird*, 567 F.2d 1157 (1st Cir. 1977). See also *Berman v. Gerber Prods. Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978); *Northwest Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969).

⁹⁶ Of course, most defensive charter provisions have sufficient flexibility to permit management to circumvent the supermajority vote or other constraints where management approves the transaction. Further, the defensive provisions that are most objectionable typically operate on the second step freezeout, not the tender offer itself. This simply shifts the inquiry, however, to whether the majority rule of a successful, and hence controlling offeror, may be curtailed by a minority veto power.

⁹⁷ There is some recognition that tender offers must be fair to all stockholders, not just those who accept. See, e.g., *Pargas, Inc. v. Empire Gas Corp.*, 423 F. Supp. 199 (D. Md.), *aff'd*, 546 F.2d 25 (4th Cir. 1976); *In re Pabst Brewing Co. & APL Corp.* (Wis. Comm'r Sec. June 6, 1978); TAKEOVERS & FREEZEOUTS, *supra* note 5, at 313-18. Whether management of the target may be placed in the position of having to attempt to protect both the minority who oppose the chilling effect on tender offers created by defensive charter provisions and the majority who wish to adopt them is questionable. It would seem that the majority have as much right to an opportunity to adopt such provisions as the minority has not to be subjected to them.

⁹⁸ No. 5798 (Del. Ch. Mar. 8, 1979).

Outdoor Sports' certificate of incorporation empowered the board of directors to issue preferred stock in series and to designate the stock's characteristics, including its voting powers. Pursuant to that authority, the Outdoor Sports management attempted to impose, through director action alone, a greater than majority vote requirement. This was done by creating a series of preferred stock with an 80% class vote on business combinations or other specified transactions with any party owning 20% or more of the outstanding voting stock of the company. The new preferred stock was to be issued as a stock dividend to the company's existing stockholders at the rate of one share for every ten shares of common stock held of record.

The Delaware Court of Chancery enjoined distribution of the preferred stock, finding that plaintiff was likely to prevail on a number of grounds, including the misuse of corporate machinery. Significantly, the court focused on the fact that management had not put the matter to the stockholders.⁹⁹ This suggests that had the stockholders authorized a class of preferred stock possessing an 80% vote on business combinations, notwithstanding the acknowledged antitakeover aim of the proposal, Telvest's challenge might not have been successful.

IV. STATUTORY SOLUTIONS

If the transfer of control involved in the typical tender offer constitutes a fundamental change equivalent in magnitude to a merger or sale of assets, then statutory solutions may be appropriate to protect stockholders from such changes that they have not approved or from their consequences.¹⁰⁰ The problem in conceiving statutory remedies is that the corporate change wrought by a tender offer is wholly in the composition of the stockholders, and the corporation as an entity apart from its owners remains unaffected. This essential difference from a merger, sale of assets or charter amendment means that statutory solutions will be directed at the rights and duties of stockholders as between themselves. The concept is certainly not foreign, as corporation laws have long permitted restrictions on transfer and similar mechanics under appropriate circumstances to prevent the acquisition of control by persons or entities objectionable to the remaining stockholders.¹⁰¹ Still, these provisions are most common in closely held corporations while tender offers are essentially a phenomenon of publicly held corporations. Possible statutory approaches would seem to fall into two natural categories suggested by the antitakeover provisions discussed above: those that would subject a shift in control to prior restraint and those that would protect minority stockholders follow-

⁹⁹ The *Telvest* court viewed the attempted preferred stock dividend as merely a contrivance to create an 80% vote on the part of the existing holders of common stock. Since in this context it was tantamount to altering the vote required by that class of stock, the court questioned the authority of the directors to effect such a change without stockholder approval.

¹⁰⁰ See Steinbrink, *supra* note 5, at 907. No state has yet, to the authors' knowledge, attempted any remedial legislation in this area. See also note 102 *infra*.

¹⁰¹ See 2 F. O'NEAL, CLOSE CORPORATIONS §§ 7.01-.29 (2d ed. 1971).

ing a shift of control. An example of the former, which could easily be effected by statute, would be the requirement of a stockholder vote to approve a transfer of control. Examples of the latter might include a right to require the corporation to purchase stock or a sterilization of the majority stockholder's voting power in connection with transactions in which such stockholder is interested.

Nevertheless, attempts to formulate appropriate statutory provisions run into seemingly endless difficulties in balancing the various interests and rights involved. Initially, any substantive corporate law dealing with the transfer of control may tend to have a chilling effect on tender offers. For example, if a right akin to an appraisal right were afforded to nontendering stockholders for a certain period of time following consummation of a tender offer, prospective bidders might be dissuaded. The practical effect of the appraisal right would be either to require a bid for any and all shares or to lead a significant number of stockholders to decide to wait out the offer in hopes of a better price in an appraisal.

The likelihood that there can be an effective vote of stockholders to approve a transfer of control through a tender offer seems dim. Assuming that it would be desirable to require stockholders to think of the interests of one another rather than personal gain, there are problems in determining when a stockholder vote should occur and who should be entitled to vote. If the stockholder vote is to come before commencement of the tender offer, it would seem that advance notice would be required. This would run afoul of the preemption and commerce clause arguments that have called into question the validity of existing state takeover statutes.¹⁰² There are, of course, other problems. Should the vote simply approve the concept of a change of control to a single majority stockholder, or should the vote include a consideration of price? If the consideration to be received in the tender offer is subject to a vote of stockholders, then little has been gained, because acceptance of a tender offer is in a sense the functional equivalent of a vote in favor of the transfer of control.

The problem is no simpler if the vote is taken after consummation of the tender offer. Certainly if the tender offer is successful, there would hardly appear to be the need for a vote. The shares of stock acquired by the offeror could, of course, be disenfranchised, but that would leave the vote to the nontendering stockholders, possibly including management, who by not tendering may have already indicated a disapproval of the transfer of control. Finally, the reality of the situation may be that the

¹⁰² State attempts to regulate tender offers have focused on advance notice and duration, with some requiring assessment of the offer's fairness. See generally E. ARANÓW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 207-45 (1977). The validity of such statutes is in question. See *Great Western United Corp. v. Kidwell*, 439 F. Supp. 420 (N.D. Tex. 1977), *aff'd*, 577 F.2d 1256 (5th Cir. 1978), *rev'd on other grounds*, 99 S. Ct. 2710 (1979). Compare *Dart Indus. Inc. v. Conrad*, 462 F. Supp. 1 (S.D. Ind. 1978) (Delaware takeover statute unconstitutional) with *City Investing Co. v. Simcox*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,942 (S.D. Ind. 1979) (Indiana takeover statute constitutional).

overwhelming majority of stockholders is less concerned with whether there is a transfer of control and more concerned with the price they receive for their stock. The same could be said of shareholders in the context of mergers and sales of assets, indicating the difficulty, if not impossibility, of dealing with the stockholders' motives for approving or disapproving a given transaction.

There are those who undoubtedly would object, on policy grounds, to having their right to sell their shares to whomever they choose inhibited by concern for the effect on fellow stockholders who for whatever reasons desire to remain participants in the enterprise. Nevertheless, this is an age in which individual rights must be weighted against the rights of others, and it may be that public policy will demand that control not be concentrated in the hands of a single stockholder to the detriment of the remaining minority stockholders.

If the problem concerns the consequences to the remaining minority following a transfer of control, rather than the transfer itself, then it may be more appropriate to regulate corporate conduct following the acquisition of control by a single stockholder rather than attempt to limit the acquisition itself. As already indicated, one method of protecting minority interests in the tender offer context is to provide an appraisal right. This right would be similar in substance to the right of redemption that stockholders are now creating for themselves, with the principal difference being the method of determining the purchase price that the corporation must pay minority stockholders for their shares.

Aside from the deterrent effect on tender offers inherent in such a statutory provision, the usefulness of an appraisal right in a tender offer is highly questionable. First, it would not necessarily assure stockholders a price equivalent to that offered in the tender offer. Second, it focuses on stock as a cash investment to the exclusion of other facts. Third, it is hard to justify permitting remaining minority stockholders to require the corporation to purchase their stock at what may turn out to be a higher price than was offered in the tender offer when that same opportunity is not afforded stockholders who did tender. Those who tendered presumably made a conscious decision between the desirability of continued participation in the enterprise and accepting the price presently obtainable through the tender offer. Nontendering stockholders made a similar decision, and it is difficult to see why they should thereafter have the right to compel the corporation to buy them out. Finally, the appraisal right is not aimed at the particular vulnerability created in the transfer of control.

If the problem is that the acquisition of control permits the bidder thereafter to deal unfairly with the minority, a more appropriate statutory response may be to inhibit the exercise of that control, at least with respect to corporate transactions in which the majority stockholder has an interest. Accordingly, it might be provided that any corporate transaction such as a merger or sale of assets in which the controlling stockholder is interested will be subjected to not only a vote of all stockholders, but also to a separate vote of those stockholders not interested in the transaction. Such

a statutory provision would subject the classic freezeout merger to the approval of a majority of the minority stockholders.¹⁰³ Presumably, this restores the element of corporate democracy that is eliminated when one stockholder controls sufficient shares to dictate the course of corporate affairs. To obtain this salutary effect, however, the majority stockholders must sacrifice their right to vote their stock in their own interests.

While it is interesting to speculate on the types of substantive corporate law changes that might be implemented to deal with the transfer of control, in the final analysis it may be that no such statutory changes are necessary. The real focus should be on the relationship between all of the stockholders and their willingness to surrender some of their present rights in favor of preventing one stockholder from gaining absolute control. In short, are stockholders willing to forego a potentially profitable tender offer in order to minimize or eliminate the risk that they or their fellow stockholders may emerge as minority stockholders in a controlled enterprise? From this perspective, the relevant questions are for the stockholders to decide. As the variety of antitakeover provisions adopted to date indicate, it may be that the stockholders are able to protect themselves.¹⁰⁴ The adoption of antitakeover provisions represents what one commentator has likened to a declaration of independence.¹⁰⁵ It is a statement that stockholders are confident in the way the corporation is being managed and that they do not want to risk being foreclosed from continued participation in the corporation. If a majority of stockholders is willing to adopt such provisions to protect itself, it should be permitted to do so. If such proposals fail to win approval, that should be notice to both management and those stockholders in favor of such proposals that at least a majority of stockholders is willing to forego continued participation if the price is right.

If substantive legislation is useful at all in this context perhaps it might best deal with the vote required to adopt or repeal the antitakeover provisions. Under present law, it seems clear that the vote required to repeal antitakeover provisions may be substantially higher than the vote required

¹⁰³ Alternatively, the controlling stockholder may be required to vote his shares in proportion to the vote of the minority. This device has been used in a number of recent mergers to "sterilize" the vote of the controlling stockholder and avoid the problems raised in *Singer v. Magnavox*. The technique has won some approval from the courts as a means of preserving corporate democracy. See, e.g., *TBK Partners, Ltd. v. Warshaw*, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,909 (S.D.N.Y. March 10, 1977); *Weinberger v. UOP, Inc.*, No. 5642 (Del. Ch. April 5, 1979); *Bromberg v. Stern*, No. 19747/78 (N.Y. Sup., N.Y. County, Feb. 16, 1979).

¹⁰⁴ The increasing popularity of antitakeover provisions indicates that shareholders adequately protect themselves against unwanted, imposed control only assuming a degree of effectiveness for defensive charter provisions, an assumption many commentators are unwilling to make. See note 11 *supra*.

¹⁰⁵ See Steinbrink, *supra* note 5, at 906. Management might be more effectively protected against attack for opposing a takeover if a more explicit declaration were forthcoming in the form of a stockholder resolution directing management to oppose actively any takeover attempts.

to adopt them.¹⁰⁸ It might be fairer to require that an 80% vote provision be itself subject to adoption by an 80% vote. This approach, however, runs counter to the present public policy of the corporation statutes, which permit a bare majority to merge the corporation out of existence, to sell its assets, and to work other fundamental changes including the dissolution and liquidation of the corporation. It may be that the broad enabling type of corporation statute is inherently flexible enough to deal with the exposure of minority interests. That being the case, perhaps the stockholders of corporations should be permitted to work out the relationship between themselves with respect to whether they wish to be subjected to the threat of a tender offer and its consequences.

V. CONCLUSION

It was noted at the outset that this was a quadripartite commentary, and as such is not easily susceptible to a single conclusion. However, one premise does emerge that may serve as a concluding recommendation, and that is that before any rulemaking, new legislation or similar action is undertaken to regulate adoption of antitakeover provisions, more thoughtful analysis of these provisions' purposes and effects is necessary.

The shortcoming of the Division of Corporation Finance's Release is the indirect manner in which it expresses a position and a policy respecting antitakeover provisions. On the one hand the Release is tentative, for want of any hard evidence upon which to condemn such provisions. On the other hand the Division has expressed its opposition to tactics it views as disturbing the hypothetically balanced tender offer field. The courts have similarly failed to address the issues directly, although this may be more a function of the procedural posture of the cases and the underlying allegations, most being attempts to obtain injunctive relief under federal securities laws and not direct challenges under state law to antitakeover provisions. Yet validity under state corporation law is arguably the fundamental issue that should be resolved first. Legislation addressed specifically to the antitakeover provision issues is, of course, nonexistent at present. As might be expected, the most resourceful antitakeover participants have been the companies themselves and opposing offerors.

Moreover, there is a glaring lack of evidence that the antitakeover provisions now being adopted have any material impact on the securities market, alter the hypothetical balance that the federal securities laws purport to maintain, genuinely affect the liquidity of investment that some argue should be preserved, or unfairly interfere with stockholders' rights. Indeed, antitakeover provisions have yet to be demonstrated to amount to anything more than a corporate Maginot Line.

¹⁰⁸ State statutes usually establish the minimum vote for amending the corporate charter. Even where the result of the amendment is to impose a greater vote on a subsequent amendment some states require that the statutory minimum vote continue to apply. Compare DEL. CODE ANN., tit. 8, § 242 (1974) with N.Y. BUS. CORP. L. § 616(b) (McKinney 1963).

As the Division's release itself evidences, hasty attempts to deal with the problem will inevitably result in additional and unanticipated problems ranging far beyond the conduct sought to be controlled. For this reason, it seems prudent that any rulemaking or legislative action should be postponed until there exists an adequate foundation for such action, perhaps built upon the statistical information the Division is now compiling. It may also be helpful to wait until the state courts have had an opportunity to meet the questions head on, in particular the policy considerations involved with the innovative supermajority vote, fair price, and right of redemption provisions and their impact on minority stockholders. Until then, corrective rulemaking or legislation appears premature.