The Courts and the Market for Corporate Control

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The last two decades have witnessed a dramatic change in the market for corporate control. Business combinations that twenty years ago would have taken perhaps a year to accomplish, and which could not have occurred at all without the blessing of the acquired company's management, today occur in a matter of weeks, with or without the consent of the "target's" management. Corporations and even some wealthy individuals have shown themselves increasingly willing to commit huge sums in attempts to gain control of large enterprises previously thought to be immune from acquisition by virtue of their very size. Our financial markets have even developed a new form of currency—high-yield debt obligations or "junk bonds"—to facilitate these transactions. "Merger mania" is sweeping the countryside, or so it has been said.

What has happened, in a nutshell, is that corporate control, once a very illiquid commodity, has become increasingly more liquid. And the more liquid an asset becomes, the more activity there will be in the market for that asset.

In itself, the increased activity in the market for corporate control is not a surprising development. Control has long been recognized as a valuable asset, entitled to a premium, and the pitched battles that have been waged to gain or retain it are by no means a recent phenomenon. For the most part, though, the early fights for corporate control took the form of proxy contests. These tended to be very expensive for the insurgents and involved difficult and uncertain choices for shareholders, who were asked to prognosticate about the relative abilities of the contending slates of managers to generate a return from the company's assets. Proxy contests were therefore not a particularly efficient means of acquiring control, and they occurred with comparatively limited frequency.

As with any other valuable asset, however, it was just a matter of time before normal market forces led to the development of a more efficient method—in this case the non-negotiated or "hostile" tender offer—to extract the ore of corporate control from the motherlode. A tender offer presents shareholders with a simple choice: to sell or not to sell, for the consideration and upon the conditions established by the bidder. Tender offers are fast and, while they do involve costs, they offer the prospect of equity ownership at a price the offerer considers attractive. In the late 1960s, tender offers proliferated, gradually supplanting the proxy contest as the preferred takeover device and bringing with them a sharp increase in liquidity in the market for corporate control.

What is unique about the increased liquidity in the market for corporate control is the role the courts have played in bringing it about. The "liquefaction" of other kinds of assets has occurred with little, if any, involvement from the courts. In recent years, for example, a thriving market has developed in collateralized debt obligations, as a result of which relatively illiquid but income-producing assets such as home mortgages, car loans, and equipment leases have been packaged into something that can be

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widely held and can change hands in the public market at a moment's notice. Other types of formerly illiquid assets, ranging from timberlands to oil producing properties, have been "securitized" and thereby liquefied as well. All this has occurred without (at least so far as I am aware) a single court decision of any particular note.

In contrast, courts have been called upon repeatedly to mediate disputes in the market for corporate control. The reason, it is often said, is that transactions in this market involve intermediaries—target management—whose interests, unlike those of traditional market intermediaries such as underwriters and brokers, occasionally lead them not to bring buyers and sellers together, but to try to keep them apart. Target management has frequently sought, in effect, to keep corporate control off the open market by asking courts to enjoin hostile tender offers.

More recently, incumbent managers have tried to restrict trading in this valuable asset by adopting structural defenses such as the "poison pill," which requires would-be acquirers to negotiate to obtain management's approval of a proposed transaction or to risk potentially fatal economic injury if they do not.

The courts have demonstrated a strong predilection . . . "to allow the forces of the free market to determine the outcome" of contests for corporate control.

The Williams Act

The Williams Act was passed by Congress in 1968 in response to the increasing use of the tender offer as a device to acquire corporate control. Although originally introduced by Senator Harrison Williams of New Jersey for the purpose of restraining the predations of "white collar pirates" on our "proud old companies," the Act as ultimately passed had a distinctly free-market orientation.

In very general terms, the Act requires various disclosures to be made in connection with a tender offer, and provides an array of procedural protections designed to give shareholders sufficient time to evaluate these disclosures and to assure that all tendering shareholders are treated fairly. There are also provisions requiring the disclosure of purchases that result in the ownership of more than 5 percent of the outstanding equity securities of a corporation—a sort of distant early warning system to alert shareholders and the market in general to a potential shift in control.

The intent of the Act, as is clearly evident from its legislative history, was to allow shareholders to make informed investment decisions in the face of a takeover bid, without favoring either incumbent management or the bidder. Indeed, the legislative history explicitly acknowledges the important role that tender offers play in replacing inefficient management, thus suggesting a desire by Congress to ensure that liquidity in the market for corporate control was not impeded by the new legislation.

Despite Congress's intention, it soon became apparent that target managers would attempt to use the Williams Act to block tender offers and remove control of "their" companies from the market. The first appellate test of this strategy came less than a year after the Act's passage, when the Second Circuit reviewed, and denied, a request by the Electronic Specialty Corporation for injunctive relief blocking a pending tender offer by International Controls Corporation on the ground that the bidder had failed to disclose material information in violation of the Act. Judge Friendly, writing for the court, cautioned district judges to "be vigilant against resort to the courts on trumped-up or trivial grounds as a means for delaying and thereby defeating legitimate tender offers." Where judicial relief was necessary, he suggested that it could best be granted at the preliminary injunction stage and proposed a number of equitable remedies—most notably corrective disclosure—aimed at providing shareholders with the benefit of the information and procedural protections mandated under the Williams Act without depriving them of the opportunity to consider a premium offer for their shares. Quoting the Executioner in the Mikado, Judge Friendly observed that the "object all sublime" was to "let the punishment fit the crime," thus implying that blanket injunctions that threw the tender offer baby out with the bath water would not be favored.

Nevertheless, over the next few years, target companies occasionally succeeded in using the Williams Act to block bids for control by unwanted suitors. For example, General Host Corporation obtained a preliminary injunction halting a tender offer for its shares by Triumph American, Inc., which had failed to disclose that the success of its offer would make General Host subject to certain foreign

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1Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274 (2d Cir. 1986).


5Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969).
By the late 1970s, courts had become adept at enforcing the Williams Act without dampening the market for corporate control. In a fascinating imbroglio in 1978, a group of Middle Eastern investors led by Bert Lance acquired nearly 20 percent of the stock of Financial General Bankshares, a Washington, D.C. bank holding company, without making the filings required under the Williams Act. The group had acquired its stake largely through a series of privately negotiated transactions at premiums over the prevailing market prices. A smaller number of shares had also been acquired in the market. The SEC obtained a consent injunction against the Lance group which prohibited any future violations of the securities laws, but at the same time expressly permitted its members to proceed with their bid for control, provided that they did so by means of a tender offer for 100 percent of Financial General’s shares at a price not less than the highest price paid in the private transactions. The intent of this arrangement was to afford small shareholders the same opportunity to receive a premium for their shares as the large holders who had negotiated directly with the Lance group.

Financial General objected to the SEC consent injunction on the ground that it failed to provide any meaningful sanction for a clear transgression of the Williams Act. However, the district court refused to disturb the deal worked out with the SEC, though it did require the Lance group to offer rescission to shareholders whose stock had been acquired in the lower priced transactions in the open market. The court stated that the prevention of further purchases by the Lance group, as the target company had requested, would deprive the shareholders the opportunity to consider an offer that they might well find attractive and give “undue weight to the interests of incumbent management relative to the interests of FG’s shareholders and the investing public.”

Other decisions in the takeover area, even those not directly involving the Williams Act, confirm the general judicial proclivity for a free and liquid market for corporate control. In Missouri Portland Cement Co. v. Cargill, Inc.,* the Second Circuit reversed a district court order enjoining Cargill’s target offer for Missouri Portland on antitrust grounds. Once again, Judge Friendly was sharply critical of the tendency of target companies to assert legal violations solely as a means to block unsolicited tender offers, a practice he described as “[d]rawing Excalibur from a scabbard where it would doubtless have remained sheathed in the face of a friendly offer.” According to Judge Friendly, the antitrust laws, and by implication other federal regulations, were not “meant to endow management of a target company with the power to block trade in its securities” unless there was a real showing of a violation that would threaten serious harm to the public. In 1982, in Edgar v. MITE Corp.,† the Supreme Court found an Illinois takeover statute that severely burdened the market for corporate control to be invalid under the Commerce Clause, confirming the conclusion reached in numerous earlier cases in the lower federal courts involving similar state statutes. Recent attempts to state legislatures to draft around the result in Edgar have met a similar fate. And just last year, the District of Columbia Court of Appeals, in a case involving Storer Communications, approved an interpretation by the FCC of the Federal Communications Act that allowed a proxy contest for a licensed broadcaster to proceed with only minimal regulatory intervention, thereby reenforcing the governmental interest in controlling access to the airwaves with the Storer shareholders’ interest in corporate democracy and, ultimately, a freer market for corporate control.‡

†Edgar v. MITE Corp., 457 U.S. 624 (1982).
§Storer Communications, Inc. v. FCC, 763 F.2d 436 (D.C. Cir. 1985).
Courts have also resisted efforts to expand the reach of the Williams Act. In 1985, the Ninth Circuit rejected the SEC’s claim that a series of open market purchases of its own shares by Carter Hawley Hale in response to a premium bid by The Limited constituted a tender offer regulated by the Williams Act. A few months later, the Second Circuit reached a similar conclusion in the battle for control of SCM Corporation.

In the latter case, Hanson Trust, in response to a variety of defensive measures by SCM, withdrew its original tender offer and thereafter, in the space of just a few hours, purchased about 25 percent of SCM’s shares in a series of five privately negotiated transactions with large institutional holders and one open market transaction. SCM, with amicus support from the SEC, challenged these purchases as being a de facto tender offer which could only be accomplished in accordance with the procedures mandated by the Williams Act. Focusing on the class of persons who need the protection of the Act, the Second Circuit rejected this claim. The court reasoned that sophisticated sellers engaging in freely negotiated transactions are fully able to fend for themselves and need neither the time nor the information provided under the Williams Act. Indeed, such transactions are an example of the free market at its best—a buyer and seller engaging in an informed exchange, each for his own benefit. It was, the court implied, the type of activity to be encouraged, not controlled.

These cases illustrate the growing realization by the courts that a liquid market for corporate control can be beneficial to the public at large and to target shareholders. The public benefits by having assets moved to more productive uses, and shareholders gain by receiving greater value in return for their assets.

### Poison Pills

As a result of decisions such as those discussed above, target companies have realized that litigation is of limited use in stopping a hostile tender offer. Accordingly, they now look to other defensive tactics in order to deal with non-negotiated bids for corporate control. One of the most prevalent of these is the “poison pill,” a structural device that imposes a fatal economic penalty upon an acquirer who proceeds without management’s approval.

Pills, or shareholder rights plans as they are more formally known, come in a variety of forms. In general, however, they involve the issuance of rights, customarily by a company’s board of directors without shareholder approval, that “flip in,” in the current parlance, to allow shareholders to purchase shares of the target at a steep discount upon the occurrence of certain triggering events such as the acquisition of a specified percentage of the issuer’s shares; in the case of a merger with or into an acquirer, the rights “flip over” to permit the holder to purchase shares of the acquirer at a discount. While the flip-in and flip-over can result in severe dilution to acquirers, most pills can be “deactivated” by management through a redemption of the rights either before the triggering event or within a specified period thereafter. The effect is thus to encourage bidders to negotiate with management rather than proceeding with an acquisition unilaterally.

In Moran v. Household International, Inc., the Delaware Supreme Court upheld the validity of a flip-over pill installed by Household, which was not then known to be the object of any acquirer’s affections. The court noted, however, that should an offer emerge, the board’s decision whether or not to deactivate the pill must be made with the interest of the shareholders in mind, and would be subject to review in accordance with the standards traditionally applied in evaluating the conduct of corporate fiduciaries. The court also took pains to point out that the terms of the flip-over pill adopted by Household did not totally preclude a proxy contest or tender offer for control of the company.

A pill can be used by management to bargain for a higher price or better terms from a prospective acquirer, or to neutralize that acquirer while other bidders are sought. These ends

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**There is as yet no indication that the pill will produce higher values for shareholders than the market produced by itself before the pill was invented.**

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*SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985).

*Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985).


*Dynamics Corp. of America v. CTS Corp.*, supra note 13.
cent of the company’s shares, seemed “more a reflex device of a management determination determined to hold on to power at all costs than a considered measure for maximizing shareholder wealth.” After the Seventh Circuit’s ruling, CTS announced that it was seeking other bidders and adopted a revised pill plan, the financial impact of which was far less extreme than the original plan. The district court approved the new pill, finding that it would help to “insure an orderly auction of the company.” At the time of writing the matter is sub judice before the Seventh Circuit.

A New York district court recently struck down a pill with severely dilutive flip-in and flip-over provisions that had been adopted by NL Industries just a few months before the announcement of a bid for the company by Harold Simmons, a Dallas investor. The court held that the flip-in provision resulted in an impermissible discrimination between shareholders of the same class, in violation of the corporation law of New Jersey, NL’s state of incorporation, because the plan provided that a bidder whose purchases triggered activation of the pill could not exercise any rights attached to its own shares. The same conclusion had been reached last year with respect to flip-in pills adopted by Asarco and AMF, also New Jersey corporations, although the law in other jurisdictions may compel a different result.

Significantly, in the NL case, the court was faced with a situation where the pill had been activated and the rights, though not yet distributed to shareholders, were unredeemable. The court was especially concerned with the fact that the triggering of the pill was irreversible and had the effect of preventing all future tender offers. The court observed that if the “board of directors instead of adopting a rights plan had adopted a rule that no tender offers would be permitted it would clearly be beyond their power.”

The poison pill is only just beginning to be tested in the courts. How­

ever, these early decisions suggest that courts will view with great skepticism pills that are adopted hastily to block a specific offer or which have the effect of closing off the market for corporate control altogether.

Lock-ups and No-Shops

Lock-ups and no-shop provisions are devices which, like the pill, can also severely impede the market for corporate control. A lock-up usually takes the form of an option granted to a friendly acquirer, or “white knight,” to buy stock or a valuable asset of the target in the event that another bidder emerges. No-shop provisions usually appear in merger agreements and provide that the target will deal only with the white knight. Depending on the circumstances in which they are granted, lock-ups and no-shops can be used as inducements to attract additional bidders into the market for corporate control, or to restrict the bidding and limit the market to a single acquirer. In three cases within the past year, courts have taken a dim view of the latter result.

In two cases which, paradoxically, rely on each other (due to the fast-moving nature of tender-offer litigation), a bench opinion from one court may be relied on by another court, whose opinion is then used to reinforce the written opinion of the first court when it is later issued) the Delaware Supreme Court and the Second Circuit voided lock-up options granted by Revlon and SCM respectively. Both cases involved bidding contests between hostile tender offerers and white knight bidders favored by management. In each case, after several rounds of bidding, management rewarded the white knight bidder with an option to purchase valuable assets of the target in the event that the disfavored bidder prevailed. These options effectively ended the bidding, because neither hostile bidder was prepared to take over a target that would immediately be stripped of its most highly prized assets. Yet in each case, the option was granted in return for an offer that represented only a marginal improvement over the hostile offerer’s previous bid, and in each case the hostile offerer had indicated that it might go higher.

Both courts found that management had breached its fiduciary duty to shareholders. And both concluded that while a target’s management is not obligated to put the corporation on the auction block, once it determined to do so it must seek to maximize values for shareholders and may not take steps that limit or freeze the market.

The same result was reached in the recent battle for control of Fruehauf Corporation. There, management responded to an unfriendly offer by Asher Edelman by approving a leveraged buyout bid sponsored by Merrill Lynch in which senior Fruehauf executives were participants. The Fruehauf board agreed to a no-shop provision in the merger agreement with the LBO bidder and also agreed to pay Merrill Lynch’s financing and advisory fees—some $30 million. Moreover, the board refused to give Edelman equal access to Fruehauf’s financial records to assist him in considering whether to increase his bid. A federal district court in Detroit enjoined consummation of the Merrill Lynch offer and reopened the bidding, holding that bidding contests must be played out “on an even and illuminated playing field.” The Sixth Circuit affirmed.

Conclusion

These recent decisions regarding defensive tactics are in line with those involving the Williams Act, and indeed, with the purpose of the Williams Act. They reflect a recognition that the market for corporate control works best when it is well-informed and liquid, and suggest that interference with either the free flow of information or the market’s liquidity will not be tolerated. If this trend in court decisions continues, the market for corporate control will continue to grow, resulting in enhanced value for shareholders and increased efficiency in the transfer and use of corporate assets.


"Edelman v. Fruehauf Corp., supra note 2."