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INTRODUCTION

Contra to some predictions of a slow-down in takeover battles, 1984 has witnessed a new wave of "megamergers," many of which have precipitated shooting matches both at the corporate and Congressional levels.

In March, 1984, The Securities and Exchange Commission commenced its consideration of numerous federal limitations which would affect the tactics in takeovers, as proposed to Congress in 1983 by the Advisory Committee on Tender Offers. The following articles, student comments, and casenote discuss a number of these tactics as well as the controversy of federal pre-emption of state law in the tender offer arena. A bibliography of legal articles written since 1965 relating to tender offers and their regulation is also included. The plethora of such articles is indicative that the takeover battleground has not nor will it likely become peaceful in 1985.
STATE AND FEDERAL REGULATION OF SHARK REPELLENT PROVISIONS: HOW MUCH IS NEEDED?

by

Roger E. Lautzenhiser*

Although the extent of their deterrent effect has been questioned, defensive charter and by-law provisions have never been more popular. In recent years, dozens of companies have amended their charters and by-laws to include supermajority voting requirements, staggered board provisions, special nomination requirements for directors, provisions authorizing the issuance of "blank check" preferred stock, stock transfer restrictions and a myriad of other "shark repellent" provisions designed to deter unsolicited takeover attempts and proxy contests. In addition, numerous companies have adopted fair price provisions and other charter provisions designed to discourage two-tier, front-end loaded takeover bids. These latter types of provisions serve to assure that all target company shareholders are treated fairly in the event of a takeover.

The growing popularity of defensive charter and by-law measures has generated a considerable amount of debate as to whether they

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1. The deterrent effect of defensive charter and by-laws provision has been questioned by a number of prominent attorneys who specialize in the representation of target and bidder companies in takeover battles. See, e.g., 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS 265 (1978) (acknowledging that "it is doubtful whether staggered board provisions have any real effect" and that the effectiveness of supermajority provision is "open to debate"). See generally, 1 A. FLEISCHER, JR., TENDER OFFERS DEFENSES, RESPONSES, AND PLANNING 11 (1983).

2. See, e.g., Blustein, Measures to Discourage Takeovers Stir Controversy at Annual Meetings, Wall St. J., Apr. 18, 1983, at 29. ("Though the shark-repellent ideas aren't new, more companies than ever are trying to adopt them . . . ."); Metz, Foiling Suitors; To Forestall Takeovers, Many Concerns Move to Shore Up Defenses, Wall St. J., Mar. 18, 1983, at 1 ("Potential takeover targets are rushing to shore up their defenses at an unprecedented pace . . .").

3. In a "two-tier, front-end loaded takeover bid," the bidder acquires a controlling equity interest in a target company through a partial cash tender offer and then acquires the remaining shares through a second-step "freeze-out" merger at a price that is lower than that offered in the opening tender offer and/or in some less desirable form of consideration. For a discussion of two-tier pricing transactions, see supra text accompanying footnotes 45-48.

4. It can be argued that fair price provisions and other related charter and by-law measures which are not designed to deter takeover attempts should not be characterized as shark repellent provisions. This distinction is not made for purposes of this article, however.
serve the best interests of target company shareholders or simply protect the positions of incumbent management. Commentators have argued that defensive charter and by-law provisions are contrary to the basic principles of corporate democracy because they allow corporate managers to exercise control after they have lost shareholder support and permit minority shareholders to block corporate changes that may be supported by the holders of a significant percentage of the corporation’s shares. Commentators have also complained that shark repellent provisions, to the extent they are effective in discouraging takeover efforts, interfere with the takeover process as it occurs in the national economy and deprive shareholders of the opportunity to sell their shares at a premium. They have argued that defensive provisions serve to hinder a process that is generally beneficial to shareholders of target and bidder companies and to society as a whole.

The Securities and Exchange Commission’s Advisory Committee on Tender Offers in its Report of Final Recommendations has recommended that “Congress and the Commission . . . adopt appropriate legislation and/or regulations to prohibit the use of charter and by-law provisions that erect high barriers to change of control and thus operate against the interests of shareholders and the national marketplace.” While giving lip-service to the importance of a system of state corporation laws and the business judgment rule, the Advisory Committee concluded that restrictions on the transfer of corporate control imposed by corporate charters and by-laws constitute an improper interference with the conduct of takeovers in the national securities markets. The Advisory Committee recommended that until such provisions are prohibited, companies adopting measures that establish a greater shareholder vote

5. See e.g., E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 195 (1977); Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 TEX. L. REV. 1, 30-32 (1978).
7. See Easterbrook & Fischel, supra note 6, at 1182 (tender offers “increase social welfare by moving productive assets to higher-valued uses and to the hands of better managers”); Bebchuk, The Case for Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028, 1033 (1982).
9. Id. at 34 (Recommendation 33).
10. Id. at 34.
than the minimum vote required by state law should be required to obtain the same level of shareholder approval to adopt the provisions initially. In addition, the Advisory Committee suggested that issuers be required periodically to submit shark repellent provisions to their shareholders for ratification or an advisory vote.

The recommendations of the Advisory Committee raise important questions concerning the role, if any, that Congress and the Commission should play in regulating the adoption of defensive charter and by-law provisions. This article argues that federal regulation of these defensive measures would represent an unusual and unwarranted intrusion by the federal government in the internal affairs of state-chartered corporations, an area traditionally regulated by state law. It is asserted that federal regulation in this area is not needed to protect the efficient operation of the national securities markets. While it is acknowledged that shark repellent provisions may create conflicts of interest between shareholders and corporate managers and may unfairly limit the voting rights of majority shareholders, it is argued that these concerns, inasmuch as they involve the internal operations and business structure of a corporation, are best left to the states to address and resolve.

This article is divided into two parts. Part I surveys the numerous types of defensive charter and by-law provisions that have been adopted by corporations in recent years. Part II examines the objections that have been raised with respect to the use of charter and by-law devices to discourage takeover attempts and concludes that new state regulation is needed to make it more difficult for corporations to adopt many of the provisions. Part II also reviews the recent proposal of the Advisory Committee for new federal regulation of defensive charter and by-law provisions and discusses why such regulation is unnecessary and unwise.

11. Id. at 36-37 (Recommendation 36).
12. Id. at 37-38.

On March 13, 1984, the Securities and Exchange Commission agreed to support most of the recommendations of the Advisory Committee. However, it objected to the recommendations of the Advisory Committee which would require federal preemption of state corporation laws in areas traditionally regulated by the states. The Commission declined to adopt the Advisory Committee's recommendation that Congress or the Commission prohibit charter and by-law provisions that erect barriers to changes of control. Although the Commission noted its concern with the growing use of defensive charter and by-law provisions, it stated that "it was not prepared to concur with such a broad intrusion with state corporate law."
I. SURVEYING THE CURRENT ARSENAL OF DEFENSIVE
CHARTER AND BY-LAW PROVISIONS

Although defensive charter and by-law provisions take many different forms, most shark repellents can be divided into one of two categories. The first group consists of provisions designed to impede efforts by successful bidders and proxy contest participants to effect shifts in control of the board of directors. The second group of provisions includes measures designed to make it more costly or otherwise more difficult for a successful bidder which has acquired a significant block of shares to complete a second-step business combination to eliminate the remaining shareholders of the target company. The first part of this article surveys the most common forms of shark repellent provisions in each of these categories and reviews a number of other popular forms of shark repellent provisions that do not fit into either of these general categories.

A. Use of Charter and By-Law Amendments to Thwart
Transfers of Board Control

Unless a corporation adopts certain defensive charter or by-laws provisions, a transfer of control of its board of directors can occur...
very quickly if a dissident shareholder or group initiates a successful proxy contest or if a bidder is able to acquire a majority of a corporation's outstanding voting shares through a tender offer or other stock accumulation program. Under the corporation laws of most states, the holders of a majority of a corporation's outstanding voting shares have the ability to elect at least a majority of the directors at a single meeting of shareholders. Thus, it is possible for an insurgent shareholder or group to elect a controlling number of the company's directors through a single proxy contest even though it does not own a majority of the company's outstanding shares. Similarly, at a single meeting of shareholders, a successful bidder which has acquired a majority share position will be able to capture control of the board of directors. The successful bidder has the additional advantage of being able to call a special meeting of shareholders to remove a controlling number of the incumbent directors and to replace them with its own nominees. Moreover, under the corporation laws of some states, the successful bidder will be able to take such action without a meeting pursuant to a written consent. By adopting a variety
of different shark repellent measures, an issuer can significantly delay the amount of time required by a successful bidder or a proxy contestand to obtain board control.

1. Classifying the Board.

Classification of the board of directors is the most common method of preventing rapid shifts in control of the board of directors. Ordinarily, a company will amend its charter or by-laws to classify its board of directors into three classes consisting of approximately the same number of directors with each class standing for election once every three years. The effect of classifying the board into three classes is to require at least two successive annual meetings in order for a successful bidder or insurgent group to elect a majority of the board members.

In order to assure that the impact of a classified board is not circumvented, corporations frequently amend their charters to include a number of ancillary charter and by-law provisions. For example, a large number of companies have sought to prevent a majority shareholder from removing and replacing incumbent directors by adopting charter or by-law provisions which allow directors to be removed for cause or which create supermajority voting requirements for removal. Many companies have also

a meeting of shareholders. See, e.g., Ohio Rev. Code Ann. §1701.54 (Page 1982). In states where all shareholders must execute an action in writing, it is virtually impossible for a bidder who has acquired a controlling share interest in a public corporation but less than all of the outstanding shares to take shareholder action in this fashion.

19. The corporation law statutes of many states limit the maximum number of classes of directors to three. See, e.g., Del. Code Ann. tit. 8, §141(d) (Supp. 1983) (provides for one, two or three classes); Ohio Rev. Code Ann. §1701.57(B) (Page 1982) (two or three classes consisting of not less than three directors each). The New York Stock Exchange will not list a corporation's stock if it has more than three classes of directors. New York Stock Exchange Listed Company Manual, §308.00 at 3-4 (June 3, 1983). A few states permit classification of the board of directors into four classes. See, e.g., N.Y. Bus. Corp. Law §704(a) (McKinney 1963).

20. In Delaware, directors may be removed with or without cause except that if the board is classified, removal of directors may be effected for cause only, unless the certificate of incorporation otherwise provides. Del. Code Ann. tit. 8, §141(k)(i) (Supp. 1983).

21. See, e.g., Ohio Rev. Code Ann. §1701.58(C) (Page 1982). Provisions which create supermajority voting requirements for removal of directors may be unenforceable in Delaware where the statute expressly provides that directors may be removed by the holders of a majority of the shares then entitled to vote at an election of directors. Del. Code Ann. tit. 8, §141(k) (Supp. 1983). For a discussion of the validity under Delaware law of supermajority vote requirements for removal of directors, see Hochman & Folger, supra note 13 at 541-42.
amended their charters or by-laws to give their boards of directors the sole authority to fix the number of directors and to fill vacancies on the board.\textsuperscript{22} Other defensive measures that are designed, at least in part, to protect classified boards include provisions which require shareholder action to be taken only at meetings of the shareholders and not pursuant to written consent\textsuperscript{23} and measures that prohibit shareholders from calling special meetings of shareholders.\textsuperscript{24}

The business purpose that is frequently given for classifying the board of directors is to moderate the pace of change in the board and thereby assure continuity of corporate management and policies.\textsuperscript{25} Issuers argue that this continuity permits the board to represent more effectively the interests of all shareholders. Although classification of the board only delays and does not prevent a change in board control, such a delay may frustrate a successful bidder's business plans for the target company and result in significantly higher acquisition costs. A potential bidder that is contemplating a takeover attempt may conclude that a classified board of directors makes the target an undesirable acquisition candidate when compared to other companies whose boards are not staggered. Classification of the board also may serve to deter proxy contests by an insurgent shareholder or group seeking to obtain control of a company by electing its own slate of directors. An insurgent that is faced with a two-year battle for control may conclude that the risks and costs associated with two successive proxy contests are simply too high.

Classification of the board of directors is probably more effective in deterring proxy contests than in discouraging unsolicited tender offers. A number of commentators have argued that most

\textsuperscript{22} See, e.g., DEL. CODE ANN. tit. 8, §141(b); \textit{but see}, OHIO REV. CODE ANN. §1701.56(A)(2) (Page 1982) (authority of the shareholders to fix or change the number of directors may not be restricted).

\textsuperscript{23} See, e.g., DEL. CODE ANN. tit. 8, §228(b) (Supp. 1983); see also supra note 18 and accompanying text.

\textsuperscript{24} For an example of a provision eliminating the right of shareholders to call a special meeting, see Proxy Statement of Foster Wheeler Corp. (March 18, 1983), \textit{reprinted in} 2 A. FLEISCHER, \textit{supra} note 1, at 693 [Exhibit 10]. In some states such as Ohio, the right of shareholders to call a meeting may not be eliminated. OHIO REV. CODE ANN. §1701.40(A)(3) (Page 1982). In Delaware, a special meeting of stockholders may be called by the stockholders only if so provided in the certificate of incorporation or by-laws. DEL. CODE ANN. tit. 8, §211(d) (Supp. 1983).

\textsuperscript{25} See Banner & Finley, \textit{supra} note 13, at 634. See also Proxy Statement of McDonalds Corporation (April 8, 1983); Proxy Statement of Thomas Industries, Inc. (March 24, 1980).
incumbent directors would not remain as directors and continue to defend against a controlling shareholder following a successful tender offer. They point out that few directors would continue to battle a majority shareholder in view of the fiduciary responsibilities that would be owed to that shareholder and the costs of the litigation that would undoubtedly ensue.

A large number of companies elected to classify their boards of directors in 1983. The renewed interest in this type of defensive provision was undoubtedly the result of the increasing use of the proxy contest by insurgents as a vehicle for electing a company's board of directors or as a means of forcing the corporation to undertake some extraordinary corporate transaction. Board classification was also popular as a result of the growing use of the threat of a proxy contest by would-be raiders seeking to sell their shares to the issuer at a premium.

2. Additional Provisions to Thwart Changes in Board Control

In addition to board classification, corporations have recently adopted a variety of other types of charter and by-law provisions designed to prevent rapid changes of control in their boards of directors. A number of companies have sought to prevent shareholders from making surprise nominations at meetings of shareholders by amending their charters or by-laws to require that notice of a proposed nomination be submitted to the corporation in advance of the meeting at which the nomination is made. If management is aware in advance of the intention of a shareholder to nominate a director at a shareholders' meeting, it can disseminate information to the corporation's shareholders concerning the proposed nominee so that the shareholders will have the opportunity

26. See, e.g., Gilson, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept, 34 STAN. L. REV. 775, 793-96 (1982); Banner & Finley, supra note 13, at 636; 1 M. LIPTON & E. STEINBERGER, supra note 1 at 265.
27. See, e.g., Gilson, supra note 26, at 794; Banner & Finley, supra note 13, at 636.
28. See Blustein, supra note 2, at 29.
29. See Banner & Finley, supra note 13, at 634.
30. Id. at 636. See also, Tobin & Maiwurm, Beachhead Acquisitions: Creating Waves in the Marketplace and Uncertainty in the Regulatory Framework, 38 BUS. LAW 419, 422-23 (1983).
31. See Hochman & Folger, supra note 13 at 539-40. For examples of charter provisions requiring special nomination procedures for the election of directors, see Proxy Statement of First National Cincinnati Corporation (March 9, 1983); Proxy Statement of Ohio Casualty Corporation (March 18, 1983).
to evaluate his or her qualifications. Perhaps of even more importance to management, nomination requirements give members of management the opportunity to evaluate the proposed nominee and, if necessary, increase their efforts to solicit proxies to be voted in favor of their own slate of nominees. A number of corporations have also amended their charters or by-laws to establish restrictive director qualifications designed, at least in part, to make it more difficult for a successful bidder to fill board seats.

B. Shark Repellent Provisions Designed to Deter Second-Step Transactions

1. Traditional Supermajority Provisions

Takeovers are frequently designed as two-step transactions with an initial tender offer to obtain a controlling interest in the target company followed by a second-step "freeze-out" merger or similar business combination in which the minority shareholders are eliminated for cash or some other form of consideration. Under the corporation laws of many states, the second-step transaction may be effected by the affirmative vote of the holders of a mere majority of the outstanding voting power of the corporation, unless the corporate charter requires a higher percentage.

Charter provisions which require for approval of mergers and

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32. Banner & Finley, supra note 13, at 640-41.
33. Qualification requirements are generally valid so long as they are reasonable. See, e.g., McKee & Co. v. First Nat'l Bank, 265 F. Supp 1 (S.D. Cal. 1967) (upheld validity of by-law provision requiring that directors be a resident of county where corporation had its principal place of business and not be an attorney for or otherwise connected with a bank). Some state statutes expressly provide that the directors shall have such qualifications as are set forth in the charter or by-laws. See, e.g. Ohio Rev. Code Ann. §1701.56(A)(3) (Page 1982).
34. Delaware, for example, requires that an agreement of merger or consolidation be approved by the affirmative vote of the holders of a majority of the outstanding stock of the corporation entitled to vote thereon, or by a greater vote as provided in the certificate of incorporation. Del. Code Ann. tit. 8, §251(c) (Supp. 1983). In certain cases, only a vote of the holders of the stockholders of the surviving corporation is required. Del. Code Ann. tit. 8, §§102(b)(4), 251(f) (Supp. 1983). Delaware also provides for a majority vote on a dissolution or on disposition of all or substantially all of a corporation's assets, unless a greater vote is provided in the certificate of incorporation. Del. Code Ann. tit. 8, §§102(b)(4), 271(a), 275(b) (Supp. 1983). A few states such as Ohio require that mergers and certain other business combinations be approved by the holders of at least two-thirds of the corporation's voting power, or such different proportion as the articles may provide. See, e.g., Ohio Rev. Code Ann. §1701.78(F) (Page 1982) (merger); Ohio Rev. Code Ann. 1701.76 (Page 1982) (sale or other disposition of all or substantially all of the assets of corporation); Ohio Rev. Code Ann. §1701.86 (Page 1982) (voluntary dissolution).
other business combinations the affirmative vote of the holders of a higher percentage of the outstanding shares than is otherwise required by law have been a popular defensive device for many years.\textsuperscript{35} Although these “supermajority provisions” take many different forms, most measures require that various broadly defined “business combinations”\textsuperscript{36} involving the issuer and a “related” or “interested” shareholder\textsuperscript{37} be approved by the holders of a specified percentage of the voting power of the corporation which is higher than the minimum percentage required by statute. Ordinarily, the required vote ranges anywhere from 66-2/3\% to 95\% of the voting power of the corporation, although some supermajority provisions require that the transactions be adopted by a supermajority vote of the outstanding shares held by persons other than the interested shareholder. Most supermajority measures carve out an exception to the supermajority vote requirement where the proposed transaction has been approved by a majority or some higher percentage of the “continuing directors”\textsuperscript{38} of the corporation. This excep-

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35. For examples of supermajority provisions, see Proxy Statement of Anchor Hocking Corporation (March 31, 1979); Proxy Statement of Wendy's International, Inc. (March 26, 1980); Proxy Statement of Ohio Casualty Corporation (March 18, 1983); Proxy Statement of Union Oil Co. of California (March 28, 1983), \textit{reprinted in} 2 A. FLEISCHER, JR., \textit{supra} note 1, at 1047 [Exhibit 43-Extract].

36. The term “business combination” is usually defined very broadly in supermajority provisions to include mergers and consolidations; the issuance of securities to an “interested” shareholder; sales, leases, exchanges, pledges, transfers or other dispositions involving any assets of the corporation constituting more than a specified percentage of the fair market value of the total consolidated assets of the corporation; any plan or proposal for liquidation or dissolution; any reclassification of securities, recapitalization of the corporation, or merger with a subsidiary of the corporation which has the effect, directly or indirectly, of increasing the proportionate share of the outstanding stock of the corporation or any subsidiary held by an “interested shareholder”; or any agreement, contract or other arrangement for any one or more of these transactions. See, e.g., Proxy Statement of Union Oil Co. of California (March 28, 1983), \textit{reprinted in} 2 A. FLEISCHER, JR., \textit{supra} note 1, at 1047 [Exhibit 43-Extract].

37. A “related” or “interested shareholder” is often defined in a supermajority provision to include the beneficial owner of more than a designated percentage (usually ranging anywhere from 10\% to 30\%) of the voting stock of the corporation. Ownership of stock held by “affiliates” or “associates” of a particular shareholder is usually attributed to such shareholder. The term “beneficial owner” is given the meaning ascribed to that term in Rule 13d-3 of the General Rules and Regulations under the Securities Act of 1934, as amended. The terms “affiliate” and “associate” are generally given the meanings ascribed to those terms in Rule 12b-2 of the General Rules and Regulations under the Securities Exchange Act of 1934, as amended.

38. The term “continuing directors” is generally defined to include (1) any member of the board of directors who is not affiliated with the related or interested shareholder and who was a director of the corporation prior to the time such shareholder became a related
tion assures that the supermajority provision will not limit the flexibility of the directors to effectuate routine business transactions or to negotiate transactions with white knights or even hostile bidders. 39

The principal purpose of the traditional supermajority provision is to discourage two-tier takeover bids by making it more costly or difficult for the successful bidder to effect a second-step transaction. As with many other types of shark repellent measures, the supermajority provision is designed to encourage the potential bidder to negotiate with the target company with respect to the proposed acquisition. When soliciting shareholder approval of these provisions, management typically claims that a negotiated transaction would result in significant benefits to the target corporation and its shareholders which would not be available in the context of a hostile takeover. Despite the development of new and more innovative defensive measures, supermajority provisions remain a popular shark repellent among issuers. The popularity of these provisions may be due in part to the fact that their validity has generally been upheld by the courts. 40

Whether a supermajority provision is an effective deterrent to an unsolicited takeover attempt will depend, of course, on how important it is to the potential bidder to acquire the entire equity interest of the target company. 41 If the bidder's goal is to purchase

or interested shareholder and (2) any successor to any such director who is not affiliated with the related or interested shareholder and who was elected or recommended by a majority of the "continuing directors."

39. Banner & Finley, supra note 13, at 644.

40. See Seibert v. Gulton Industries, Inc., Civ. Action No. 5631 (Del. Ch. June 21, 1979), summarily aff'd, 414 A.2d 822 (Del. 1980) (upheld validity of supermajority provision requiring an 80% shareholder vote for approval of business combination with persons owning more than 5% of corporation's shares unless directors had approved transaction); Seibert v. Milton Bradley Co., 405 N.E. 2d 131 (Mass. 1980) (see infra note 71); see also, Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978) (court implied that a supermajority provision was valid when it enjoined an attempt by a successful offeror to circumvent a supermajority vote requirement for a second step merger); FMC Corp. v. R.P. Scherer Corp., 1982 FED. SEC. L. REP. [CCH] ¶ 98,800 (Del. Ch. 1978) (court implied that supermajority vote requirement was unobjectionable where it was not proposed as a defensive measure in response to an existing tender offer).

41. A second-step transaction may be critical to the bidder. Gilson, supra note 26, at 786. Gilson notes that the elimination of minority shareholders may result in important benefits to the bidder including the realization of "synergistic" benefits to the combined firms, the reduction of total costs by eliminating duplicative functions, and the elimination of costs associated with maintaining shareholders records and complying with disclosure requirements under the federal securities laws. Id., at 786.

In some cases, a bidder may seek to acquire less than the entire equity interest of the
all of the outstanding shares of the target company, a supermajority provision may prove to be a powerful deterrent, especially in the case where corporate managers hold enough shares to thwart the supermajority vote. If, however, the bidder desires to acquire only a partial equity interest in the target company, the supermajority provision will have little deterrent value even if management owns a large block of the target company's shares.


The so-called "fair price provision," a modified version of the traditional supermajority provision, has become a popular defensive device in recent years. In most respects, fair price provisions are identical to traditional supermajority provisions except that they contain an additional exception to the supermajority vote requirement for a second-step transaction where the consideration to be paid is at least equal to some minimum amount and is in the form of cash or the same type of consideration used by the successful bidder to acquire its controlling share interest. Unless a "fair price" is paid in the second-step transaction and certain procedural requirements are satisfied or the transaction is ap-
proven by the "continuing" directors of the corporation, the fair price provision requires that the transaction be adopted by a super-majority vote of the shareholders ranging anywhere from 66-2/3% to 95%. Although fair price provisions utilize a variety of different formulas for establishing the minimum required price, most of these provisions require that the price be at least equal to the highest amount paid by the controlling shareholder for its shares during a specified period of time preceding the second-step transaction. Fair price provisions typically provide that if the second-step transaction does not involve the receipt of cash or other consideration by the shareholders of the target corporation so that they cannot receive the minimum required price (e.g., the transaction involves an issuance of shares to the interested shareholder), only the approval of the continuing directors will eliminate the super-majority vote requirement.

The growth in the popularity of fair price provisions is due in large part to the increase in takeovers involving two-tier pricing satisfied in order to avoid the supermajority shareholder vote requirement, unless the transaction has been approved by a majority of the Continuing Directors. For instance, fair price provisions frequently provide that the interested shareholder must not have received (other than proportionately as a shareholder) at any time after it became an interested shareholder, whether in connection with the second-step transaction or otherwise, the benefit of any loans or other financial assistance from the target corporation. In addition, these provisions typically require that a proxy or information statement describing the second-step transaction and complying with the requirements of the Proxy Rules under the Securities Exchange Act of 1934 be mailed to all shareholders at least 30 days prior to the consummation of the transaction. For a more complete description of the procedural requirements in fair price amendments, see Banner & Finley, supra note 13, at 651-53.

44. A number of different formulas have been utilized to determine the "fair price" that must be paid in the second-step transaction. For instance, a fair price provision adopted by one corporation in 1983 required that the minimum price in the second-step transaction be at least equal to the higher of (a) the highest per share price paid by the interested shareholder for any shares of common stock acquired by it (1) within the two-year period immediately prior to the first public announcement of the proposal of the business combination (the "Announcement Date") or (2) in the transaction in which the interested shareholder became an interested shareholder, whichever was higher, plus interest compounded annually at the prime interest rate of a designated bank from the date on which the interested shareholder became an interested shareholder through the date of consummation of the business combination less dividends paid on the common stock during such period or (b) the fair market value per share of common stock on the Announcement Date. The fair price provision set forth a similar minimum price requirement for all other classes of capital stock of the corporation. See Proxy Statement of United Technologies Corporation (March 9, 1983), reprinted in Banner & Finley, supra note 13, at 675 (Extract).

Most fair price provisions require that the interested shareholder pay the minimum required price to the holders of each class of voting stock of the corporation, whether or not the interested shareholder owned shares of that class prior to proposing the business combination.
transactions in which an initial partial tender offer is followed by a second-step “freeze-out” merger at a lower price and/or in a less desirable form of consideration than that available in the opening tender offer. The so-called “two-tier, front-end loaded” takeover has become a favorite acquisition technique of bidders in recent years because of the advantages it offers the bidder. Two-tier bids tend to produce a rapid tender of shares after the announcement of the tender offer by shareholders who are concerned that their shares will not be purchased at the cash price offered in the initial tender offer. Furthermore, by initiating a partial tender offer and then obtaining the remaining shares through a second-step merger with its equity securities or subordinated debt, a bidder can significantly improve its ability to finance the takeover. Even if the bidder’s own financial condition does not support a loan, a bank may lend funds for the first-step transaction because of the strong security position that will exist upon consummation of the second-step merger.

Fair price provisions are beneficial to shareholders of a target company because they assure that shareholders whose shares are eliminated in a second-step transaction will not be squeezed out at an unfair price. Furthermore, by eliminating the possibility that shareholders will be forced to dispose of a portion of their shares at an unfavorable price in a later transaction, fair price measures serve to reduce the pressure on shareholders to tender immediately.


The Commission recently revised Rule 14a-8 of the General Rules and Regulations under the Securities Exchange Act of 1934, as amended, to require bidders in an oversubscribed partial tender offer to purchase shares pro rata from all shares received during the period the tender offer is open. Prior to the adoption of revised Rule 14a-8, a bidder in such a situation was only required to purchase pro rata the shares tendered during the first 10 calendar days of the tender offer. See §14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78n(d). Revised Rule 14a-8 should serve to reduce the pressure on shareholders to tender immediately upon the announcement of a two-tier offer in order to ensure that their shares are included in the proration “pool.” However, shareholders will still be under pressure to tender their shares in the opening tender offer to avoid being “frozen out” at an unfavorable price in the second-step transaction.

46. See Finkelstein, supra note 45, at 291-92.
after the announcement of the initial tender offer. Where a fair price provision is in place, shareholders have additional time to make an informed decision as to whether they should tender their shares to the bidder. Fair price provisions also address the problem of unequal treatment of shareholders which may result in two-tier transactions. When the initial tender offer is announced, market professionals are generally better able to take advantage of the higher-priced offer than other less sophisticated shareholders. Fair price provisions, to the extent they force the offeror to acquire all of the outstanding shares at a uniform price, reduce the advantages enjoyed by market professionals.

By making the second-step transaction more costly to a bidder, fair price provisions may serve to discourage a bidder from initiating a takeover attempt for a target company. However, as in the case of traditional supermajority provisions, these defensive measures will have little deterrent effect where a potential bidder seeks to acquire only a portion of the target company’s outstanding shares. Indeed, fair price provisions may have the unintended effect of encouraging partial offers which may be less favorable to target company shareholders than two-tier, front-end loaded transactions.

Although the courts have not had the occasion to address the validity of fair price provisions, their similarity to supermajority

47. As discussed, the Commission recently revised Rule 14d-8 of the General Rules and Regulations under the Securities Exchange Act of 1934, as amended, to create a single proration period extending throughout the duration of the tender offer. See supra note 45. Before Rule 14d-8 was revised, a bidder was required to prorate all shares tendered during the first 10 calendar days of the offer and shares tendered during the ten calendar days following any increase in the consideration offered. This 10-day proration rule allowed bidders to use multiple proration pools to “lock-up” shares tendered early in the offer by increasing the consideration offered after the conclusion of each successive proration period. See Finkelstein, supra note 45, at 292-93. The complexities that were created by the use of multiple proration pools worked to the advantage of market professionals who were better equipped to make informed decisions very quickly. Although Rule 14d-8, as amended, should serve to reduce the advantages enjoyed by market professionals in two-tier bids, market professionals will continue to obtain a higher proration factor in two-tier bids. Unsophisticated or uninformed investors frequently fail to tender their shares in a timely or proper fashion and are therefore precluded from participating in the opening tender offer.

48. It was the view of a number of the members of the Commission’s Advisory Committee that two-tier bids are generally more favorable to target company shareholders than partial offers with no second step-transaction. These members argued that the price paid in the second step of a two-tier takeover bid is normally greater than the market price which the stock would have had after the partial tender offer if no second step had occurred. Advisory Committee, supra note 8, at 25.
provisions, whose validity has been upheld by the courts, suggests that they would be enforced by the courts if challenged.49


A small number of companies have amended their charters to include mandatory redemption provisions. These provisions grant the shareholders the right to require the corporation to purchase their shares in the event a shareholder or group of affiliated shareholders acquires a specified percentage of the outstanding shares of the corporation (usually ranging anywhere from 20%-45%) and such acquisition is not approved by the board of directors or a supermajority vote of the shareholders.50 Several formulas have been utilized to calculate the repurchase price including the highest price at which shares have been previously acquired by the interested shareholder or the highest market price of the shares on the date the interested shareholder became an interested shareholder, whichever price is greater.51 Mandatory redemption provisions are designed to deter both partial tender offers and two-tier pricing transactions. Unlike the fair price provision, the mandatory redemption device does not give the successful bidder the opportunity, after the completion of a partial tender offer, to decide whether it wants to initiate a second-step transaction to eliminate the remaining shareholders.

The validity of mandatory redemption provisions has not been tested in the courts and, in the view of many, is open to question.52

49. For a discussion of the enforceability of fair price and mandatory redemption provisions under Delaware law, see Finkelstein, supra note 45, at 301-10.
50. Id. at 298-99. For examples of mandatory redemption provisions, see Proxy Statement of Rubbermaid, Inc. (March 24, 1978), reprinted in 2 A. Fleischer, Jr., supra note 1, at 707 [Exhibit 11]; Proxy Statement of Amedeo, Inc. (April 29, 1983), reprinted in Bann & Finley, supra note 13, at 699.
51. Finkelstein, supra note 45, at 298.
52. Mandatory redemption provisions may be invalid under Delaware law. Arguably, Section 151(a) of the General Corporation Law of Delaware prohibits a corporation from issuing a class of common stock that is redeemable at the option of the holder. Del. Code Ann. tit. 8, §151(a) (Supp. 1983). Moreover, even if these provisions are valid under Delaware law, they would not be operable if the redemption would impair the corporation’s capital. Del. Code Ann. tit. 8, §160(a)(1) (Supp. 1983). For a discussion of the validity of mandatory redemption provisions, see Banner & Finley, supra note 13, at 655 ("The validity of compulsory redemption provisions has not been tested in the courts, and involves numerous questions which are not raised by most shark repellants.”); Finkelstein, supra note 45, at 310 ("... carefully drafted fair price, mandatory bid, and flip over provisions may be valid under Delaware law").
Unless and until the courts provide answers to the enforceability questions raised by these provisions, it is doubtful whether they will become a widely-used defensive technique.


The mandatory bid provision is another type of charter provision that is designed to deter two-tier, front-end loaded bids and partial offers. Under a mandatory bid provision, if a shareholder or group of affiliated shareholders accumulates a specified percentage (usually ranging from 20%-45%) of a corporation's outstanding shares, it must immediately initiate a tender offer for the remaining shares unless the initial share accumulation is approved by the board of directors or the shareholders who are unaffiliated with the controlling shareholder or group. Mandatory bid provisions typically require that the tender offer price be at least equal to the highest price paid by the controlling shareholder or group for its shares or the highest market price of the shares existing prior to the tender offer, whichever price is greater. As in the case of mandatory redemption provisions, the validity of mandatory bid provisions is open to question. This fact is perhaps the primary reason why both of these measures have not been adopted by more companies.

C. Blank Check Preferred Stock and Other Defensive Measures

Corporations in the United States are currently adopting a variety of shark repellent amendments that do not fit into either of the two categories discussed above. For example, corporations in recent years have adopted shark repellent amendments which require shareholder approval of significant share acquisitions, im-
pose limitations on the maximum voting power of any single shareholder⁵⁷ and create restrictions on the ownership of the corporation's shares.⁵⁸

A large number of companies have adopted charter amendments authorizing a class of “blank check” preferred stock as a defense against unsolicited takeover attempts. Under most state corporation law statutes, the corporate charter may authorize a class of preferred stock issuable from time to time by the board of directors in one or more series with such voting powers and other designations, rights, preferences, qualifications and limitations as are established by the board of directors.⁵⁹ The ability of the board of directors to cause the issuance of a new series of preferred stock whose terms have been tailored by the board can serve as a potent weapon to thwart a takeover attempt. Upon the announcement of a takeover effort, the board is in the position to cause the target corporation to issue to a friendly party a series of preferred shares entitling the holder to exercise a significant percentage of the voting power of the corporation, to vote as a class for

and any shares owned by certain members of management of the corporation.

The amendment to the Code of Regulations of GF Business Equipment incorporates the principal requirements of the recently-enacted Ohio Control Share Acquisition Statute [OHIO REV. CODE ANN. §1701.831 (Page 1982)], the only difference being that the amendment requires a two-thirds vote of the shareholders, whereas the Ohio Control Share Acquisition Statute requires approval of only a majority of the shareholders entitled to vote.

⁵⁷. See Proxy Statement of MCI Communications Corp. (June 7, 1982), reprinted in 2 A. FLEISCHER, JR., supra note 1, at 933 [Exhibit 34-Extract]. MCI Corp. amended its charter to provide that any shareholder which acquired in excess of 10% of the outstanding shares of the corporation and then failed to make a tender offer for any and all of the corporation's shares at a designated price would be entitled to exercise only 1/100 of a vote per share for each share in excess of 10% of the outstanding shares.

Restrictions on voting rights may be valid if they are reasonable and are imposed for a proper business purpose. See, e.g., Providence & Worchester Co. v. Baker, 378 A.2d 121 (Del. 1977) (court upheld charter provision giving shareholder only 1 vote for every 20 shares in excess of first 50 shares owned). For a discussion of the legality of voting restrictions under Delaware Law, see 1 A. FLEISCHER, JR., supra note 1, at 36 n.92.

⁵⁸. See Proxy Statement of Foremost-McKesson, Inc. (June 17, 1980), reprinted in 2 A. FLEISCHER, JR., supra note 1, at 925 [Exhibit 33-Extract]. Foremost amended its charter to grant to the Board of Directors the power to restrict stock ownership by persons whose ownership of shares of the corporation might jeopardize the corporation's licenses, franchises and other proprietary rights. Certain types of restrictions on the ownership of shares of a corporation may be invalid. See, e.g., Joseph Seagram & Sons, Inc. v. Conoco, Inc., 519 F. Supp. 506 (D. Del. 1981) (by-law provision purporting to limit number of shares that could be held by aliens found to be invalid under Delaware law).

⁵⁹. See, e.g., DEL. CODE ANN. tit. 8, §151 (Supp. 1983). In some states directors are not permitted to set the voting rights of the preferred stock and voting rights, if any, must be set forth in the charter. See, e.g., OHIO REV. CODE ANN. §1701.06(A)(12) (Page 1982).
the election of a designated number of directors or to vote as a separate class on certain transactions such as mergers. 60

The creative use of blank check preferred stock was perhaps the most interesting development in the use of defensive charter and by-law provisions in 1983. A number of issuers, which were the targets of tender offers or stock accumulation efforts, issued to their stockholders, in the form of a stock dividend, shares of a class of convertible preferred stock whose terms were decided by the target's board of directors. 61 The terms of these "poison pill" preferred stock issues were designed, in part, to protect the shareholders of the issuing company from the effects of two-tier, front-end loaded, bids or partial tender offers. 62

"Poison pill" preferred stock operates in much the same manner as the mandatory redemption provision to deter two-tier, front-end loaded transactions and partial bids. Under the terms of the typical "poison pill" preferred stock issue, if a third party acquires a specified percentage of the corporation's outstanding voting power (ranging anywhere from 20%-45%) and thereafter fails to complete a second-step merger or other business combination to acquire the remaining shares within a specified period of time, the preferred stock becomes redeemable, at the election of the holders, at a price that is based upon the highest price paid by the bidder to acquire its controlling block of stock. 63 In the event of a second-step merger, the holders of the preferred stock have the opportunity to exchange their shares for shares of a substitute preferred stock of the bidder company. Each share of the substitute preferred stock is convertible into a number of shares of voting common stock of the bidder company or its parent company that is determined according to a formula based upon the highest price paid by the bidder for its shares of the target company. 64

Although the use of "poison pill" preferred stock was challenged several times in the courts in 1983, 65 many questions remain with respect to the legality of this type of defensive device. 66 Until

60. Hochman & Folger, supra note 13, at 547.
61. See Atkins, Mergers and Acquisitions: Developments in Certain Defensive Techniques, in FIFTEENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 751, 771-83.
63. Id. at 299-301.
64. Id.
65. Id. at 294-96.
66. Atkins, supra note 61, at 772 ("The legality of these preferred stock issues is still subject to question."); Finkelstein, supra note 45, at 307 ("serious questions remain unresolved
there is controlling precedent supporting the validity of the use of the "poison pill," it is unlikely that convertible preferred stock dividend programs will become commonplace among public corporations in the United States.

II. STATE AND FEDERAL REGULATION OF SHARK REPPELLENT PROVISIONS

The growth in the popularity of shark repellent measures in corporate charters and by-laws has been accompanied by a chorus of opposition to their use as defensive weapons against takeover attempts. Critics of shark repellent measures have raised a number of concerns regarding their impact on shareholders and the national securities markets in general. They have argued that defensive charter and by-law provisions serve to protect the positions of corporate managers who may no longer be favored by the shareholders, give corporate managers the ability to block bids for corporate control which may serve the best interest of the shareholders, and create unreasonable limitations on the voting rights of majority shareholders. It has also been argued that shark repellent measures impede the operation of the takeover process as it occurs in the national securities market. Proponents of this latter view have claimed that defensive measures have an adverse impact upon the welfare of shareholders of both target and bidder

67. Critics of shark repellent provisions argue that these measures, to the extent they deter takeover attempts, eliminate an important mechanism whereby shareholders are able to eliminate an inefficient management. See Gilson, supra note 26, at 777. They also claim that by removing the threat of a takeover, these provisions eliminate an incentive for incumbent management to perform well. See, e.g., Fischel, supra note 5, at 305, 341. Critics of defensive charter and by-law provisions also argue that these provisions give management the ability to block takeover transactions that would benefit shareholders. Thus, it is claimed that "[s]hark repellent amendments that give management the same ability to block tender offers as the corporate statute gives with respect to mergers and sales of assets result in management's effective monopoly on corporate control . . . . Shark repellent amendments eliminate an essential means by which the corporate structure—ideally a coherent framework of statutory, judicial, and market components—constrains managerial discretion." Gilson, supra note 26, at 821-22. Critics of shark repellent measures also argue that the holders of a majority of a corporation's outstanding shares should not be able, through the adoption of defensive measures, to restrict the voting rights of persons who may acquire a majority of the corporation's shares in the future. See Gilson, supra note 26, at 790-92. This occurs, for example, when the holders of 51% of the corporation's shares adopt a defensive charter provision which cannot be amended or repealed except by the affirmative vote of the holders of 85% of the shares.
companies and society as a whole because they frustrate the smooth functioning of the national market for control of publicly-held firms, a process which they believe is beneficial to shareholders and the national economy. The balance of this article reviews these concerns and examines the extent to which additional state and federal regulation is needed to limit the ability of corporations to adopt defensive charter and by-law provisions.

A. Regulation of Shark Repellent Provisions by the States

1. Traditional Approach of the Courts to the Validity Question

The validity of shark repellent provisions is primarily a question of state law. A corporation that desires to implement a defensive charter or by-law provision must look to the corporation laws of the state in which it is organized to determine whether it is permitted to adopt the particular provision under consideration. The corporation law statutes found in most states expressly authorize a corporation to adopt most of the defensive charter and by-law provisions which are currently popular among corporations in the United States.

Although there are very few reported cases involving the legality of defensive charter and by-law provisions, most of the reported cases have upheld the validity of the challenged provisions. The courts in these cases have tended to limit their inquiry to whether the challenged provision complies with the technical language of the governing corporation law statute. This approach has virtually guaranteed the validity of most shark repellent measures. The
courts have declined to examine such issues as whether defensive charter and by-law provisions create an inherent conflict of interest for corporate managers or whether they violate the rights of majority shareholders by permitting minority shareholders to thwart corporate transactions favored by the majority.\textsuperscript{72}

\textsuperscript{72} The approach that the courts have adopted in these cases is understandable. Where a statute expressly authorizes a corporation to adopt a particular charter or by-law provision, a court will be reluctant to expand its analysis beyond the specific language of the relevant statute. Moreover, where a charter or by-law provision has been adopted by the holders of a majority of a corporation's shares, a court is likely to reject the claim that
2. Addressing the Problems with Shark Repellent Provisions: The Need for New State Regulation

The failure of the courts to address the significant problems presented by shark repellent provisions has prompted calls for new state law restrictions on the ability of corporations to adopt provisions which unduly restrict the voting rights of majority shareholders or grant to corporate managers the power to thwart shifts in corporate control that may be favored by the holders of a high percentage of the corporation's outstanding shares. In fact, a number of commentators have proposed a general prohibition on the adoption of shark repellent measures. What many of the proponents of these proposals have overlooked, however, is that certain types of defensive charter and by-law provisions serve to protect shareholders from the effects of abusive takeover techniques and some of these provisions serve valid purposes which are

the provision is unfair to shareholders.

The cases involving the validity of shark repellent provisions adopted before the announcement of a takeover attempt do not examine whether the corporate officers and directors may have violated their fiduciary responsibilities by seeking the implementation of defensive charter and by-law provisions. A fiduciary analysis is generally not pertinent to an examination of shark repellent provisions if such measures have been adopted by the shareholders. Even if a shark repellent measure creates a conflict of interest for management, the approval of the measure by an affirmative vote of the shareholders makes it very difficult for a shareholder later to establish a claim against management for breach of their fiduciary duties in seeking to implement the defensive measure. Where management has sought to implement defensive charter and by-law provisions after the announcement of a takeover attempt, the claim is often made that management has sought to maintain itself in control of the corporation at the expense of the shareholders of the corporation in violation of its fiduciary responsibilities. See Maiwurm & Tobin, supra note 30, at 441.

If the directors of a corporation unilaterally amend the corporation's by-laws without shareholder approval to adopt a shark repellent provision, their actions will be evaluated in terms of whether they represented a valid exercise of the directors' business judgment. Id. at 441. Under the business judgment rule, the directors, when they act in good faith, are held to enjoy a presumption of sound business judgment which the courts will not disturb if any rational purpose can be attributed to their decisions. Id. at 441. See also, Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir. 1981), cert. denied, 454 U.S. 1092 (1981). The party challenging the action has the initial burden of establishing that the directors acted in bad faith before the burden shifts to the directors to establish the action had a valid business purpose. Maiwurm & Tobin, supra note 30, at 441. See also, Johnson v. Trueblood, 629 F.2d 287, 292-93 (3rd Cir. 1980), cert. denied, 650 U.S. 999 (1981); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 701-04 (2d Cir. 1980). Under this standard, it is very difficult for a shareholder to challenge the adoption by the directors of a shark repellent amendment since such action can usually be attributed to some rational business purpose. Maiwurm & Tobin, supra note 30, at 441.

73. See, e.g., Gilson, supra note 26 at 828-29 (proposal to prohibit use of lock-up amendment); Advisory Committee, supra note 8 at 36; Easterbrook & Fischel, supra note 6.
independent of their defensive function. While state law limitations on the ability of corporations to adopt shark repellent measures are needed, they must be narrowly tailored so that they do not prevent the adoption of adopting measures that will clearly serve the best interests of the shareholders and the corporation.

A simple solution to many of the problems presented by shark repellent provisions is found in the corporation law statutes of the State of Michigan and is proposed for inclusion in the forthcoming revised Model Business Corporation Act. The Michigan Business Corporation Act provides that any amendment of the charter which "adds, changes or deletes" a provision that requires the vote or concurrence of the holders of a greater proportion of the shares to take a particular action than is required by statute must be "authorized by the vote required to amend the articles pursuant to [the Michigan Business Corporation Act], or by the same vote as would be required to take action under such provision, whichever is greater." Thus, under the Michigan Business Corporation Act, a proposal to adopt a supermajority charter provision which requires an 80 percent vote to approve mergers and other business combinations would require the same 80 percent vote for adoption by the shareholders initially. Similarly, a proposal to amend the charter to include a "lock-up provision" requiring an 80% shareholder vote to make further amendments to the charter would require the same 80 percent vote for adoption. Since most defensive charter provisions are held in place with lock-up amendments, the Michigan statute is applicable to the adoption of a large percentage of the shark repellent measures which are currently being adopted in the United States.

74. As discussed previously, a significant percentage of the shark repellent measures adopted in recent years have been designed to protect shareholders from the abusive effects of two-tier, front-end loaded bids and partial tender offers. Such provisions have not been adopted for the purpose of deterring tender offers generally. See supra notes 3-4 and accompanying text.


The section proposed for inclusion in the revised Model Business Corporation Act is closely modeled after the Michigan statute.\textsuperscript{77} It also would require that any addition, change or deletion of a supermajority provision in the charter be adopted by the greater vote specified in such provision. The proposed Committee Comment accompanying this section explains the reason for the new requirement: "since the effect of a supermajority provision is to permit a minority to block the will of the majority in perpetuity, the Committee believes the vote for its adoption should be by the same supermajority in order to ensure that the provision has widespread shareholder support proportionate to the restriction being imposed."\textsuperscript{78}

A statute requiring an equivalent supermajority shareholder vote to adopt a supermajority provision or lock-up amendment addresses many of the concerns that have been raised by the critics of shark repellent measures. Such a statute makes it more difficult for corporate managers to implement defensive measures which do not serve the best interests of shareholders. Under the corporation laws of most states, corporate managers are able, with the support of the holders of a majority of the outstanding shares, to implement shark repellents that, in effect, give management the authority to block corporate transactions that may be in the interest of the target company's shareholders. It is a relatively simple task for management to obtain the required majority vote because of its control of the distribution of proxy statements and the solicitation of proxies. If a supermajority shareholder vote is required to adopt supermajority and lock-up provisions, there is a much greater likelihood that these provisions will be approved only in cases where they have the support of the holders of a substantial percentage of a corporation's shares.\textsuperscript{79} A statutory provision of this type also addresses the concern that shark repellent provisions unfairly limit the voting rights of future majority shareholders. Such a statute prevents the holders of a certain percentage of a corporation's outstanding shares from adopting

\textsuperscript{77} Model Act Committee, supra note 83, at 1901.
\textsuperscript{78} Id. at 1900-91.
\textsuperscript{79} There is evidence that shareholders are developing a greater awareness of the possible impact of shark repellent measures and are beginning to review proposals for their adoption more closely. For example, institutional investors are frequently voting against provisions which are designed to discourage takeovers. See, e.g., Bluestein, supra note 2, at 29; Metz, supra note 2 at 1.
defensive measures that cannot later be removed by the holders of the same percentage of shares.

Unlike many of the proposals for regulation of shark repellent measures, the approach of the Michigan statute does not create unreasonable restrictions on the ability of shareholders to adopt defensive charters and by-law amendments which they believe are in the best interest of the corporation and its shareholders. As long as the provisions may be amended or repealed by an equivalent shareholder vote, the holders of a substantial percentage of a corporation's voting shares should not be prevented from implementing defensive charter and by-law measures even if such provisions may have the effect of protecting the positions of incumbent management or permitting management to block corporate changes that may prove beneficial to the shareholders.

B. Regulation of Shark Repellent Provisions at the Federal Level

Although the staff of the Securities and Exchange Commission has promulgated specific disclosure requirements for proxy statements containing shark repellent proposals, neither Congress nor the Commission has sought to regulate the types of provisions that a corporation may include in its charter or by-laws. The absence of federal regulation in this area is not surprising, however. Recognizing the important role of the states in regulating the business structure and internal operations of corporations, Congress has not sought to federalize the substantial body of law regulating these matters. Moreover, with the exception of certain financial institutions, Congress has declined to establish a national system of federal chartering of corporations. Congress has determined that the most critical decisions on the operation and business structure of a corporation should be left to the states to work out through experiment and experience.


81. The Supreme Court of the United States has recognized the importance of state law in governing the internal affairs of corporations. See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 478-80 (1977). In Santa Fe, the Court ruled that a merger under Delaware's short-term merger statute was neither deceptive nor manipulative and therefore did not
The limited role of the federal government in regulating the business structure and internal operation of corporations is reflected in the federal securities statutes. Although of vital importance, these statutes are intended to create a number of minimum disclosure requirements and prohibitions against manipulative and deceptive practices which must be satisfied by everyone. This arrangement has not left the Commission without a meaningful role, however. The Commission has the critically important function of ensuring proper disclosure and preventing fraud and manipulation. Furthermore, the Commission's responsibility for administering the periodic reporting requirements of the Securities Exchange Act of 1934 is invaluable to shareholder protection and the preservation of the integrity of the national securities market. The Commission also has the very important responsibility and power of setting minimum requirements for proxy statements, prospectuses in public offerings and disclosure in tender offers.

In its 1983 report to the Commission, the Advisory Committee on Tender Offers recognized that its proposals with respect to shark repellent provisions would result in significant federal intervention in an area traditionally governed by the states. It concluded that a determination of the extent to which Congress or the Commission should intrude in this area should be based upon a "balancing of two competing interests: minimal preemption of traditional state corporate law and maintenance of the integrity of the national

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violate Section 10(b) of the Securities Exchange Act of 1934, as amended, or Rule 10b-5 thereunder. The Court held that a claim of fraud and fiduciary breach in a complaint will state a cause of action under Section 10(b) and Rule 10b-5 only if the conduct alleged can be viewed as "manipulative or deceptive" as those terms have been defined by the courts. Id. at 474. The Court held that "Congress by §10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." Id. at 479.

82. In fact, it was through these powers that the Commission responded to Santa Fe v. Green—it supplied rules of disclosure in going private transactions. The Commission, consistent with its traditional role, limited itself in this situation to disclosure and prevention of fraud and manipulation, and left to state law the complex questions of business purposes and substantive fairness in these transactions.


83. Advisory Committee, supra note 8, at 34-35.
securities market in which tender offers take place". The Committee concluded that charter and by-law provisions which erect high barriers to change of corporate control "improperly interfere with the conduct of takeovers in the national market place" and therefore should be prohibited by Congress or the Commission.

Contrary to the conclusion of the Advisory Committee, federal limitations on the adoption of shark repellent measures are not necessary to protect the efficient operation of the takeover process as it occurs in the national securities markets. First, it is unclear whether takeovers are per se beneficial to shareholders, the national economy or the national securities markets. Neither Congress nor the Commission should act to protect a process whose value to the national economy is not yet proven. Second, even if it is assumed arguendo that takeovers are generally beneficial, it is unclear whether shark repellent measures actually serve to impede the takeover process. It would be unwise for Congress to take the unusual step of intervening in the internal affairs of corporations to outlaw shark repellants unless it has been established that these measures actually deter takeovers. While the authority of Congress to enact legislation regulating the adoption of shark repellent measures is conceded, it is submitted that there is simply no good reason for it to exercise its authority in this area.

Notwithstanding its call for a ban on shark repellent measures, the Commission's Advisory Committee acknowledged in its report that it did "not believe there [was] sufficient basis for determining that takeovers [were] per se either beneficial or detrimental to the economy or the securities markets in general, or to issuers or their shareholders, specifically." The report stated that a "substantial majority" of the Advisory Committee was "unable to agree that substantial economic benefits or detriments of takeover activities have been conclusively established." Arthur J. Goldberg, a former United States Supreme Court Justice and a member of the Advisory Committee, in a statement separate from the Ad-

84. Id. at 34.
85. Id.
86. The consequences of a federal prohibition of shark repellent measures are potentially far-reaching. Any intrusion of this type by the federal government carries with it the threat of an eventual federalization of the extensive body of state law governing the business structure and internal operation of corporations in the United States.
87. Advisory Committee, supra note 8, at 9.
88. Id. at 8.
visory Committee report, noted that "no evidence was presented to the Advisory Committee and no authoritative study seems to have been made as to whether, in the long run, tender offers have contributed to corporate viability or profitability or have benefited shareholders of the offeror or target company or the public".\(^9\)

The extensive commentary on the effects of tender offers is divided on the question of whether the tender offer process is generally beneficial to shareholders and the national marketplace. A number of commentators have concluded that takeovers result in significant economic and social costs. They have argued that tender offers divert corporate resources from productive investments.\(^9\) They have also claimed that the threat of unsolicited takeovers results in significant costs to the economy by shifting the focus of corporate managers from long-range corporate planning to short-term profits.\(^9\)

Even if the takeover process does increase shareholder welfare and produce benefits to the economy as a whole, a federal prohibition of shark repellent measures is not needed to protect the operation of this process as it takes place in the national securities markets. First, it is unclear whether shark repellent measures have any impact whatsoever in discouraging takeovers.\(^2\) In fact, there is some evidence that defensive measures serve to force higher takeover bids rather than deterring bids altogether.\(^3\) Second, even if shark repellents are a deterrent to tender offers, the national securities markets serve to "discipline" corporate managers who

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89. Advisory Committee, supra note 8 at 124 (Separate Statement of Arthur J. Goldberg).
93. A number of commentators have argued that the ability of corporate managers to resist unsolicited tender offers benefits target company shareholders by encouraging competing bids from white knights and others at higher prices. See, e.g., Herzel, Schmidt & Davis, Why Corporate Directors Have a Right to Resist Tender Offers, 6 CORP. L. REV. 107, 109-10. Furthermore, a number of studies have shown that shareholders often benefit when a takeover is initially rejected by the directors of the target company. See Lipton, Takeover Bids in the Target's Boardroom: An Update After One Year, 36 BUS. LAW 1017, 1025-26.
orchestrate the adoption of these provisions and create disincentives for the implementation of these measures.

In a statement separate from the report of the Advisory Committee, Advisory Committee members Frank H. Easterbrook and Gregg A. Jarrell point out that investors have the opportunity to decide whether or not they want to purchase shares of corporations which have adopted tough anti-takeover provisions in their charters and by-laws. Accordingly, the existence of shark repellent provisions in a corporation’s charter or by-laws will be reflected in the market price of its stock if adequate information concerning these measures has been disseminated in the marketplace. Corporations which do not have defensive provisions in their charters or by-laws will be rewarded in the securities markets, while corporations which adopt provisions that do not benefit investors should experience a decline in the market price of their stock and become even more attractive takeover candidates. Corporations with defensive charter and by-law provisions that protect inefficient managers may limit their profitability and growth which should also result in lower stock prices. Because of the rewards that the market provides to companies whose organizational documents do not bulge with defensive provisions, corporations have an incentive to avoid adopting defensive measures which are not beneficial to their shareholders.

A company's adoption of shark repellent provisions will be assimilated into the market price of its stock only if it has provided the market with accurate and complete information with respect to its defensive devices. The critical role of the Commission, therefore, is to make sure that adequate disclosure of the existence of anti-takeover provisions is made by companies whose securities are traded in the national securities markets. The Commission must also prohibit fraud and manipulation in connection with the adoption of shark repellent provisions. This responsibility might involve, for example, the implementation of rules prohibiting the adoption of defensive measures after the announcement of a tender offer. A company which has not adopted shark repellent provisions should not be permitted to “deceive” the

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94. Advisory Committee, supra note 8, at 87 (separate statement of Frank H. Easterbrook and Gregg A. Jarrell).
95. Id. at 87.
96. Id. at 87.
97. Id. at 87.
market by implementing these measures after the announcement of a takeover. 98 Except for federal regulation aimed at ensuring full and fair disclosure and preventing fraudulent or manipulation activities, federal regulation of shark repellent measures is not necessary to protect the smooth operation of the tender offer pro-

98. In their separate statement, Advisory Committee members Jarrell and Easterbrook suggest that a federal prohibition of shark repellent measures adopted prior to the announcement of a tender offer is unnecessary because the market is able to "discipline" corporate managers who seek to load up the charters of their companies with defensive measures. Advisory Committee, supra note 8, at 87. Messrs. Easterbrook and Jarrell argue that a federal safeguard may be necessary, however, to prevent corporate managers from changing the rules after the announcement of a tender offer:

The managers of a firm that has announced itself open to tender offers may attempt to welch on the deal and prevent the transfer of control. Arrangements that seem advantageous to them when they were writing articles, by-laws and contracts, the better to sell securities, may seem less beneficial once they have reviewed the money and then feel their positions threatened. Managers thus cannot be allowed to change the rules once the game has begun.

... We would expect state courts to enforce articles and by-laws rigorously, but if they do not there might be cause for a federal tender offer rule ensuring that firms stick with whatever position on tender offers they adopted in the articles and by-laws. Id. at 88-89.

Easterbrook and Jarrell also suggest the need for federal regulation requiring firms to seek reauthorization for shark repellent measures every "few" years. They note that such a requirement would "relieve the shareholders of the costs of putting a proposal on the ballot, and the reauthorization vote gives shareholders an opportunity to organize to restore the status quo should they think that the change in the earlier vote is now hurting the firm." Id. at 90. They also recommend delaying the effectiveness of anti-takeover amendments for one year after they have been adopted. This proposed rule is intended to permit shareholders "to wage a proxy fight or arrange a tender offer before the rules take effect." Id. at 103-04.

Easterbrook and Jarrell's recommendation that the Commission adopt a federal tender offer rule prohibiting companies from changing their articles or by-laws after the announcement of a takeover attempt is a good one. As these two commentators emphasize, assuming the market has incorporated information concerning an issuer's defensive charter and by-law provisions into the market price of an issuer's securities, corporate managers should not be permitted to "change the rules once the game has begun." See Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981) (defensive tactics of a target company after the announcement of a tender offer can be found to constitute "manipulative acts" violative of Section 14(e) of the Securities Exchange Act of 1934 even without deception). But see Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2nd Cir. 1983) (grant of stock option by target company as a defensive device in tender offer was not a "manipulative device" for purposes of Section 14(e) of Securities Exchange Act of 1934).

It is not clear, however, whether the reauthorization vote and delayed effectiveness requirements proposed by Messrs. Easterbrook and Jarrell are necessary to protect the takeover process as it occurs in the national securities markets. Nevertheless, in comparison to the Advisory Committee's call for a federal prohibition of certain shark repellent measures, these recommendations would involve much less federal intervention in the regulation of the internal affairs of corporations.
cess as it occurs in the national marketplace. The national securities markets will act to encourage issuers to limit the amount of defensive armor in their charters and by-laws and discipline companies that adopt defensive measures that are not favored by shareholders. As for concerns that shark repellent measures result in unfairness to shareholders, these are matters that are best left to the states to resolve through changes in the state corporation law statutes.

III. CONCLUSION

The growth in the number of companies adopting defensive charter and by-law provisions has generated a considerable amount of debate about the effects of these provisions on shareholders and management as well as their impact on the takeover process in general. Numerous proposals have been made for new state and federal limitations on the ability of corporations to amend their charters and by-laws to include antitakeover devices. An examination of the impact of these provisions on shareholders suggests that limitations are needed. However, in view of the types of problems created by shark repellent provisions, restrictions on the ability of corporations to adopt these provisions should be imposed by the states rather than by the federal government.

99. Advisory Committee, supra note 8 at 87 (separate Statement of Frank H. Easterbrook and Gregg A. Jarrell.)
IN DEFENSE OF THE CORPORATE COUP

by

Henry G. Manne*

Du Pont pays $7.5 billion to buy up Conoco. Santa Fe Industries and Southern Pacific agree to merge in a $5.2-billion deal, creating the third largest railroad in the country. Allied acquires Bendix for $2.3 billion in a celebrated takeover battle started when Bendix tries to absorb Martin Marietta. How could such high-priced shuffling of corporate assets possibly benefit the economy?

The popular wisdom is that it doesn’t and can’t. Harvard professor Robert Reich, darling of the neo-liberals, is typical of the most recent anti-merger sentiment. In The Next American Frontier, his apologia for a government industrial policy published last spring, Reich put corporate mergers at the top of his list of sins of “paper entrepreneurialism.” Soon Time magazine was characterizing corporate takeover battles as “paper chases.”

But if Reich managed to coin a catchy label, he is not alone in his view that the business mergers that have been making headlines don’t make much economic sense. Here are already-huge corporations apparently diverting their firms’ resources from production or from their own stockholders. Often, in “hostile takeovers,” the managers of the “target” firms don’t want their companies to be acquired. The “raiding” corporations seek to gain control anyway via tender offers—using public solicitations to buy stocks directly from the target firms’ shareholders, at high premiums over the stocks’ market value. Thus the parries, thrusts, and billion-dollar deals that can seem like a waste of time and money.

“I think it is time for the Congress to send a clear signal to corporate America that we will no longer tolerate unrestrained warfare between top management for control of corporate assets,” declared Rep. Peter Rodino (D-N.J.) last summer, when he introduced legislation to restrict large mergers. The proposed measure would ban any large mergers not deemed to be “in the public interest” by the Justice Department and the Federal Trade Commission. The two agencies would be enjoined to judge a merger’s

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effect not only on competition (that, they've always been empowered and eager to do) but on employees and the "effective management of corporate assets." Whether or not the legislation passes—it seems unlikely at this time—it embodies widely held sentiments.

Meanwhile, the Securities and Exchange Commission, the government's main arm of stock-market regulation, is carrying on a review of tender-offer policy. Tender offers are used in only a small percentage of mergers; in 1982, for example, there were 2,400 mergers, of which 94—only 3.9 percent—involved tender offers. But these are the ones that can make news in the mass media, and in the wake of the Bendix-Martin Marietta battle in late 1982, the SEC initiated a study of its regulation of corporate takeovers, with a view to better protecting stockholders' interests.

Up till now, the government's primary weapon against mergers has been the antitrust laws. Mergers, particularly among firms in the same industry, have often been deemed among the least defensible kinds of behavior under US antitrust laws—right up there with price fixing.

Thus we find the Federal Trade Commission voting unanimously in 1982 to stop Gulf Oil from buying Cities Service, claiming that the proposed merger could jeopardize competition. The FTC's action succeeded, as Gulf withdrew the offer, citing antitrust obstacles, although other factors may have been involved as well.

The FTC also challenged the acquisition of two hospital chains by the Hospital Corporation of America, because its share of the acute-care market in a 13-county area around Chattanooga, Tennessee, would rise from 16-17 percent to 30-32 percent. Further evidence of the supposed threat to competition was the estimate that the company's share of the market for inpatient-psychiatric services in the same geographic area would rise from about 7 percent to about 38 percent.

The antitrust laws also played a major role in stopping Mobil's attempt in 1981 to take over Conoco and then Marathon. Du Pont won the contest for Conoco, but its ability to acquire it at $98 a share, compared to Mobil's offer of $129, was helped by threats from the FTC and the Justice Department to go to court against Mobil if it won. Investors were properly concerned that if they accepted Mobil's offer, the deal would later be nullified.

Later, Mobil failed to acquire Marathon even though it offered up to $126 for stock that had been selling at $64. Marathon executives secured an injunction against Mobil under the antitrust
laws, and the FTC proceeded to file suit in opposition to the takeover. Marathon executives were thus able to fend off Mobil in favor of a "friendly takeover" by US Steel.

Why should the government, and sometimes incumbent management, be using the antitrust laws to block mergers that the market, by the existence of willing buyers and sellers, demonstrates to be desirable? The long-standing rationale is a fear of monopolization; consumers are to be protected from high prices by preventing industry concentration via merger. Under new proposals, the government would gain additional weapons, ostensibly needed to protect shareholders and the public interest. Unfortunately, all this ignores significant new learning in economics—the discovery of how capital markets, unlike government regulations, actually serve the public and provide protection for consumers and shareholders.

Briefly, the apparatus works like this: The stock market accurately measures and reflects in the stock price the relative quality of each company’s management. If for any reason a company is receiving lower-quality management than someone else would be willing to provide, the company’s stock will be priced lower accordingly. This lower price will attract the interest of competing managers who see an opportunity to give better management to the company. They will want to purchase enough of the company’s stock, for which they will have to offer a premium over its low market price, to acquire managerial control. By better management, they hope to realize a gain on the shares purchased.

In this light, modern economic scholarship has shown the traditional view of mergers—as a threat to the competitive economy—to be a highly simplistic and even perverse view of things. For while there is a possibility of market power being generated by the merging of two firms, such mergers are essential to the competitive functioning of the market for corporate control. The possibility of takeovers is an extremely effective device for assuring significant competition for managers’ positions. They are thus spurred to act in the shareholders’ interest. And if they do not, the shareholders will benefit from competing managers’ buying up their stock at a premium over its market price.

An understanding of the market for corporate control lays to rest most of the hoary bugaboos about the “separation of ownership and control” that have plagued our corporation laws since Adolf A. Berle, Jr., and Gardiner Means popularized that concept 50 years ago in their famous work, *The Modern Corporation and
Private Property. Berle and Means correctly pointed out that in the form of business ownership known as the corporation, the stockholder-owners have no active voice in corporate decisionmaking. Much has been made of this in the ensuing years, and while it has been pointed out that the arrangement is suitable precisely to investors who wish to provide capital but do not have to be involved in management, many laws have been passed to make sure that corporate directors and managers don't use the firm's assets to serve their own interests at the expense of the shareholders.

In fact, though, the best thing the courts and lawmakers can do to protect shareholders is to allow competition in the market for corporate control. By stifling the market, with antitrust laws and other measures, they protect from significant competition those individuals currently functioning as the managers of stockholder-owned companies. The fact that those managers do not like competition for their positions—while enthusiastically praising it elsewhere, of course—certainly does not argue against a change in government policies. After all, who does like competition for his position?

But the opportunity for the executives of one corporation to pay a premium to the stockholders of another corporation to induce them to accept a merger is vital to the market. This transaction with shareholders is the primary protection our economic and legal systems offer against poor management, since the holdings of individuals are generally too small to allow them to rid a company of a managerial team that has caused stock prices to decline.

A buyout offer made by another corporation, which is itself subject to the same capital-market discipline, is also the best evidence (not perfect, but the best) that a change in the control of the assets of the target firm would improve economic efficiency. So takeovers not only protect shareholders against managerial abuse; they also enhance the efficiency of the economy's distribution of resources, including managerial talent.

The incumbent managers of a firm can and do construct roadblocks against a tender offer. Some of these defensive tactics may be useful in ensuring that shareholders get an appropriate price for their shares. But it is hard to believe that antitrust claims of the sort frequently used to fend off takeovers honestly reflect any legitimate concern that target company managers have either for their own shareholders' or for society's welfare. One can just
imagine how incumbent managers could use a vague “public interest” rule to protect themselves from being replaced by another management team.

The case is no stronger—albeit less ironic—when the government sues on antitrust grounds. An FTC or Justice Department decision to prevent a merger implies that government lawyers and economists can know more about the business desirability of a specific merger than can the parties involved. For, even assuming that a merger gives some monopoly power (usually a heroic assumption), this merely reflects the “cost” side of the transaction. But there is also a “benefit” side—the benefits to be derived by all shareholders from active and unrestricted competition in the market for corporate control.

The pernicious effects of the government’s antimerger activities under the antitrust laws are compounded by the securities laws. Current federal securities regulations significantly increase the purchase price of target firms. This decreases returns to acquiring firms and reduces the volume and productivity of takeovers. Hence, an unknown number of productive takeovers are deterred, and the takeovers that do occur produce smaller social gains.

It is common sense that stockholders are better off when offered a premium for stock that was selling for less before a tender offer. But it has taken imaginative, sophisticated statistical studies by financial experts to drive home the point. The results of research by economists at leading universities like Chicago, Rochester, and UCLA can be briefly summarized: the stockholders of a target firm make a good deal of money from a tender offer; the stockholders of the acquiring firm also realize significant gains, as their stock’s price generally increases; and even if a tender offer is successfully blocked by the target firm’s management, the stock declines in price but does not drop back to its pre-tender level.

Fans of monopoly theory may see such evidence as supporting the notion that mergers breed monopoly profits, but the facts do not bear this out. If a takeover increased the market power of the acquiring firm, the firm would be able to raise product prices (otherwise, why be concerned about market power?). But if this firm can raise its prices, so can other firms competing in the same industry. So the price of these companies’ shares would also go up on announcement of a takeover, as the market reflected their new potential for higher profits.

In fact, however, analysis of stockprice data shows that the value
of competing firms' stocks does not go up in response to a takeover bid. This supports the view that takeovers are evidence of competition in the market for corporate control and not of efforts to achieve market power. Likewise, government antimerger activities, such as ordered divestitures, have not been found to depress stock prices in the affected industry.

The evidence also shows that mergers generally perform a beneficial function in reallocating physical resources from less-efficient to more-efficient users. And while some takeovers prove less desirable than the parties to the merger predicted, government authorities certainly have less ability to predict the results of any given takeover than do the parties involved or the stock market.

Contrary to popular worries, then, mergers and tender offers are not economically wasteful. Takeovers are not simply power games but reflect competition in a vital market, the market for control of valuable corporate assets. And there is no good reason for the government to interfere with the private, voluntary agreements that fuel takeovers.
INTRODUCTION

It is axiomatic that an economic downturn, such as that experienced by this nation at the turn of the decade, has a deleterious impact on both the public and private sectors of the American capitalistic society. In the corporate sphere, the problems fostered by a struggling economy become more acute as business competes vigorously to obtain a share of the relatively finite sales dollars available in the sagging market place. When a corporation less effectively weathered the economic tempest, this fact is generally reflected in the declining market price of the company's shares of stock. Often, when the total dollar value of the corporation's assets exceed the aggregate selling price of the company's total outstanding shares, the company becomes an attractive target for a takeover. Frequently, the vehicle employed to facilitate this assumption of control is the cash tender offer.

Due primarily to the existing bleak economic conditions, the
1980's greeted corporate America with an inordinate amount of acquisition-related activity. One source reports that in 1981, 2,395 acquisitions and mergers were recorded, while 1982 had witnessed in excess of 1700 acquisitions and mergers. Even more remarkably, this contagion of activity has seen the Goliaths fall as well as the Davids. No longer are the smaller, more susceptible companies the prime targets; in recent years, even the larger and more financially successful corporations have fallen prey to this acquisitional fervor.

To combat the corporation's potential absorption by a raiding entity, target management often utilizes various anti-takeover defense tactics in an effort to preserve the company's independent identity. If these tactics should prove to be unsuccessful, and a change of control takes place, incumbent management must face the stark reality that their jobs—as well as their financial livelihood—may well be terminated by the new controlling faction.

The anti-takeover techniques developed by target corporations to adequately cope with the threats and the perceived disadvantages of a potential takeover have been, to say the least, creative, numerous, and not without controversy. The most recent subject

9. The proper role of target management in a pending hostile takeover bid has been the subject of lively debate in recent legal and business literature. One faction contends that management should assume a passive role only, except for disclosing to shareholders, pursuant to 17 C.F.R. § 240.14e-2 (1983), management's reasons for advocating resistance of a proposed tender offer. This group reasons that, due to the inherent conflict of interest that exists whenever management decisions are made which could affect their own ouster, management merely raises a barrier to protect their own economic interests and, thus, no valid business justification exists for across the board resistance. This position further emphasizes that, in any tender offer, the offer is made to the shareholders personally, and the decision to accept or reject a tender offer should be theirs alone. See, Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 BUS. LAW. 1733, 1745-46 (1981); Johnson, supra note 3, at 54, 59-62.

Proponents of active management involvement in takeover bids argue that management, due to their superior position of knowledge and expertise, are capable of determining that active resistance will benefit the employees, suppliers, customers and the community as a whole and, therefore a valid business justification does exist. Furthermore, shareholders are always benefitted by rejection; of the 36 hostile tender offers rejected between 1973 and 1979, the shares of over 50% of the targets are either currently at a higher price
area for anti-takeover activity has been the executive compensation contract; more specifically, an increasing number of corporations are executing ‘golden parachute’ agreements with many members of their top level management. A golden parachute is a compensation agreement which provides high level officials of a corporation with substantial financial remuneration, either in the form of severance payments, benefits, or both, in the event the corporation experiences a change in control. The metaphor ‘golden parachute’ has been attached to these agreements because, in essence, they permit an executive to “bail out” of a corporation with substantial compensation, thus assuring his “safe landing” upon departure.

Aside from the objections voiced against anti-takeover tactics in general, golden parachutes, because they award executives substantial amounts of corporate assets for nothing more than leaving the corporation, raise particularly sensitive and controversial questions of fiduciary duty and self-dealing. Further compounding the problem is the fact that the propriety of these agreements remains untested; because very few parachutes have been exercised by those executives who have them, only a few lawsuits have been filed challenging their enforceability, and none have been decided on the merits.

than the offered price or were subsequently acquired by another company for a higher price than the original tender offer. See Lipton, Takeover Bids in the Target’s Boardroom, 35 Bus. Law. 101, 106, 110 (1979-80).

10. See Prentice, supra note 8, at 341; Morrison, supra note 5, at 82.

11. Comment, supra note 6, at 615.


13. See, e.g., supra note 9.

14. This is descriptively referred to as having “pulled their ripcords.” See Morrison, supra note 5, at 86.


16. Ward Howell Int’l., Inc., 1983 Survey of Employment Contracts and “Golden Parachutes” Among the Fortune 1,000: An Update of the 1982 Survey, (Dec. 29, 1983) [hereinafter referred to as Ward Howell Survey]. Survey data was gathered from the most recent proxy statements solicited from the FORTUNE 1,000 list. Approximately 650 proxies
The purpose of this article is to analyze golden parachute agreements, paying particular attention to the justifications advanced to support these contracts as well as the objections raised in opposition. In addition, some relevant statistical data will be presented as will some typical provisions of golden parachutes. Finally, in the absence of specific case law pronouncements on validity, golden parachutes will be explored with an eye towards possible judicial reaction and analyses, both under the business judgment rule and under the more basic notions of traditional contract law.

I. OBJECTIVE CONSIDERATIONS

A. Some Relevant Statistical Data on Golden Parachutes

To adequately comprehend the magnitude of the potential problems posed by golden parachutes, both to corporations using and contemplating their use, and to the overcrowded courts that may have to determine their validity, it is important to examine some statistical data relating to the prevalence of these termination agreements and other related matters. A recent survey\(^\text{17}\) conducted among the Fortune 1,000 reveals that roughly 48% of the largest corporations protect their top executives with employment contracts, and 49% of that group include change of control 'triggers' in the employment contracts.\(^\text{17}\) Of the latter group protected by change in control provisions, 29% have been awarded pure golden parachutes.\(^\text{18}\) In sum, 25.5% of the largest U.S. companies protect their top executives with change of control agreements, up 15% over 1982.\(^\text{19}\) Hewitt Associates, a consulting firm that recently surveyed 250 of the largest U.S. companies, determined that the number of corporations executing parachutes has increased 42% over the past three years. They predict, however, that the number of new adoptions will level off in 1984.\(^\text{20}\)

Those companies with change of control provisions protect from one to eighty-three employees,\(^\text{21}\) but most companies protect be-
between two and five executives, and only a few protect more than sixty, although it has been reported that one corporation protects an astounding 234 employees. The summary figures show that 13.3% of the responding companies indicated that they protect at least one executive, 37% protect a mere two to five executives, 30.1% protect six to twenty-four executives, and 4.2% protect as many as twenty-five to eighty-three executives. The chairman is protected by 50.3%, the president by 53.1%, the chief executive officer by 46.2%, and senior, executive, or group vice presidents by 54.5%.

The triggering mechanism for most golden parachutes is generally comprised of two components—a change in corporate control and a change in the affected executive’s status. Of those companies with change of control definitions, 30.1% define the change in terms of the amount of stock owned by an outsider. Twenty-one percent define a change in control as outside ownership of more than 20% of the corporation’s outstanding shares, while 6.3% use 30% as the triggering ownership threshold.

The cash value of the total benefits to be paid out if the parachute is exercised ranges from a low of $143 thousand to a high of $38.7 million, with the largest group paying between one and two million dollars. Almost 45% of the companies with parachutes entitle their executives to lump sum payments upon departure, which generally are computed as some multiple (usually two or three) of a year’s salary.

B. Applicable Federal Law

Executive employment contracts, and accordingly golden parachutes, insofar as they have an impact on the relationships between the officers and the corporation, and the officers and the shareholders, are largely matters of state law. The practitioner, however, should be aware of certain federal regulations that come into play when executive compensation contracts are in place.

As a general rule, it is necessary that shareholders of publicly

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23. Morrison, supra note 5, at 86.
25. Id. at 2.
26. Id. at 3.
27. Id.
28. Id. at 1.
29. Id. at 4.
30. Id.
held companies be advised of the existence of special employment contracts. This is especially true when the disclosure (or non-disclosure) of such agreements would be sufficiently material to affect the shareholders' tender decision in the midst of a tender offer.\textsuperscript{31} Federal securities law, under Item 7 of Schedule 14A,\textsuperscript{32} requires the disclosure of remuneration of directors and executive officers if action is to be taken with regard to 1) the election of directors, 2) any bonus, profit sharing, or other remuneration agreement, 3) any pension or retirement plan in which these officers or directors will participate, and 4) the granting or extension of any options, warrants or rights to purchase any securities to any of these officers or directors.\textsuperscript{33} This requirement includes disclosure of any 'change of control' agreements with such persons. Furthermore, Item 3(b) of Schedule 14D-9\textsuperscript{34} requires the disclosure of any material contract or agreement and any actual or potential conflict of interest between the person filing and the target or raider.\textsuperscript{35}

Finally, it is interesting to note that regulatory agencies that profess to have jurisdiction over the subject matter of certain executive compensation contracts have recently become more active. One source\textsuperscript{36} points out, for example, that the Federal Home Loan Bank Board has promulgated regulations that prohibit institutions insured by the Federal Savings and Loan Insurance Corporation from entering into employment contracts that would constitute an "unsafe or unsound practice." An "unsafe or unsound practice" includes practices that "could lead to material loss or damage to the institution."\textsuperscript{37} While relatively few agencies have taken this type of action, in the future such regulations may become more commonplace.

II. FORMAT AND PROVISIONS

The form and substance of golden parachutes are theoretically limited only by the minds and imaginations of creative corporate

\begin{itemize}
\item[\textsuperscript{31}] See Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851, 873 (2d Cir. 1974) (dicta).
\item[\textsuperscript{33}] 17 C.F.R. § 240.14a-101 (1983).
\item[\textsuperscript{34}] Profusek, Executive Employment Contracts in the Takeover Context, 6 Corp. L. Rev. 99, 111 (1983).
\item[\textsuperscript{35}] 17 C.F.R. § 240.14d-101 (1983).
\item[\textsuperscript{36}] Handbook, supra note 12.
\item[\textsuperscript{37}] Id. at 434 (citing 12 C.F.R. §§ 545, 563, and 571 (1981)).
\end{itemize}
planners. From a more practical perspective, however, certain types of provisions are consistently more common to most parachutes even though the specific operative terms may vary from corporation to corporation.

Parachutes can be executed in one of three different manners: they can be included as part of the original contract of employment when the executive is initially hired; they can be added subsequent to the execution of the original contract and are made a part thereof; and they can be executed notwithstanding the absence of any written original employment contract. Regardless of the specific manner of execution, three principal components have become characteristic of the parachute agreement.

First, as golden parachutes by definition are triggered by a change of control, it is generally common that the agreement defines in some detail when a change of control occurs. The most common control trigger is the acquisition by another entity of a specified percentage of the target company's outstanding shares of voting stock. Interestingly, ownership of fifty-one percent is not necessary to gain control since a widespread distribution of voting stock reduces the amount necessary to constitute control. Accordingly, control can inure to the beneficial owner of a block of stock that does not equal a majority interest. Most companies utilizing this trigger, therefore, define the ownership threshold in the twenty to thirty percent range, but some have gone as low as fifteen percent and as high as fifty-one percent. The problem with establishing too low a triggering threshold is that the parachute could become operative prematurely. Thus, if threshold shares are acquired by a non-hostile entity, such as an existing corporate affiliate, an executive's parachute provisions would nonetheless become invocable. Moreover, if the minimum acquisi-

38. See generally Handbook, supra note 12, at 430.
40. See Morrison, supra note 5, at 85.
41. The Securities and Exchange Commission has defined "control" in the following manner. "The term 'control' (including the terms 'controlling', 'controlled by', and 'under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person whether through the ownership of voting securities, by contract, or otherwise. 17 C.F.R. §§ 230.405, 240.12b-1 (1983).
42. See Profusek, supra note 34, at 105.
44. See Profusek, supra note 34, at 105.
45. Morrison, supra note 5, at 85.
47. Id.
tion is in fact made by a hostile raider, management, by bailing out early in a takeover attempt, could essentially disarm the corporation of leadership when it needs it most. As stated by one critic, "one would think that a company would want all hands at the battle stations, not heading for the escape hatch."48

While undoubtedly the most prevalent, not all parachutes define a change of control solely in terms of an outsider's acquisition of a specified percentage of voting stock. Some have employed a "merger or consolidation" clause whereby a change of control is only deemed to have occurred if subject company shareholders end up holding less than a specified percentage of the voting stock of the surviving corporation.49 Other parachutes do not become operative unless the corporation has filed the necessary report with the Securities and Exchange Commission indicating that a change in control has in fact taken place.50 Lastly, a minority of these agreements include 1) a change in the majority of the board of directors, 2) a sale of substantially all of the company's assets, and 3) the dissolution of the company, as other possible change in control triggering events.51

A common practice of many corporations is to utilize several alternative change of control triggers in the same parachute agreement. Conoco, Inc., for example, in its agreements with the chairman and eight other officers, stipulates that a change in control occurs if the company's common stock is no longer listed on the New York Stock Exchange, or if twenty percent of its stock is acquired by an outsider.52 Sunbeam Corp., on the other hand, provides that its parachutes are triggered if a change in control occurs sufficient to require SEC reporting,53 or if an outsider acquires twenty-five percent of its voting securities, or if during any consecutive two year period the then existing majority of the board of directors is changed.54 Brunswick Corp., like Sunbeam, also

48. Morrison, supra note 5, at 85.
49. See Profusek, supra note 34, at 105-06.
50. A change in control is required to be reported to the SEC pursuant to Item 1 of Form 8-K, 17 C.F.R. § 249.301 (1983), and Item 5(f) of Schedule 14A, 17 C.F.R. § 240.14a-101 (1983). Profusek, supra note 34, at 106. See also Appendix A.
51. Profusek, supra note 34, at 106-07.
53. See supra note 50.
utilizes these same reporting, acquisition percentage, and "change in the board" triggers, with some minor variations.\textsuperscript{55}

A second typical component found in most parachute agreements is a section setting forth provisions which protect the executive in the event the succeeding corporation attempts to adversely alter his employment status in lieu of dismissing him from his post altogether.\textsuperscript{56} These contingent provisions are only operative after a change of control has occurred, and they permit the officer to voluntarily terminate his employment if 1) his specified duties, compensation, or benefits are materially reduced, 2) the successor relocates or requires the manager to travel in excess of a stated percentage of his time, or 3) in "good faith" the officer determines that he is unable to effectively carry out the duties and responsibilities of his former position.\textsuperscript{57} One writer posits that justification for the inclusion of these contingencies can be gleaned by analogy from the rules defining the duty to mitigate damages. Under this rationale, the mitigation duty does not require a terminated employee to accept an inferior position, unreasonable relocation or travel requirements, or a job from an "objectionable" employer. Accordingly, when a change in control results in these same degradations, self-termination and retention of benefits is similarly justifiable.\textsuperscript{58}

The third common component is the remunerative section which outlines the corporation's compensatory obligations in terms of severance payments, benefits, or otherwise, if and when the parachute is exercised.\textsuperscript{59} In many situations, these total benefit packages are extremely generous and lucrative. Conoco, for example, awards each protected executive a monthly salary equal to one-twelfth of his then annual base salary, plus one-twelfth of his then highest annual incentive plan award. The CEO receives these payments for eight years, the president for four years, and the other officers for three years. Additionally, each executive is entitled to receive for those stated periods all the other benefits

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\item \textsuperscript{55} Brunswick Corp., Schedule 14D-9, Exhibit 2 at 15-19 (Feb. 16, 1982); Riger, supra note 52, at 22-23.
\item \textsuperscript{56} Handbook, supra note 12, at 426-28.
\item \textsuperscript{57} Profusek, supra note 34, at 107. Conoco, Sunbeam, and Brunswick all utilize some mix of these contingencies, generally termed 'voluntary termination' for 'Good Reason'. See Riger, supra note 52, at 19, 21, 23. A sample provision appears in Appendix B.
\item \textsuperscript{58} Profusek, supra note 34, at 107-08 n.22.
\item \textsuperscript{59} Handbook, supra note 12, at 426-28. A sample provision appears in Appendix C.
\end{itemize}
and stock options as if he still were fully employed. The eighteen protected Sunbeam executives, by contrast, would receive their annual base salary for the duration of the contract, plus any vacation time and bonus payments then owed by the company. Furthermore, each officer would be entitled to a lump sum payment of his highest preceding salary multiplied by one, if his age was less than fifty, or by one and one-half, if between fifty and fifty-five, or by two, if fifty-five or over. As with Conoco, all life, medical, accident and disability insurance are continued, but only for two years or until the executive has secured new employment.

The duration period for these benefits is different for each granting company. Many contracts extend for five years or longer, a few are in effect for only one to four years, and some specify no duration period at all. Many compensation experts feel that two years gives an executive ample time to become re-employed; even in more difficult times, however, a top executive can usually find a new job in eight months. This essentially enables the officer, if re-employed, to “double dip” for the remainder of his parachute contract. Most corporations are relieved of the obligation to pay if the executive dies. Few companies, however, terminate parachute benefits if the employee finds new employment. An even fewer number require an offset of parachute benefits in the amount of a rehired executive’s new employment remuneration, which in one instance led to this startling situation: Nick A. Caporella of Burnup and Sims of Florida parachuted after a hostile stock acquisition with a lump sum of 300% of his base salary, plus accelerated stock options. In addition, he took with him seventeen other executives who collectively bailed out with $4 million and other stock options. By the end of that same month, Caporella was back at Burnup and Sims in his old CEO’s chair effectively having his corporate cake and eating it too.

III. JUSTIFICATIONS AND CRITICISMS

Proponents of golden parachute agreements have advanced numerous arguments in an effort to justify the use of these compensation arrangements in the takeover environment. Needless to
say, these justifications have been squarely opposed and soundly criticized by many as being specious and devoid of merit. The following section will examine several of the more common policy arguments in support of these contracts, and attempt to discern what true merit, if any, these justifications possess.

A. An Effective Defensive Tactic

It is frequently contended that parachutes are an effective tool for fending off potential or actual corporate takeover bids. This is so, it is argued, because the raider will be discouraged from either making or continuing a tender offer when it realizes that, if successful, it will be faced with 1) trying to control a company whose top management has since bailed out, and 2) making huge severance and benefit payouts to the departed officers which will effectively boost the total acquisition cost far beyond the anticipated level.

While at first blush this contention seems sound and plausible, an examination in light of current takeover realities weakens this argument at its very core. As an initial matter, it is highly improbable that an acquiring company is so preoccupied with incumbent target management's potential en masse departure that it will be deterred from pursuing a truly coveted acquisition. Furthermore, the raiding corporation, which is generally insensitive to incumbent management's desires, more often than not intends to replace either a majority, if not all, of the target's top executives with ones of their own choosing once control has changed hands. Second, most authorities disbelieve the notion that the increase in acquisitional cost prompted by these looming severance payouts is of sufficient magnitude to thwart a determined raider. Indeed, while the dollar amount of potential severance payouts may be significant for the executives who will benefit, they usually amount to less than one percent of the total cost of acquisition, which is often stated in terms of billions of dollars. In short, while an

65. See Handbook, supra note 12, at 434 n.3.
66. Prentice, supra note 8, at 341.
67. See generally Comment, supra note 6, at 615. If this were not true, one would have to wonder why a paranoid target management feels the pressing need to be protected by golden parachutes in the first place.
68. Alibrandi, Are 'Golden Parachutes' Needed Protection or Merely Sweetheart Deals?: Benefits Smack of Elitism, and This Can Only Breed Contempt, L.A. Times, Oct. 9, 1983, § IV, at 3, col. 1. See also Morrison, supra note 5, at 85.
69. Comment, supra note 6, at 622.
inordinate number of parachutes may in some cases significantly raise the total cost of a given acquisition, the dollar amounts due under those agreements are de minimis when compared to the aggregate value of the takeover offer.\textsuperscript{70}

From the shareholders' perspective, there are other considerations as well. First, one must be ever cautious and skeptical about management policies which deny the shareholders the opportunity to even consider premium offers for their securities.\textsuperscript{71} Second, if economic considerations are crucial in a tender offer, the offeror may only reduce, instead of withdraw, his premium price offer which would be clearly contrary to the shareholders' interests.\textsuperscript{72} This should raise, in the mind of shareholders, at least a suspicion that the corporation, by granting to top executives substantial sums in the event of a change in control, is motivated by considerations other than their best interests.

B. \textit{Preserving Management Objectivity}

Another common policy argument in support of golden parachutes, often referred to as the "Non-Distraction Theory,"\textsuperscript{73} is that parachutes aid in maintaining management objectivity in the face of a hostile tender offer. Parachute proponents contend that these agreements are extremely beneficial in that top level managers, wrapped in a protective cloak guaranteeing their financial security, will be better able to cast aside their own personal financial worries. Accordingly, with their objectivity intact, they will be better prepared to evaluate the merits of any proposed tender offer solely with the interests of the shareholders in mind.\textsuperscript{74}

From an objective evidentiary standpoint, there exists no statistical proof whatsoever that executives are in fact more effective in protecting the interests of shareholders during a hostile tender offer merely because their financial and job security is ensured through lavish change of control agreements.\textsuperscript{75} From a pure policy perspective, this contention is equally unsupportable. One commentator has stated that parachute security for the individuals

\textsuperscript{70} \textit{Handbook, supra} note 12, at 435.
\textsuperscript{71} The controversial debate concerning management's duty during tender offers is beyond the scope of this article. \textit{See supra} note 9.
\textsuperscript{72} Johnson, \textit{supra} note 3 at 70-71.
\textsuperscript{73} \textit{See Handbook, supra} note 12, at 434 n.3.
\textsuperscript{74} \textit{See Prentice, supra} note 8, at 341. \textit{See also} Morrison, \textit{supra} note 5, at 82.
\textsuperscript{75} Alibrandi, \textit{supra} note 68, § IV, at 3, col. 2.
who are directly responsible for the progress of the company is justifiable for the same reasons that justify other executive compensation arrangements. But is this necessarily true? Losing one's job, whether through shareholder or board of director ouster, or through replacement by a new controlling entity, is a common risk shared by all top executives in the corporate sphere. Existing compensation packages of salary and fringe benefits generously reward these officers both for taking this risk and for directing the affairs of the company in the interest of the shareholders and the corporation as a whole. It is an odd and ironic notion which perceives it necessary to reward executives with extravagant benefits over and above their existing compensation to essentially perform the job they were hired to do in the first place. As stated by Quentin Wood, Chairman of Quaker State Oil Refining Corp., "Parachutes are not required to induce management to do the job it's supposed to do."

Additionally, instead of encouraging management to act selflessly as guardian of shareholder concerns, the existence of golden parachutes may have the opposite effect. Protected executives, finding themselves in the uniquely comfortable situation of being protected regardless of the outcome of a takeover struggle, could become apathetic, reckless, or even influenced into a position of abandon. As such, management's duty to adequately apprise shareholders of the important considerations in a pending tender offer may take a back seat to the potential financial gains awaiting each of them should the tender offer succeed. As one writer has observed, it would be a truly uncomfortable situation indeed if, while waiting anxiously in one's seat for his flight to take off, the pilot and crew boarded with parachutes strapped to their backs.

C. Assuring Retention and Continuance of High-Quality Management

The third and final argument is multi-faceted. In the main it is contended that parachutes, by providing security against unan-

76. Profusek, supra note 34, at 101.
77. Riger, supra note 52, at 32.
78. See Comment, supra note 6, at 620. See also Handbook, supra note 12, 434 n.3.
79. Golden Parachutes, supra note 20, at 34.
80. Comment, supra note 6, at 620; see also Alibrandi, supra note 68, § IV, at 3, col. 2.
81. Johnson, supra note 3, at 70.
82. Alibrandi, supra note 68, § IV, at 3, col. 2.
ticipated and uncontrollable risks such as a change of control, are extremely valuable in attracting and retaining high-quality management personnel. This consideration is most important to companies in more financially precarious positions because they are the most attractive takeover targets; accordingly, they are the group most in need of competent, quality managers. Parachute proponents further assert that the target corporation, and thus its shareholders, will be assured of continuity of high quality management. This is so because management will have greater incentive for remaining in the company’s employ throughout the tender offer, and, if the takeover is successful, the new controlling entity will be more reluctant to replace incumbents when large severance payouts will be the necessary consequence.

Initially, changes in control, and losing one's job, are normal risks of everyday corporate life and thus they can hardly be considered “unanticipated.” But even if such risks are “unanticipated,” one has to wonder why the executive, more so than any other employee, should be deserving of this protection. If a manager is in fact a stellar performer, the new regime may keep him to retain his expertise. Should he not be so retained, new employment should not be difficult to secure as his past performance and ability should precede him into a market that is constantly in search of quality management personnel. Moreover, is it wise to remove all risk? Probably not. As one commentator has pointed out, “[I]n business, reward goes hand in hand with risk. By removing all risk in a job, you also remove much of the incentive for better performance, which is in no one’s best interest.”

Attraction and retention of top quality managers is without question a major objective of any business organization. When justifying golden parachutes, however, “attraction of quality executives” appears to be more of an ex post facto rationalization than a

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83. Profusek, supra note 34, at 101.
84. Brunswick states their rationale as follows: “The Company wishes to attract and retain well-qualified executive and key personnel and to assure both itself and the executive of continuity of management in the event of any actual or threatened change in control of the Company.” Riger, supra note 52, at 29. Conoco states that these agreements “are designed to encourage the executive to remain in the employ of the company by providing them with greater security.” Id. at 28.
85. See supra text accompanying note 77.
86. See Riger, supra note 52, at 32.
87. Alibrandi, supra note 68, § IV, at 3, col. 2.
88. Id., § IV, at 3, col. 2.
Gold parachute agreements are executed at least after the employee has already been hired, and many are not executed until a tender offer is underway. The parachute, therefore, has played no role in the hiring process. Moreover, if retention is the goal, how does the parachute aid in accomplishing this objective? By definition, the fundamental function of these agreements is to pay benefits upon the executive's termination and exit, not upon his continued employment. The definition, then, belies its purpose; the payment of benefits upon termination is an act inconsistent with the officer's retention. It could be argued that if the parachute at least induces managers to remain throughout the takeover battle, then it has served its retention—and thus its continuity of management-function. But again, management should not require additional compensation to perform the job for which it was originally hired.

A third consideration is whether golden parachutes help retain quality management at all. As discussed above, an acquiring company is more likely to retain the top performers of the incumbent staff; it is the lackluster and the undesirable performers who will be given their pink slips. Ironically, however, it is this latter group of officers who will reap reward upon departure. One author has said it best:

Golden parachutes are often rewards for mediocrity and even incompetence. An executive of the old order who has consistently performed well and helped build a sturdy, valuable company will often be retained by the new regime. Such an executive is in no need of "incompetence insurance." Golden parachutes, however, grant unconscionable salaries to those executives who are unable to adjust to new ownership, or worse, to those who have not earned the chance to try.

Additionally, parachutes, which purport to preserve 'quality' personnel, have not always been executed by companies that are reaping in the fruits of outstanding management performance. For ex-

89. See Riger, supra note 52, at 29.
90. Id. at 28.
91. One commentator has posed another justification—that the incumbents who exercised these agreements "enabled, themselves to walk away from a job well done with their dignity intact." See Dwyer, Contracts Eliminate Manager Bias in Judging Takeover Bids. L.A. Times, Oct. 9, 1983, § IV at 3, col. 5. One has to wonder, however, how walking away from a corporation with an overstuffed wallet helps to aid in preserving one's dignity and integrity.
92. Comment, supra note 6, at 622.
ample, Gulf Resources and Chemical, U.S. Industries, and Allis-Chalmers sustained losses of $77.9 million, $62.7 million, and $28.8 million, respectively, for fiscal year 1981—and all of them had awarded lucrative golden parachutes to their top executives.93

Finally, it is curious that a corporation would think that, by implanting these potential payouts of large monetary benefits, it would assure continuity of the incumbent staff after a change of control has taken place. It is not likely that a raider, already having spent considerable sums in its effort to wrest control, will be deterred, by these de minimis payments,94 from placing managers of its own selection. Assurance of continuity, therefore, is an unrealistic goal in the post change of control environment since subsequent implementation of incumbent policies is never safely “assured.” More likely, as has been suggested, the objective is not continuity of management after a change in control, but rather the assurance of severance benefits once that continuity has ended.95

IV. ANTICIPATING JUDICIAL ANALYSIS

It is impossible at this juncture to anticipate how the courts will respond to challenges to the legal sustainability of golden parachute agreements. Few parachutes have been judicially challenged, and no case as of yet has been resolved on the merits.96 What can be predicted with more certainty, however, are the probable legal doctrines that will be considered when the validity of these agreements is analyzed. Principally two doctrines are relevant. First, the courts should examine the parachutes under traditional contract law notions of consideration, especially when the parachute was executed either subsequent to the executive’s hire, subsequent to the execution of the executive’s original compensation agreement, or during the pendency of a hostile tender offer. Second, the applicability of the business judgment rule—with the related considerations of fiduciary duty—will also prove to be vital issues when determining the legal validity of the golden parachute contract.

93. Morrison, supra note 5, at 86. (Data cited from table entitled “Money-Losing Companies with Parachutes”).
94. See text accompanying supra notes 68-69.
95. See Riger, supra note 52, at 29.
96. See supra note 15.
A. Existence of Consideration

As a condition of enforceability, common law contract principles require, as a general rule, that promises be made for consideration. 97 Consideration, though often an elusive concept both in theory and in practice, has nonetheless been reduced to three identifiable elements. First, the promisee must suffer some legal detriment, i.e., he must do or promise to do something he otherwise would not be legally obligated to do. Second, the detriment incurred must induce the promise; more specifically, the promisor must have made the promise because he wishes to exchange it for the detriment to be induced by the promise. Third, the promise must induce the detriment—the promisee must know of the offer and intend to accept. 98

Legal detriment, bargained for and exchanged for the promise, is the essence of consideration. 99 Furthermore, where a party promises to do what he is already legally obligated to do, regardless of whether or not that duty is contractual, no detriment is incurred by that party; thus the promise lacks consideration. 100

These basic concepts of contract law will have considerable bearing on the validity of golden parachute agreements. It should be recalled that there are three situations in which parachutes can be executed: contemporaneously with, or subsequent to, a written compensation agreement, or subsequent to an employee’s hire where no original compensation agreement exists. 101 It is doubtful that consideration is lacking when a parachute is included in an original compensation contract. It is in the latter two instances, however, that consideration does become an issue; this is true because, in general, the executive is not required to perform any additional duties or assume any new responsibilities in order to receive his benefits award. 102 If consideration is found to be lack-

98. Id.
99. Id.
100. The Pre-Existing Duty Rule. Id. at § 4-7.
101. See supra note 38 and accompanying text.
102. Inasmuch as the golden parachute is a phenomenon borne of the recent flurry of takeover activity, most prominent and controversial parachutes were executed either some time prior to the initiation of, or some time during the pendency of, an unsolicited tender offer. This writer uncovered no parachute included as part of a newly hired executive’s employment contract.
ing, then the parachute payments are nothing more than gifts to the departing executive, constituting a waste of corporate assets. 103

Cases involving stock option grants to executives are analytically excellent models of the consideration doctrine at work in the compensation contract area. These cases, moreover, are remarkably similar factually to the golden parachute situation in that stock options: 1) are frequently granted at some indeterminant point in time after the executive is hired; 2) are frequently made exercisable even after the executive has terminated his employment; and 3) are often challenged as lacking consideration and as constituting corporate waste.

In Kerbs v. California Eastern Airways, 104 shareholders attacked, inter alia, a stock option plan executed by the Board of Directors in favor of certain named executives. The options were exercisable within a five year period after issuance, and, in the event of the executive's termination, the options still were available provided the departed executive exercised them within six months after the date of his termination. The plaintiff stockholders claimed this plan lacked consideration and, therefore, it was a gift and a waste of corporate assets. 105

The Supreme Court of Delaware observed initially that questions of sufficient consideration rise and fall on the facts and circumstances of each case. 106 Consideration may be found, for instance, in the desire to either retain a valued employee or to gain the services of a prospective employee. In either event, however, there must exist a reasonable relationship between the value of the services to be secured and the value of the options granted as inducement or compensation. 107 In addition, the facts and circumstances of the plan must "reasonably insure that the contemplated benefit will inure to the corporation." 108

103. Riger, supra note 52, at 17. Corporate waste is basically the disposal of assets of the corporation (1) without legal consideration, and (2) under circumstances which constitute a breach of fiduciary duty on the part of the officers or directors involved. Id. at 26. In Michelson v. Duncan, 407 A.2d 211 (Del. 1979), the court held that an averment of "no consideration" was tantamount to an allegation of gift or waste of assets. The essence of a claim of waste of corporate assets, the court continued, is "the diversion of corporate assets for improper or unnecessary purposes." Id. at 217.

104. 90 A.2d 652 (Del. 1952).
105. Id. at 656.
106. Id.
107. Id. See also Rogers v. Hill, 289 U.S. 582 (1933). That case laid down the "relationship" test as applied to the compensation area in general.
108. Id.
The Kerbs court then proceeded to hold that the stock plan could not survive this test. The defendant corporation had argued that the plan would insure that the participating executives would remain in the company's employ, thus the contemplated benefit would in fact inure to the corporation. The court, however, was not convinced as the options could be exercised in toto either immediately upon issuance or within six months after termination. Therefore, since the executive could exercise his option immediately, and quit that day, or terminate himself immediately and still exercise his option within six months, there was no reasonable assurance that the retention benefit would inure to the company. Accordingly the stock option plan was struck down.

In Frankel v. Donovan, a Delaware court was again confronted with this same question under similar factual circumstances. The corporation in that case granted stock options to fifty of its executive employees with the express purpose of advancing the interests of the corporation "by providing an incentive to participating key executive employees in the form of an opportunity to acquire a greater proprietary interest in the corporation and thus stimulate their efforts in the corporate welfare."

In boiling the stated purpose down to its basic elements, the court reasoned that the true consideration to the corporation here was greater performance effort by each optionee motivated by the increased job satisfaction that would result from the proprietary interest these options would make available. The court held, however, that increased employee effort and loyalty resulting from elevated job satisfaction, or the enhanced incentive to remain with one's old job spurred by the existence of a stock option, were not sufficient to constitute legal consideration. Of additional significance in this opinion was the court's rejection of the corporate defendant's argument that sufficient legal consideration was furnished for the granted options because the optionees did in fact remain with the company, in the performance of their duties. The court's response was candid: if the options were defective due to inadequate consideration, subsequent events could not cure

109. Id. at 657.
110. Id.
111. 120 A.2d 311 (Del. Ch. 1956).
112. Id. at 313.
113. Id. at 314.
114. Id.
this defect; second, the optionees made no agreements to insure their continued employment but the options nonetheless were still immediately exercisable. There was no assurance the corporation would receive its contemplated benefit and, therefore, the plan was invalid.\textsuperscript{115}

By contrast, consider Olson Brothers, Inc. v. Englehart.\textsuperscript{116} In that case, stock options were granted to several top executives of Bellanca Corporation, a stagnant company that was on the brink of ruin. The directors determined that the corporation could only be saved by working out some plan of merger with another entity, and to accomplish that end, it would be necessary to retain the services of the current Board members, some of whom had already threatened to resign. In accordance with those objectives, the stock options were granted. A merger was consummated sometime thereafter and the successor, Olson Brothers, Inc., filed a declaratory judgment action challenging the grant of the options. The lower court had sustained the validity of the grant.

In a somewhat cursory opinion, the Delaware Supreme Court affirmed the lower court’s finding of validity. Ostensibly sensitive to Bellanca’s precarious condition at the time the grant was made, the court outlined the Kerbs test and held that it was satisfied here.\textsuperscript{117} The options were granted to encourage the optionees to remain until merger arrangements were made, and, the optionees did so remain until the Olson Brothers deal was consummated. What was most significant in the case, however, was the fact that the original Board resolution required the Board members’ continued service as a condition for the exercise of the options. Although this condition was eliminated shortly before the Olson transaction, the reason it was eliminated was that the Olson deal was so imminent; the condition no longer would serve any useful purpose.\textsuperscript{118} Accordingly, because of these circumstances, “the corporation could

\textsuperscript{115} Id. at 314-15. In Frankel, it is interesting to note that the court recognized that the executives were grossly underpaid. This was because the corporate defendant was a federally subsidized shipping line which was subject to the $25,000 salary ceiling imposed by the Merchant Marine Act of 1936. Notwithstanding the corporation’s honorable effort to provide more substantial compensation, the court still held the stock options invalid. Id. at 313 n.4.
\textsuperscript{116} 245 A.2d 166 (Del. 1968).
\textsuperscript{117} Id. at 168.
\textsuperscript{118} Id.
be reasonably expected to receive the contemplated benefits from the grant of the options." 119

When specific golden parachute contracts finally are examined by the courts under the strictures of the consideration doctrine, it is expected that the analysis employed will run consistently parallel with the stock option cases. As such, three key factors will be of critical importance: one, was the consideration sufficient at the time the parachute was executed, and not merely justified by post hoc rationalization; two, is there a reasonable relationship between the value of the services to be performed and the value of the parachute agreement granted as inducement or compensation; and three, are there any circumstances at the time of execution which indicate that the corporation can reasonably expect to receive the contemplated benefits from the execution of the parachute agreement.

It is submitted that parachutes executed as part of an initial compensation package would in all likelihood avoid these problems; the employment services of the executive would provide ample consideration. It is those agreements executed immediately before or during a hostile tender offer that will undoubtedly spark the issue. Under those circumstances, 'retaining quality managers,' 'preserving continuity of management,' 'maintaining management objectivity,' and other such justifications 120 become difficult to accept as the managers protected are not required to perform any additional services or assume any new responsibilities that are not already covered by the existing compensation plan. There can be no reasonable relationship between services and benefits as no new services are required; what is provided is a one-way payout if a change in control occurs, and to collect under this plan, all the executive has to do is resign. Similarly, it is difficult to see what benefit the corporation can "reasonably expect to inure" from the execution of such agreements. Perhaps it is that the executive will feel more like 'sticking it out' and doing the job he was hired to do, or perhaps the sedative effect of the parachute will sufficiently calm his nerves so that he can now make sensible decisions in the interests of the shareholders. In any event, these are benefits the courts most likely will find difficult to embrace. As one author

119. Id.
120. See supra section III.
has noted, these contracts are more like insurance policies, payable upon a change of control and, possibly, the occurrence of some other event. The trouble is that no premium was ever paid for this policy.\textsuperscript{121}

B. \textit{Fiduciary Duty and the Business Judgment Rule}

Corporate compensation plans lie uniquely within the province of the board of directors; as such, the adopting board must comply with the legal requirements of consideration and fairness, and they also must act consistent with their duties as fiduciaries.\textsuperscript{122} A ‘Fiduciary’ is described as “a person having a duty created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking.”\textsuperscript{123} In the corporate context, the directors are the fiduciaries of the corporation elected by the shareholding owners. As fiduciaries, the directors must execute their business judgment as prudent businessmen in the good faith belief that their actions are in the best interests of the corporation.\textsuperscript{124} The directors owe loyalty and allegiance to the corporation; their loyalty must be undivided and their allegiance influenced only by the best interests of the corporation.\textsuperscript{125}

Despite these seemingly rigid restrictions on the decision-making process, the courts generally apply the highly deferential 'business judgment rule' when the propriety of any given policy decision is challenged by the shareholders. This rule, often subject to various formulations, is stated best as follows:

Directors of corporations discharge their fiduciary duties when in good faith they exercise business judgment in making decisions regarding the corporation. When they act in good faith, they enjoy a presumption of sound business judgment, reposed in them as directors, which courts will not disturb if any rational business purpose can be attributed to their decisions.\textsuperscript{126}

The reasoning underlying the rule is that the courts are ill equip-

\textsuperscript{121} Riger, \textit{supra} note 52, at 34.
\textsuperscript{122} \textit{Id.} at 26.
\textsuperscript{123} \textit{BLACK'S LAW DICTIONARY} 563 (rev. 5th ed. 1979).
\textsuperscript{124} \textit{See} Lipton, \textit{supra} note 9, at 105.
\textsuperscript{125} \textit{See} Johnson, \textit{supra} note 3, at 68.
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ped to second guess the decisions of corporate managers who are more knowledgeable about the affairs of both the corporation and the industry.127 For the business judgment rule to be available, however, certain elements must be present:128
1) personal interest or self-dealing must be absent;
2) the decision must be informed (i.e. all facts relevant to the decision must be considered);
3) a reasonable belief that the corporation's best interests are being served, must be present;
4) good faith must be present; it will be found to be lacking if, among other things, improper motives are present (i.e. perpetuation in office).

There is at present a controversy among writers and scholars whether or not the business judgment rule should be applied by the courts when the validity of golden parachutes is finally tested. This controversy becomes particularly acute when the parachutes under consideration are executed either immediately before or during a hostile tender offer. One group contends that the rule should be applied;129 they reason that golden parachutes should be evaluated as any other executive compensation agreement regardless of its time of execution, and that the business justifications often advanced are sufficient to warrant judicial deference to the decision of the directors. The opposing faction, however, disagrees.130 Essentially they argue that when parachutes are executed a short time before, or sometime during, a takeover attempt, the justifications are invalid; that the true purpose for the parachute is to permit the departing executives, should the change in control occur, to "plunder the corporate treasury as they leave."132 Therefore, since this purpose is impermissible and a clear breach

127. See Johnson, supra note 3, at 55; Easterbrook & Fischel, supra note 9, at 1746.
128. Elements provided by J. Hinsey, The Business Judgment Rule in the Unfriendly Transaction - An Update, Tenth Annual Securities Regulation Institute, University of California at 1 (Jan. 21, 1983). Hinsey draws a distinction between the "business judgment rule" and the "business judgment doctrine." He points out that the rule shields individual directors from liability for damages stemming from the decision made, whereas the doctrine is geared to the decision itself, the legitimacy of the decision maker, and the appropriate judicial deference under the circumstances. Id. at 3.
129. See, e.g., Profusek, supra note 34, at 103; A. Fleischer, supra note 32, at 11.
130. See supra section III.
131. See, e.g., Johnson, supra note 3, at 70; Riger, supra note 52, at 36-37. See also Easterbrook & Fischel, supra note 9, at 1745.
132. Comment, supra note 6, at 625.
of the directors' fiduciary duty, they should be denied the protection of the business judgment rule.

Both of these arguments appear to have merit. But the question still remains: which position will the courts most likely embrace? The answer, as will be developed, is neither—and sometimes both.

It is doubtful that the courts will adopt either of these approaches as the universal rule of validity to be applied to all golden parachute agreements. More likely, each of these viewpoints will find independent application, depending, as always, on the facts and circumstances surrounding the execution of the challenged contract.

Parachutes executed while a takeover bid is pending, and which award substantial sums of money and benefits if the takeover is successful, are the most problematic. It should be recalled that, as relevant here, the judicial deference called for by the business judgment rule is not available when 1) personal interest or self-dealing is present, or 2) good faith is lacking, i.e., an improper motive is present. When considering allegations of self-dealing, personal interest, or other similar motives, courts generally employ the "primary purpose" test in order to discern if the improper motive is in fact sufficiently present. Under that test, the challenger must show that the primary motive of the corporation's action was to further this self-serving purpose. Showing merely that an improper motive existed is not sufficient; it must be demonstrated that the improper motive "predominated in the making of the decision in question." If the challenger makes the requisite showing, however, the business judgment rule is not available to the corporation, and the burden then shifts to the company to prove its actions were justified by a valid business purpose.

The impact of these rules does not make clear that the business judgment rule always will, or always will not, be available to a corporation when specific golden parachutes are challenged. What

133. See supra note 128 and accompanying text. These two elements are really difficult to separate. If self-dealing is present, then the self-serving motive most likely constitutes bad faith.

134. See, e.g., Condec v. Lunkenheimer, 230 A.2d 769 (Del. Ch. 1967). Other counts have styled the test differently; see, e.g., Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977) ("Sole and primary" purpose); Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975) ("Compelling" purpose); but the concept of the test is the same. The test generally has been applied when retention of control was the alleged self-dealing. It is contended here, however, that the test would be equally applicable when other self-serving motives are at issue.


136. Id. at 293.
is clear, however, is that when these contracts are executed in the midst of heated takeover battles where the success of the takeover seems probable and the retention of the officer appears unlikely, the inference is almost irrebuttable that the primary purpose of the contract is the granting of financial benefits once the inevitable finally occurs. Accordingly, these circumstances will make the challenger's burden easier to satisfy, shifting the burden of justification to the corporate defendant. Justifying the contract, moreover, will be similarly difficult. The justifications advanced to support golden parachutes have been shown to be specious in many respects, but they are especially so when a takeover is imminent.\(^{137}\)

This set of circumstances outlines the clearest situation for a probable judicial finding of invalidity. Most parachutes, however, will not arise under circumstances this severe, and the applicability or inapplicability of the business judgment rule will be determined on the basis of the facts at issue. While the justifications asserted to support golden parachutes appear to be tenuous, it is unclear whether the courts will embrace these contentions as persuasive, valid business purposes. Furthermore, the judicial response to compensation contracts triggered solely by a change in corporate control is equally obscure. Some have argued that all compensation agreements directly tied to changes in control should be impermissible;\(^{138}\) others, however, feel that these agreements should be judicially sustained if they are reasonable under the circumstances.\(^{139}\)

C. Enhancing the Probabilities of Judicial Approval

Corporations that presently desire to implement the golden parachute agreement as part of its compensation system should employ the following considerations to at least enhance the chances that their contracts will survive judicial scrutiny:

- Time of Execution. Undoubtedly this factor will be very instrumental in the contract's validity because of the self-dealing inferences raised. Therefore, these agreements should be adopted prior to any announced, expected, or actual takeover attempts,\(^{140}\) and the more removed the better. Clearly,

137. See supra section III.
138. See, e.g., Johnson, supra note 3, at 71.
139. See, e.g., Profusek, supra note 34, at 103.
140. Id. at 103-04.
parachutes executed commensurate with the executives' original compensation agreement are the most likely to be upheld, under both the consideration doctrine and the business judgment rule. But when executed during a takeover, courts may well be skeptical of the purported justifications that the agreement was needed to retain the executive or to insure his independent, objective judgment.  

*Benefits Provisions.* As an obvious generality, the benefits should be reasonable. Factors militating against a reasonableness determination would include 1) severance benefits that constitute a significant and unusual value to the company, 2) benefits awarded without an extension of the employment term or a requirement of some additional obligation on the part of the executive, 3) substantial benefits awarded when the corporation's financial condition is precarious, and 4) compensation and benefits awarded which are inconsistently more lucrative than the compensation benefits provided under the original compensation package, and are not benefits the executive could reasonably expect in the absence of a change of control.  

*Stockholder Ratification.* These contracts should be subjected to a vote of the shareholders after proper disclosure. When sufficiency of consideration is at issue, at least in stock option cases, in the absence of independent shareholder ratification, interested directors have the burden of proving that there existed a "fair exchange" for the benefits received. When there is shareholder ratification, the burden of proof is on the shareholders. This notion should be equally applicable when golden parachutes are challenged. Moreover, board action approved by the shareholders carries a convincing measure of validity.

*Disinterested Directors.* As with most insider transactions in corporations, validity of board action is more likely upheld if approved by a disinterested majority or a board committee. One writer has commented that this factor should not make a difference since many outside directors often owe their posi-

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142. See *Handbook, supra* note 12, at 433-35; *Profusek, supra* note 34, at 103.
tions to insiders, or they are not in a position to gather adequate data on the fairness of the compensation or its affects upon shareholders.\(^\text{145}\) Regardless, the approval of a disinterested majority can only help, not hinder, the validity of the agreement.

As a final note, the Securities and Exchange Commission, through its Advisory Committee on Tender Offers, has stated its position on golden parachute agreements.\(^\text{146}\) The Commission reported:

[T]he committee shares the public concern that such forms of compensation, particularly when adopted following the commencement of a tender offer, can present the appearance of self-dealing on the part of management at a moment of corporate vulnerability and a failure to place the interests of shareholders foremost. The Committee believes this perception is significant enough to warrant regulation.\(^\text{147}\)

Accordingly, the Committee formulated Recommendation 38, which provides, first, that the board of directors shall not adopt change in control contracts once a tender offer has commenced. Second, if the contract is adopted prior to a tender offer, the issuer should disclose the terms and parties to the contracts in the Change of Control section of the annual proxy statement. Third, a non-binding advisory vote of the shareholders at the annual meeting is recommended to ascertain shareholder sentiment on the corporation's continued practice of providing these agreements.\(^\text{148}\)

**SUMMARY AND CONCLUSION**

The grim national economy at the turn of this decade set off an unprecedented flurry of takeover activity in the American business world. In response, corporations across the country began to implement many different tactics in an effort to deal with this rising tide of takeover activity. One such tactic which has emerged is the golden parachute, a compensation agreement, triggered by a change in control, which permits protected executives to leave the corporation with substantial pay and other severance benefits. The statistics show that an increasing number of companies are

\(^{145}\) Johnson, supra note 3, at 70.

\(^{146}\) Securities and Exchange Commission, Advisory Committee on Tender Offers, Report of Recommendation (July 15, 1983).

\(^{147}\) Id. at 40.

\(^{148}\) Id. at 41.
resorting to the golden parachute, while other sources indicate that the number is leveling off. Whatever is the case, the golden parachute, at least at present, is a fact of modern day corporate life.

There have been many justifications advanced in favor of these agreements, such as "maintaining quality managers" and "insuring management objectivity," but the persuasiveness of these contentions is questionable, especially in the context of certain typical parachute agreements. Moreover, the legal validity of these agreements remains unknown as no case challenging these contracts has been resolved on the merits. It is projected that the contract law principles of consideration and the business judgment rule will be the primary doctrines employed in judicial review. Furthermore, the facts and circumstances surrounding the execution of every agreement will be of paramount importance regardless of which legal rule is employed as the test.

Several factors are of particular importance, such as time of execution, the reasonableness of the benefits, shareholder ratification, and a disinterested board majority vote. While a proper execution under the most favorable circumstances will not assure validity, at least the chances of judicial approval will be greatly enhanced.

JEFFREY T. ROYER
APPENDIX A

Change in Control. No benefits shall be payable hereunder unless there shall have been a change in control of the Company, as set forth below, and your employment by the Company shall thereafter have been terminated in accordance with Section ___ below. For purposes of this Agreement, a “change in control of the Company” shall mean a change in control of a nature that would be required to be reported in response to Item 5(f) of Schedule 14A of Regulation 14A promulgated under the Securities Exchange Act of 1934, as amended (“Exchange Act”); provided that, without limitation, such a change in control shall be deemed to have occurred if (i) any “person” (as such term is used in Sections 13(d) and 14(d) of the Exchange Act) is or becomes the “beneficial owner” (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company representing 25% or more of the combined voting power of the Company’s then outstanding securities; or (ii) during any period of two consecutive years, individuals who at the beginning of such period constitute the Board cease for any reason to constitute at least a majority thereof unless the election, or the nomination for election by the Company’s stockholders, of each new director was approved by a vote of at least two-thirds of the directors then still in office who were directors at the beginning of the period.

APPENDIX B

Termination Following Change in Control. If any of the events described in Section ___ hereof constituting a change in control of the Company shall have occurred, you shall be entitled to the benefits provided in Section ___ hereof upon the subsequent termination of your employment unless such termination is (a) because of your death or Retirement, (b) by the Company for Cause or Disability or (c) by you other than for Good Reason.

(i) Disability; Retirement.
(A) Termination by the Company of your employment based on “Disability” shall mean termination because of your absence from your duties with the Company on a full time basis for 130 consecutive business days, as a result of your incapacity due to physical or men-
nal illness, unless within thirty (30) days after Notice of Termination (as hereinafter defined) is given following such absence you shall have returned to the full time performance of your duties.

(B) Termination by the Company or you of your employment based on "Retirement" shall mean termination in accordance with the Company's retirement policy, including early retirement, generally applicable to its salaried employees.

(ii) *Cause.* Termination by the Company of your employment for "Cause" shall mean termination upon (A) the willful and continued failure by you to substantially perform your duties with the Company (other than any such failure resulting from your incapacity due to physical or mental illness), after a demand for substantial performance is delivered to you by the Chief Executive Officer of the Company or the Salary, Stock Option and Bonus Committee of the Board, which specifically identifies the manner in which such executive believes that you have not substantially performed your duties, or (B) the willful engaging by you in misconduct which is materially injurious to the Company, monetarily or otherwise. For purposes of this paragraph, no act, or failure to act, on your part shall be considered "willful" unless done, or omitted to be done, by you not in good faith and without reasonable belief that your action or omission was in the best interest of the Company. Notwithstanding the foregoing, you shall not be deemed to have been terminated for Cause unless and until there shall have been delivered to you a copy of a Notice of Termination from the Chief Executive Officer of the Company or the Salary, Stock Option and Bonus Committee of the Board, after reasonable notice to you and an opportunity for you, together with your counsel, to be heard before the Salary, Stock Option and Bonus Committee of the Board (or, if there be no such Committee or such Committee delivers the Notice of Termination, the Board of Directors), finding that in the good faith opinion of such Committee (or the Board) you were guilty of conduct set forth above in clauses (A) or (B) of the first sentence of this paragraph and specifying the particulars thereof in detail.

(iii) *Good Reason.* Termination by you of your employment for "Good Reason" shall mean termination based on:
(A) subsequent to a change in control of the Company, and without your express written consent, the assignment to you of any duties inconsistent with your positions, duties, responsibilities and status with the Company immediately prior to a change in control, or a change in your reporting responsibilities, titles or offices as in effect immediately prior to a change in control, or any removal of you from or any failure to re-elect you to any of such positions, except in connection with the termination of your employment for Cause, Disability or Retirement or as a result of your death or by you other than for Good Reason;

(B) subsequent to a change in control of the Company, a reduction by the Company in your base salary as in effect on the date hereof or as the same may be increased from time to time;

(C) subsequent to a change in control of the Company, a failure by the Company to continue any bonus plans in which you are presently entitled to participate (the “Bonus Plans”) as the same may be modified from time to time but substantially in the forms currently in effect, or a failure by the Company to continue you as a participant in the Bonus Plans on at least the same basis as you presently participate in accordance with the Bonus Plans;

(D) subsequent to a change in control of the Company and without your express written consent, the Company’s requiring you to be based anywhere other than within fifty (50) miles of your present office location, except for required travel on the Company’s business to an extent substantially consistent with your present business travel obligations;

(E) subsequent to a change in control of the Company, the failure by the Company to continue in effect any benefit or compensation plan, stock ownership plan, stock purchase plan, stock option plan, life insurance plan, health-and-accident plan or disability plan in which you are participating at the time of a change in control of the Company (or plans providing you with substantially similar benefits), the taking of any action by the Company which would adversely affect your participation in or materially reduce your benefits
under any of such plans or deprive you of any material fringe benefit enjoyed by you at the time of the change in control, or the failure by the Company to provide you with the number of paid vacation days to which you are then entitled in accordance with the Company's normal vacation policy in effect on the date hereof;

(F) subsequent to a change in control of the Company, the failure by the Company to obtain the assumption of the agreement to perform this Agreement by any successor as contemplated in Section ___ hereof; or

(G) subsequent to a change in control of the Company, any purported termination of your employment which is not effected pursuant to a Notice of Termination satisfying the requirements of paragraph (iv) below (and, if applicable, paragraph (ii) above); and for purposes of this Agreement, no such purported termination shall be effective.

(iv) Notice of Termination. Any purported termination by the Company pursuant to paragraph (i) or (ii) above or by you pursuant to subparagraph (B) of paragraph (i) or paragraph (iii) above shall be communicated by written Notice of Termination to the other party hereto. For purposes of this Agreement, a "Notice of Termination" shall mean a notice which shall indicate the specific termination provision in this Agreement relied upon and shall set forth in reasonable detail the facts and circumstances claimed to provide a basis for termination of your employment under the provision so indicated.

(v) Date of Termination. "Date of Termination" shall mean (A) if your employment is terminated for Disability, thirty (30) days after Notice of Termination is given (provided that you shall not have returned to the performance of your duties on a full-time basis during such thirty (30) day period), (B) if your employment is terminated pursuant to paragraph (ii) above, the date specified in the Notice of Termination, and (C) if your employment is terminated for any other reason, the date on which a Notice of Termination is given; provided that if within thirty (30) days after any Notice of Termination is given the party receiving such Notice of Termination notifies the other party that a dispute ex-
ists concerning the termination, the Date of Termination shall be the date on which the dispute is finally determined, either by mutual written agreement of the parties, by a binding and final arbitration award or by a final judgment, order or decree of a court of competent jurisdiction entered upon such arbitration award (the time for appeal therefrom having expired and no appeal having been perfected).

APPENDIX C

Certain Benefits Upon Termination. If, after a change in control of the Company shall have occurred, as defined in Section ___ above, your employment by the Company shall be terminated (a) by the Company other than for Cause, Disability or Retirement or (b) by you for Good Reason, then you shall be entitled to the benefits provided below:

(i) the Company shall pay you your full base salary through the Date of Termination at the rate in effect at the time Notice of Termination is given plus credit for any vacation earned but not taken and the amount, if any, of any bonus for a past fiscal year which has not yet been awarded or paid to you under the Bonus Plans;

(ii) in lieu of any further salary payments to you for periods subsequent to the Date of Termination, the Company shall pay as severance pay to you on the fifth day following the Date of Termination a lump sum amount equal to the product of your annual base salary at the highest rate in effect during the twelve (12) months immediately preceding the Date of Termination multiplied by one of the following: (A) one, if you are less than age 50; (B) one and one half, if you are age 50, or over, but less than age 55; or (C) two, if you are age 55 or over;

(iii) the Company shall also pay to you all legal fees and expenses incurred by you as a result of such termination (including all such fees and expenses, if any, incurred in contesting or disputing any such termination or in seeking to obtain or enforce any right or benefit provided by this Agreement);

(iv) the Company shall maintain in full force and effect, for your continued benefit until the earlier of (a) two (2) years after
the Date of Termination or (b) your commencement of full time employment with a new employer, all life insurance, medical, health and accident, and disability plans, programs or arrangements in which you were entitled to participate immediately prior to the Date of Termination, provided that your continued participation is possible under the general terms and provisions of such plans and programs. In the event that your participation in any such plan or program is barred, the Company shall arrange to provide you with benefits substantially similar to those which you are entitled to receive under such plans and programs;

You shall not be required to mitigate the amount of any payment provided for in Section ___ by seeking other employment or otherwise, nor shall the amount of any payment provided for in Section ___ be reduced by any compensation earned by you as the result of employment by another employer after the Date of Termination, or otherwise.
FIDUCIARY DUTIES OF PENSION FUND MANAGERS IN CORPORATE TAKE-OVERS

INTRODUCTION

Employee benefit plans, designed to provide workers with secure income upon disablement or retirement, are being currently considered as effective blocks to unfriendly tender offers. The target company uses assets held in the pension fund to purchase enough of its own stock to defeat the offeror's attempt to gain control and the trustees then refuse to tender the target-held stock to the offeror. The trustees of plans are under a common law duty to act solely in the interests of plan beneficiaries. Further, most companies large enough to have a tender offer made for their shares are also large enough to have pension plans that fall within the scope of the Employee Retirement Income Security Act of 1974 [hereinafter referred to as ERISA]. ERISA contains a codified


fiduciary standard which is the first such standard set forth in a federal statute. Before ERISA was enacted, standards for fiduciaries of pension plans were set by individual states. Congress enacted ERISA to regulate effectively the largest accumulation of private wealth in the United States.

Trustees of pension funds are allowed by ERISA to hold qualifying employer securities if the fair market value does not exceed ten percent of the fair market value of the total assets of the plan. tax credits under Title II of ERISA).

ERISA provides that:

(a) Except as provided in subsection (b) of this section and in sections 1051, 1081, and 1101 of this title, this subchapter shall apply to any employee benefit plan if it is established or maintained—

(1) by any employer engaged in commerce or in any industry or activity affecting commerce; or

(2) by any employee organization or organizations representing employees engaged in commerce or in any industry or activity affecting commerce; or

(3) by both.


Subsection (b) exempts government pension plans, church plans, workers' compensation plans, unemployment or disability plans and non-resident alien plans maintained primarily outside of the United States. ERISA § 4(b), 29 U.S.C. § 1003(b) (1974).

5. ERISA § 404, 29 U.S.C. 1104 (1982) states in part:

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.


8. S. REP. No. 127, 93d Cong., 2d Sess., reprinted in 1974 U.S.CODE CONG. & AD. NEWS 4639, 4838. See Smith, Firms Increasingly Tap Their Pension Funds to Use Excess Assets, Wall St. J., Nov. 29, 1983, at 1, col. 6. Pension funds in the United States presently hold approximately $1 trillion in assets. This amount exceeds the federal budget. The pension funds also hold about 12% of stocks and bonds. Corporate pension funds account for $600 billion of the $1 trillion total. Id.


(a) Except as otherwise provided in this section . . .
ERISA also allows directors, officers or employees of a company to serve as fiduciaries of the plan.\textsuperscript{10} Section 408(c)(3) of ERISA

\textsuperscript{(2)} A plan may not acquire any qualifying employer security or qualifying employer real property, if immediately after such acquisition the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10 percent of the fair market value of the assets of the plan.

A qualifying employer security is a “bond, debenture, note, or certificate or other evidence of indebtedness” if it is acquired

\textsuperscript{(A)} on the market, either (i) at the price of obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission; or (ii) if the obligation is not traded on such a national securities exchange, at a price not less favorable to the plan than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;

\textsuperscript{(B)} from an underwriter, at a price (i) not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission and (ii) at which a substantial portion of the same issue is acquired by persons independent of the issuer; or

\textsuperscript{(C)} directly from the issuer, at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;


A qualifying “holding percentage” will be enforced after December 31, 1984:

\textsuperscript{(3)(A)} After December 31, 1984, a plan may not hold any qualifying employer securities or qualifying employer real property (or both) to the extent that the aggregate fair market value of such securities and property determined on December 31, 1984, exceeds 10 percent of the greater of—

\textsuperscript{(i)} the fair market value of the assets of the plan, determined on December 31, 1984, or

\textsuperscript{(ii)} the fair market value of the assets of the plan determined on January 1, 1975.


The implementation of the holding rule may affect a trustee’s duties in a tender offer. For example, if a plan holds over nine percent of its total assets in employer stock and a tender offer is made, the possible increase in the stock’s price may drive its aggregate percentage in the plan over ten percent. The trustee must either sell, or tender, if the plan is not eligible for a holding exemption contained in ERISA § 407(b), 29 U.S.C. 1107(b).

\textsuperscript{10} ERISA § 408(c)(3), 29 U.S.C. § 1108(c)(3) (1982):

\textsuperscript{(c)} Nothing in section 1106 of this title shall be construed to prohibit any fiduciary from—serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

ERISA defines a “fiduciary” as

Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under
creates a built-in tension for those who are both employees of the company and trustees of the company pension plan. As one commentator points out "[o]nly a rare individual can affiliate closely with a corporation and still view an offer's takeover attempt with detachment." 11

Trustees are placed in a position of conflicting duties and loyalties when a tender offer is made and the company management objects. 12 The conflict arises from the trustee's duty to act solely for the benefit of plan participants and his duty to the corporation and its shareholders. 13 The trustee's duty toward plan participants, especially when governed by ERISA, should outweigh any duty to the corporation. 14 The opportunity to purchase and hold com-

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section 1105(c)(1)(B) of this title.


A trustee is also defined:

(a) Except as provided in subsection (b) of this section, all assets of an employee benefit plan shall be held in trust by one or more trustees. Such trustee or trustees shall be either named in the trust instrument or in the plan instrument described in section 1102(a) of this title or appointed by a person who is a named fiduciary, and upon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that—

(1) The plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to this chapter, or

(2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 1102(c)(3) of this title.


A "named fiduciary" is also defined:

(2) For purposes of this subchapter, the term "named fiduciary" means a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly.


11. Lynch & Steinberg, supra note 1, at 915. See also Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982), cert. denied, ___ U.S. ____, 103 S. Ct. 488 (1982). This comment assumes that the trustee of the plan is also a corporate employee.

12. Generally, if management objects to a tender offer, it is considered a hostile offer. Comment, Duties, supra note 1, at 1692 n.1. See also supra note 3 and accompanying text.

13. Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cir. 1982), cert. denied, ___ U.S. ____, 103 S. Ct. 488 (1982) (Directors who decided to fight hostile tender offer but as trustees tendered company shares held in plan might have violated their duty as directors to shareholders); Lynch & Steinberg, supra note 1, at 915-17.

14. Bierwirth, 680 F.2d at 272 n.8 (Trustee's fiduciary duties to the beneficiaries of an express trust are the highest known to law).
pany shares, in the employee benefit fund, however, opens up the possibility and temptation for misuse of the plan to the benefit of the corporation in a hostile tender takeover attempt.

I. NON-ERISA FIDUCIARY STANDARDS

The common law standard for fiduciary duty was first formulated in 1830 in *Harvard College v. Amory* in which the highest court in Massachusetts held a trustee to the standard of how "men of prudence, discretion and intelligence manage their own affairs." Three cases, all affecting pension funds but not brought under ERISA, illustrate traditional common law standards which have been applied to pension fund trustees.

The federal district court in *Withers v. Teachers' Retirement System of New York* applied the prudent man standard used in *Amory* to trustees of a teachers' pension and annuities' trust. The trustees of the benefit plan in *Withers* purchased highly speculative New York City bonds to help stave off the city's impending bankruptcy. The City was a major contributor to the benefit plan and the trustees feared that if the City went bankrupt, essential service claims would precede the plan's claims and that the City would be unable to continue to contribute funds to the plan.

The trustees, in making the decision to invest in the speculative bonds, thoroughly investigated all alternatives available to the plan. The trustees' purchase of the bonds was essential to the success of the bail-out plan. The trustees, however, refused to authorize the purchase until a number of conditions were met. Two of the conditions were making payments of retirement benefits an essential claim of general creditors and requiring the City to indemnify the plan's trustees against possible liability. Retired teachers brought suit, claiming that the purchase constituted a breach of fiduciary duty by the trustees.

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15. Id.
17. 26 Mass. (9 Pick.) 446, (1830).
18. Id. at 461.
21. Id. at 1252.
22. Id. at 1253.
23. Id. at 1250.
The court held that the trustees had not violated their fiduciary duty to the beneficiaries of the retirement plan, as the objective in purchasing the bonds was to protect the fund and not to benefit the City of New York. The court determined that the trustees made the decision after an independent, thorough and objective investigation of the facts—a quality investigation performed by the trustees.\textsuperscript{24} They independently reviewed financial data and consulted with financial experts to discover the extent of New York's financial crisis and the necessity of the plan's involvement in the bail-out plan.\textsuperscript{25} The court stated that "[t]heir process of decision . . . was a rational one of weighing the negative against the positive."\textsuperscript{26} The trustees met their common law duties of acting solely in the interest of the plan's beneficiaries and of independently investigating facts and possible alternatives.\textsuperscript{27}

In \textit{NLRB v. Amax Coal Co.}\textsuperscript{28} the United States Supreme Court held that employer-selected trustees are not both fiduciaries of the employee pension fund and agents of the employer. The union representing Amax's employees had called a strike, partially over Amax's refusal to continue to contribute to the national pension fund. Amax wanted to set up its own fund and appoint its own trustees. The company charged that the union's insistence on remaining in the national fund constituted illegal coercion under the Labor Management Relations Act [hereinafter referred to as LMRA].\textsuperscript{29} In a suit brought by the NLRB under the LMRA the defendant, Amax, argued that management-appointed trustees acted in both capacities, as agents of the company and as fiduciaries of the fund.\textsuperscript{30}

The court held that a fiduciary of a pension trust owes "undivided loyalty to the interest of the beneficiaries in administer-
ing the trust." The court also stated that if Congress uses terms that have an accumulated and settled definition under common law, courts must infer that Congress intended those terms to have the same meaning absent contrary indications. Implicit in the LMRA was the standard which does not allow trustees to advance the interests of the employer in administering the fund. The trustees of the fund were held to not be representatives of the company under the LMRA.

Blankenship v. Boyle involved the use of coal miners' pension assets to benefit the miners' union, trustees of the fund and the union-controlled bank. The trustees accumulated large amounts of cash and kept the money in interest-free checking accounts at a bank owned and controlled by the union. The fund had three trustees: a representative of the union, a representative of the mine owners, and a neutral party. The trustees failed to invest the cash and generate income for the benefit of participants. The amount kept in the bank was far greater than the funds necessary for day-to-day operations, although the trustees claimed that the cash on hand was necessary in case of a strike. The pension fund had been accumulating cash for almost twenty years since its inception in 1950.

In addition to finding the failure to invest the cash properly was a breach of fiduciary duty, the federal district court held that the trustees further violated their fiduciary duties by permitting the plan to retain investments in utility stocks that had declined in value. The union trustee had sought to gain control of several utility companies in order to force them to purchase union-mined coal. The trustees had loaned money to businesses in which the union and bank had interests, approved a pension increase to help the union representative's chances of re-election, and withdrew pensioners' health cards to force mine owners to account properly for all contributions owed to the fund. The investment decisions may

31. Id. at 327-28.
32. Id. at 329.
33. Id. at 330 n.13. The court also noted that Congress explicitly codified this fiduciary standard in ERISA. Id. at 332.
34. Id. at 338.
36. Id. at 1099.
37. Id. at 1096, 1099.
38. Id. at 1105.
39. Id. at 1104, 1105, 1107.
have resulted in some incidental benefit to the plan participants. However, under common law, the court held that trustees are required to act solely in the interests of beneficiaries, and that the Blankenship trustees breached their duty when they failed to do so.\textsuperscript{40} The court noted that trustees of pension funds are allowed more discretion than trustees of private trusts in administering large, complex pension trusts. The decisions made by the trustees affected the coal industry as well as the participants. However, despite the increase in discretion allowed to pension trustees, the court held that they had failed to act exclusively for the benefit of the plan and, instead, had collaborated with and furthered the interests of the union.\textsuperscript{41}

Withers, Amax and Blankenship illustrate the strict fiduciary duties imposed upon pension fund trustees under common law standards. Essentially, they must conduct independent investigations and must act solely for the benefit of plan participants.

II. ERISA FIDUCIARY STANDARDS

Although this common law standard for pension fund trustees may appear to have been strict, Congress nevertheless believed that these standards were inadequate to protect the growing number of employee benefit plan participants, as evidenced by the breaches of duty in Blankenship. Congress enacted ERISA in 1974 with its substantive duties to both protect plan participants and provide guidelines for plan fiduciaries. Congress was concerned with the potential for abuse in the large, privately held pension trusts and the lack of effective, uniform fiduciary standards.\textsuperscript{42} Congress additionally believed that workers have a right to know the qualification requirements to receive benefits from the fund\textsuperscript{43} and was concerned with the lack of communication of plan contents

\textsuperscript{40} See supra note 18 and accompanying text.

\textsuperscript{41} Blankenship, 329 F. Supp. at 1095; see also Comment, Duties, supra note 1, at 1718-19. Blankenship was decided in 1971 three years before the enactment of ERISA. \$1, 29 U.S.C. \$ 1001. The fiduciary violations by the trustees and their abuses of the participants' rights would not have been tolerated under ERISA's strict fiduciary standards. See ERISA \$ 404, 29 U.S.C. 1104 (Fiduciary duties); ERISA \$ 405, 29 U.S.C. \$ 1105 (Liability for breach of co-fiduciary); ERISA \$ 409, 29 U.S.C. \$ 1109 (Liability for breach of fiduciary); ERISA \$ 501, 29 U.S.C. \$ 1131 (Criminal enforcement); ERISA \$ 502, 29 U.S.C. \$ 1132 (Civil enforcement).


\textsuperscript{43} S. Rep. No. 634, 92d Cong., 2d Sess. 1, 22-23 (19\_\_).
and requirements to participants. Finally, Congress wanted plans to have fair vesting and adequate funding requirements. The legislation existing prior to the enactment of ERISA could not satisfactorily regulate these aspects of private pension systems.

ERISA includes all of the requirements discussed above, and includes codified fiduciary standards:

(a)(1) Subject to sections 1103(c) of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.

The fiduciary requirements contained in ERISA were drawn from


48. ERISA § 404(a), 29 U.S.C. § 1104(a) (1982). Section 1103 re-emphasizes that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan." ERISA § 403(a)(1), 29 U.S.C. § 1103(c)(1) (1982).
the existing common law of trusts "but with modifications appropriate for employee benefit plans." The legislative history of ERISA indicates that the courts should apply common law rules and interpret the standards "bearing in mind the special nature and purpose of employee benefit plans." Moreover, the statute supersedes all state laws that relate to employee benefit plans. In addition to using these two approaches to the fiduciary standards, in relation to hostile tender offers, two sections of ERISA, §§404(a)(1)(A) and (B), exclusive purpose and the prudent man rules, are of primary importance in evaluating a trustee's duties. Section 406(b), the prohibited transactions requirement, has been held not to apply to trustees in a tender offer.

A. Exclusive Benefit Standard

ERISA § 404(a)(1)(A) requires that a pension plan trustee discharge his duties "solely in the interest of the participants and beneficiaries . . . for the exclusive purpose of providing benefits to participants and their beneficiaries." Although there is no definitive legislative history indicating the meaning of exclusive purpose, trustees should consider the following factors: (1) the cost of the asset must not exceed its fair market value; (2) the investment must generate a fair return; (3) the investment should not deprive the plan of sufficient liquidity so as to interfere with


Except as provided in subsection (b) of this section, the provisions of this subchapter and subchapter III of this chapter shall supersede any and all State law insofar as they may now or hereafter relate to any employee benefit plan described in section 1003(a) of this title and not exempt under section 1003(b) of this title. This section shall take effect on January 1, 1975.
55. See Comment, Prudent Response, supra note 1, at 848.
distributions; and (4) the investment must meet the prudence standards set forth in ERISA § 404(a)(1).58

The exclusive benefit rule is considered a catch-all rule, designed to include a transaction that may not be imprudent or listed as a prohibited transaction but which was not made solely in the interests of plan participants. The exclusive benefit rule is usually considered in connection with either the prudent man rule or the prohibited transaction rule, discussed below.59

B. Prudent Man Standard

ERISA § 404(a)(1)(B) requires that the trustee discharge his duties with "the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man . . ." would consider relevant.60 The requirements of the prudent man standard are satisfied if the trustee: (1) gives appropriate consideration to facts and circumstances he knows or should know are relevant to that particular investment, including its effect on the entire plan portfolio; and (2) takes into consideration the risk of loss, opportunity for gain and any other effect the investment might have on the plan.61 The trustee also must satisfy his common law duty to make an independent investigation of the facts.62

C. Prohibited Transactions

Section 406(b) of ERISA provides that a fiduciary of a plan may not deal with plan assets in his own interest or act in any transaction on behalf of a party whose interests are adverse to the plan.63


59. Id.

60. 29 U.S.C. § 1104(a)(1)(B) (1982). See also Note, Fiduciary Responsibility, supra note 4, at 1075. One view of the prudent man standard interprets it as a prudent expert standard, but the better view is that the expertise required will vary with the size of the plan. Id.

61. Rules and Regulations for Fiduciary Responsibility, 29 C.F.R. § 2550 404a-1 (1983); See also Comment, Duties, supra note 1, at 1707; Comment, Prudent Response, supra note 1, at 846.

62. See supra notes 19-42 and accompanying text.

63. 29 U.S.C. § 1106(b) (1982):

(b) A fiduciary with respect to a plan shall not—

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.
There are two exceptions to the self-dealing provisions of § 406. First a trustee of a plan may be a director, officer or employee of the sponsoring company. Second, a plan may invest up to ten percent of the fair market value of its assets in company stock. These provisions were included so as to not unduly disrupt established business practices and to enhance the efficient functioning of pension plans.

The federal court of appeals in Donovan v. Bierwirth held that the prohibited transaction section did not apply to trustees who purchased company stock for the target's pension plan during a hostile tender offer. Section 406(b)(2) was interpreted as "requiring a transaction between the plan and a party having an adverse interest." The trustees were not transacting business with an adverse party but with the plan's sponsoring corporation. The court saw no reason to expand § 406(b)(2) given the broad ambit of § 404, the prudent man and exclusive purpose rules.

III. THE TENDER OFFER CONTEXT

A. Pre-Tender Offer Tactics

The three provisions of ERISA governing the fiduciary duties of plan trustees cause conflicts of interest in a takeover attempt. The trustee must act as a prudent man solely for the benefit of the plan participants, and not for the sponsoring company who may be under seige. In addition the corporate trustee faces the problem of self-interest in his continuation of his role as trustee in light of salary and other benefits paid to him by the sponsoring company. To avoid problems created by hostile tender offers, trustees may choose to implement pre-tender offer defensive mechanisms.

68. Id.
69. Id. However, the recent case of Leigh v. Engle, No. 82-2943, 82-3040 (7th Cir. Jan 27, 1984) (available March 20, 1984 on WESTLAW, CA7 lib.) held that the protective provisions of § 406 should be construed broadly to protect beneficiaries and should apply to trustees who use pension funds to either aid in a corporate takeover attempt or to block a hostile tender offer.
70. Lynch & Steinberg, supra note 1, at 915; Comment, Prudent Response, supra note 1, at 848-49.
71. Impediments, supra note 1, at 504; Note, Defenses, supra note 1, at 594.
A company sponsoring an employee benefit plan can select a plan that could help defend or discourage a hostile tender offer by permitting the fund to purchase the sponsoring corporation's stock or by placing company stock in the hands of employees who will generally follow the lead of management against a takeover. An employee stock ownership plan [hereinafter referred to as ESOP] is a stock bonus plan, qualified under Internal Revenue Code provisions designed to invest primarily in qualifying employer securities. The ESOP purchases newly issued company stock with funds obtained from a lending institution, and secured by the company stock. The stock is credited to the account of the individual employee participating in the plan as the debt is repaid by the company. The advantage of this plan is that the trust can immediately purchase a large block of shares and the company can repay the debt over a period of time through its contributions to the ESOP. A further advantage of the ESOP is that voting rights are passed to participants only when the stock is allocated to their individual accounts, allowing the trustees to vote the stock during the early years of the ESOP.

Several other alternative plans are available. One such alternative is an employee stock purchase plan which allows employees to purchase company stock by contributing a fixed amount each month. However, the plan is most effective on a long-term basis and employee support is necessary. A company may also implement a profit sharing plan which has several different investment

74. Note, Defenses, supra note 1, at 594-95.
75. Impediments, supra note 1, at 507-08.
76. Id. at 508. There are also variations of ESOP's, such as the Tax Reduction Act Stock Ownership Plan (TRASOP) which allows employers to finance contributions of company stock through tax credits. Other alternatives are: Qualified Voluntary Employee Contribution plans (QVEC) which permits employees, including those covered by an existing plan, to make a limited contribution to the employer's plan, and which can designate different types of investments including the employer's stock. Employees select the mode of investment they desire and with strong company—employee relations, most will select company stock. Profit Sharing Stock Ownership Plan (P-SOP) is a profit sharing plan which invests primarily in the sponsoring company's stock. Id. at 506-07.
77. Id. at 504-05.
funds, one of which is a company stock fund. The advantage of this plan is that each employee can choose to direct his contributions into one of the investment funds. A drawback, however, is that profit sharing plans work best over a long period of time. Most plans transfer the right to vote employer stock in relation to the amount each employee contributes. When the plan is first set up, the trustees retain the voting control over company-held stock and therefore remain under ERISA requirements. Eventually the voting control passes to the employee. 78

The ESOP, employee stock purchase plan and profit sharing plan may have an advantage in that they avoid some of the conflict of interest problems created under ERISA if employees are free of any pressure, direct or indirect, from their employer when choosing to invest in company stock. Plan trustees nevertheless retain their fiduciary duties in their administration of the plan. 79 Moreover, if the trustees have control of the voting rights of shares and a bid for change of management is made, they must vote the shares according to ERISA's prudent man and exclusive benefit standards. 80 The same fiduciary standards apply to trustees with the power to buy or sell company stock on behalf of the plan in a tender offer. 81 Trustees may, however, incorporate their intended response to a tender offer within the plan's documents, but the trustees' ability to respond to conditions different than envisioned when the response was drawn up will be severely limited. 82

B. Tender Offer Alternatives

Trustees of pension plans have four choices available to them in a hostile tender offer situation. They may retain the stock in the plan, sell it on the open market, tender the stock to the offeror or purchase more of the target's stock to block the success of the offeror's tender offer. 83 Additionally, the company may amend its present pension plan or issue a new plan, such as an ESOP, discussed above. 84

78. Id. at 505.
79. Id. at 511, citing H.R. REP. NO. 1280, 93d Cong. 2d Sess. 305, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 5038, 5086. (The Department of Labor has not issued rules on the voting rights of plan participants.)
81. See supra notes 65 and 66.
82. Comment, Prudent Response, supra note 1, at 863 & n.138.
83. Id. at 865-70; Comment, Duties, supra note 1, at 1696.
84. Note, Defenses, supra note 1, at 600.
The last alternative presents two problems. First, if the target company issues a new plan, during a tender offer, the company must show a valid business purpose for doing so. The primary purpose for implementing a new pension fund cannot be to defeat the hostile tender offer. If the fund’s trustees agree to amend the existing plan, their actions must meet ERISA’s strict fiduciary requirements by being prudent and acting solely in the interests of the plan’s participants. Further, given the short time frame of most tender offers, amending the plan may be too time consuming for effective use, especially if the trustees seek prior approval of the Internal Revenue Service.

Generally, in a tender offer situation, the premium offered for the target’s shares is substantially higher than the market price. A pension plan that tenders its shares stands to make a substantial profit. Trustees may, however, consider other economic factors beside profits, such as the long term effects of a successful offer on the plan. For example, in *Wither’s v. Teachers’ Retirement System of New York*, the trustees’ decision to invest in speculative bonds was held prudent under the circumstances, because the purchase was necessary for the long term vitality of the plan.

Plan trustees have a valid interest in the financial soundness of the offeror and its pension plan and a decision to retain stock, made after a thorough, independent investigation of all relevant facts is not per se imprudent if it incidentally benefits the target company. Trustees would be violating their fiduciary duty if they tendered company shares to an inadequately funded and ill-managed corporation with a pension plan in the same dire financial shape. Thus, the trustees must discover the offeror’s financial status through a careful investigation and cannot rely only on the offeror’s prospectus or public statements.

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85. *Impediments*, supra note 1, at 511.
87. Comment, *Prudent Response*, supra note 1, at 863 n.138; *Impediments*, supra note 1, at 510. (Prior approval of plan amendments is not a legal requirement but lack of it may increase the risk of liability of the plan trustees).
89. 447 F. Supp. 1248 (S.D.N.Y. 1978); see supra notes 17-26 and accompanying text.
90. *Id.* at 1255.
91. See Comment, *Duties*, supra note 1, at 1696.
92. *Bierwirth*, 680 F.2d at 271.
93. *Id.* at 273.
The price of a target corporation's stock typically rises during a tender offer. If a sale of the stock by the trustees could be prudent if the trustees conclude that the tender offer will be unsuccessful and that the rise in price is only temporary. Thus the plan profits but does not directly aid or hinder the offeror. If however the directors of the target corporation are fighting the tender offer, this sale by the trustees could be viewed by the shareholders as a breach of duty especially if the trustees are corporate officers or directors.

Perhaps then the best way to avoid liability in a hostile tender offer context is for plan trustees to tender company shares. They avoid any appearance of acting in the interests of the company or themselves by tendering. This solution may have obvious problems for the corporate trustee. Further a problem may arise if there are two competing tender offers, one by an offeror favored by the target company, and another by a hostile offeror. Generally, trustees should tender to the highest bidder unless it is clearly imprudent to do so.

Purchasing additional target shares for the pension plan may also be an effective block to a hostile tender offer. However, the motivation behind the purchase is likely to be seriously questioned. In order to avoid liability by meeting ERISA's fiduciary standards, the trustees should, independently and objectively, thoroughly investigate all issues before making their decision.

IV. DONOVAN V. BIERWIRTH: AN ANALYSIS OF ERISA FIDUCIARY DUTIES IN A TENDER OFFER CONTEXT

In Donovan v. Bierwirth, the Second Circuit Court of Appeals considered whether trustees of a pension fund violated their fiduciary duties. In Donovan v. Bierwirth, the Second Circuit Court of Appeals considered whether trustees of a pension fund violated their fiduciary duties.

94. Id. at 266 (target company's stock, selling at around $23 to $28 rose to the mid-thirties range after hostile tender offer made).
95. Id. at 269 (after hostile tender offer enjoined, price fell to mid-twenties).
96. Comment, Prudent Response, supra note 1, at 866 n.157.
97. Bierwirth, 680 F.2d at 272.
98. Comment, Prudent Response, supra note 1, at 866.
100. Independent investigation has been interpreted as requiring more than a cursory inquiry; see Bierwirth, 680 F.2d at 263; Withers, 447 F. Supp. at 1248.
101. See Comment, Prudent Response, supra note 1, at 868; Comment, Duties, supra note 1, at 1708.
102. Bierwirth, 680 F.2d 263.
fiduciary duties by refusing to tender company held stock and by purchasing more stock during a hostile tender offer. The court held that the trustees' actions were not a per se violation of ERISA. The court also held, however, that the trustees had not made an impartial decision and had not acted solely in the interests of the plan participants. The trustees were enjoined from exercising any power over company stock held in the plan but retained their position over the other ninety percent of the plan's assets.

In September 1981, LTV Corporation made a hostile tender offer of $45 per share for up to seventy percent of Grumman, the target corporation. Grumman's officers decided that it was in the best interests of the corporation to fight the tender offer. The president of Grumman, its chief financial officer and its treasurer were trustees of the Grumman pension plan. All three as directors took part in the decision to reject LTV's offer. Acting in their capacity as trustees, they decided that tendering company shares held in the pension plan would not be in the best interests of the pension plan, but that it would be in the best interests of the plan to purchase over one million additional shares at an average price of $38.27. The stock had been selling in the mid-twenties immediately prior to the tender offer.

At the single meeting held by the trustees to consider whether to tender Grumman stock, three items were considered. First, the fiduciary standards of ERISA were presented by Grumman's in-house counsel. Second, a letter from Grumman's investment banker, stating that LTV's offer was inadequate, was discussed. Third, a report from a national brokerage firm recommending Grumman stock as a good investment was considered. After a short discussion, the three trustees approved the investment of up to ten percent of the plan's total assets in Grumman stock. The trustees also amended the trust agreement specifying that Grumman would indemnify the trustees in case of liability.

103. Id. at 264.
105. 680 F.2d at 267.
106. Id. at 264.
107. Id. at 266.
109. 680 F.2d at 269. But see Withers, 447 F. Supp. at 1253, 1259 (fact that trustees required inclusion of indemnification before agreeing to purchase of speculative bonds was not "prime mover" in their decision). ERISA § 410(a), 29 U.S.C. § 1110(a) (1982) voids exculpatory provisions contained in the plan relieving ERISA fiduciaries from personal liability.
The Secretary of Labor argued that the activities of the trustees as directors precluded them from exercising detached judgment on behalf of the pension plan participants and that the proper course for trustees in their position was resignation. The court rejected the Secretary's argument and instead discussed the factors the trustees should have considered in making their decision on the plan's response to LTV's offer.

The court determined that as trustees, they were under a duty to discover what their duty was in such a complex situation. The court found that the trustees had instead treated their fiduciary duties casually, as "something to be attended to when the hectic pace of fighting the tender offer would permit." The court held that the trustees could have discovered their duty by seeking the advice of independent counsel rather than in-house counsel who was too closely involved to give adequate independent advice. It stated that independent counsel is not always necessary, only in unusual situations requiring advice "from someone above the battle."

The court additionally faulted the trustees on their lack of "careful and impartial" investigation. The trustees had relied upon LTV's prospectus to conclude that the offeror's pension plans had unfunded liabilities. Further investigation by the trustees would have shown that the unfunded liabilities were limited substantially to a subsidiary of LTV and would have had little effect on the well-being of Grumman's plan. Grumman's trustees, unlike the

However, plans may purchase liability insurance for their trustees as long as the insurer has recourse against the fiduciary. A fiduciary may also purchase his own insurance and a fiduciary's employer may supply liability insurance. ERISA § 410(b), 29 U.S.C. § 1110(b) (1982).


111. 680 F.2d at 271.

112. Id. at 272-76. The common law time frame for judging investment decisions made by trustees is at the time the decision was made. In Re Bank of New York, 35 N.Y.2d 512, 323 N.E.2d 700 (1974).

113. 680 F.2d at 272.


trustees in *Withers*, concluded after a cursory investigation that it was in the best interests of the plan to purchase additional Grumman stock. The trustees neither sought out LTV’s financial records nor did they consult with independent financial experts as the trustees did in *Withers*.

The trustees failed to balance the benefit of retaining and purchasing additional Grumman stock against the risk that the price might decrease if the tender offer was unsuccessful. The trustees argued that their decision not to tender was made in the interests of the participants, and that they could therefore lawfully impede LTV’s offer through a purchase of Grumman shares for the benefit of Grumman plan participants. The court pointed out that the trustees are required to calculate the risks and benefits of investments. The purchase put the trustees in “almost certainly a ‘no-win’ situation.” If the tender offer failed, the price would probably return to its pre-tender offer level and if the offer succeeded, the Grumman plan would have become a minority shareholder in Grumman as a subsidiary of LTV. As the court noted, Grumman was fighting the tender offer on the basis of LTV’s poor financial future.

The last factor considered by the court was the trustees’ subjective belief. The court concluded that although the trustees honestly believed their actions benefitted plan participants, the trustees did not meet ERISA fiduciary requirements. The conduct of the trustees was the crucial element, not their good faith belief in the validity of their actions. The sincerity of their belief was irrelevant to determining the prudence of their conduct.

The court found enough evidence of imprudence on the part of the trustees to affirm the issuance of a preliminary injunction enjoining the trustees from exercising control over Grumman stock.

117. See supra note 27 and accompanying text. But see Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983) (Trustees’ cursory review of out of date appraisal report led to imprudent investment).
118. See supra notes 73-79 and accompanying text.
119. Bierwirth, 680 F.2d at 274; see supra note 45.
120. Bierwirth, 680 F.2d at 275.
121. Id.
122. Id. at 276; Comment, Prudent Response, supra note 1, at 856 & n.97.
held in the plan. This decision was based on the trustees lack of judgment and inadequate investigation. Unanswered were the questions whether resignation was the only solution open to the Grumman trustees, and whether it was valid to use company-held stock as an impediment to a hostile tender offer. Based on the facts before it, the court had no reason to reach a conclusion on these more difficult issues.

Bierwirth sets forth guidelines for corporate trustees to consider when faced with a hostile tender offer. These guidelines are helpful to the trustee but strict adherence to them will not prevent liability on the part of the trustee. Individual tender offers differ substantially, as do types of company pension plans. These differences prevent any one case holding from providing a bright line rule that ERISA trustees can comfortably follow. Bierwirth illustrates that courts faced with interpreting ERISA will scrutinize the facts closely and will adhere to Congress' intention to protect fund beneficiaries.

124. Bierwirth, 680 F.2d at 276.
125. Id. at 271-72.
126. Id. at 276. See also Kranz, Resistance to Takeovers: A Look at Grumman's Response to LTV, 1982 J. PENSION PLAN & COMPLIANCE 214, 229.
128. See Leigh v. Engle, No. 82-2943, 82-3040 (7th Cir. Jan. 27, 1984) (available March 20, 1984, on WESTLAW, CA7 lib.), holding that plan administrators violated ERISA by using plan assets to aid in corporate takeovers. The trustees were members of a loose confederation of corporations controlled by a single individual. Their moves as trustees and as individuals dovetailed with his acquisition programs. The district court held that because the trust profited handsomely from the trustees' actions, ERISA had not been violated. The court of appeals overruled the district court and pointed out that the "nature of the breach of fiduciary duty alleged here is not the loss of plan assets but instead the risking of the trust's assets at least in part to aid the defendants in their acquisition program." Id. at 15. Plaintiffs in ERISA actions are not required to show loss of trust assets, only that the assets were put at risk by the trustees.

The court in Leigh relied heavily on Donovan v. Bierwirth in its analysis of ERISA §§ 404 and 406. To the Seventh Circuit, Bierwirth offered "two avenues" for dealing with the fiduciary standards in § 404. The court stated "[t]he first avenue focuses on the potential for conflicts of interest between the fiduciaries and the plan beneficiaries" while the second avenue requires "a broader inquiry into the fiduciaries' actions where they may have substantial interests in a control contest." Id. at 23. At the minimum, trustees in a potential position of conflict must engage in "intensive and scrupulous independent investigation" of options available to them. The court, based upon the particular facts before it, believed that a third factor was needed to evaluate the actions of the trustees. It considered the "extent and duration" of the trustees' actions (which tracked their investment decisions as individuals for over a year).

The Secretary of Labor, as amicus curiae, again recommended resignation as the best course of action for a fiduciary placed in an inherently conflicting position. Id. at 38. The
CONCLUSION

There are conflicting views as to the best approach for pension fund corporate trustees during a hostile tender offer. One view recommends that, in spite of the risks involved, pension plans can be valid impediments to takeovers. As long as trustees realize the risks and can prove, through evidence of careful independent investigation, that they acted solely in the interests of the plan, they should meet ERISA's fiduciary obligations. The fact that their decision indirectly benefits the corporation does not make the decision automatically imprudent.

The contrary view is that these pension plans cannot be used to impede a takeover, and therefore corporate trustees must resign during the course of the tender offer. Resignation may be the only "practical solution" to the conflicting interests that arise during a hostile offer if trustees have control over target stock. The three non-ERISA cases, Amax, Withers and Blankenship illustrate that courts require trustees to act for the exclusive benefit of plan participants and to make careful, prudent decisions regarding plan activities. ERISA codified these common law standards for the purpose of stricter and more uniform application. Under these standards, although trustees retain the legal right to control company shares it may be impossible to exercise that right. The Bierwirth court did not recommend automatic resignation but implied that resignation was the proper course for the trustee who, as a corporate director, knows that his judgment is biased.

Resignation may be the better choice but not the only choice. Withers illustrates that in a situation detrimental to the life of court favorably viewed the Secretary's suggestion but refused to adopt a per se rule requiring trustees to resign. Id. at 38 n.31. The court noted that resignation of trustees in favor of neutral trustees would "calm the fears of plan beneficiaries" and prevent courts from having to "sift through the complicated events surrounding a takeover in an attempt to gauge the prudence and motivations of trustees." Id. at 38.

Leigh and Bierwirth both signal that courts should and will flexibly interpret ERISA to protect the interests of plan beneficiaries.

129. Impediments, supra note 1, at 513.
130. Id.
132. Id. at 870.
133. See supra notes 18-42 and accompanying text.
134. See supra note 43 and accompanying text.
135. 19 B.S. Young, BUSINESS ORGANIZATIONS, § 17.02[2] (1984); See supra notes 21-28 and accompanying text.
136. Bierwirth, 680 F.2d at 276.
the plan, trustees might remain in their positions.\textsuperscript{137} A threat by the offeror to terminate the plan is not sufficient, however. ERISA contains codified standards for plan mergers and terminations and the offeror must meet ERISA requirements or face liability himself.\textsuperscript{138} In order for the trustees to support their actions and avoid personal liability,\textsuperscript{139} they should be in an "either-or" situation, the collapse of the plan versus a high-risk investment. It is a matter of degree. Such an extreme example rarely occurs however in a tender offer and the risks to trustees remaining in office during a tender offer are great.\textsuperscript{140}

Trustees who are not directors or officers of the company sponsoring the plan face problems similar to the corporate trustee. The duty of loyalty to the corporation is not present but conflicting self-interest remains. The trustee who tenders stock may help the offer succeed and lose his position in the process. The trustee who is thorough in making his decision probably will not violate ERISA's fiduciary standards by not tendering and remaining in office. However, considering the rise in the price of company-held stock and the potential profit for the plan, the trustee must positively prove that not tendering or selling on the open market is the prudent decision.\textsuperscript{141}

The key to avoiding liability in a tender offer context requires two complementary elements. First, the trustee must act solely in the interests of the participants and second, he must independently and carefully investigate all relevant factors necessary to make a prudent decision. By so doing he meets both common law standards and ERISA's exclusive benefit standard and the prudent man standard.

\textsuperscript{137} Kranz, supra note 127, at 229.
\textsuperscript{139} Persons empowered to bring a civil action against trustees for breach of fiduciary duty are:

(a) A civil action may be brought—

(1) by a participant or beneficiary—

(A) for the relief provided for in subsection (c) of this section, or

(B) to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan;

(2) by the Secretary, or by a participant, beneficiary or fiduciary for appropriate relief under section 409 of this title;


\textsuperscript{140} Bierwirth, 660 F.2d 263, is currently the only case dealing with a fiduciary's duties in a tender offer under ERISA. See Impediments, supra note 1, at 510.

\textsuperscript{141} Comment, Duties, supra note 1, at 1704 & n.52.
DELAWARE'S SOLUTION TO THE PROBLEM OF THE MINORITY STOCKHOLDER IN A CASH-OUT MERGER—

INTRODUCTION

The Signal Companies, Inc. (hereinafter Signal), is a diversified technologically based Delaware corporation with stock traded on the New York, Philadelphia and Pacific Stock Exchanges. In 1974, Signal sold one of its subsidiaries for $420 million in cash. With this surplus cash, Signal became interested in purchasing UOP, Inc., formerly known as Universal Oil Products Company (hereinafter UOP), a diversified, industrial Delaware corporation, whose stock at the time was listed on the New York Stock Exchange.

Following arms length negotiations in April 1975, Signal agreed to purchase from UOP 1.5 million of UOP's authorized but unissued shares and to make a cash tender offer for 4.3 million of UOP's publicly held shares for $21 per share. At the time, UOP's shares were trading on the New York Stock Exchange at just under $14 per share. Signal's acquisition of these 5.8 million shares gave it a 50.5% interest in UOP.

At UOP's next annual meeting, Signal nominated and, as a result of its position as majority stockholder, elected six members to UOP's thirteen member board of directors. Of these six, five were either directors or employees of Signal. The sixth director had represented Signal as an investment banker in its tender offer negotiations with UOP. In addition, UOP's retiring president was replaced by a Signal employee and officer of one of its subsidiaries, James V. Crawford. Mr. Crawford was elected a director of both UOP and Signal. Between April 1975 and the end of 1977 Signal did not attempt to increase its interest in UOP. Because Signal still had not found suitable investment opportunities for all of its excess cash at the end of 1977, however, it turned its attention

3. 426 A.2d at 1335-36.
4. Id. at 1336.
once again to UOP, where its 1975 tender offer had been greatly over-subscribed.\(^6\)

At the instigation of Signal's chairman of the board and its president, two Signal officers, Messrs. Arledge and Chitea, who were also UOP directors, conducted a feasibility study which indicated that it would be a good investment for Signal to buy the remainder of UOP's outstanding shares (49.5\%) at any price up to $24 per share. Although this report was discussed with the Signal management officials who requested it, it was never brought to the attention of UOP's non-Signal directors. Rather, it was agreed that a meeting of Signal's Executive Committee be called for February 28, 1978, to propose that Signal acquire the remaining stock of UOP at $20-21 per share through a cash-out merger.\(^7\) Although he was not a member of the Executive Committee, UOP's president, Mr. Crawford, was invited to attend. He voiced no objection to the offered price range of $20-21 per share. The Executive Committee agreed that the proposal should be presented to Signal's and UOP's boards of directors on March 6, 1978.\(^8\) A press release was immediately issued referring to "negotiations" between the two corporations as announced by Forrest N. Shumway, president and chief executive officer of Signal, and James V. Crawford, president of UOP. The announcement also referred to the fact that UOP's closing stock on that date was $14.50 per share. On March 2, 1978, Signal issued a second press release again referring to "negotiations," and this time announcing Signal's recommendation of $20 to $21 per share for UOP's 49.5\% minority interest.\(^9\)

Between Tuesday, February 28 and Monday, March 6, 1978, a total of four business days, UOP's president, Mr. Crawford, spoke to all UOP's non-Signal directors. In addition, on March 3, 1978, he contacted James W. Glanville, a long time director of UOP, and a partner in Lehman Brothers Kuhn Loeb, Inc. (hereinafter Lehman Bros.), who had been UOP's investment banker for many years, to request that they prepare a fairness opinion regarding Signal's

\(^6\) Id. at 705.
\(^7\) Id. A merger is "a union effected by the absorbing of one or more existing corporations by another which survives and continues the combined business." H. BALLANTINE, BALLANTINE ON CORPORATIONS 881 (rev. ed. 1946). A cash-out merger is one where cash (as opposed to securities or other property) is the consideration for the exchange. E. FOLK III, THE DELAWARE GENERAL CORPORATION LAW, A COMMENTARY AND ANALYSIS 324 (1972).
\(^8\) 457 A.2d at 705-06.
\(^9\) Id. at 706.
offer in time for the March 6, 1978, meeting. Mr. Glanville's immediate reaction was that a price of $20-21 was fair, since it represented a 50% premium over UOP's market price. Mr. Crawford meanwhile indicated to the chairman of Signal's board that his communications with the non-Signal directors of UOP led him to believe they would not approve the merger unless it was at the top of the range, i.e., $21 per share. He never bargained, however, for more than $21.10

On March 6, 1978, Signal and UOP held simultaneous board meetings; communications between the two were maintained by a telephone hook-up. Signal's board unanimously adopted a resolution authorizing Signal to propose to UOP a cash merger for $21 per share, providing that the merger be approved by a majority of UOP's outstanding minority shares voting at a stockholders meeting to consider the proposal, and further providing that the minority shares voting in favor of the merger, when added to Signal's 50.5% interest, be equal to at least two-thirds of all outstanding UOP shares; otherwise the merger proposal would fail. After consideration of Signal's proposal, Mr. Crawford and Signal's chairman of the board left the meeting to allow the non-Signal UOP directors to discuss it. Upon their return, a vote was taken, and the proposal adopted. Although five Signal directors on UOP's board abstained from voting, "the minutes show that each of them 'if voting would have voted yes'."11 Mr. Crawford, himself a Signal director, and the other Signal-backed director, the investment banker, voted in favor of the merger.12

On March 7, 1978, UOP by letter notified its shareholders of the action of its board of directors concerning Signal's offer. Despite the urgency impressed on Signal's and UOP's boards to immediately consider the offer, however, the merger was not submitted to UOP's shareholders until May 26, 1978. At that meeting 56% of the 5,688,302 minority shares were voted, resulting in a total minority vote of 51.9% in favor of the merger. When the minority vote

10. Id. Interestingly, although Mr. Glanville sought a $250,000 fee for a fairness opinion, Mr. Crawford convinced him to accept $150,000. Yet Mr. Crawford did not show the same initiative in negotiating for a higher price per share on behalf of UOP's minority shareholders. Id. at 711.
11. Id. at 707.
12. 426 A.2d at 1340. Weinberger II is clear on this point, whereas Weinberger III, 457 A.2d at 707, in its attempt to condense the facts, gives the impression that UOP's president, Mr. Crawford, and all of the Signal nominated UOP directors abstained.
in favor of the merger was added to Signal's vote, a total of 76.2% of UOP's outstanding shares voted to approve the merger. Only 2.2% of UOP's shares were voted against it.\textsuperscript{13}

Consequently, by the terms of the merger agreement, on May 26, 1978, UOP merged with Sigco, Incorporated, a wholly-owned subsidiary of Signal. "As a result of the merger, UOP, as the surviving entity, became the wholly-owned subsidiary of Signal, and UOP's former minority shareholders were paid the sum of $21 per share for their former interests in UOP."\textsuperscript{14}

Subsequently, William B. Weinberger, a former shareholder of UOP, filed a class action in the Court of Chancery of Delaware, New Castle County, attacking the fairness of the merger. The court held that because Signal had not used its majority position to bring about a predetermined result affecting the minority, but had structured the merger so that it could not have been approved without a majority of the minority shares voting for it, specific acts of fraud or misrepresentation had to be alleged for the complaint to state a cause of action. As it did not allege such specific acts, the complaint was dismissed.\textsuperscript{15}

Weinberger, on behalf of all UOP minority shareholders who had not exchanged their shares for the merger price, then amended his complaint, arguing that because $21 per share was grossly inadequate, the merger was unfair and should be set aside, or in the alternative, the minority should receive "equitable rescission" in the form of money damages or stock in Signal.\textsuperscript{16} Weinberger's

\textsuperscript{13} 457 A.2d at 708. Approximately twenty-two percent of UOP's outstanding shares were not voted.

\textsuperscript{14} 426 A.2d at 1335; see also Weinberger v. UOP, Inc., 409 A.2d 1262, 1264 (Del. Ch. 1979) [hereinafter cited as Weinberger I].

\textsuperscript{15} 409 A.2d at 1267-68.

\textsuperscript{16} 426 A.2d at 1335. The complaint also named Lehman Bros. as a defendant on grounds of conflict of interest and conspiracy. Since the court of chancery determined that plaintiff offered no authority establishing a duty owed by a banking firm in rendering a fairness opinion, and since there was no evidence of conspiracy, judgment was entered in favor of Lehman Bros. Id. at 1341, 1348. Because plaintiff dismissed Lehman Bros. as a defendant before its appeal to the Supreme Court of Delaware, 457 A.2d at 703 n.3, no further reference will be made to Lehman Bros. as a defendant.


Rescission calls for the cancellation of the bargain and the return of the parties to the status quo and hence where this is impossible because of the disposal or retirement of the stock involved, the proper measure of damages should be the equivalent value of the stock at the time of resale or at the time of judgment.
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claims were again denied as the court of chancery found that there was a proper purpose for the merger,\textsuperscript{17} that there were no material misrepresentations by UOP or Signal,\textsuperscript{18} that UOP's board of directors did not breach their fiduciary duty to the minority shareholders in approving the merger,\textsuperscript{19} and that the merger price was fair to the minority shareholders of UOP.\textsuperscript{20}

Upon Weinberger's appeal,\textsuperscript{21} the Supreme Court of Delaware found that Signal failed to disclose material information contained in the Arledge and Chitea feasibility study under circumstances amounting to a breach of fiduciary duty to UOP's minority shareholders. As a consequence, it held that the merger was unfair, both in terms of fair dealing (because the minority was misled) and fair price (because value was not fairly determined). It further held that as a result of this unfairness, the vote of the majority of the minority stockholders in favor of the merger was misinformed, and a misinformed vote will not be ground for shifting from the majority the burden of proving entire fairness.\textsuperscript{22} The court overruled\textsuperscript{23} the business purpose test established by Singer \textit{v. Magnavox Co.}\textsuperscript{24} and its progeny; held the "Delaware block" method of determining fair value as outmoded; and overruled Lynch \textit{v. Vickers Energy Corp.}\textsuperscript{25} insofar as it "purports to limit the Chancellor's discretion to a single remedial formula for monetary damages in a cash-out merger. . . ."\textsuperscript{26}

As \textit{Weinberger} illustrates, one of the consequences of making a successful tender offer is that, should the original offeror, now the majority stockholder, wish to obtain 100\% control (and thereby change the corporation from a publicly to a privately held one),\textsuperscript{27} it is confronted with the problem of how best to acquire the minority's stock interests. One method is to merge the subsidiary into the parent either directly or through another corporation established for that purpose, as for example Sigco, Incorporated was in

\begin{thebibliography}{9}
\bibitem{17}426 A.2d at 1350.
\bibitem{18}\textit{Id.} at 1353.
\bibitem{19}\textit{Id.} at 1356.
\bibitem{20}\textit{Id.} at 1362.
\bibitem{21}457 A.2d 701 (Del. 1983).
\bibitem{22}\textit{Id.} at 703, 711.
\bibitem{23}\textit{Id.} at 715.
\bibitem{24}380 A.2d 969 (Del. 1977).
\bibitem{25}429 A.2d 497, 505-06 (Del. 1981) [hereinafter cited as \textit{Lynch II}].
\bibitem{26}457 A.2d at 714.
\end{thebibliography}

1984]
the Weinberger case. In Delaware, this can only be accomplished by following the formal merger procedure set out in its statutes which will be discussed in the next section. But unlike a merger between two previously unrelated corporations, a “second-step merger”—the first step being the tender offer—is now accompanied by the additional problem of a fiduciary duty owed by the majority to the minority shareholders in cashing out the minority’s interests, and the extent of compliance with that duty. Because the concept of fiduciary duty is an equitable one, it goes beyond mere compliance with statutory requirements.

The aim of this article is to show how the Delaware courts of equity have resolved the problem of the minority shareholder, particularly the development of the ideas of “fiduciary duty” owed by the majority to a minority shareholder, and of “fairness,” in the hope that one attempting a second-step cash-out merger involving a Delaware corporation can better plan such a merger to prevent unnecessary litigation.

I. BACKGROUND

Before embarking on an analysis of Delaware case law, it is first necessary to fully understand the statutory basis for consummating a merger in Delaware at the time of the merger between UOP and Sigco, Incorporated.

A. The Statutory Basis for a Cash-Out Merger

At common law, a minority of one could thwart a merger. Today, modern statutes like Delaware’s eliminate the minority’s ab-

27. This process is also known as “going private” or “freezing out” the minority.
28. The scope of this article is limited to Delaware law. There will be no attempt to discuss the implications of nondisclosure or misrepresentation under the Securities Exchange Act of 1934, §§ 9, 10, 10(b), 15 U.S.C.A. §§ 78i, 78j, 78j(b) (West 1981 & Cum. Ann. 1983). It will be noted, however, that Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), a case involving a minority stockholder suing its parent corporation in federal court following a Delaware short-form merger, held that “[t]here may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5 to ‘cover the corporate universe.’” Id. at 479-80.

For an article discussing a federal attempt to regulate transactions involving public corporations seeking to go private, see Gannon, An Evaluation of the SEC’s New Going Private Rule, 7 J. CORP. L. 55 (1981).
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solute veto: "because the power to merge is conferred by statute, every stockholder in a Delaware corporation accepts his shares with notice thereof."³⁰

Delaware provides for two types of mergers—a short-form, or § 253î merger, and a long-form, or § 251î merger. The § 253 short-form merger permits a parent corporation by resolution of its board of directors to merge with a subsidiary where the parent owns at least 90% of the outstanding shares of each class of stock and one of the corporations is a Delaware corporation. Only in the situation where the parent is not the surviving corporation is stockholder approval required. In that case, the merger must be approved by a majority of the outstanding stock of the parent at a meeting to be held no sooner than twenty days after notice of the purpose of such meeting has been mailed to each stockholder.³³

The § 251 long-form merger, which is the one under which UOP was merged into Sigco, Incorporated, permits any two or more Delaware corporations to merge into a single corporation.³⁴ The board of directors of each corporation must adopt a resolution approving the merger, giving the terms and conditions, the method of carrying the merger into effect, the amendments or changes in the certificate of incorporation of the surviving corporation effected by the merger, and the manner of converting shares of each constituent corporation into shares of the surviving corporation, or cash, property, rights or securities of any other corporation.³⁵ This agreement must be submitted to the stockholders of each corporation involved in the merger at an annual or special meeting to act on the proposal, to be held no sooner than twenty days after

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"vested rights" theory of corporate law through the "enabling philosophy" that permitted the establishment of merger statutes, to those providing for cash a the consideration. Id. at 626-7.

33. § 253(a) (1983). Citations will be made to the latest edition of Del. Code Ann. whenever there is no change from the law in effect at the time of the merger between UOP and Sigco, Incorporated.
34. § 251(a) (1983).
35. § 251(b) (1983).
due notice is mailed to all stockholders of record. A majority of
the outstanding stock must be voted in favor of the adoption of
the merger agreement in order for the merger to take place.36

A stockholder who has been offered cash as the consideration
for his shares under either a § 251 or a § 253 merger may obtain
an appraisal under § 262.37 That section provides that in a cash-out
merger, the minority stockholder who has neither voted in favor
of the merger nor consented in writing to it "shall be entitled to
an appraisal by the Court of Chancery of the fair value of his shares.
..."38 In order for appraisal rights to be perfected, the corpo-
ration proposing the merger, not less than twenty days before the
meeting of stockholders, must notify the stockholders that they
are entitled to such rights. Before the vote on the merger, each
stockholder must deliver to the corporation a written demand for
appraisal of his shares. Within ten days after the effective date
of the merger, the surviving corporation must notify each
stockholder who submitted a demand and who did not vote in favor
of or consent to the merger that it has become effective.39

The stockholder seeking appraisal must file his petition demand-
ing a determination of the value of all stock in the court of chancery
within 120 days after the effective date of the merger. Notwith-
standing the above, a stockholder may withdraw his demand for ap-
praisal and accept the terms of the merger if done within sixty
days of the effective date of the merger.40

Following notice to the corporation, a hearing on the petition
will be held to determine which stockholders are entitled to an
appraisal and to:

36. § 251(c) (Cum. Supp. 1982). However, § 251(f) (Cum. Supp. 1982) provides that no vote
of the stockholders is necessary where the certificate of incorporation is not affected or
the stock will be identical before and after their merger. Cf. § 251(c), (f) (1983).
37. § 262(a) (1983). See also § 253(d) (1983) (extending appraisal rights to stockholders
in § 253 mergers where all the stock of the subsidiary Del. corporation is not owned by
the parent immediately prior to the merger).
38. § 262(a) (1983). However, § 262(b) (1983) denies appraisal rights where the considera-
tion for the merger is either shares of stock or cash for fractional shares 1) in the surviv-
ing or resulting corporation or 2) in any other corporation which will be listed on a national
securities exchange or held of record by more than 2,000 stockholders. See E. FOLK III,
THE DELAWARE GENERAL CORPORATION LAW 391-95 (1972) discussing the 1969 version of § 262(k)
which reads the same as today's § 262(b). Prior to 1967, an appraisal remedy was available
to all stockholders regardless of the consideration. Id. at 396.
appraise the shares, determining their fair value exclusive of any
element of value arising from the accomplishment or expectation
of the merger, together with a fair rate of interest, if any, to be
paid upon the amount determined to be the fair value. In determin-
ing such fair value, the Court shall take into account all relevant
factors.41

The appraisal statute thereby protects the minority stockholder
from an arbitrary decision by the majority stockholder to cash him
out for less than his interest is worth. "The basic concept of value
under the appraisal statute is that the stockholder is entitled to
be paid for that which has been taken from him, viz., his propor-
tionate interest in a going concern."42

The critical issue is whether an appraisal is the minority
stockholder's only remedy for dissatisfaction with either the cir-
cumstances surrounding the cash-out merger or the monetary con-
sideration offered for his interest in the corporation.

B. Beyond Statutory Compliance—A Look At The Equities.

1. The Early Cases—Development of a Fiduciary Duty Owed
By Majority To Minority Stockholder.

Although the early cases to be discussed did not specifically deal
with a cash-out merger, the Delaware courts have freely adopted
the principles established in them to that situation. In Cole v. Na-
tional Cash Credit Ass'n,43 a case where preferred stockholders
sought to enjoin a stock for stock merger, the court said that the
merger statute existing at that time offered a dissenting
stockholder the option of electing to take his share in the con-
solidated company or to "secure a valuation of his stock in money
and collect the same as a debt due."44 The court went on to say
that such an election does not arise in circumstances where the
attempted merger is illegal or fraudulent.

[I]f consent to the merger be induced by fraud practiced upon a con-
senting company, a stockholder is under no duty to elect whether
he will abide by the merger so induced or take his money. In such

42. Tri-Continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950) (addressing a predecessor
statute to § 262).
43. 156 A. 183 (Del. Ch. 1931).
44. Id. at 187.
a case equity holds that no just alternatives are presented to him for a choice.\textsuperscript{45} The critical question, however, is whether a stockholder can seek a remedy in a court of equity where there is no actual fraud. On the one hand, there is dicta in the \textit{Cole} case to the effect that a "conscious abuse of discretion" or "a breach of trust or such maladministration as works a manifest wrong to the dissentients"\textsuperscript{46} would amount to constructive fraud and would offer a remedy in equity. On the other hand, the court applied to majority stockholders a rule generally thought to apply only to directors: "[t]he same presumption of fairness that supports the discretionary judgment of the managing directors must also be accorded to the majority of stockholders whenever they are called upon to speak for the corporation. . . ."\textsuperscript{47} It also recognized that mere inadequacy of price does not of itself constitute fraud.\textsuperscript{48} Applying these principles to the case before it, the court found no actual or constructive fraud that would justify enjoining the merger.

Taking \textit{Cole} one step further, in \textit{Gottlieb v. Heyden Chemical Corp.},\textsuperscript{49} a case where a minority stockholder sought equity relief to rescind stock option plans actually ratified by the stockholders which permitted directors to purchase for themselves stock at less than market value, the Supreme Court of Delaware said that the burden is on the dissenting stockholder "to prove that no person of ordinarily sound business judgment would be expected to entertain the view that the consideration furnished by the individual directors is a fair exchange for the options conferred."\textsuperscript{50}

Not until \textit{Warshaw v. Calhoun},\textsuperscript{51} an action by minority stockholders seeking appointment of a receiver for liquidation or reorganization and for an accounting, did the Supreme Court of Delaware address the issue of what constitutes sound business judgment as applied to a person who acts as a director of both a parent and a subsidiary corporation. It concluded that such a person owes "the same duty of good management to both corporations. This

\begin{flushleft}
\textsuperscript{45} \textit{Id.} \\
\textsuperscript{46} \textit{Id.} \\
\textsuperscript{47} \textit{Id.} at 188. \\
\textsuperscript{48} \textit{Id.} (citing \textit{Allied Chem. & Dye Corp. v. Steel Tube Co. of America}, 120 A. 486, 494 (Del. Ch. 1923)). \\
\textsuperscript{49} 91 A.2d 57 (Del. 1952). \\
\textsuperscript{50} \textit{Id.} at 58. \\
\textsuperscript{51} 221 A.2d 487 (Del. 1966).
\end{flushleft}
duty is to be exercised in the light of what is best for both corporations.\textsuperscript{52} It is here that the concepts of business judgment and fiduciary duty intersect. The courts presume that directors (and as Cole indicated, majority stockholders as well)\textsuperscript{53} will exercise sound business judgment in decisions involving the corporation; therefore, the courts will not interfere unless the directors or majority stockholders have abused the trust inherent in their positions as fiduciaries.

The problem is twofold: (1) what is the extent of fiduciary duty owed to the minority? and (2) how is the court to determine whether that duty has been breached, particularly in a situation where the majority is on both sides of a transaction?

For the classic definition of fiduciary duty, the cases consistently point back to Guth v. Loft, Inc.,\textsuperscript{54} which involved an officer of a corporation who used its funds to take for himself a business opportunity that rightly belonged to the corporation:

While technically not trustees, they [corporate officers and directors] stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.\textsuperscript{55}

Guth was extended in David J. Greene & Co. v. Dunhill International, Inc.,\textsuperscript{56} which involved minority stockholders who sought to enjoin a merger of their corporation with Dunhill, the owner of 80.3% of its stock. The David J. Greene & Co. court announced that duties and standards comparable to those imposed on directors should be imposed on stockholders when they determine the

\textsuperscript{52} Id. at 492.
\textsuperscript{53} 156 A. at 188.
\textsuperscript{54} 5 A.2d 503 (Del. 1939).
\textsuperscript{55} Id. at 510.
\textsuperscript{56} 249 A.2d 427 (Del. Ch. 1968).
policy of a corporation, as in that instance they are the corporation.\textsuperscript{57}

Once established that such a duty is owed, the problem then becomes how to determine its breach. The court in \textit{Guth} said that “[t]he occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.”\textsuperscript{58} Thus, it comes down to a question of what is fair. If the transaction was fair, there was no breach of fiduciary duty; if it was not fair, there was a breach.

The concept of fairness was first articulated in a merger setting in \textit{Sterling v. Mayflower Hotel Corp.}\textsuperscript{59} which involved the appeal of a denial of plaintiff’s motion to enjoin the merger of Mayflower Hotel Corp. into its parent, the Hilton Hotels Corp., on a stock for stock basis. The Supreme Court of Delaware said that the test of fairness to a minority stockholder upon such a merger is that he “receive the substantial equivalent in value of what he had before.”\textsuperscript{60} It reiterated the court’s view that a majority stockholder stands in a fiduciary position in dealing with the minority’s property, and where it stands on both sides of the transaction, the majority bears the burden of establishing the entire fairness of the merger.\textsuperscript{61} In other words, once a minority stockholder establishes (i.e., by virtue of its relationship) that a fiduciary duty is owed, the burden then shifts to the majority stockholder to establish under the careful scrutiny of the court that the transaction was entirely fair.

The problem is how to determine what is fair to \textit{all} parties. Not until \textit{Getty Oil Co. v. Skelly Oil Co.}\textsuperscript{62} did the Supreme Court of

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\item \textsuperscript{57} Id. at 434 (citing Allied Chem. & Dye Corp. v. Steel & Tube Co. of America, 120 A. 486 (Del. Ch. 1923)) [hereinafter cited as \textit{Allied}]. Although \textit{Allied} is one of the earliest Del. cases imposing on majority stockholders who speak for the corporation the fiduciary duty which the law imposes on directors, it was a court of chancery decision, and was in the context of a sale of assets. The court granted a preliminary injunction of the sale of assets because the minority stockholders charged that the price was so low as to be a fraud upon them. Id. at 496-97.
\item \textsuperscript{58} 5 A.2d at 510.
\item \textsuperscript{59} 99 A.2d 107, 108 (Del. 1952). Although the appraisal statute in effect in 1952 provided for appraisal rights on a stock for stock merger, an appraisal was not sought as a breach of fiduciary duty was charged. \textit{Id.} at 109. See also E. FOLK III, \textit{THE DELAWARE GENERAL CORPORATION LAW} 396 (1972).
\item \textsuperscript{60} Id. at 114.
\item \textsuperscript{61} \textit{Id.} at 109-10. After carefully scrutinizing the merger, the court found that “Interlocking directorates are not in themselves unlawful . . . ,” and concluded the merger was fair. \textit{Id.} at 118-19.
\item \textsuperscript{62} 267 A.2d 883 (Del. 1970).
\end{itemize}
Delaware acknowledge that a parent corporation also owes a fiduciary duty to its own shareholders. The court said that there is a limit to the parent’s fiduciary duty to its subsidiary: “the duty does not require self-sacrifice.” It concluded that judicial interference in parent-subsidiary transactions (in this case whether the parent owed its subsidiary a duty to share its oil import allocations) is warranted only where unfairness results from ‘gross and palpable overreaching.’

Until Singer v. Magnavox Co., however, no case specifically dealt with the issue of breach of the fiduciary duty of fairness owed by a majority to a minority stockholder in the context of a $251 cash-out merger.

2. The Singer Solution—The Business Purpose Test

In Singer v. Magnavox Co., minority shareholders of The Magnavox Co. (hereinafter Magnavox) brought a class action following the merger of Magnavox with T.M.C. Development Corp. (itself a subsidiary of North American Philips Development Corp., the ultimate parent corporation being North American Philips Corp.) seeking rescission of the merger and damages. Like Weinberger, the merger was the second step, the tender offer being the first, in the total acquisition of Magnavox’s stock by North American Philips Corp. The directors of Magnavox (four of nine were also directors of the parent corporation and three others were employees of Magnavox by contract with the parent), unanimously agreed to the merger. The stockholders of Magnavox were given notice of a meeting to consider the merger, and a proxy statement advised that the book value of the stock was $10.16 and the merger price $9.00 per share; they were also told that approval was assured because North American Philips Development Corp. already owned 84.1% of Magnavox’s common shares. Subsequently, the meeting was held and the merger approved.

The Singers then filed a complaint in the court of chancery alleging that the merger was fraudulent because it did not serve any business purpose other than the forced removal of public minority shareholders from an equity position in Magnavox at a grossly inadequate price, and that in approving the merger at that price,

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63. Id. at 888.
64. 380 A.2d 969 (Del. 1977).
65. Id. at 971-72.
the defendants breached their fiduciary duty to the minority stockholders. The court of chancery granted defendants' motion to dismiss, holding that the merger was not fraudulent merely because it served no valid business purpose other than to eliminate the minority, and that, in any event, plaintiff's sole remedy for dissatisfaction with an expressly authorized merger under § 251 was an appraisal under § 262. 66

Upon plaintiffs' appeal, the Supreme Court of Delaware, in considering the obligation owed by the majority to the minority stockholders in the context of a § 251 merger, agreed with the court's pronouncement in Guth that the question must be decided 'upon broad considerations of corporate duty and loyalty', 67 and rejected any notion "that statutory compliance insulates the merger from judicial review." 68 It also rejected plaintiff's charge of fraud, instead grounding its decision on principles of fiduciary duty. The court reaffirmed the established law regarding interested mergers that the corporation, who as majority stockholder stands on both sides of a transaction, has the burden of establishing the entire fairness of the merger. 69 The court proceeded to quote Guth's classic definition of the duty owed by a corporate director and held that it was applicable to a majority stockholder as well. 70

The court determined that this fiduciary obligation, which defendants agreed they owed, could not be met by a statutory appraisal proceeding. It reasoned that an appraisal statute protects only the value of the shares, not the right to the shares themselves. Even though a corporation has the statutory power to merge, sometimes said to be akin to the power of eminent domain, 71 it does not follow

66. Id. at 972. See Stauffer v. Standard Brands, Inc. 187 A.2d 78, 80 (Del. 1962), which held that in the context of a § 253 short-form merger, where there is no fraud involved, and the only dispute is the value of the shares, appraisal is the exclusive remedy. David J. Greene & Co. v. Schenley Indus., Inc. 281 A.2d 30 (Del. 1971) applied the Stauffer rationale to a § 251 long-form merger, holding that where there is "no fraud or blatant over-reaching [plaintiff's]...recourse is to an appraisal." Id. at 35. The rationale is that equity should not intervene to prevent a merger when a statute already provides a fair and efficient method for a dissenting stockholder to seek redress. Id. at 36.
67. 380 A.2d at 975 (quoting Guth, 5 A.2d at 511).
68. 380 A.2d at 975.
69. 380 A.2d at 976 (citing Sterling, 93 A.2d at 109-10).
70. 380 A.2d at 977 (citing Guth, 5 A.2d at 510). See supra text and accompanying note 55.
71. 380 A.2d at 978 (citing Fed. United Corp. v. Havender, 11 A.2d 331, 338 (Del. 1940)). In Fed. United Corp. a shareholder, seven months after the merger, contested the validity of a stock for stock merger because he did not get money dividends on his preferred shares prior to the merger. The court dismissed the complaint, as barred by laches, because the
that it has the power to merge simply for the purpose of getting rid of the minority. “[J]ust as a minority shareholder may not thwart a merger without cause, neither may a majority cause a merger to be made for the sole purpose of eliminating a minority on a cash-out basis.” The court held:

that a § 251 merger, made for the sole purpose of freezing out minority stockholders, is an abuse of the corporate process; and the complaint, which so alleges in this suit, states a cause of action for violation of a fiduciary duty for which the Court may grant such relief as it deems appropriate under the circumstances.

The court then said, however, that proof of a purpose other than a freeze-out will not necessarily discharge the majority’s duty as the court will still scrutinize the circumstances under the “entire fairness” rule of Sterling. It further held that appraisal is not the exclusive financial remedy in such cases.

The Singer court thus concluded that lack of business purpose did not constitute fraud, as plaintiffs had claimed, though it did constitute a breach of fiduciary duty. Because of that conclusion, the court did not actually address plaintiffs’ claim that defendants breached their fiduciary duty by approving the merger at an inadequate price.

The Singer court did not say that a valid business purpose justifies a merger; to the contrary, it specifically said it was still necessary to scrutinize the transaction for entire fairness even where there is a valid business purpose. It is the relationship between the corporations that calls the rule of fairness into play, not the business purpose. In this regard, Singer did not deviate from existing Delaware law. Perhaps, however, all that Singer attempted to do in proposing the business purpose test was to offer another specific example of the kind of activity that constitutes a breach of fiduciary duty, meaning to offer clarity to the issue of fiduciary duty and not intending it to be a necessary condition for establishing a breach. Singer was, however, a departure from...
existing law in that it applied the rationale offered in *Sterling*, to a cash-out merger, and thereby avoided consideration of the appraisal statute.

The very next month, the Supreme Court of Delaware decided *Tanzer v. International General Industries*. Tanzer was an appeal from a denial of a preliminary injunction to enjoin a merger of a parent and a subsidiary, both Delaware corporations. The court applied the business purpose test announced in Singer, but took it two steps further. First, it answered Singer’s unanswered question of whose business purpose was at issue, and concluded that, because the majority has a right to vote its own shares for the purpose of a merger, it is its business purpose that the court must examine. The court then found that the majority stockholder had a legitimate and compelling interest that was not a subterfuge for freezing-out an unwanted minority, and affirmed the court of chancery’s denial of a preliminary injunction. The second step it took beyond Singer was to interpret it as authorizing a fairness hearing even when no breach of fiduciary duty was found, by remanding the case for an evaluation not only of price, but of “entire fairness.” This follows the *Sterling* notion that because of the very existence of a fiduciary relationship, fairness once challenged must be determined by a court of equity.

76. 379 A.2d 1121 (Del. 1977).
77. 380 A.2d at 980 n.11. The Supreme Court of Delaware specifically left resolution of this question to another day since it was not necessary to the disposition of Singer.
78. 379 A.2d at 1125.
79. On remand, *Tanzer v. Int’l Gen. Indus.*, 402 A.2d 382 (Del. Ch. 1979), the court of chancery found that there were no disputed factual issues-only the legal question of whether the transaction was intrinsically fair to the minority stockholders. Id. at 385. The parties suggested eight criteria for determining fairness:

1. The purpose of the merger.
2. Alternatives to a cash-out merger.
3. Independent recommendations concerning fairness of price.
4. Adequate notice to minority stockholders.
5. Possibility of public issue at a high price followed by a merger at a low price.
6. Use of surviving corporation’s funds to finance the merger (i.e., to cash-out the minority).
7. Existence of appraisal rights available to minority shareholders.
8. Parent corporation’s appropriation of the benefits of a merger.

After considering these factors, the court concluded the merger was intrinsically fair. Emphasized in its decision was that the defendants established a valid business purpose, a majority of the minority actually approved the merger [though unlike *Weinberger* that was not a condition of approval], and the minority received a premium of 29% over the pre-merger market price. Finally, the court considered that the plaintiffs offered no evidence to refute a showing of fairness. Id. at 390-95.
The final case in the Singer trilogy is Roland International Corp. v. Najjar (hereinafter Roland). Najjar, representing minority stockholders in Roland, filed a class action seeking damages allegedly resulting from a breach of fiduciary duty owed by Roland in connection with a § 253 short-form merger with Landro Corp. The minority charged that the merger, accomplished by a board of directors all of whom occupied seats on the boards of both corporations, was initiated for no other purpose than to eliminate their 2.4% public interest. The minority, rather than accept $5.25 per share in cash or seek an appraisal under § 262, filed an action in the court of chancery. Roland filed a motion to dismiss which was denied.

On appeal, the Supreme Court of Delaware went beyond Singer in its articulation of what is at the core of fiduciary duty when it said that "corporate property belongs (in the equitable sense) to all shareholders (not just majority shareholders), and that those in control of the corporate machinery are accountable to all owners of the corporate property...." That duty is breached when the majority uses the corporate machinery to "cash-out" the minority by excluding "them from continued participation in the corporate life, for no reason other than to eliminate them." The defendants in Roland argued that § 253 presumes a proper purpose for a merger and that there is no need for judicial inquiry as a § 262 appraisal is the exclusive remedy for determining fairness where the sole issue is the value of a minority's shares. In response, the court said that defendants missed the point of Singer, which is that the law of fiduciary duty does not arise from the statute, but is independent of it. Its impact, however, is not felt until statutory compliance is first achieved. "[T]he duty arises from long-standing principles of equity and is superimposed on many sections of the Corporation Law, including, we think, § 253." Thus, although the purpose of § 253 is to provide the parent with a means for eliminating the minority, it still presumes a valid business purpose for so doing.

81. 407 A.2d at 1033.
82. Id. at 1034 n.4.
83. Id. at 1034.
84. Id. at 1035.
85. Id. at 1036.
86. Id. (agreeing with Stauffer's articulation of the purpose of § 253, but saying it does not read Stauffer as approving a merger without a valid business purpose).
Because a majority stockholder always owes a fiduciary duty to treat the minority fairly, regardless of whether there is a valid business purpose to merge, the court in addition to affirming Singer, affirmed its position in Tanzer that a minority stockholder is still entitled to judicial review of the "entire fairness" of the transaction, and thus held that the minority did present a cause of action, entitling it to equitable relief.

The Singer trilogy returns to the Sterling v. Mayflower Hotel view that the existence of a fiduciary duty demands "entire fairness" which in turn demands equitable intervention when a breach of that duty is charged. It considers as aberrational and thus overruled Stauffer v. Standard Brands and David J. Greene & Co. v. Schenley Indus. Inc. to the extent that they held that where no fraud was involved, only a dispute over the value of the minorities' shares, a § 262 appraisal is the exclusive remedy. Both Stauffer and David J. Greene & Co. presumed that a choice of an exclusive remedy must be made, even though § 262 itself demands no such choice.

By its introduction of the business purpose test Singer, though not intending it to be a litmus test of fairness, offered those like Weinberger, seeking to attack a merger, a formula for so doing. Taking the business purpose test together with the notion that one need not resort to an appraisal where there is a breach of fiduciary duty, Weinberger asserted this formula in the court of chancery.

II. THE WEINBERGER TRILOGY

A. Weinberger I

Although Weinberger alleged that the majority stockholder breached its fiduciary duty to the minority, because the price offered was grossly inadequate and the sole purpose of the merger was to benefit the parent corporation by eliminating the minority, the court of chancery chose to ignore the Singer formula for demanding relief. It saw another issue in the Weinberger facts:

87. Id at 1034-35.
88. Id. at 1037.
89. 93 A.2d 107, 109-10.
90. 187 A.2d 78, 80. See supra note 66.
91. 261 A.2d 30, 35.
92. 409 A.2d 1262 (Del. Ch. 1979).
"Does a complaint state a cause of action against a majority shareholder for bringing about a cash-out merger of minority shareholders where it reveals on its face that the merger could not have been approved without an affirmative vote of a majority of the minority shareholders?" The court of chancery agreed with the principles set forth in the Singer trilogy, but considered Roland as offering the key to resolving Weinberger I: "The fiduciary duty is violated when those who control a corporation's voting machinery use that power to 'cash-out' minority shareholders, that is, to exclude them from continued participation in the corporate life, for no reason other than to eliminate them." The Weinberger plaintiffs, unlike the plaintiffs in the Singer trilogy, were not powerless to stop the merger. The court reasoned that a fiduciary duty is not breached where the majority leaves the crucial decision to the minority, because the majority could not consummate the merger without the minority's consent. The court concluded that

where the complaint fails to charge a use of its majority position by a shareholder to bring about a predetermined result affecting the minority, and simply charges, in essence, that the terms of the merger proposed by the majority shareholder were unfair, then it seems to me that the burden should then be on the plaintiff to allege and prove the unfairness, or to allege fraud or some other basis for condemning the terms of the merger plan.

The court of chancery cautioned, however, that its decision was not meant to imply that one could avoid judicial scrutiny by requiring approval of a majority of the minority, but only that where these are the facts, the Singer rationale is inapplicable as the burden of proof shifts to the plaintiff to establish a breach. It then dismissed Weinberger's complaint.

93. Id. at 1264. The court's statement is not entirely accurate as only a majority of the minority voting their shares at a meeting for that purpose could approve the merger. Then assuming a majority of all voting minority shares could be obtained, it was required that these shares when added to the number of shares voted by Signal, equal at least two-thirds of all outstanding shares of UOP (not two-thirds of shares actually voted). The court makes this point clear later on in its opinion. Id.
94. Id. at 1266 (quoting Roland, 407 A.2d at 1034).
95. Id. at 1267.
96. Id. at 1267-68. Cf. Michelson v. Duncan, 407 A.2d 211 (Del. 1979), which was not a merger case. It was a stockholder derivative action against a corporation, its officers and directors, to set aside stock options granted key employees which had been ratified by the shareholders. The supreme court stated the settled rule of Delaware was that "where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail. (emphasis added)." Id. at 220 (quoting
B. Weinberger II

Weinberger amended his complaint and alleged: 1) that Signal unfairly used its majority position for no other purpose than to cash-out UOP's 49.5% minority interest at a grossly inadequate price; 2) that Signal abused its majority position by causing its controlled board and UOP's to issue proxy information and press releases which either misrepresented or failed to disclose the manner in which the merger price had been established; 3) that UOP's board failed in its fiduciary duty to negotiate for a higher price; and 4) that the true value of the shares at the time of the merger was $26 according to the evaluation of plaintiff's experts.

The court concluded the legal standard to be applied was that enunciated in Sterling, as both Singer and Tanzer started and finished with Sterling. The court then announced what it viewed as the effect of Sterling in light of the Singer trilogy:

Sterling stands for the proposition that where a majority shareholder stands on both sides of a merger transaction which will result in the forced removal of the minority shareholders of the subsidiary in exchange for something of value for their minority shares, and where the transaction is attacked in a suit in this Court by or on behalf of the minority shareholders on the grounds that the value being offered is inadequate and that the majority shareholder has breached its fiduciary duty in some way because of the manner in which the exchange or conversion value was agreed upon or determined, then this Court has a duty to examine all pertinent elements of the entire transaction so as to make sure that the minority is being treated fairly.

The point at which the court of chancery differs from the Sterling and Singer line of cases is that it insists that the burden of proof is on the plaintiff attacking the fairness of the merger to demonstrate grounds for invoking a fairness hearing. It asserts that the existence of a fiduciary relationship is not enough to invoke the hearing. Only upon the plaintiff's demonstrating some unfairness will the burden shift to the majority stockholder to

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Gerlach v. Gillam, 139 A.2d 591, 593 (Del. Ch. 1958)). Michelson went on to hold that "shareholder ratification shifted the burden of proof of want or inadequacy of consideration for the grant of the options from defendants to plaintiff." 407 A.2d at 224.

98. Id. at 1341.
99. Id. at 1344.
100. Id. at 1345.
establish by a preponderance of the evidence that the transaction was fair.

Applying Sterling and the additional elements of fairness offered by Singer (that the majority may not use its position for the sole purpose of excluding the minority) and Tanzer (that the majority may only rid itself of the minority for a bona fide business purpose) the court of chancery found:

1) The fact that Signal and UOP structured the merger so that a majority of the minority’s shares were necessary for approval did not remove them from the fairness test of Sterling—it only shifted the burden to the plaintiff to demonstrate grounds to invoke the fairness hearing. 102

2) Signal as an investment company had a legitimate business purpose in attempting to place its surplus cash in UOP shares. 103

3) There were no material misrepresentations to the minority. The court said that plaintiff’s concept of “negotiation” was too restrictive; that a price range of $1.00 per share was significant in the context of 5,688,302 shares; that since none of the UOP directors voted against the merger, it was not misleading for press releases to call it “unanimous”; and that the standard of “complete candor” established in Lynch I had been met. 104

4) UOP’s board, composed of experienced businessmen, did not breach its fiduciary duty in concluding that $21 was a fair price, considering the tender offer in 1975 was made at the same price

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101. Id. at 1343, 1346.
102. Id. at 1346. The court explained its original dismissal as based on a finding that Signal did not use its voting power to eliminate the minority as proscribed by Singer.
103. Id. at 1350.
104. Id. at 1351-53. Lynch v. Vickers Energy Corp. 383 A.2d 278 (Del. 1977), [hereinafter cited as Lynch I] did not involve a merger, but a tender offer. The plaintiff brought a class action for damages charging the successful tender offeror with a breach of fiduciary duty for making less than a full disclosure of the target’s assets in its offer. Id. at 279. The case is significant because it set forth a standard to be used by chancery in evaluating the rights of minority shareholders.

The Court’s duty was to examine what information defendants had and to measure it against what they gave to the minority stockholders, in a context in which ‘complete candor’ is required. In other words, the limited function of the Court was to determine whether defendants had disclosed all information in their possession germane to the transaction in issue. And by ‘germane’ we mean, for present purposes, information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock.

Id. at 281. The fiduciary duty of complete frankness “requires disclosure of all germane facts. Completeness, not adequacy, is both the norm and the mandate under present circumstances.” (emphasis in original). Id.
and the market value of the stock then was just under $14 per share versus $14.50 per share prior to the merger. 105

5) Under Sterling, the test of what a minority stockholder is entitled to receive is "the substantial equivalent in value of the shares he held before the merger."106 The same factors that go into an appraisal under § 262 also go into a judicial determination of "entire fairness." Therefore, the court rejected plaintiff's comparative and discounted cash flow analyses showing the worth of the stock at not less than $26 per share, because those methods considered the value to Signal as 100% owner, and UOP minority interests are not entitled to receive what the stock was ultimately worth to the majority, only its present value to UOP holders.107 Judgment was entered for defendants.108

Although Weinberger II basically followed the Sterling and Singer trilogy precedents (differing only in its articulation of where the initial burden of proof lies) the court of chancery's view of the facts in applying those legal standards went against Weinberger.

C. Weinberger III109

Upon Weinberger's appeal to the Supreme Court of Delaware, the court limited itself to five issues in its opinion:

1) The plaintiff's duty to plead sufficient facts demonstrating the unfairness of the challenged merger;
2) The burden of proof upon the parties where the merger has been approved by the purportedly informed vote of a majority of the minority shareholders;
3) The fairness of the merger in terms of adequacy of the defendants' disclosures to the minority shareholders;
4) The fairness of the merger in terms of adequacy of the price

105. 426 A.2d at 1354.
106. Id. at 1360 (quoting Sterling, 93 A.2d at 110).
107. 426 A.2d at 1356-62. The comparative analysis involved "a comparison of the premium over market being paid within a related time frame for mergers or tender offer-merger combinations which resulted in 100 per cent ownership to the acquiror and in which the cost of acquisition was $100 million or more." Id. at 1356. The discounted cash flow analysis "looks to the cash generating capability of a company as a going concern. It is based upon the amount of cash that can be taken from a company by its owner at a given time without adversely affecting its financial and business condition." Id. at 1357.
108. Id. at 1363.
109. 457 A.2d 701 (Del. 1983). The Supreme Court of Delaware wrote an opinion on February 9, 1982, but withdrew it. Id. at 703 n.1.
paid for the minority shares and the remedy appropriate to that
issue; and
5) The continued force and effect of Singer v. Magnavox Co., Del.,
380 A.2d 969, 980 (1977), and its progeny. 110

The court then summarized its holdings.
1) It affirmed the Chancellor's ruling that in a suit challenging
a cash-out merger, the plaintiff must allege specific acts of fraud,
misrepresentation or other misconduct demonstrating the un-
fairness of the merger to the minority. 111

2) It affirmed, in principle, that the plaintiff first bears the
burden of invoking the fairness doctrine, which then shifts to the
majority stockholder the burden of establishing by a preponderance
of the evidence that the merger was fair. However, it concluded
that where a majority of the minority shareholders voted in favor
of a merger, "the burden entirely shifts to the plaintiff to show
that the transaction was unfair to the minority. . . . But in all this,
the burden clearly remains on those relying on the vote to show
that they completely disclosed all material facts relevant to the
transaction." 112

3) It reversed on the issue of the adequacy of defendants'
disclosures. It held that material information regarding UOP's and
Signal's bargaining positions was withheld from the minority under
circumstances amounting to a breach of fiduciary duty. The court
concluded that where the majority has not met its burden of
establishing it disclosed all material facts relevant to the transac-
tion, the burden does not shift to the minority just because the
minority voted in favor of the merger, as the minority's vote was
not an informed one. 113

4) It reversed on the issue of fairness of price paid, because
the approach to valuation was too formulaic. It considered the
exclusive remedy for minority shareholders challenging a cash-out
merger to be an appraisal under § 262. The appraisal is, however,
to be an expanded approach to valuation. The court overruled Lynch II 114 "to the extent that it purports to limit a stockholder's monetary

110. Id. at 703.
111. Id.
112. Id. (citing Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979)).
113. 457 A.2d at 703.
114. 429 A.2d at 505-06 (a tender offer situation, not a cash-out merger). Lynch II held
that rescissory damages were to be determined as of or prior to the date on which the
trial for damages ended, using the traditional "Delaware block" methods of evaluation of
relief to a specific damage formula." 115

5) It reversed the Chancellor's ruling on the issue of the applicability of the business purpose rule announced in the Singer trilogy and held it was no longer the law of Delaware. 116

After setting forth its holdings and reviewing the facts, the Supreme Court of Delaware proceeded to give its analysis. It announced as the primary reason mandating reversal its finding that the feasibility study prepared by Messrs. Arledge and Chitea, directors of both Signal and UOP, had never been disclosed to the non-Signal-backed members of UOP's board of directors or to the minority stockholders. 117 This report was significant because it asserted as advantageous to Signal the ousting of the minority at a price as high as $24 per share, when the range given for the UOP outside directors to consider was $20-21 per share. 118

asset value and market value (though giving credit for the amount already paid by the tender offeror, with interest.) See supra note 16 for Fletcher's definition of rescission. The same definition is quoted in Lynch II, 429 A.2d at 501.

115. 457 A.2d at 703-04.
116. Id. at 704. The case itself, however, was not reversed on this issue.
117. Id. at 708. With the very same feasibility study before it, the Chancellor made no comment on whether its nondisclosure was a breach of fiduciary duty. Since he held there was no material misrepresentation by Signal, presumably he found the failure to disclose the study unobjectionable. This brings us to the question of whether an appellate court, on review of an equitable proceeding, can make its own findings contrary to those of the Chancellor. The tradition in Delaware is to give the supreme court a broad scope of review.

[It is our duty to review the evidence to test the propriety of the findings below. When the evidence consists primarily of depositions, documents, or the report of a master or appraiser, we may make our own conclusions, if the requirement of doing justice requires it and if the findings below are clearly wrong. Furthermore, when we are concerned with findings arising from deductions, processes of reasoning, or logical inferences, it is our duty to review them and, if the requirement of doing justice requires it and if the findings below are clearly wrong, then to draw our own inferences and reach our own conclusions. This is not to say, however, that we may ignore the findings below. On the contrary, when they are supported by the record and are the product of an orderly and logical deductive process, we, in the exercise of judicial restraint, accept them, even though independently we might have reached opposite conclusions. This, we think, is the rule this Court has followed in the past, and it is the rule it will continue to follow for the future.

In re Del. Racing Ass'n, 213 A.2d 203, 208-09 (Del. 1965).
118. 457 A.2d at 708. Mr. Arledge outlined the benefits to Signal as:

1) Provides an outstanding investment opportunity for Signal—(Better than any recent acquisition we have seen.)
2) Increases Signal's earnings.
3) Facilitates the flow of resources between Signal and its subsidiaries—(Big factor—works both ways.)
4) Provides cost savings potential for Signal and UOP.
5) Improves the percentage of Signal's 'operating earnings' as opposed to 'holding
Since the study was prepared by two UOP directors, using UOP information for the exclusive benefit of Signal, and nothing whatever was done to disclose it to the outside UOP directors or the minority shareholders, a question of breach of fiduciary duty arises. This problem occurs because these were common Signal-UOP directors participating, at least to some extent, in the UOP board's decision-making processes without full disclosure of the conflicts they faced.119

After setting out the Delaware view that the relationship of the parties imposed a fiduciary duty, the court proceeded to determine whether there had been a breach of that duty, using the standard announced in Lynch I of "complete candor."120 The court then measured the information known to the majority against what was given to the minority to determine not whether it was adequate, but whether it was complete. In other words, did the Signal designated UOP directors fulfill their fiduciary duty of uncompromising loyalty?121 The court reasoned that, given the absence of an arms length transaction and the fact that Signal's designees on UOP's board participated in structuring the merger to Signal's benefit, an obvious conflict of "divided loyalties" was presented. The court then cited its previous holdings on the issue of fiduciary duty to the effect that the burden is on directors who act on both sides of a transaction to establish its entire fairness,122 including a demonstration that they exercised their duty in the light of what was best for both corporations.123 Although its citations were to the duty of directors, the court attributed the divided loyalties of the directors to Signal, the majority stockholder, and concluded that Signal had not established that the transaction was fair.124

The next section of the opinion represents Weinberger III's unique contribution to Delaware corporate law, in that for the first time,
the court directly attempted to define "fairness." It stated that fairness has two aspects: fair dealing and fair price. Fair dealing relates to the timing of the transaction, "how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." Fair price deals with the economic and financial aspects such as "assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." The test for fairness is not a bifurcated one, however; it is still entire fairness, though the court recognized that in a non-fraudulent transaction price may appear to outweigh other features of the merger. Because in Weinberger III the court found reversible error on both grounds, it proceeded to address each separately.

The court concluded that Signal did not deal fairly with the minority, because it possessed by virtue of the Arledge-Chitea feasibility study superior knowledge which it was under a duty of candor to reveal, yet did not. Further, the evolution of the merger showed it was initiated by Signal under short time constraints—the UOP board had only four business days to consider it. In addition, the structure of the transaction was controlled entirely by Signal. Even UOP's president, a Signal appointee, never really discussed price outside of the range proposed by Signal. The circumstances surrounding the "fairness opinion" of Lehman Bros. revealed that Signal had urged its preparation under extreme time constraints, yet UOP's minority was unaware of this fact. Finally, the minority was denied information showing that Signal was willing to pay $24 per share for their stock, which would have resulted in their receiving an additional $17,000,000. Under these circumstances, the court concluded, the minority's vote on the merger was meaningless.

The court concluded that the minority was denied a fair price for its shares because the Chancellor erred in rejecting plaintiff's offer to prove its value at $26 per share. The Chancellor was acting consistent with precedent by approaching the value in the same

125. Id.
126. Id.
127. Id.
128. Id. The court also said: "Moreover, one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy." Id. (citing Lank v. Steiner, 224 A.2d 242, 244 (Del. 1966)).
129. Id. at 712.
way as in an appraisal, applying the “Delaware block” or weighted average method of assigning a particular weight to assets, market price and earnings and adding the resulting amounts to determine the value per share. The Supreme Court of Delaware departed from past practice, however, by holding that the “Delaware block” method would no longer exclusively control in appraisal or other stock valuation proceedings. Instead, proof of value by any techniques generally considered acceptable in the financial community would be considered. In so ruling, the court indicated it was not establishing a new standard, but merely reiterating the standard set out in Tri-Continental Corp. v. Battye, without explaining why that standard had not been consistently applied:

By value of the stockholder’s proportionate interest in the corporate enterprise is meant the true or intrinsic value of his stock which has been taken by the merger. In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into the fixing of value. Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders’ interest, but must be considered by the agency fixing the value. (Emphasis added.)

The court also grounded its holding in the statutory language of § 262(h) which requires that the court of chancery shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors . . . . (Emphasis added.)

130. Id.
131. Id at 713.
132. Id. Except for Jacques Coe & Co. v. Minneapolis-Moline Co., 75 A.2d 244 (Del. Ch. 1950), the cases the court cites as using the Delaware block method pre-date Tri-Continental Corp., 74 A.2d 71 (Del. 1950). In Jacques Coe & Co., the court of chancery quoted Tri-Continental Corp., 74 A.2d at 72, and concluded “that the appraiser properly considered elements other than market value in arriving at his evaluation,” 75 A.2d at 247; however, the appraiser was still weighing averages of asset value and earnings and dividend value.
133. 457 A.2d at 713 (quoting 74 A.2d at 72 (Del. 1950)).
134. 457 A.2d at 713 (quoting DEL. CODE ANN. tit.8, § 262(h) (Cum. Supp. 1982)).
The court, after comparing prior amendments to § 262, concluded that it was the legislature's intent that all relevant factors be considered, excepting only speculative effects that may arise as a result of the merger.¹³⁶ Interestingly, it was precisely because the court of chancery considered the methods offered by Weinberger's experts as speculative that it refused to consider them: "I think it significant to note that both [methods] were based on the value that one would supposedly derive as a result of becoming a 100 per cent owner of an ongoing corporation as opposed to acquiring a less than 100 per cent interest."¹³⁷ In a radical departure from prior practice, the Supreme Court of Delaware, however, held that "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation may be considered."¹³⁸ Fair value includes "any damages, resulting from the taking, which the stockholders sustain as a class."¹³⁹ It therefore believed plaintiff's evidence should have been "part of the factual mix", and "[u]ntil the $21 price is measured on remand by the valuation standards mandated by Delaware law, there can be no finding at the present stage of these proceedings that the price is fair."¹⁴⁰

The court then addressed the remedy sought by the plaintiff, which was not an appraisal of the value of the stock as of the date of the merger, but rescissory damages of the type contemplated in Lynch II—the increment in value that Signal enjoyed as a result of acquiring and holding UOP's stock (a substitute for rescission).¹⁴¹

As the court considered that Lynch II also utilized the Delaware block formula in its computation of rescissory damages, it over-

¹³⁵. 457 A.2d at 713-14.
¹³⁶. 426 A.2d at 1356.
¹³⁷. 457 A.2d at 713. This is a radical departure because by definition value arising from the accomplishment or expectation of the merger is speculative. Again, although the general practice was otherwise, authority for the proposition came from Tri-Continental Corp., 74 A.2d at 72:

    Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained at the date of the merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must be considered by the agency fixing the value. (Emphasis added).

¹³⁸. Id.
¹³⁹. 457 A.2d at 714.
¹⁴⁰. Id. See Lynch II, 429 A.2d at 501. See supra notes 16 and 114.
ruled it to the extent that it purported to limit the Chancellor's discretion to that single remedial formula in a cash-out merger.\textsuperscript{141}

Although \textit{Weinberger III} was remanded for consideration of the fair price to be paid based on the court's liberalized appraisal standards, the court announced that in future cases "the provisions of 8 Del. C. § 262, as herein construed, respecting the scope of an appraisal and the means for perfecting the same, shall govern the financial remedy available to minority shareholders in a cash-out merger."\textsuperscript{142} It stated that it was returning to the principles of \textit{Stauffer} and \textit{David J. Greene \& Co. v. Schenley Indus., Inc.} "mandating a stockholder's recourse to the basic remedy of an appraisal."\textsuperscript{143} On the other hand, the court announced it did not intend to limit the historic powers of the Chancellor to grant whatever relief is called for in a given situation "including rescissory damages" where the appraisal remedy may not be adequate.\textsuperscript{144} By way of illustration, it included situations "where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved."\textsuperscript{145}

Finally, the court addressed the business purpose rule it announced in \textit{Singer}. In effect, it concurred with the Chancellor's interpretation that \textit{Singer} was basically following existing law, but simply added as another example of breach of the fiduciary duty owed by the majority to the minority the use of the majority's controlling position via the mechanism of a cash-out merger for no other purpose than to eliminate the minority. The court concluded, however, from the Chancellor's finding, that Signal had met the business purpose test that, because a business purpose could so easily be found, the additional element it gave to the

\textsuperscript{141} 457 A.2d at 714. \textit{Lynch II}, however, dealt with a tender offer, and did not purport to apply to a cash-out merger, but as is frequently the case in Delaware, a concept is often adopted from one situation and applied to others.

\textsuperscript{142} Id. at 715. Certain plaintiffs caught in the gap for whom it was too late to seek an appraisal, as the statutory time period had passed, were to be afforded the "quasi-appraisal" remedy granted to Weinberger. Id. at 714-15.

\textsuperscript{143} Id. at 715 (citing \textit{Stauffer}, 187 A.2d 78, and \textit{David J. Greene \& Co. v. Schenley Indus., Inc.}, 281 A.2d 30).

\textsuperscript{144} 457 A.2d at 714.

\textsuperscript{145} Id. (citing \textit{Cole}, 156 A. at 187, which said a duty to elect between accepting a merger or accepting a statutory appraisal does not arise where fraud, actual or constructive, is present). The irony here is that the court concluded there was a material nondisclosure, but was careful not to label it misrepresentation or fraud. Yet a plaintiff with a case similar to Weinberger's arising in the future can only pursue a statutory appraisal as his remedy, though in fact he has been defrauded by omission.
fairness test of Sterling, considered in the light of the expanded appraisal remedy and broad discretion granted the Chancellor, served no useful purpose.\textsuperscript{146} It thus held that it "shall no longer be of any force or effect."\textsuperscript{147}

The court then reversed the finding of the Chancellor that the circumstances of the merger and the price paid were fair, and remanded for further proceedings. It also ordered that plaintiff's motion to enlarge the class be granted.\textsuperscript{148}

III. THE WEINBERGER III FAIRNESS TEST—AN ANALYSIS

Because material information needed to acquaint the shareholders with the bargaining positions of Signal and UOP was withheld under circumstances amounting to a breach of fiduciary duty, the Supreme Court of Delaware concluded that the merger did not meet the test of fairness.\textsuperscript{149}

The court, rather than announcing a new test of fairness, considered that it was following the "entire fairness" standard announced in Sterling.\textsuperscript{150} In so doing, it refined that standard by setting forth the two elements of fairness—fair dealing and fair price—but insisted that the concept was not a bifurcated one.\textsuperscript{151} It concluded that both aspects of fairness were missing from the UOP merger, and that the majority vote of the minority stockholders was meaningless as a result.\textsuperscript{152}

Upon its finding that there was a breach of fiduciary duty, the court was free to grant whatever equitable relief it deemed just under the circumstances. The case could have been decided upon this basis alone, with the only significant addition to the Singer

\textsuperscript{146} 457 A.2d at 715 (citing Weinberger II, 426 A.2d at 1342-43, 1346-50).
\textsuperscript{147} 457 A.2d at 715.
\textsuperscript{148} Id. The class was originally limited to those who voted against the merger and/or who had not surrendered their shares, Weinberger II, 426 A.2d at 1335. But because of the breach of fiduciary duty owed the entire minority (resulting in a meaningless vote by the majority of them), the entire minority is to get the benefit of the decision on remand. Letter from Chancellor Grover C. Brown to Attorneys William Prickett, Jr.; A. Gilchrist Sparks, III; and Robert K. Payson (May 25, 1983) (concluding that defendants are to bear the cost of notifying all minority stockholders whether they voted in favor or against the merger, excluding only those minority stockholders who previously opted out of plaintiff's original class action).
\textsuperscript{149} 457 A.2d at 703.
\textsuperscript{150} Id. at 715.
\textsuperscript{151} Id. at 711.
\textsuperscript{152} Id. at 712, 714.
line of cases being its articulation that, in circumstances where the majority of a minority voted in favor of a merger, the burden is on the minority to establish some basis for invoking a fairness hearing. Instead, the court chose to make new law by 1) overruling the business purpose requirement of Singer, Tanzer and Roland, and 2) fashioning a new remedy in situations like Weinberger's.

What is the effect of overruling the business purpose requirement of the Singer trilogy? While it can be argued that, in overruling the business purpose requirement of the Singer trilogy, all the court did was eliminate one example of what constitutes a breach of fiduciary duty from the grounds of relief sought by dissatisfied minority shareholders, its ruling has a broader impact. Prior to Singer, very few cases were brought and won on the charge of breach of fiduciary duty. Even Sterling (an action to enjoin a merger), which announced the view that the very existence of a fiduciary duty demands "entire fairness" (which in turn demands equitable intervention when a breach of that duty is charged), resulted in a decision that the merger in issue was fair. Thus, although the court characterized Weinberger III as a case of fiduciary duty and permitted the Chancellor to grant whatever equitable relief may be appropriate, thereby not precluding an action to enjoin a merger on grounds of breach of fiduciary duty,

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153. Id. at 703 (even here, the Supreme Court of Delaware was affirming the Chancellor's finding).

154. Id. at 715.

155. Id. at 714-15.


157. 98 A.2d at 109-10, 119.

158. 457 A.2d at 712.

159. Id. at 714.
by overruling the business purpose test of the *Singer* trilogy the court has indicated its intention to treat such actions in the same manner as they had traditionally been treated prior to *Singer*.

Before analyzing what remedy is now offered in situations similar to Weinberger's that may arise in the future, it is necessary to first examine the remedy afforded to Weinberger himself, because the two are not the same. In *Weinberger III*, the court specifically permitted the Chancellor on remand to grant rescissory damages, which is an equitable remedy.¹⁶⁰ Thus the court treated Weinberger as if what was at stake was the right to the shares themselves as announced in *Singer*¹⁶¹—that is, by way of substitution of money returning to the dissenting stockholder his continued equity in the merged corporation, rather than by granting him the value of the stock as of the day of the merger (which is what an appraisal offers).

Even though it granted an equitable remedy to Weinberger, the court held that plaintiffs such as Weinberger must hereafter pursue a statutory appraisal as their exclusive monetary remedy.¹⁶² The court did acknowledge that “[t]he appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved,”¹⁶³ but breach of fiduciary duty was not among those exceptions. This is particularly troublesome, because breach of fiduciary duty, as illustrated by *Weinberger III* itself, is one example of fraud, constructive fraud, not actual fraud.

Constructive fraud consists in any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or any one claiming under him, by misleading another to his prejudice, or to the prejudice of any one claiming under him; or, in any such act or omission as the law specially declares to be fraudulent, without respect to actual fraud.¹⁶⁴

The problem is that, on the one hand, the court found that the majority stockholder in *Weinberger III* breached its fiduciary duty to the minority stockholders by not disclosing material informa-

¹⁶⁰ Id.
¹⁶¹ 380 A.2d at 977-78.
¹⁶² 457 A.2d at 715.
¹⁶³ Id. at 714. This contrasts with the court's conclusion in *Singer* that lack of business purpose did not constitute fraud, though it did constitute a breach of fiduciary duty, and as such qualified as a distinct cause of action. 380 A.2d at 980.
¹⁶⁴ BLACK'S LAW DICTIONARY 595 (5th ed. 1979).
tion necessary for them to make an informed vote on the merger. On the other hand, because the court did not actually label the majority's actions as fraudulent or self-dealing, but switched its focus to the remedy to be sought, it treats situations like that in Weinberger III, which may arise in the future, as equitable actions only if they seek the traditional equitable remedies (e.g. injunction, rescission). Weinberger actually sought rescission, or in the alternative ""equitable rescission' in the form of either an award of money damages to the former UOP minority shareholders or an award to each member of the class of an appropriate stock interest in Signal." Where the minority seeks a strictly monetary remedy, however, its recourse is limited to an appraisal.

The court accomplished this result through its interpretation of the concept of fairness. The court speaks of "fairness" as if this concept were somehow separate from the notion of fiduciary duty. It thus disregards the point of Sterling, which was that fairness is the standard by which fiduciary duty is measured. Inherent in the obligation to be fair is a fiduciary responsibility. That duty of fairness is quite distinct from the remedy afforded by the appraisal statute. Delaware's appraisal statute seeks to compensate the minority stockholder for the loss of his equity in a corporation involved in a cash-out merger, in which the stockholder does not wish to participate. The point of the statute is to give the dissident stockholder an objective evaluation of his interest. Its function is not to decide whether a corporation acted unfairly in determining value. Despite its protestations to the contrary, the court in Weinberger III seemed to treat fairness as a bifurcated concept.

165. 457 A.2d at 709.
166. Id. at 714-15. Although it had determined that unfair dealing had been present in Weinberger III, the court held that where monetary relief is the only remedy sought in a cash-out merger, "a stockholder's recourse [is] to the basic remedy of an appraisal." Id. at 715. In so doing, it announced it was reviving Stauffer and David J. Greene & Co. v. Schenley Indus. Inc. Id.

At the same time, the court said that:

While a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established, we do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate. . . . The Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages.

Id. at 714.
167. 426 A.2d at 1335.
168. 457 A.2d at 715.
169. 93 A.2d at 109-10.
in its equating fair dealing with the remedy of an action in equity and fair price with an appraisal. Because Weinberger did not seek to enjoin the merger, and it was too late to set it aside, the court considered that the only issue for the Chancellor to determine was the appropriate monetary remedy.

The Court's decision gives no guidance to a future minority stockholder who upon learning of fraud, self-dealing etc., seeks to object to a cash-out merger that has already taken place. Is he supposed to seek an appraisal and at the same time file a suit in equity? That might seem unlikely, as the two alternatives have traditionally been regarded as mutually exclusive, and, in any event, might be construed as encouraging litigation and double recovery. On the other hand, it is not at all clear whether the Chancellor himself, as opposed to an appraiser, will be making a determination of value, and at the same time rule on the equities, within the confines of the appraisal proceeding itself. It does appear, however, that an appraisal proceeding, instead of being an administrative hearing, is likely to take on even more of the character of a trial, because of the problems in determining which methods of valuation are to be judicially recognized. Furthermore, due to the complexity of Weinberger III's permitting endless theories of valuation, appraisal proceedings will invariably take more time.

The case analysis (Section I.B.) shows that the concept of breach of fiduciary duty first arose in a non-merger situation where no statutory remedy was available, and was freely adopted subse-

170. 457 A.2d at 714 (this is indicated in its characterization of its remedy for Weinberger and others for whom the statutory appraisal remedy is lost due to the expiration of more than 120 days since the effective date of the merger-§ 262(e)-as "quasi-appraisal").
171. 457 A.2d at 714 (permitting the plaintiff on remand to test the "fairness" of the $21 price offered for his shares).
173. § 262(h) (Supp. 1982) provides: "Upon application by the corporation or by any stockholder entitled to participate in the appraisal proceeding, the Court may, in its discretion, permit discovery or other pretrial proceedings and may proceed to trial upon the appraisal prior to the final determination of the stockholder entitled to an appraisal." Cf. § 262(h) (1983).

Already, in one of the few decisions citing Weinberger III, the Court of Chancery in Bershad v. Curtiss-Wright Corp., No. 5827, slip op. (Del. Ch. March 21, 1983) (available December 20, 1983, on LEXIS, decorp library, case file), said: "[I]n view of the liberalized approach to valuation, the rules of discovery should also be construed liberally. While these documents, whether pre or postmerger, may later prove to be inadmissible, such documents may lead to discovery of admissible evidence pertaining to the issue of the value of the stock." Bershad was a case caught in the gap before the revised standard for appraisal proceedings was to be applied. No decisions under the new appraisal remedy have as yet been reported as appealed.
quently in a cash-out merger situation. *Weinberger III*, in effect, corrected what it deemed to be the aberration, the idea that breach of fiduciary duty is itself an automatic ground for ignoring the appraisal statute, at least in the post-merger stage, as there the only practical remedy is damages. At the same time, however, it continued to utilize the language of breach of fiduciary duty as far as Weinberger's specific case was concerned, and held that appraisal is the exclusive financial remedy, because it is fair. "Obviously, there are other litigants . . . whose rights to challenge the element of fair value must be preserved."\(^{174}\) Again the court is confusing fair price arrived at in the context of fair dealing with the fair value offered by the appraisal statute. And again it treats price as separable from entire fairness, and relegates consideration of it to an appraisal. "However, in a non-fraudulent transaction we recognize that price may be the preponderant consideration outweighing other features of the merger."\(^{175}\) The Supreme Court of Delaware has, in effect, said that its previous decisions in this area (with the possible exception of *Stauffer* and *David J. Greene & Co. v. Schenley Indus. Inc.*\(^{19841}\)) have been erroneous. In an effort to appear less radical, however, it outwardly acknowledged the concept of entire fairness as first articulated in a merger situation in *Sterling*, but then hid it in the concept of an appraisal. Thus, the new fairness test becomes basically a test of valuation, which is not really a test of fairness at all. In so doing, the court has blurred both the concepts of fiduciary duty and fairness. What it has accomplished in its stead is an insistence that the appraisal remedy be sought in all situations where monetary relief is sought, and in return offers a promise of a more sophisticated valuation in the appraisal proceeding. Indeed, the basic thrust of its decision was to make appraisal more attractive by expanding it as a remedy.

**CONCLUSION**

In light of *Weinberger III*, what then are some of the considerations a corporation might face in pursuing a cash-out merger as a method of purchasing 100% control of a corporation under Delaware law?

1) The *Weinberger III* court suggests that, to avoid a charge of breach of fiduciary duty, it would be best to have outside direc-

\(^{174}\) 457 A.2d at 714.

\(^{175}\) Id. at 711.
tors of the subsidiary prepare all papers and do all negotiating with the parent corporation (thus, eliminating the possibility of nondisclosure of material information by those having a fiduciary duty to disclose such information). Where this is not possible, it appears that full disclosure to the stockholders of the dual roles played by the joint directors might satisfy the test of fairness, as it did in Sterling. 176 As indicated in Section III of this article, however, without a showing by the minority of actual fraud, it is unlikely a corporation will have to defend itself on these grounds either pre or post merger.

2) Because Weinberger III continued to impose on the parent corporation the burden of proving it acted fairly, structuring a merger so that a majority of the minority vote is necessary for it to proceed will not offer real relief in the event litigation should ensue, unless it can be shown that the minority vote was an informed one. 177 The problem here, of course, is how much information can be withheld from the minority by the majority. It is intimated in Weinberger III that if Signal had used non-UOP directors to prepare the feasibility study, Signal would have met the test of fairness and not have been required to disclose the contents of the study. 178

3) Because a corporation may eliminate the minority without threat of suit on the ground of lack of business purpose, the chances of a merger being thwarted by an action for injunction based on breach of fiduciary duty are greatly reduced. 179

4) Because appraisal (an individual remedy) is the exclusive financial remedy and must be perfected within 120 days after the effective date of the merger, 180 the chances of having to defend a class action suit on strictly equitable grounds at the post merger stage are also greatly reduced. In addition, in order to protect themselves against a charge of laches, it appears that most equitable actions will be brought by individuals simultaneously with a demand for monetary relief in the appraisal proceeding. It might also appear that the Chancellor would hold the appraisal proceeding in abeyance until the equitable charges were resolved. Since equitable actions would be brought on an individual basis, those proceedings are likely to be more time consuming for the court.

176. 93 A.2d at 114.
177. 457 A.2d at 703.
178. Id. at 709-10 n.7.
179. See supra text accompanying note 156.
On the other hand, because of the cost involved in a trial, and the *Weinberger III* court's view that where a monetary remedy is sought, appraisal is the exclusive remedy, it is unlikely that many equitable actions will be filed by individuals at the post merger stage.

5) The expanded valuation proceeding, however, is one area that may benefit the minority stockholder over the corporation, especially because of the opportunity to consider known elements of future value that are not the product of speculation, and the Court's statement that "[w]hen the trial court deems it appropriate, fair value also includes any damages, resulting from the taking, which the stockholders sustain as a class." From this quotation and the context in which it appears one could conclude that the court is offering each minority stockholder the post merger equitable remedy of rescissory damages within the confines of the appraisal proceeding, thus eliminating the need for filing a separate equitable action either individually or as a class.

In conclusion, *Weinberger III* seems to represent the view that a minority stockholder in a subsidiary corporation cannot thwart a merger that has been statutorily complied with by the majority parent corporation, without first establishing actual fraud or something very close to it, as a charge of breach of fiduciary duty alone is not sufficient to take a case out of a statutory appraisal. The court presumed that in future cases the expanded appraisal remedy would fully compensate the minority so that no other relief will be sought. Perhaps the court is correct. For after all, a corporation cannot be at the mercy of every stockholder, or it could not survive to achieve the purposes of its Articles. In this respect, *Weinberger III* offers a pragmatic approach. It leaves routine objections to a merger to an administrative (albeit expanded) procedure, reserving the equitable remedies for the exceptional cases demanding exceptional treatment. In so doing, it appears that *Weinberger III* offers a Delaware corporation seeking to follow-up a tender offer with a second-step cash-out merger greater protection and a greater chance of succeeding without prolonged litigation. On the other hand, it appears to offer the minority stockholder a better price for his stock.

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181. 457 A.2d at 715.
182. Id. at 713.

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THE DEMISE OF STATE TAKEOVER REGULATIONS

INTRODUCTION

The regulation of tender offers has become more than an issue of securities law. Conflicts between state and federal tender offer regulations have revived the often dormant provisions of the Commerce and Supremacy Clauses. In *Edgar v. MITE Corp.*, the Supreme Court struck down the Illinois Business Take-over Act, holding that the state regulatory scheme constituted an impermissible burden on interstate commerce under the Commerce Clause. As a result of this decision, the future viability and significance of state statutes regulating tender offers is in question. This comment will examine the conflict between federal and state regulation of tender offers, and discuss the future of state regulation in light of recent judicial decisions.

I. THE WILLIAMS ACT

It is generally agreed that the Williams Act was passed to fill a void in federal securities regulation by providing for the disclosure of detailed information by the offeror in a tender offer. "The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information regarding the qualifications and intentions of the offering party." Congress sought to achieve an equilibrium in these regulations so that neither the offeror nor the target company's management would have an advantage during the pendency of the offer.

1. 102 S. Ct. 2629 (1982).
2. Ill. Rev. Stat. Ch. 121 1/2, § 137.51 et seq.
3. MITE, 102 S. Ct. at 2643.
6. MITE, 102 S. Ct. at 2636, citing Rondeau v. Mosinee Paper Co., 422 U.S. at 58. "Critics
There are several key components to the Williams Act [hereinafter referred to as the Act]. First, the Act provides that prior to the commencement of an offer after which the offeror would, directly or indirectly, be the owner of five percent of a class of equity securities in the target company, the offeror shall have filed detailed information of the offer with the Securities and Exchange Commission [hereinafter referred to as SEC] by filing a schedule 14 D-1, and shall have provided same to the target company's management. The disclosed information shall contain both the identity and background of the offeror, as well as the nature of the offer, including any major corporate changes the offeror anticipates making. The Act further provides that stockholders who tender their shares may withdraw the shares within the first seven days of the offer, or anytime after 60 days from the date of the original offer if the shares have not yet been purchased. If more than the number of shares sought to be acquired are deposited during the pendency of the tender offer, the shares must be purchased pro rata. It further provides that if the consideration offered to shareholders is increased during the tender offer, then all shares must be purchased for the same price, regardless of whether the shares were taken up by the offeror prior to the offer price increase.

Two important aspects of the Act should be noted. First, there is no provision in the Act for determining the substantive fairness of a tender offer. Second, the Act does not itself foreclose state

10. 15 U.S.C.A. §§ 78 m(d)(1)(B) and (c) (West 1982). See also Tender Offer Statement on Schedule 14D-1, SEC Reg. § 240.14d-100, [1983] FED. SEC. L. REP. (CCH) ¶ 24, 284 C.
regulation. In fact, an amendment to the Securities and Exchange Act of 1934, recognizes the existence and viability of state securities regulation. 14

II. AN OVERVIEW OF STATE REGULATION

Over two-thirds of the states have passed takeover statutes. 15 All of these statutes contain provisions which could effectively delay the offer. Many of the state statutes contain pre-filing notice requirements. 16 In addition, many of these statutes provide for a state agency with the power to hold a hearing to determine the sufficiency of the disclosure 17, and in some states the agency has the power to determine the substantive fairness of the offer. 18 Further, most of the state statutes provide that the target company itself may request a hearing. 19 It is contended that the above provisions are pre-empted to the extent they conflict with the provisions or intent of the Williams Act. 20

The primary conflict between state and federal takeover regulation, however, involves the "jurisdiction" of the state statutes—"jurisdiction" referring to the provisions of the statute detailing which target companies are within the statute's reach. While the definition of "jurisdiction" varies from state to state, there are five basic components of the statutes which are quite similar: incorporation under state law; principal place of business within the state; substantial assets within the state; doing business within the state; and the number of shareholders within the state. The similarities between the statutes can be observed by looking at a few examples of state statutes to be discussed more fully hereinafter. The Ohio statute applied when the target corporation was incorporated in Ohio, or if it had its principal place of business

15. Thirty-eight states have passed takeover statutes. For a complete listing, see, Note, Securities Regulation—Kentucky Take-over Bids Act Declared Unconstitutional, 10 N.KY. L. REV. 461, 468 (1983). See also Comment, supra note 4 at 880-85.
17. Id.
or substantial assets within the state. The Maryland law applied if the target company was a Maryland corporation, doing business in Maryland, and thirty-five or more of its shareholders resided in Maryland. The Oklahoma Act applied if the target company was either 1) an Oklahoma corporation, 2) had its principal place of business and substantial assets in Oklahoma, 3) had substantial assets and significant operations in Oklahoma, or 4) Oklahoma residents owned ten percent of any class of equity securities subject to the offer. By their terms, the effect of these statutes goes beyond the state's boundaries. It is the ability of these statutes to affect shareholders nationwide that has created the Commerce Clause conflict.

III. CONSTITUTIONAL BACKGROUND AND EARLY DECISIONS

Since 1824, the Supreme Court has been forced to strike a balance between state and federal regulation of commerce. The Commerce Clause provides that "Congress shall have power to regulate commerce with foreign nations and among the several states ... ." In explaining this power, the Supreme Court has stated:

The genius and character of the whole government seem to be, that its action is to be applied to all the external concerns of the nation, and to those internal concerns which affect the states generally; but not to those which are completely within a particular state, which do not affect other states, and with which it is not necessary to interfere, for the purpose of executing some of the general powers of the government.

The power of Congress to regulate interstate commerce is subject to no other limitations than those set forth in the Constitution. Congress' power is exclusive as long as the subject of its regulation is national in nature. These early decisions were re-affirmed in 1964, in Katzenbach v. McClung, in which the Court determined Congress' ability to regulate local activity. The Court held that

26. Id.
Congress could properly regulate a single restaurant since it had a rational basis for concluding that the prejudicial activity of restaurants in refusing to serve blacks interfered with the flow of food in interstate commerce: "[W]here we find that the legislators, in light of the facts and testimony before them, have a rational basis for finding a chosen regulatory scheme necessary to the protection of commerce, our investigation is at an end."

The modern test of a state statute's validity when the statute appears to regulate interstate commerce, was expounded by the Supreme Court in *Pike v. Bruce Church, Inc.*. In *Pike*, the Court stated, "Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits." This weighing of local benefits against the burden imposed on interstate commerce would eventually be at the heart of the analysis in *MITE*.

Conflicting federal and state regulations of interstate commerce are also subject to the provisions of the Supremacy Clause.

The first inquiry is whether Congress, pursuant to its power to regulate Commerce, U.S. Const. Art I, has prohibited state regulation of the particular aspects involved in this case . . . . But when Congress has "unmistakenly ordained" [citations omitted] that its enactments alone are to regulate a part of commerce, state laws regulating that part of commerce must fall.

A determination of legislative intent is essential in the analysis of whether a state statute has been pre-empted by federal law, but this determination has presented a variety of problems for the judiciary. The issue is whether or not the Williams Act pre-empts the state statutes. In determining the legislative intent of

29. Id. at 304.
30. Id. at 303-04.
32. Id. at 142, citing Huron Cement Co. v. Detroit, 362 U.S. 440, 443 (1960).
33. U.S. Const., art. VI, cl. 2.
the Williams Act, the courts have examined the debates leading to the passage of the Act.36

The inter-relationship of the Commerce Clause and the Supremacy Clause has appeared before, in areas other than securities law.37 In describing this inter-relationship, one commentary has noted that:

[T]he court has adopted the same weighing of interests approach in pre-emption cases that it uses to determine whether a state law unjustifiably burdens interstate commerce. In a number of situations the Court has invalidated statutes on the pre-emption ground when it appeared that the state laws sought to favor local economic interests at the expense of the interstate market.38

This idea has also appeared in recent securities law decisions. Specifically addressing the state statutes regulating tender offers, the pre-emption issue is whether the state statutes are an “obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”39

The constitutionality of a state takeover statute was first addressed by a federal appeals court in Great Western United Corp. v. Kidwell40, where the Fifth Circuit Court of Appeals held that

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36. See, e.g., MITE, 102 S. Ct. at 2638; Crane Co. v. Lam, 509 F. Supp. 782, 787 (E.D. Pa. 1981); Dart Industries v. Conrad, 462 F. Supp. 1, 12 (S.D. Ind. 1978); Generally, the courts ask two questions to determine legislative intent. First, did Congress expressly intend to pre-empt state regulation of tender offers. See Rice, 331 U.S. at 230. If the answer is no, the question then remains whether that intent can be inferred by the nature of the federal regulations. See City of Burbank v. Lockheed Air Terminal, Inc., 411 U.S. 624, 633 (1973). An alternative approach was taken in a conflict between a California statute and the New York Stock Exchange Rules, where the Court, finding that pre-emption was unnecessary, attempted to reconcile the federal and state regulations. See Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117 (1973). While the reconciliation approach seems to be a valid alternative, it could not be applied to cases of direct conflict between state and federal statutes where the state statute interferes with the purpose and procedures of valid federal regulations. Id. at 139-40. See also Comment, supra note 4, at 906-08.

37. See, e.g., Burbank v. Lockheed Air Terminal, Inc., 411 U.S. 624 (1973) (Court held that the Federal Aviation Act of 1958, as amended, pre-empted a local noise abatement ordinance because of the need for uniform national regulation of aircraft noise).


40. 577 F. 2d 1256 (5th Cir. 1978), rev’d on venue grounds sub nom. 443 U.S. 173 (1979).
the Idaho Takeover Statute\textsuperscript{41} was unconstitutional. The Idaho statute provided that the Director of the Idaho Department of Finance and incumbent management would receive advance notice of the offer\textsuperscript{42}, and that both the Director and management could request a hearing.\textsuperscript{43} Idaho argued that it sought to protect investors by "involving the directors and officers of the target in the evaluation of a tender offer."\textsuperscript{44} The court found this "fiduciary" approach conflicted with the "market approach to investor protection adopted by Congress . . . ."\textsuperscript{45} Interpreting Congressional desire for both fair disclosure and neutrality, the court stated, "The reason for this approach was Congressional recognition that tender offers often benefit an investor and that a statute preventing tender offers could harm, rather than protect, investors."\textsuperscript{46} Thus, while the Williams Act does not confer a right on the offeror to complete the offer, Great Western was entitled to give investors a fair presentation of the offer without incumbent management being given an advantage should it attempt to block the offer.\textsuperscript{47}

In retrospect, the analysis of the court appears quite simple. Congress sought to prevent either a tender offeror or target management from having an advantage during the pendency of the offer. Idaho, by giving management additional time through delay of the offer and by creating a fiduciary relationship between management and shareholders in analyzing the offer, gave incumbent management an advantage in an attempt to defeat the offer. Addressing the disclosure provisions of the Idaho Statute,\textsuperscript{48} the court was not convinced that the additional disclosure was of any real benefit to the investor, and found that Congress believed the task of determining proper disclosure belonged with the SEC.\textsuperscript{49} The statute, therefore, conflicted with the Williams Act and was pre-empted under the Supremacy Clause.\textsuperscript{50}

The court also examined the effects of the Idaho statute on in-

\textsuperscript{45} Great W. United Corp., 577 F.2d at 1279.
\textsuperscript{46} Id. at 1277.
\textsuperscript{47} Id.
\textsuperscript{49} Great W. United Corp., 577 F.2d at 1280.
\textsuperscript{50} Id. at 1279-80.
terstate commerce. Idaho argued that the statute protected both local management and investors, which is a legitimate purpose for state regulation. While Idaho's statute would apply even when none of the investors were Idaho residents, possibly more important is the inherent conflict in Idaho's argument. The court held that while Idaho may have interests in protecting both local investors and local management, the respective interests of the investors and management during the pendency of a tender offer are often in direct conflict. By providing delay for target management, the Idaho statute may, and often did, act to the detriment of investors. This is in direct conflict with Congressional intent. Because the statute is not limited to Idaho shareholders, the Idaho statute is acting to the detriment of shareholders nationwide. "Idaho's law is designed to alter the disclosure made in securities transactions between Idaho and another state, two other states, and even entirely within another state. Idaho's law can also change the time when, if ever, those non-Idaho securities sales will occur."

The court applied the Pike test to determine the statute's validity and determined that the state statute was subject to stricter scrutiny than a rational relationship test because of its potential Commerce Clause conflict. The court held that the extraterritorial impact of the Idaho statute placed too great a burden on interstate commerce.

A year later, a constitutional challenge to the Ohio Takeover Act produced a different result. In AMCA Intern. Corp. v. Krouse, the Ohio statute withstood challenges under both the Commerce Clause and the Supremacy Clause. One possible factor was that the target company, Warner & Swasey, was an Ohio corporation, with its principal place of business in Ohio and more than seventy-five percent of its assets in Ohio, and thirty percent of Ohio resident shareholders. However, the Ohio statute applied regardless of the number of resident shareholders and exempted offers ap-

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51. Id. at 1283.
52. Id.
54. See supra text accompanying notes 31-32.
55. Great W. United Corp., 577 F.2d at 1285.
56. OHIO REV. CODE ANN. § 1707.041 (Baldwin 1978). The new Ohio statute did not repeal this section. See infra text accompanying note 144.
58. Id.
proved by target management.\textsuperscript{60} The statute further provided for pre-filing notice,\textsuperscript{61} permitted the Ohio Division of Securities to call a hearing in its own discretion or at the request of target management,\textsuperscript{62} contained more detailed disclosure provisions than those contained in the Williams Act,\textsuperscript{63} and allowed for an administrative inquiry into the fairness of the offer and the disclosure.\textsuperscript{64}

The Ohio court based its analysis on whether Congress explicitly sought to protect investors through the market approach.\textsuperscript{65} Citing \textit{Piper v. Chris-Craft Industries, Inc.},\textsuperscript{66} the court felt that "the Williams Act accords no 'right' to a tender offeror to make an offer, much less to succeed in consummating it."\textsuperscript{67} The court found that Ohio's statute provided greater investor protection by addressing itself only to hostile offers, and by placing a fiduciary obligation on target management. It thus held that the statute did not conflict with the Williams Act.\textsuperscript{68}

The court further held that under the \textit{Pike} test, the Ohio statute did not place too great a burden on Interstate Commerce. Because "friendly" offers were exempted under the statute, the court applied the \textit{Pike} analysis to the treatment of "hostile" offers.\textsuperscript{69} The court's focus on local interest centered upon its determination that tender offers were the functional equivalent of internal affairs transactions.\textsuperscript{70} This was weighed against the impairment of non-

\begin{itemize}
  \item \textsuperscript{60} Id. at § 1707.041(A)(1)(d).
  \item \textsuperscript{61} Id. at § 1707.041(B)(1).
  \item \textsuperscript{62} Id. at §§ 1707.041(B)(1)(a)-(c).
  \item \textsuperscript{63} Id. at § 1707.041(B)(3).
  \item \textsuperscript{64} Id. at § 1707.041(B)(4) and § 1707.13.
  \item \textsuperscript{65} AMCA, 482 F. Supp. at 936.
  \item \textsuperscript{66} 430 U.S. 1 (1977) (a tender offeror does not have an implied cause of action for damages based on alleged anti-fraud violations by target management or a successful competitor under § 14(e) of the Securities Exchange Act of 1934, as amended, or under Rule 10b-6).
  \item \textsuperscript{67} AMCA, 482 F. Supp. at 937.
  \item \textsuperscript{68} Id. at 938.
  \item \textsuperscript{69} See also, Comment, supra note 4, at 935 ("Consequently, the need for uniformity, as well as the inherent characteristics of the tender offer, suggest that the chartering state, relying on the internal affairs characterization, could properly seek to regulate tender offers."); Note, \textit{Preemption and the Constitutionality of State Tender Offer Legislation}, 54 \textit{Notre Dame Law} 725, 735 (1979) ("First, tender offers, in nature, design and effect, are devices to gain control of a corporate entity. Hence, the tender offer is the functional equivalent of the proxy solicitation . . . .").
  \item \textsuperscript{70} Id. at 939. An internal affairs transaction, such as a merger or dissolution, is governed by the laws of the chartering state. They are governed by the same scheme of regulation as the election of directors and the issuance of shares. See Comment supra note 4, at 931-34.
\end{itemize}
resident shareholders, which the court said was therefore only an incidental aspect of effectively protecting Ohio resident shareholders.\textsuperscript{71} AMCA argued that an additional burden on interstate commerce was that it not only suffered from excessive expenses and lost profits, but that the Ohio statute prevented $200 million from entering the stream of commerce.\textsuperscript{72} The court found, however, that the Ohio statute did not act to the business or economic detriment of other states, and therefore did not place too great a burden on interstate commerce.\textsuperscript{73} While recognizing the potential for the Ohio statute to place burdens upon interstate commerce, the court looked at the trading activity of Warner & Swasey and the probable future investment plans of AMCA.\textsuperscript{74} This analysis ignores the Supreme Court's rational basis analysis in \textit{Katzenbach}.\textsuperscript{75} The trading activity of Warner & Swasey, and the $200 million involved in this offer, were significant when included in the aggregate market effect caused by the extraterritorial reach of statutes such as Ohio's. Two years after the AMCA decision, the Ohio twenty day pre-filing notice was held unconstitutional as conflicting with federal regulation.\textsuperscript{76}

The AMCA decision was not readily accepted. In \textit{Dart Industries Inc. v. Conrad}\textsuperscript{77}, an Indiana district court found that the Delaware Act\textsuperscript{78} was unconstitutional on both Supremacy Clause and Commerce Clause grounds. The court, recognizing the large number of major corporations incorporated in Delaware, found that the statute's effect on interstate commerce was quite significant.\textsuperscript{79} Further, the court determined that the statute was pre-empted by the Williams Act because it imposed a pre-notice filing and it altered the Act's withdrawal provisions.\textsuperscript{80} The court concluded that tender

\begin{itemize}
\item \textsuperscript{71} AMCA, 482 F. Supp. at 939.
\item \textsuperscript{72} Id. at 939-40.
\item \textsuperscript{73} Id. at 940.
\item \textsuperscript{74} Id. at 940-41. The court found that Warner & Swasey stock increased in price and volume trading. The court also thought that if the offer for Warner & Swasey failed, then AMCA would simply find an alternate investment. Id.
\item \textsuperscript{75} 379 U.S. 294 (1964); see also supra notes 25-27.
\item \textsuperscript{77} 462 F. Supp. 1 (S.D. Ind. 1978).
\item \textsuperscript{78} Delaware Tender Offers Act, codified at \textsc{Del. Code Ann. tit. 8 \S 203(a)(1-3)}.
\item \textsuperscript{79} \textit{Dart}, 462 F. Supp. at 11.
\item \textsuperscript{80} Id. at 13. The Delaware Tender Offers Act provided that the target company receive notice at least 20 days prior to the offer. The notice requirement included financial information beyond that required by the Williams Act. The court found the additional information irrelevant to the shareholders' decision. Id.
\end{itemize}
offers provide economic benefits, and that Congress sought to maintain a situation in which shareholders could make a free and informed choice, without the offeror or target management being given an advantage in determining the outcome of the offer.\textsuperscript{81}

In Crane Co. \textit{v. Lam}\textsuperscript{82}, a preliminary injunction was granted when the Pennsylvania Takeover Disclosure Law\textsuperscript{83} was found to contain provisions similar to the Idaho and Delaware statutes. The court initially held that the twenty-day advance notice requirement was pre-empted, noting that delay created by the statute conflicted with Congress' attempt at neutrality.\textsuperscript{84} The Pennsylvania Securities Commission argued that the state had strong local interests in protecting investors and the internal affairs of management.\textsuperscript{85} The court found that these interests were outweighed by the burden imposed on interstate commerce; its effect on non-resident shareholders; its potential to conflict with other state statutes; and its ability to interfere in offers potentially beneficial to shareholders.\textsuperscript{86} Of great interest was the court's attack on the internal affairs argument:

[D]efendants' argument, as stated, fails to suggest any state interest in governing the internal affairs of in-state corporations other than the protection of investors, which has already been discussed. The only conceivable, nonprotectionist state interest which could support such legislation on the basis of the situs of incorporation or the principal place of business is a state's arguable interest in attracting investment capital to the state by ensuring investors that their investments will be protected from abuse.\textsuperscript{87}

While the court recognized the state's interest as legitimate, it found that "these state interests are either weak or tenuously served by the Pennsylvania Act . . . ."\textsuperscript{88}

IV. \textit{EDGAR v. MITE CORP.}

Numerous other district courts considered the constitutionality of state takeover statutes prior to the \textit{MITE} decision,\textsuperscript{89} and the

\begin{footnotes}
\item 81. \textit{Id.} at 12.
\item 84. 509 F. Supp. at 787.
\item 85. \textit{Id.} at 789.
\item 86. \textit{Id.} at 789-91.
\item 87. \textit{Id.} at 789.
\item 88. \textit{Id.}
\item 89. \textit{See Great W. United Corp. \textit{v. Kidwell}, 577 F.2d 1256 (5th Cir. 1978) rev'd sub. nom. }
\end{footnotes}
arguments presented were generally the same. The Supreme Court's decision in *MITE* resolved these disputes among the district courts as to the constitutionality of state takeover statutes, at least to the extent that such statutes have the same effect as the Illinois statute struck down in *MITE*. The MITE Corporation, which was organized under Delaware law, filed a Schedule 14 D-1 with the SEC on January 19, 1979. MITE sought to purchase all the outstanding shares of the Chicago Rivet and Machine Co., an Illinois Corporation. Under the Illinois Business Take-over Act, the offer did not become effective until twenty days after filing with the Secretary of State, or after a hearing where the fairness


91. *MITE*, 102 S. Ct. at 2633.

92. ILL. REV. STAT. ch. 121 1/2 §§ 137.51-137.70 (1979).

93. Id. at § 137.54.A (1979).
of the offer could be questioned. 94 The Illinois statute applied if ten percent of any class of securities subject to the offer were owned by Illinois residents, or if two of three requirements were met: the target corporation was organized under Illinois law; its principal executive office was in Illinois; or ten percent of its stated capital and paid-in surplus was represented in Illinois. 95

The Court, recognizing the purpose of the Williams Act, affirmed the opinion of the Seventh Circuit Court of Appeals which found the statute unconstitutional, stating "that Congress sought to protect the investor not only by furnishing him with the necessary information but also by withholding from management or the bidder any undue advantage that could frustrate the exercise of an informed choice." 96 The court added that the shareholders' ability to withdraw from the offer and the guarantee that investors would benefit from an increase in the tender offer evidence an intent to include the investor in this neutral approach. 97

Illinois argued that two major state interests were served: the statute protected resident security-holders and the statute merely regulated corporate internal affairs. 98 As to the claim of protection of resident investors, the Court noted that the statute also affected non-resident shareholders who were beyond Illinois' stated interest, especially as the statute could apply when all the shareholders were non-residents. 99 The Court also rejected the internal affairs argument stating that tender offer transactions do not necessarily "implicate the internal affairs of the target company." 100

Weighing the local interest of Illinois against the burden the statute imposed on interstate commerce, it was clear that the Supreme Court considered the "jurisdiction" of the statute to be overbroad in allowing a substantial national effect in violation of the Commerce Clause.

The most obvious burden the Illinois Act imposes on interstate com-

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94. Id. at §§ 137.54.A-E (1979).
95. Id. at § 137.52-10 (1979).
96. MITE, 102 S. Ct. at 2636-37, (citing MITE Corp. v. Dixon, 633 F. 2d 486, 496 (7th Cir. 1980)).
97. MITE, 102 S. Ct. at 2636-37.
98. MITE, 102 S. Ct. at 2642.
99. MITE, 102 S. Ct. at 2642.
100. MITE, 102 S. Ct. at 2643, (citing Great W. United Corp. v. Kidwell, 577 F. 2d 1256, 1280 n. 53 (5th Cir. 1978)).
merce arises from the statute’s previously-described nationwide reach which purports to give Illinois the power to determine whether a tender offer may proceed anywhere.

The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest-valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.101

Justice White additionally wrote as to the constitutionality of the Illinois statute under the Supremacy Clause, an opinion which was not joined by a majority of the Court.102 Justice White considered the statute as interfering with Congress’ intent as expressed in the Williams Act.103 The first, and probably clearest, conflict addressed was the twenty-day advance notice during which time the target company could take action to stall, or possibly defeat the offer. Justice White saw this as a powerful tool, one which Congress clearly wished to avoid providing to target companies.104 The hearing provisions were also unconstitutional because they gave further advantages to incumbent management. The hearings, which could be indirectly requested by management, defeated the equality Congress sought to create.105

Justice White concluded that the hearing provision, which permitted the pre-offer determination of fairness, clearly conflicted with the shareholders’ ability to make a free choice, the ultimate goal of providing detailed disclosure, and therefore required pre-emption under the Supremacy Clause.106

V. POST-MITE CONSIDERATION

Since the decision in MITE, there have been a number of judicial decisions applying both the Supreme Court’s language and

101. MITE, 102 S. Ct. at 2641-42 (citations omitted).
102. MITE, 102 S. Ct. at 2635-37.
103. MITE, 102 S. Ct. at 2635-36, (citing Hines v. Davidowitz, 312 U.S. 52, 67 (1941) (other citations omitted)). In the actual text of the opinion, Justice White makes the Supremacy Clause argument first. Despite the fact it failed to carry a majority consent, its logic was subsequently followed in numerous cases.
104. MITE, 102 S. Ct. at 2637.
105. MITE, 102 S. Ct. at 2638.
106. MITE, 102 S. Ct. at 2639-40.
holding.  Some decisions have taken the additional step of suggesting what a majority of the Court would do if presented with the Supremacy Clause question. While one might argue that the decision in MITE would not render all state regulation of tender offers invalid, the limitations placed upon state statutes in light of MITE may eventually render the statutes ineffective for their stated purpose.

In National City Lines, Inc. v. LLC Corp., the Missouri Takeover Act was held to be pre-empted by the Williams Act because it provided for delay, and contained substantive provisions conflicting with both the Williams Act and SEC regulations. Addressing the subject of delay, which was caused both by pre-filing notice and hearing provisions, the court stated: "State statutes which can be used to unduly delay tender offers are pre-empted by the Williams Act. The extended delay threatens the viability of tender offers by discouraging the tender offeror from completing the offer once made." The court further held that the disclosure required by the Missouri Act contradicted Congressional judgment, which provided that the SEC should determine the adequacy of disclosure.

The Maryland and Michigan takeover statutes were also determined to be unconstitutional on the basis of the MITE decision, in one of the most complex and hostile tender offers, both from a legal and a corporate perspective, involving three companies: Bendix Corporation, Martin-Marietta Corp., and United Techno-

107. Sharon Steel Corp. v. Whaland, 466 A.2d 919 (N.H. 1983); Esmark Inc. v. Strode, 634 S.W. 2d 768 (Ky. 1982); Mesa Petroleum Co. v. Cities Service Co., 715 F.2d 1425 (10th Cir. 1983); National City Lines, Inc. v. LLC Corp., 687 F.2d 1122 (8th Cir. 1982); Bendix Corp. v. Martin-Marietta, 547 F. Supp. 522 (D. Md. 1982); Telvest, Inc. v. Bradshaw, 697 F. 2d 576 (4th Cir. 1983); Agency Rent-A-Car v. Connally, 686 F. 2d 1029 (1st Cir. 1982).
108. See, e.g., National City Lines Inc. v. LLC Corp., 687 F. 2d 1122 (8th Cir. 1982); Esmark Inc. v. Strode, 639 S.W.2d 768 (Ky. 1982); Sharon Steel Corp. v. Whaland, 466 A.2d 919 (N.H. 1983).
110. 687 F. 2d 1122 (8th Cir. 1982).
112. National City Lines, 687 F. 2d at 1124. The Missouri Act conflicted with the Williams Act in that it provided for a minimum twenty day waiting period and a hearing at the commissioner's request. It also granted the commissioner the power to determine what disclosure was necessary. It also altered the time schedules for shareholders to exercise their withdrawal and pro rata rights. Id. at 1131-32.
113. Id. at 1131.
114. Id. at 1131-32.
logies. Bendix initially made an offer to purchase up to 48% of Martin-Marietta's outstanding shares for approximately $42.00 per share, but subsequently amended its offer to purchase up to 54% of the stock at $48.00 per share. In response to this offer, Martin-Marietta made an offer to purchase approximately 50% of Bendix' outstanding shares for $75.00 per share. At the same time, United Technologies made a similar offer for Bendix stock, apparently acting in co-operation with Martin-Marietta. The cases arising out of the various tender offers involved a number of federal courts in several states. To examine the entirety of the transactions and the legal debates which ensued would require a separate article; however, several points are worth noting in the context of this comment. In awarding a declaratory judgment to Bendix in the Maryland case, the federal district court held the Maryland takeover statute unconstitutional stating:

To paraphrase the Supreme Court, the Maryland Law imposes considerable burdens on interstate commerce because it gives Maryland the power to determine whether a tender offer may proceed anywhere. As the Supreme Court noted, "the effects of allowing" one state "to block a nationwide tender offer are substantial"... Indeed, it is difficult to characterize the Maryland Law's "sweeping extraterritorial effect" as anything but a naked and direct restraint on interstate commerce.

In the Michigan case, the Sixth Circuit Court of Appeals held the Michigan Takeover Offers Act unconstitutional because it created delay, and thus overruled actions taken by the Michigan Corporations and Securities Bureau, which had filed a Cease and Desist Order against Martin-Marietta and United Technologies for filing false or misleading statements. However, while there is little question of the unconstitutionality of the delaying tactics of the Michigan statute, the anti-fraud provisions are directly related to investor protection, and may present one of the few exceptions to the MITE holding, to be discussed hereinafter.

The constitutionality of state takeover statutes has been heard

117. Id. at 532 (citation omitted).
119. Bendix, 690 F. 2d at 560.
120. See, infra Section VI.
in a number of other courts. While it would be too burdensome to discuss all of the cases, two state supreme court cases are worth noting. In Esmark, Inc. v. Strode, the Kentucky Take-over Bids Act was declared unconstitutional. The court relied heavily on the decision in MITE, placing equal emphasis on all parts of Justice White's opinion, and applied the Supreme Court's analysis to a non-traditional tender offer. Only three months later, a "creeping tender offer" received similar treatment, and an amendment to the Virginia Take-Over Act was declared unconstitutional.

The New Hampshire Supreme Court came to a similar conclusion in Sharon Steel Corp. v. Whaland, but only after the case was remanded to it for re-consideration in light of the holding in MITE. Although the case involved large-block open-market purchases of securities as opposed to a tender offer, the court found that the New Hampshire takeover statute was overly broad, and that it failed to provide significantly better investment protection than that afforded by the Williams Act.

The most recent federal review of state takeover statutes took place in Mesa Petroleum Co. v. Cities Serv. Co. The Tenth Circuit Court of Appeals viewed tender offers as a "nationwide phenomenon, invariably made through the instrumentalities of interstate commerce." In holding the Oklahoma Take-Over Act unconstitutional, it found that the burden of the Oklahoma statute's
ability to halt tender offers nationwide clearly outweighed those state interests which were weakly served by the statute.\textsuperscript{133}

VI. ANALYSIS

As to state takeover statutes, it seems clear that pre-filing notice requirements and hearing provisions, which delay the natural sequence of the offer, are unconstitutional. Further, the broad language being used to define the jurisdiction of these statutes has been held to place too great a burden on interstate commerce. Insofar as the state statute places a restraint on interstate commerce, it is invalid.\textsuperscript{134} Did the court in \textit{MITE} foreclose all state regulation, or is there some permissible scope of state regulation? The SEC Advisory Committee on Tender Offers published its Report of Recommendations on July 8, 1983.\textsuperscript{135} Placing an emphasis on shareholders' interests, it focused on meaningful disclosure,\textsuperscript{136} stating: "The tender offer process seems the best way available to us of insuring that terms, price and conditions are made available equally to all shareholders in a timely fashion."\textsuperscript{137} The Committee's recommendations on state takeover statutes were brief and to the point: "State regulation of takeovers should be confined to local companies."\textsuperscript{138} Defining "local," it stated:

The Committee considered various formulations for a definition of a "local" company. One definition included companies with more than 50\% of the voting shares held within the state of incorporation, no listing on a national securities exchange, aggregate market value of voting stock held by non-affiliated stockholders of $20 million or less, and annual trading volume of such stock less than one million shares. Although the Committee ultimately elected to leave the definitional task to the Commission, it suggests that in developing the concept the Commission focus on the factors referred to in this footnote.\textsuperscript{139}

The Committee has developed a very limited "jurisdictional" concept. Comparing the provisions in the report to those contained

\textsuperscript{133} \textit{Mesa}, 715 F. 2d at 1430.
\textsuperscript{134} \textit{MITE}, 102 S. Ct. at 2641.
\textsuperscript{135} [1983] \textit{FED. SEC. L. REP.} (CCH) No. 1028 (Special Report July 15, 1983.).
\textsuperscript{136} Id. (Contained in the letter from the Committee Chairman to the Chairman of the SEC, dated July 8, 1983.).
\textsuperscript{137} Id.
\textsuperscript{138} Id., at 17.
\textsuperscript{139} Id.
in the state statutes discussed previously, it can easily be seen that a statute based on these provisions would be much more restricted in its ability to affect interstate commerce. While reducing the burden placed on interstate commerce, however, the burden must nevertheless be outweighed by local benefits. When drafting statutes regulating tender offers state legislators should bear in mind that the courts have not given great weight to the arguments of the state as to the protection of its interests. The argument may be given greater validity if the statute attempts to actually provide further investor protection than that provided by the Williams Act.

The Committee further provided that federal law should not preempt state corporate law except to "eliminate abuses or interference with the intended functioning of federal takeover regulation." At the same time, the Committee recommended that takeover regulation reflect the neutrality sought by Congress and mandated in MITE, and that it should be recognized that takeover transactions take place in a national market. The decisions previously discussed also stressed both this intent of neutrality and the national nature of tender offers. The courts have held that provisions contained in the state statutes interfere with the neutrality sought by Congress, and have found that substantive provisions contained in the statutes conflict with those of the Williams Act.

State takeover statutes recently enacted in response to the MITE decision and its progeny probably do not go far enough to meet the goals suggested by the Advisory Committee. Ohio was the

140. See, e.g., MITE, 102 S. Ct. at 2642-43.
141. FED. SEC. L. REP., supra note 135, at 18.
142. Id. at 15.
144. See, e.g., MITE, 102 S. Ct. at 2629; National City Lines, 687 F. 2d at 1131; Great W. United Corp., 577 F. 2d at 1277-79.
145. The substantive provisions include pre-filing notice, hearing provisions which can create delay, and provisions altering the withdrawal and pro rata provisions of the Williams Act.
146. These amendments were drafted prior to the SEC Advisory Committee report. See, e.g., OHIO REV. CODE ANN. § 1701.01(y) (Baldwin 1982); N.H. REV. STAT. ANN. § 421-A:5 (as amended) (1988); VA. CODE § 13.1-331 (1989); DEL. CODE ANN. tit. 8 § 209 (1983); GA. CODE ANN. § 14-6-1 et seq. (Supp. 1983); S.D. CODIFIED LAWS ANN. § 47-32-1-47 (1983). Not all writers agree. See, Sargent, supra note 143, at 729 ("In short, the revised takeover laws express a tradi-
first state to amend its takeover statute in response to the decision in MITE. The "jurisdictional" provision, which has been made part of the corporate code instead of the securities laws, provides that an "Issuing public corporation" means a domestic corporation with fifty or more shareholders that has its principal place of business, principal executive offices, or substantial assets within this state . . . ." This definition probably does not sufficiently restrict the extraterritorial reach of the statute: "Thus, for example, the Act would control the ability of a California resident to sell a twenty-one percent interest in an Ohio-based company to a New York resident in a transaction taking place in Florida." While the provision is placed in the corporate code, its application to tender offers creates problems, both because of its nationwide effect and the rejection of tender offers as being internal affairs transactions.

Additionally, while the new Ohio statute creates a more definite time schedule, its major effect is to statutorily create substantial delay. MITE previously established that delay gives target management an advantage which Congress sought to avoid.

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148. OHIO REV. CODE ANN. § 1707.07(y) (Baldwin 1982).
149. Kreider, supra note 146, at 121.
150. MITE, 102 S. Ct. at 2642-43.
151. Kreider, supra note 146, at 119.
152. MITE, 102 S. Ct. at 2637; see also, Sargent, supra note 143, at 708-09. In discussing the revised Indiana statute (IND. CODE ANN. §§ 23-2-31-7-8 (Burns Supp. 1983) amended by Pub. L. No. 215 (1981)), Sargent distinguishes between "precommencement" and "prepurchase" waiting periods, at the end of which a mandatory waiting period is held. However, unless the mandatory hearing is justified by state interests superior to those rejected by the Supreme Court in MITE, the statute still fosters delay which conflicts with Congress' intent as expressed in MITE. Sargent also distinguishes the revised Pennsylvania Statute (PA. STAT. ANN. tit. 21 § 74(a) (Purdon Supp. 1983)) which, in effect, prohibits purchases during the first twenty days to allow the state to exercise discretion in reviewing the offer. It is again questionable that the state's interests in reviewing the offer will outweigh the burden caused by the delay. Congress left the determination of sufficient disclosure to the SEC as recognized in MITE. Finally, Sargent argues that that delay, in and of itself, is an insufficient showing of the burden, but that there should be a particular showing that an advantage was given to management. While this appears reasonable, it seems to require an after-the-fact determination. What target management will do with the delay can only be known after it has acted. The ability of management to use this time to the detriment of the offeror, and possibly the investor, defeats the Congressional purpose of neutrality and free choice, whether or not target management chooses to act in every case.
The Ohio amendments are subject to challenge under the Supremacy Clause because they provide a substantial advantage to incumbent management through its control of the proxy machinery and its ability to marshal its opposition to an offer during the statutorily mandated period of delay. In addition, by substituting majority rule for individual investor decision-making with respect to a tender offer, the amendments may be found to conflict with the federal policy of investor autonomy and freedom of choice.

In Sharon Steel Corp. v. Whaland, the New Hampshire Supreme Court had declined to rule on the constitutionality of the 1983 amendments to the New Hampshire takeover statute. However, the failure of the legislature to substantially revise the statute's "jurisdiction," and the preservation of hearing provisions which foster delay, will almost certainly render the statute unconstitutional.

If states wish to preserve the basic formats of their statutes, certain suggestions are worth considering. First, pre-notice filing requirements could be maintained if the filings were strictly confidential. As long as target management is unaware of the proposed offer, it has no advantage. A state's interest in preventing fraudulent disclosure is both legitimate and in the interest of the investor. A hearing to address the information disclosed must also be confidential and conducted promptly in order to avoid delay of the commencement date of the offer. The disclosure requirements of the state should be satisfied by filing copies of the SEC filing, as Congress placed the burden of determining the scope of appropriate disclosure on the SEC.

In attempting to alleviate the Commerce Clause conflict, states must turn their statutes inward, so that their effect remains within the state's borders. A recent proposal in Wisconsin would have been limited to companies which have 51% of the shares owned by residents, or 51% of the shareholders as residents. The company must also have substantial assets within the state, and either be organized under Wisconsin law or have its principal offices

154. 466 A. 2d 919 (N.H. 1983); see supra text accompanying n. 127-29.
157. Id. at § 421-A:5 (as amended) (Supp. 1983).
158. Wisconsin 1983 Senate Bill 301 (this bill has passed the Senate and was set on the House calendar for March 22, 1984).
A contrasting approach was originally vetoed by the governor of Maryland, but was amended and subsequently enacted. The Maryland bill applies mainly to transactions such as internal affairs transactions which require shareholder votes. While inherently different in form, these approaches both attempt to remove the scope of the statute from the stream of interstate commerce:

If there is room under the MITE decision for a new breed of state takeover statutes, it seems clear that to survive constitutional challenge these statutes will have to either be narrowly drawn with an emphasis on the protection of in-state shareholders or they will have to regulate, as the Maryland approach would have, transactions traditionally regulated by state corporate law.

CONCLUSION

The MITE decision has marked the demise of traditional state takeover statutes. While not expressly foreclosing state regulation, the decision, at a minimum, will require states to completely revise their statutes so they do not burden interstate commerce. The states will also be required to alter substantive provisions to insure the statutes do not interfere with the Congressional objectives of neutrality and investor protection as expressed in the Williams Act.

States desiring to regulate tender offers will be searching for new approaches to regulation. States whose statutes follow the traditional pattern will most certainly be determined unconstitutional. Putting a "new face" on the old statute would apparently not satisfy the MITE holding. The conflict with the Williams Act arises from the jurisdictional scope of the statute and what it procedurally imposes prior to the offer's commencement. Only the statute which effectively deals with these considerations will survive.

Scott Brody

159. Duffy, supra note 153, at 18.
160. Md. Corp. & Ass'n's §§ 3-302 (as amended), 8-301 (as amended), 3-601-603 (Ch. 1, special session 1983).
161. Id.
162. Duffy, supra note 153, at 19.
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