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UNPROFITABLE MERGERS: TOWARD A MARKET-BASED LEGAL RESPONSE

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The reams of commentary on corporate mergers, acquisitions, and tender offers have focused largely on protection of shareholders of acquired (or target) companies from both the depredations of acquiring (or raider) companies and the cupidity of their own managements in either negotiating the terms or obstructing the accomplishment of transactions. Virtually no attention has been paid to the plight of shareholders of acquiring companies devastated by unwise acquisitions. This oversight is surprising: some acquisitions have been spectacular disasters, destroying hundreds of millions of dollars in the value of the acquiring company's stock.[1] Nor are these isolated cases: on average, acquisitions produce little or no gain for acquiring companies.[2] A few commentators have recommended eradicating unprofitable acquisitions by requiring approval of the acquirer's shareholders, altering the accounting treatment of mergers, or enjoining conglomerate mergers. Close analysis shows that these proposals would not solve the problem. This Article proposes instead a response based on the most reliable index of the profitability of an acquisition—the reaction of the acquirer's stock price.

Part I of this Article will describe and explain the problem of unprofitable acquisitions.[3] Part II will show that prior proposals cannot solve the problem and would create new problems of their own.[4] Part III

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1 *See infra* text accompanying notes 6, 7 & 23.

2 *See infra* text accompanying note 8.

3 *See infra* text accompanying notes 6-41.

4 *See infra* text accompanying notes 42-95.

will propose a solution to the problem and answer possible objections.[5]

I. UNPROFITABLE ACQUISITIONS, THEIR CAUSES, AND THE LAW'S CURRENT RESPONSE

A. *The Problem of Unprofitable Acquisitions*

Corporate acquisitions often send the market value of the acquiring company's stock plummeting. The losses can be dramatic. When DuPont acquired Conoco, the market value of its stock sank $789 million, a 9.9% decrease.[6] Chesebrough-Ponds, Internorth, and Allied also suffered sharp losses when they announced their respective acquisitions of Stauffer Chemical, Houston Natural Gas, and Signal.[7] Although such astonishing declines are atypical, acquisitions generally are no blessing for the acquired company's shareholders. Some studies have found, on average, slight gains from acquisitions, but other studies have found that, on average, acquiring companies suffer losses,[8] and even the more opti-

5 *See infra* text accompanying notes 96-149.

6 Ruback, *The Conoco Takeover and Stockholder Returns*, SLOAN MGMT. REV., Winter 1982, at 17, 19, 21. *See* Wall St. J., Oct. 11, 1978, at 47, col. 3 (upon announcement of acquisition, value of acquirer's stock fell 7%).

7 Chesebrough-Ponds' stock fell over 10%, a loss in value of about $135 million, upon announcement of its acquisition of Stauffer. Cole, *$1.25 Billion Is Bid for Stauffer*, N.Y. Times, Feb. 20, 1985, at Dl, col. 3. Rumors alone of Internorth's acquisition of Houston Natural Gas caused Internorth's stock to fall 3%. Cole, *Houston Natural Bid Seen*, N.Y. Times, May 2, 1985, at Dl, col. 6; *see also infra* note 23. When the merger agreement was announced, Internorth's stock fell further, for a two-day decline of 10%—a net loss of over $250 million. Cole, *Gas Pipeline Giants Agree to a Merger*, N.Y. Times, May 3, 1985, at Dl, col. 5. On the day it was announced that Allied would acquire Signal Companies, Allied's stock dropped nearly 10%, a total market loss of over $350 million. Cole, *$5 Billion Allied Deal for Signal*, N.Y. Times, May 16, 1985, at Dl, col. 6. Ironically, "[i]n trading after the exchange closed, Allied bounced back to $42, down only $1.875, after it said that it was no longer interested in bidding for Hughes [Aircraft Company]." *Id.* In other words, Allied offset some of its losses from the Signal acquisition by stating that it would not make another acquisition, which presumably would also have been unprofitable. *See also* Crudele, *Rorer Buys Drug Unit of Revlon*, N.Y. Times, Nov. 30, 1985, at 29, col. 1 (Rorer's stock fell 8% upon agreement to purchase Revlon's prescription drug unit); Fabrikant, *Lorimar in Accord to Merge*, N.Y. Times, Oct. 8, 1985, at Dl, col. 4 (Telepictures' stock fell nearly 10% on agreement to acquire Lorimar).

8 Some studies find net gains to acquirers. One study, for example, found that bidders' stock price gained on average 3.8%. Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 11, 16-17 (1983); *see also* Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345 (1980). Some studies have concluded that any profits from acquisitions are insufficient to justify their transaction costs. *See* Dodd & Ruback, *Tender Offers and Stockholder Returns: An Empirical Analysis*, 5 J. FIN. ECON. 351 (1977); Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. FIN. ECON. 303 (1974). Other studies find net losses to bidders. *See, e.g.*, R. BREALEY, SECURITY PRICES IN A COMPETITIVE MARKET 54-55 (1971); Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105 (1980). Finally, some studies find that losses to acquiring companies are so large as to equal gains to targets. *See, e.g.*, Firth, *Takeovers, Shareholder Returns, and the Theory of the Firm*, 94 Q. J. ECON. 235 (1980) (reviewing British data); Malatesta, *The Wealth Effects of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155, 178 (1983); Osborne, *Returns to Shareholders of Acquiring and Acquired Companies: The Case of Acquisitions of Technology-Based*

mistic studies do not deny that many acquisitions depreciate the bidder's stock. Further, all the studies may understate investor losses from acquisitions because they measure only gains or losses to common stock. A major acquisition financed with debt or retained earnings can also devastate holders of senior securities, who suddenly find the purchaser's cushion of equity in relation to its debt drastically depleted.[9]

Despite these frequent losses, one might deny that any problem exists. Professors Easterbrook and Fischel have argued that corporate managers should strive to maximize returns to investors generally, rather than to their own shareholders.[10] Accepting this argument might mean encouraging mergers, even if the purchaser's shareholders suffer losses, so long as investors as a whole still profit because the gains to shareholders of the acquired company exceed the losses to shareholders of the purchaser. This arguably is desirable not only because it increases total wealth but also because individual shareholders can avoid the risk of loss by holding diversified portfolios.[11] As applied to unprofitable acquisitions, the argument has serious flaws; it is not even clear that Easterbrook and Fischel would apply it here.[12] Some studies find that, on average, losses to acquiring-company shareholders at least equal gains to acquired-company shareholders.[13] Even if these studies are wrong, in many cases losses do exceed gains.[14] Moreover, many shareholders are not diversified. The law traditionally has not disregarded their interests, and it is questionable whether it should. It is especially troubling that Easterbrook and Fischel would deem corporate managers to owe fiduciary allegiance not to their own shareholders, but to the market generally. Would this not include the corporation's own bondholders, who often suffer from acquisitions? Would they require managers to sell the company's securities at the lowest possible price rather than the highest? As Professor Coffee has pointed out, it is hard to differentiate a duty to the

Firms in the Over-the-Counter Market (SEC Capital Market Working Paper No. 3 1980); *see also* Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1160 n.31 (1984) (citing authorities finding that acquirers incur net losses). Although many of these studies focus on the immediate market reaction as shown in the acquirer's price, there is no evidence that these reactions are biased—that is, there is no evidence of a general later rebound in acquirers' stock prices. *See infra* text accompanying note 115.

9 *See* Prokesch, *Merger Wave: How Stocks and Bonds Fare*, N.Y. Times, Jan. 7, 1986, at A1 (bondholders of both acquiring and acquired companies "are often big losers").

10 Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 708-15 (1982).

11 *Id.* at 714.

12 Professor Coffee assumes that they do. *See* Coffee, *supra* note 8, at 1216-21. Easterbrook and Fischel, however, do not actually apply their "fiduciary principle" to unprofitable mergers. Indeed, one of their conditions to application of this principle is that all "parties to the transaction be at least as well off as before the transaction." Easterbrook & Fischel, *supra* note 10, at 698. This condition obviously is not met when the acquirer's stock price declines.

13 *See supra* note 8.

14 Coffee, *supra* note 8, at 1168 n.56 and authorities cited therein.

market in takeover situations from a duty to the public generally, and many investors may rationally decline to diversify their portfolios fully.[15]

There is also a more fundamental flaw in applying the Easterbrook-Fischel thesis to the present problem. Barring an acquisition in which losses to the purchaser are exceeded by gains to the acquired company does not mean that the net gains necessarily are lost. The acquisition also might be made at a profit by the same acquirer at a lower price or by another bidder who can profit more from the target's assets. Indeed, eliminating mergers that are unprofitable to the purchaser will help ensure that the target's assets go to the purchaser who can use them best.[16] Moreover, ending unprofitable acquisitions would reduce the risk of stock ownership, which is desirable.[17]

Another possible objection to considering unprofitable acquisitions a problem is that declines in the acquirer's share price do not prove that the acquisition is detrimental. But theories of market behavior, especially the efficient market hypothesis, suggest that stock market prices are the best evidence of changes in a company's value.[18]

B. *The Causes of Unprofitable Acquisitions*

If unprofitable acquisitions resulted from mere mistakes of judgment, perhaps the law could tolerate them as it does other mistakes of business judgment.[19] Unrewarding acquisitions are too common to admit of such an explanation, however. Also, managers of acquiring companies often persist in completing an acquisition even though the market

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[15] Coffee, *supra* note 8, at 1174, 1216-21. Even a rational investor may not have a fully diversified stock portfolio because of the transaction costs of full diversification and because the rational investor seeks a diversified investment portfolio of which stocks are only one element and may be used to balance other elements. *See id.* at 1218 n.223.

[16] Consider this hypothetical: *A* Corp. has determined that it could realize gains by purchasing all the stock of *C* Corp. at up to $28 per share. *B* Corp. could realize gains by purchasing *C* at up to $30 per share. *B* has bid $29 per share. I submit that there is no good reason to permit *A* to bid $30 per share. At that price the transaction would be unprofitable for *A*. Indeed, as to the market generally, this transaction would be inferior because the additional $1 gain per share to *C*'s shareholders would be outweighed by the $2 loss per share to *A*. Prohibiting an unprofitable purchase by *A* helps to ensure the takeover with the larger synergistic gains, the takeover by *B*.

[17] The danger of losses from acquisitions increases the risk of an investment in the acquiring company. Even if these losses are offset by corresponding gains to target shareholders (which is not necessarily a valid assumption, *see* Malatesta, *supra* note 8, at 178), they complicate the risk-averse investor's goal of eliminating firm-specific risks. Most investors are risk averse and therefore acquire portfolios of investments that balance the risks of individual investments. V. BRUDNEY & M. CHIRELSTEIN, CASES & MATERIALS ON CORPORATE FINANCE 1146, 1152-53 (2d ed. 1979); J. WESTON & E. BRIGHAM, MANAGERIAL FINANCE 318-19 (5th ed. 1975). By increasing the risks of loss in individual stocks, unprofitable mergers complicate this effort to minimize the total risk to a portfolio.

[18] *See infra* text accompanying notes 109-18.

[19] The doctrine of judicial noninterference with managerial discretion is called the business judgment rule. This is the basis on which courts have refused to interfere with unprofitable acquisitions. *See infra* text accompanying notes 37-39.

already has disapproved it by knocking down the price of the acquirer's shares.

If unprofitable mergers cannot be dismissed as occasional errors of judgment, what does explain them? Corporate managers may seek growth of firm size rather than maximization of share price in order to justify better compensation and perquisites, to increase prestige, to expand opportunities for promotion, and, perhaps most importantly, to protect themselves from the discipline of the market.[20] In short, they often engage in empire building. Market restraints on management's discretion cannot prevent this. The threat of hostile tender offers sometimes limits managerial discretion.[21] Growth through acquisition, however, diminishes this threat by making any takeover more expensive and complicated and increasing the probabilities of antitrust or other regulatory obstacles to a potential raider.[22] Indeed, lawyers often recommend that corporations fearing a takeover fortify themselves by acquisitions that create such difficulties, either to defeat an existing tender offer or to discourage potential raiders from making an offer.[23] An acquisition also

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20 *See Coffee, supra* note 8, at 1157 n.24, 1167-69, 1222-34; Marris & Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LIT. 32, 36-37, 42, 46 (1980); Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1243-44 (1979); *Do Mergers Really Work?*, BUS. WK., June 3, 1985, at 88, 89 (executive ego is one reason for mergers). These works, which expressly discuss the motives for mergers, are but a small part of a broader literature arguing that managers generally strive to maximize growth rather than profits. *See* W. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH 96 (rev. ed. 1967); J. GALBRAITH, THE NEW INDUSTRIAL STATE 171-77 (2d ed. 1971); R. MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM 101-07 (1964). This literature shows, for example, that executive salaries are more closely related to firm size than to profits. Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 313 (1985).

21 The seminal work is Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

22 *See* Coffee, *supra* note 8, at 1167 n.51; Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities—An Update*, 40 BUS. LAW. 1403, 1421-22 (1985). The greater expense and complexity tends to discourage takeover attempts through proxy fights as well as tender offers.

23 A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING 36 (1978); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 305 (1983); *see* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). The court there noted that Joseph Flom, a prominent takeover lawyer, had advised Marshall Field to make acquisitions as "a legal way of coping with unfriendly takeover attempts," *id.* at 278; that this would make Field "too large to be acquired" or create antitrust impediments for any other major retailer, *id.* at 305 (Cudahy, J., dissenting); that this advice was followed by making acquisitions that would create antitrust problems for interested bidders, *id.* at 278; *accord id.* at 305-06 (Cudahy, J., dissenting); and that this was done in connection with the takeover attempt at issue in *Panter*, *id.* at 280-81; *accord id.* at 306-10 (Cudahy, J., dissenting).

Even when a company has not been made the target of a tender offer, the financial press sometimes perceives that the company has made an acquisition to discourage raiders. Thus, when Chesebrough-Ponds agreed to acquire Stauffer Chemical, and Chesebrough's stock fell over 10% in one day, analysts said that the acquisition was "a transparent attempt by Chesebrough to protect itself from being taken over." Cuff, *Cosmetics Maker Diversifies Again*, N.Y. Times, Feb. 20, 1985, at Dl, col. 5. One analyst said Chesebrough's chairman was " 'looking for a self-protection device, . . . for a can divest a company of cash that attracts raiders and replace the cash with debt that repels raiders.[24] Thus, even unprofitable acquisitions can enhance the compensation, perquisites, and promotion opportunities of the acquiring company's management and also deter takeovers. In short, acquisitions can eviscerate the principal restraint on self-serving behavior by management: the operation of market forces through tender offers. This confutes claims that the market will discipline managements that make unwise acquisitions.[25]

Nor can the need to raise new capital restrain unwise acquisitions. Managements need not worry that their self-serving behavior will impair the price at which they can sell their stock because most publicly traded companies rarely issue new stock.[26] When they do publicly issue stock, they need not care about reducing the price they can obtain because most of the loss from the reduced price falls on existing shareholders, not management.[27] Moreover, even if management felt compelled to limit its own discretion, it would be hard to draft a prohibition on unwise acquisitions and inefficient to require each company to do so individually.[28]

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way to be unappealing to corporate sharks.' " Cole, *$1.25 Billion is Bid for Stauffer*, *supra* note 7, at D6, col. 6 (quoting Jack L. Salzman of Smith, Barney, Harris Upham & Co.). This is not unique: "companies are sometimes led to doing perverse things to avoid rape. They may overpay for an acquisition in order to make themselves less sexy to potential rapists." Sloan, *Why Is No One Safe?*, FORBES, Mar. 11, 1985, at 134, 137.

24 Lowenstein, *supra* note 23, at 305. Analysts speculated that "the main motivation for [Chesebrough-Pond's acquisition of Stauffer Chemical] is to discourage takeover attempts by assuming a heavy debt load that no potential raider would want." Cuff, *supra* note 23, at D6, col. 5. Although an acquisition with stock does not divest the acquirer of cash, it not only increases the number of shares that a raider must acquire to gain control but may also place a substantial block of the acquirer's stock in the hands of the former principal shareholders of the acquired company. The latter may be offered representation on the acquiring company's board or, if they are former officers of the acquired company, offered positions with the acquiring company. They then tend to identify with incumbent management and to become allies if a takeover bid occurs.

25 *See* Easterbrook & Fischel, *supra* note 10, at 707; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1185 (1981) [hereinafter Easterbrook & Fischel, *Proper Role*].

26 *See* Myers, *The Capital Structure Puzzle*, 39 J. FIN. 575, 581-82 (1984). Companies prefer retained earnings as the source of funds for growth. If external financing is necessary, debt is preferred to equity; net new stock issues provided at most 6% of financing for nonfinancial corporations in 1973-1982. *Id.*

27 Managers will suffer from declining share prices to the extent that they are shareholders. But managers of large public companies often own only a tiny fraction of the outstanding shares, so that the effect of a decline is insignificant. Moreover, even if their loss is substantial, managers prefer it to the much more serious risk of displacement in a hostile tender offer.

28 The very enforceability of such an internal rule would be doubtful both because of its uniqueness and because of limitations on the doctrine of ultra vires. *See* H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 184 (3d ed. 1983). In trying to draft such a limitation, managements would face the same problem as commentators who have sought to impose a limit by law. The only effective, appropriate test would be that proposed by this Article—a bar on acquisitions that cause the acquirer's stock price to decline. *See infra* text accompanying notes 96-108. If this is the ideal solution, why not make it a standard term of all equity investment contracts—that is, impose it by law?

Managers also may pursue acquisitions in order to diversify their companies, and thereby reduce the risk of wide fluctuations in compensation based on the corporation's earnings in a single industry.[29] Although diversification undoubtedly is a factor encouraging acquisitions, it probably is not a major one.[30] Moreover, there is little evidence that diversifying (or conglomerate) mergers are less profitable than other mergers.[31]

That corporate managers may prefer corporate growth for selfish reasons does not necessarily mean that in pursuing acquisitions they intend to harm shareholders. As between two takeover candidates that offer the acquirer equal growth and protection from takeovers, management has no reason to prefer the acquisition that is less profitable to its shareholders, and many reasons to prefer the more profitable.[32] Why, then, are there so many unprofitable acquisitions?

First, no profitable takeover candidate may be readily apparent. The search for takeover candidates is expensive and complicated. Companies that clearly are underpriced[33] or offer substantial opportunities for synergy[34] may already have been snapped up. Attractive candidates may reject a friendly merger and be immune to a hostile takeover. Even if one takeover candidate appears most profitable, the acquirer's management may prefer a different candidate. One candidate, for example, might hold greater promise for creating regulatory or antitrust obstacles to any subsequent takeover bid for the raider.[35] Thus, in pursuing growth and security against takeovers through merger, the acquirer's management may be unable to find a merger that is profitable to its shareholders.

C. *The Law's Response*

In evaluating unprofitable acquisitions, courts repeatedly pay lip

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29 Note, *supra* note 20, at 1241-44.

30 *See infra* text accompanying notes 84-88.

31 *See infra* note 90 and accompanying text.

32 A profitable acquisition should increase management's compensation based on earnings or share price, enhance prestige, and improve the possibility of continued corporate growth. In sum, "[e]ven the empire builder will look for transactions with substantial potential for gain." Dennis, *supra* note 20, at 338.

33 If one accepts the efficient market hypothesis—that the market rationally prices stocks on the basis of all available information—there is no such thing as an underpriced public company. Easterbrook & Fischel, *Proper Role*, *supra* note 25, at 1166-67. Some commentators question whether the hypothesis is valid, especially in terms of setting a purchace price for an entire company. *See* Lowenstein, *supra* note 23, at 274. For purposes of this Article it is unnecessary to resolve this debate. It suffices to note that the frequency of unprofitable acquisitions suggests that there is not a large, readily identifiable pool of attractive takeover candidates.

34 For present purposes, synergy means any increase in the total market value of two companies arising from their merger. Such an increase could result from an increase in market power (monopoly or monopsony), improved management, tax benefits, superior access to capital, or any other of a number of reasons. *See* Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030-32 (1982); Coffee, *supra* note 8, at 1166-67.

35 *See supra* text accompanying note 22.

service to the managers' fiduciary duty to maximize shareholder wealth, but invariably deny recovery no matter how large the shareholders' loss.[36] The response of the courts is disturbing in two respects. First, courts have analyzed each unprofitable transaction in isolation. This has made it much easier to view an unprofitable acquisition as merely an exceptional mistake than it would be if courts recognized that unprofitable acquisitions are common, perhaps even the norm rather than the exception.[37] Second, courts have treated acquisitions as involving no conflict of interest for the acquirer's managers and, accordingly, have applied the business judgment rule to such cases rather than the stricter standard that would apply to self-dealing.[38] Although formulations of the business judgment rule vary, it generally requires the plaintiff to prove bad faith or, at least, conscious disregard of the interests of shareholders by the defendants.[39] This has proved a virtually impossible burden to bear, not only with respect to unprofitable acquisitions but to any corporate decision.

Neither do the federal securities laws offer any protection. Rule 10b-5 requires proof of a misrepresentation or omission of a material fact;[40] these are rare in an acquisition. Section 14(e) of the 1934 Act prohibits fraud as well as manipulation or deception, but the Supreme Court recently held that it, too, requires proof of manipulation or deception.[41]

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[36] There is no known case in which an unprofitable acquisition has been challenged successfully. Challenges have failed for various reasons. *See, e.g.*, Muschel v. Western Union Corp., 310 A.2d 904 (Del. Ch. 1973); Lewis v. Bailey, N.Y.L.J., Nov. 19, 1985, at 14, col. 2 (Sup. Ct., King's County); Danziger v. Kennecott Copper Corp., No. 21941/77 (Sup. Ct., N.Y. County, Dec. 5, 1977), *aff'd mem.*, 60 A.D.2d 552, 400 N.Y.S.2d 724 (App. Div. 1977); *see also* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (affirming dismissal of shareholder's complaint alleging that Marshall Field made unprofitable acquisitions to fend off a tender offer); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 702-04 (2d Cir. 1980) (dismissing complaint of tender offeror alleging that target persisted in unprofitable merger in order to defeat the tender offer). Although the reported cases have denied relief, some general principles of corporate law argue for a different result, and these principles have prevailed in cases involving issues that are arguably similar. *See infra* text accompanying notes 130-36.

[37] *See supra* text accompanying notes 6-8.

[38] *See infra* note 133.

[39] *See* Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. REV. 623, 646-48 (1981).

[40] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-74 (1977). Plaintiff-shareholders would have to show that management had materially deceived the shareholders. Since shareholders of the acquiring company are not generally asked to approve an acquisition, it is not even clear whether false statements to the shareholders would be material. *But see* T. HAZEN, THE LAW OF SECURITIES REGULATION 498-99 (1985). More important, since courts will not enjoin an unprofitable acquisition under state law, shareholders rarely can stop an unprofitable acquisition. Management has little need, therefore, to mislead about the facts of the transaction.

[41] Schreiber v. Burlington N., Inc., 105 S. Ct. 2458 (1985).

II. PROPOSED SOLUTIONS

Although most discussion of takeovers has focused on the plight of shareholders of target companies, some proposals have sought to protect shareholders of acquiring companies. Further, some proposals to protect target shareholders might affect shareholders of acquirers as well. This section will analyze these proposals.

A. *Restricting Defenses Against Tender Offers*

Most commentators believe that takeovers are beneficial and that defensive maneuvers by targets should be restricted by law. Some commentators criticize specific defensive tactics, and there have been legislative moves to bar some tactics, such as "greenmail" payments.[42] Other commentators would prohibit defensive maneuvers altogether or limit them to the holding of an orderly auction.[43] Intuitively, it seems that forbidding defensive tactics might lower premiums in takeovers and thus diminish the number of unprofitable acquisitions.[44] The law cannot ban all defensive tactics, however—only those that serve solely to thwart tender offers.[45] Many actions that discourage tender offers may still serve other, legitimate business purposes; corporate acquisitions are one

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42 In September 1984, a House committee reported out a bill that would have curbed greenmail and other abuses, but the session ended before the full House could act on it. Similar efforts are continuing. *See* Fed. Sec. L. Rep. (CCH) No. 1114, at 9-10 (Feb. 27, 1985).

43 Many academic commentators have argued for permitting target managements to delay a takeover bid only long enough to conduct an orderly auction so as to maximize the premium received by target shareholders. *E.g.*, Bebchuk, *supra* note 34; Coffee, *supra* note 8; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981). Other commentators believe that auctions reduce shareholder wealth by reducing the number of takeover bids; they would prohibit all defensive tactics. *See* Easterbrook & Fischel, *Proper Role*, *supra* note 25, at 1164 & *passim*. Some commentators (often practicing lawyers) approve of virtually all defensive tactics. *See* Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979). But the rule of auctioneering seems to be supported by at least a plurality of academic commentators.

44 Indeed, Easterbrook and Fischel tout the lowering of premiums as one of the benefits of their proposal, not only because it would benefit acquiring companies, but because it would benefit shareholders of potential targets by making it more likely that their shares will be acquired at a premium. Easterbrook & Fischel, *Proper Role*, *supra* note 25, at 1174-82.

45 Although there is some room for disagreement about which tactics are intended solely to thwart tender offers, most people probably would agree that these tactics include lock-ups (the practice of giving a favored bidder, or white knight, an option to acquire stock or crucial assets of the target at a bargain price); shark repellents (charter provisions that make a takeover unattractive to a bidder by, for example, requiring an impractically high shareholder approval for any merger between the company and a person who owns a large part of the company's stock); and greenmail payments, *see supra* note 42. Whether other actions will deter unsolicited tender offers "will in many cases raise an issue of causation." American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations, Reporters' Study No. 1: Transactions in Control* 31 n.13 (Feb. 22, 1985) [hereinafter ALI]. That an action may diminish the likelihood of future tender offers "should not subject such a transaction to special treatment, and the business judgment rule should generally be applicable." *Id.* at 46.

type of such action. Sometimes a target in the heat of a takeover battle makes an acquisition obviously intended only to defeat the raider.[46] Such egregious behavior could be prohibited. But the best tender offer defense does not defeat a raider, but rather dissuades him from ever making a bid. Every acquisition, though, helps deter raids by making a company larger and more complex.[47] Therefore, acquisitions that deter tender offers could not be barred without barring all acquisitions, an obviously inappropriate step.

Stripped of other defenses to tender offers, managers might experience an eat-or-be-eaten phobia—a fear that to avoid being taken over one must make many takeovers oneself, at whatever cost, and thereby grow so large and incur so much debt as to discourage raiders.[48] Thus, banning other defenses could multiply unprofitable acquisitions. But it is most unlikely that Congress, the state legislatures, or the courts will soon ban all defenses to takeovers.

A rule that encouraged auctions could make matters even worse. Denied other defenses to takeovers, corporate managers still would desperately seek safety in growth through acquisition. But if every takeover involves an auction, the odds escalate that the winner will pay an excessive price.

These remarks are not intended to disparage proposals to limit defenses to takeovers; they might well benefit shareholders of target companies and even investors generally.[49] But these changes could at the same time exacerbate the problem of unprofitable acquisitions.

B. Requiring Approval by the Acquirer's Shareholders

Professor Coffee has recommended that the purchaser be required to obtain from its shareholders approval of any corporate acquisition above a certain size.[50] Neither state laws nor stock exchange regulations require such approval for most acquisitions.[51] At first blush, shareholder

46 *See supra* note 23.

47 *See supra* text accompanying notes 22-25.

48 Although there is debate over the extent to which size alone discourages tender offers, most commentators agree that it does have some effect. *See supra* notes 22-24. Certainly, corporate managers believe that growth helps them defend against raiders. *See supra* note 23 (analysts view Chesebrough-Ponds' acquisition of Stauffer Chemical as an attempt to protect itself from takeovers).

49 *See supra* text accompanying notes 10-15.

50 Coffee, *supra* note 8, at 1269-72; *see also id.* at 1269 n.379 and authorities cited therein.

51 Generally, no approval of the acquiring company's sharholders is required if the transaction is structured as a purchase of stock (including a tender offer) or of assets. W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 145-46 (5th ed. 1980). Such approval is required only if the transaction is structured as a statutory merger or consolidation. *Id.* at 145. Even then, approval may be unnecessary unless the acquirer will increase its outstanding stock by some specified amount in the transaction. *E.g.*, DEL. CODE ANN. tit. 8, § 251(f) (1974). Stock exchange rules require shareholder approval of any acquisition, however structured, that will increase the acquirer's outstanding stock by 20%. NEW YORK STOCK EXCHANGE COMPANY MANUAL (CCH) A-284 (Jan. 25, 1978). Even with the statutory merger, however, a shareholder vote may be avoided by

approval might seem an ideal solution to the problem: shareholders can review and reject any unprofitable acquisition. There are problems, however. First, obtaining the adoption of such requirements would be difficult. The stock exchanges are private bodies that compete with each other and with the over-the-counter market to have corporations list with them for trading. They will not readily toughen their requirements for shareholder approval of acquisitions if to do so might offend corporate managements and cause them either not to list on an exchange or to delist from it.[52] Nor are state legislatures likely to impose such a requirement. Even if there is no "race to the bottom"[53] in other respects, states still have a perverse incentive to offer corporate managements laws that help ward off tender offers, and thereby attract incorporations and the accompanying lucrative franchise fees. Although Congress does not face the same competition for franchise fees as do the states, Congress traditionally has regulated only corporate disclosure and has left substantive corporate regulation to the states.

Even if requiring shareholder approval were politically feasible, it would impose substantial costs with little benefit. The most obvious

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using a triangular merger, in which the acquired company is merged into a subsidiary of the acquiring company. W. CARY & M. EISENBERG, *supra*, at 1500.

[52] *See* Wayne, *The Big Board's Fight to Stay on Top*, N.Y. Times, Oct. 14, 1984, § 3, at 1, col. 3. Indeed, far from stiffening its listing requirements, the New York Stock Exchange (NYSE) has voted to drop its prohibition against a corporation's having multiple classes of common stock with disparate voting rights. Sterngold, *Big Board Ends Equal Vote Rule*, N.Y. Times, July 4, 1986, at D1, col. 6. It is unlikely that the NYSE would expand its current requirements for shareholder approval of acquisitions. *See supra* note 51. Professor Coffee also recommends revision of a number of stock exchange regulations and extensions of these regulations by the SEC to over-the-counter companies. *See* Coffee, *supra* note 8, at 1255-66. Although these recommendations in general are eminently sound, they are designed to curb certain defensive maneuvers by targets, not unwise acquisitions by purchasers.

[53] The late Professor William L. Cary created the term "race to the bottom" to describe competition among the states to attract corporate franchise fees by offering corporation laws that benefitted managements by watering shareholder rights down "to a thin gruel." Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666, 705 (1974). He did not originate the idea, however. Justice Brandeis said that "[t]he race was one not of diligence but of laxity." Louis K. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting). Others have questioned whether such a race exists. They argue that if a state eliminated rights investors take seriously, it would become too risky to own stocks of companies incorporated there, and the value of such stocks would fall to a level unacceptable to managements. They point out, for example, that the share prices of companies do not fall when they reincorporate in Delaware. *See* Lorie, *An Economist's Perception I: A View on the Need to Revise Corporation Statutes*, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 51, 57 (D. Schwartz ed. 1979); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256-58 (1977); *see also* Dent, *supra* note 39, at 651 n.154.

A drop in share price can lead to displacement of management only through a tender offer (or a proxy fight, but this is rarely attempted by anyone who does not already control a large block of stock). Since even unprofitable acquisitions help immunize managements from takeovers, *see supra* text accompanying notes 20-25, managers and states seeking corporation franchise fees may have an incentive to encourage acquisitions despite possible damage to corporate share prices.

costs involve preparing and distributing a proxy statement and tabulating the responses. Litigation attacking proxy disclosures would occur frequently and often might require resolicitation, especially because of unfortunate Supreme Court precedent.[54] By increasing the already considerable costs of consummating acquisitions, the requirement would tend to discourage acquisitions generally, both profitable and unprofitable.

Moreover, the delays from soliciting shareholder approval could defeat even a profitable acquisition. During the wait the target might be acquired by another company. Privately owned companies, not needing to solicit proxies, would have an unfair advantage in competing with public companies. In a friendly acquisition, events during the delay might prompt the target to withdraw. In a hostile takeover bid, the target would use the delay to obstruct the acquisition.[55]

A requirement of shareholder approval for substantial acquisitions also would encounter serious drafting problems. Defining the acquisitions to be covered would be difficult. Presumably, it would be done in terms of the dollar amount of the acquisition relative to the dollar size of the acquirer. Drawing these lines would be tricky;[56] managers would seek acquisitions just below the cutoff line. Although such line-drawing is necessary, it is bound to be inexact in distinguishing mergers that may be highly damaging because the impact of an acquisition does not depend solely on its size. Also, many takeover bids result in bidding wars. Would shareholders have to approve each new bid? If so, the whole process could become hopelessly bogged down. If not, approval might become meaningless—it is impossible to gauge the profitability of an acquisition without knowing the price offered. Professor Coffee suggests

54 *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381-85 (1970) (holding that proxy solicitation concerning a merger violates proxy rules even though transaction is fair); *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (holding that an omitted fact is material if it "would have assumed actual significance in the deliberations of the reasonable shareholder" even if it would not "have caused [him] to change his vote"). Thus, at least in theory, a vote may be overturned even for a defect that did not affect the outcome of the shareholder vote. Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

55 Even a prohibition on defenses against tender offers could not catch all defensive maneuvers. *See supra* text accompanying notes 45-46. Professor Coffee argues that the delay required to obtain shareholder approval "would not need to be extensive," and that the offer could "be commenced prior to the shareholder vote and made conditional on shareholder approval." Coffee, *supra* note 8, at 1271. The delay would be at least a few weeks, however—a long time during a takeover contest; and if shareholder approval were doubtful, the target's shareholders would hesitate to tender if a rival bidder had no such condition to his bid.

56 Hybrid transactions would further complicate the line-drawing. Consider, for example, a tender offer for 51% of the target's stock that probably will be followed by a merger to take out the remaining shareholders of the target. Should the size of this transaction be computed by reference to the first-step tender offer only, or to both steps? Does the answer depend on the likelihood that the second step will occur? Also, how should assumption of the target's debts be treated? Such assumption reduces the price the acquirer pays, but may actually increase the risk of the acquisition to the acquirer.

that shareholder approval could incorporate authority to increase the offer in response to any counterbid.[57] As he recognizes, however, shareholder ratification of one bid does not imply ratification of a higher bid, and most initial bids do not succeed.[58] Shareholders would then be forced to choose between rejecting an attractive transaction, or approving it with the knowledge that they may also be authorizing a different and possibly unprofitable transaction.[59]

Even if the drafting problems could be surmounted, the benefits of requiring shareholder approval would be slim. Rarely would a proxy fight erupt; even a large shareholder outraged by a proposed transaction seldom can afford the high cost of waging a proxy fight,[60] especially since even free-spending insurgents rarely defeat management. Shareholders generally have an attitude of "rational apathy";[61] it is easier for the disgruntled shareholder to follow the Wall Street rule and sell his stock than to study proxy issues carefully and possibly wage proxy war on management. Thus, shareholders generally will receive only management's proxy statement, which will of course enthusiastically support the proposed transaction. Although the federal proxy rules require full, accurate disclosure,[62] management's support will, absent organized opposition, almost invariably assure shareholder approval.[63] Shareholder approval is, therefore, unlikely to prevent many unprofitable mergers. Indeed, requiring shareholder approval may have a perverse effect. Courts often treat shareholder approval as placing or increasing the burden on the plaintiff to prove that corporate managers breached a fiduciary duty.[64] Thus, shareholder approval actually could facilitate unwise

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57 Coffee, *supra* note 8, at 1270-71.

58 *Id.* at 1270 & n.383.

59 Shareholder approval could be bifurcated to cover separately the original deal and an increase to meet a counterbid. Not only would this be confusing to shareholders, but seeking approval without disclosure of the terms of the increase would be unfair. It is undesirable to give legal effect to such approval.

60 *See* Gilson, *supra* note 43, at 843.

61 Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 779 (1979) (citing A. DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 265 (1957)). Professors Easterbrook and Fischel have explained the economics of this phenomenon. Since no shareholder owns 100% of the shares, none has an incentive to invest in information up to the full amount of the possible gains to the corporation from such investment. Indeed, "each voter's optimal investment in information is zero if each is sure that the election will come out the same way whether or not he participates." Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 402 (1983); *see also* Clark, *supra*, at 779-83. Institutional shareholders also may be pressured to support harmful changes "to maintain a working relationship with incumbent management." DeAngelo & Rice, *Antitakeover Charter Amendments*, 11 J. FIN. ECON. 329, 334 (1983); *see also* Pickens, *Second-Class Stock Impairs Market*, Wall St. J., Feb. 13, 1986, at 26, col. 1.

62 SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1984).

63 It is extremely unusual for shareholders to reject a management proposal when there is no formal, organized opposition to it. Although instances may exist, the author does not know of any.

64 *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) (minority shareholder approval shifts burden to plaintiff to prove unfairness of freezeout transaction).

acquisitions.

C. *Accounting Rules*

Professor Coffee also proposes changes in accounting rules so as to discourage "those acquisitions most likely to be growth maximizing [rather than] those in which the bidder is truly acquiring a troubled firm."[65] He would require faster amortization of the goodwill recorded when a bidder acquires a company for more than the fair market value of its assets.[66] Faster amortization of goodwill would reduce reported earnings (but not taxes), which would discourage acquisitions involving substantial goodwill. Coffee posits that goodwill more likely "will arise in significant amounts in those acquisitions in which an excessive premium is paid."[67] The change would not discourage the acquisition of troubled companies, "the context where the takeover performs its most socially desirable role."[68]

The accounting profession is unlikely to adopt this change voluntarily, and the SEC has been reluctant to revise major accounting rules.[69] Even though the change, if made, would be somewhat beneficial, it would be a blunt and rather ineffective instrument for deterring unprofitable acquisitions. First, although substantial goodwill may be recorded more often in unprofitable mergers, there is no evidence that the correlation is perfect or even very strong. Goodwill is recorded when the purchase price exceeds the fair market value of the assets acquired (as determined by the purchaser). Although this generally occurs when the acquired company is profitable, such acquisitions are not necessarily made at excessive premiums. Nor are acquisitions of troubled companies more likely to be profitable to the purchaser and therefore to be encouraged. Mergers profit the buyer when the value it gains exceeds the price paid. One way to profit is to acquire a poorly managed company and improve it. In many cases, however, the damage done by poor management may be irreversible.[70] In such cases, the acquisition may be detrimental even though it does not give rise to goodwill. On the other hand, even the acquisition of a successful company at a substantial premium over the fair market value of its assets may profit the purchaser because of economies of scale, easier access to capital, or other factors.[71] In this case, the

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65 Coffee, *supra* note 8, at 1272.

66 *Id.* at 1273-80.

67 *Id.* at 1273.

68 *Id.* at 1275.

69 Congressman John Dingell has suggested that the SEC has delegated too much oversight authority to the accounting profession. He has held hearings at which witnesses have criticized the Commission on this score. 17 Sec. Reg. & L. Rep. (BNA) 346 (Feb. 22, 1985).

70 Coffee, *supra* note 8, at 1201 & n.164; Lowenstein, *supra* note 23, at 305 n.223.

71 For example, Monsanto's stock rose slightly on the announcement of its proposed acquisition of Searle, even though the purchase was proposed to be at a substantial premium and Searle was a successful company. Greenhouse, *Monsanto to Acquire G.D. Searle*, N.Y. Times, July 19, 1985, Dl,

acquisition may involve recording considerable goodwill, but should not be discouraged. In short, requiring faster write-off of goodwill is a blunt instrument for deterring unprofitable acquisitions.

It also would be rather ineffective. If management cares about reported earnings, it might circumvent the proposed change by increasing the write-up of assets of the acquired company, and thereby reduce the goodwill recorded;[72] in fact, the opportunity to write-up assets is an important incentive to undertake acquisitions.[73] More important, the proposed change will not affect share prices of acquiring companies. Amortization of goodwill does not affect a company's cash flow, taxes, operating earnings, or anything else except certain financial reports. Accounting changes that do not influence actual financial performance do not affect share price.[74] The proposed change might affect management only by reducing compensation tied to reported earnings. Even if this effect is material, it can be avoided by shifting to compensation based on other determinants (such as share price) or simply by eliminating write-off of goodwill from computation of earnings-based compensation. The impact of the accounting change on management would then be virtually nil.[75]

D. *Prohibiting Diversifying Acquisitions*

It has been proposed that the problem of excessive premiums can be solved by prohibiting diversifying acquisitions.[76] The argument is that

col. 6, at D4, col. 2. In a more striking case, Philip Morris acquired General Foods, clearly a successful company, for $5.8 billion and recorded $2.8 billion of this as goodwill. Blatant empire building or self-serving diversification? The market thought not: Philip Morris rose over 2.5% in the two days following the announcement of the deals. *What's Inevitable and Worth $55 Billion?*, BUS. WK., Oct. 14, 1985, at 132.

72 When assets are acquired for more than their book value, the purchaser writes up their value on his books to their fair market value as determined by him pursuant to generally accepted accounting principles. *See* Coffee, *supra* note 8, at 1273. Professor Coffee recognizes that this gives the purchaser wide discretion, but he believes that in cases involving large premiums substantial goodwill will remain. *Id.* at 1273-74. Professor Lowenstein, however, reports that in the management buyout of Fred Mayer, Inc., for $420 million cash, there was a considerable write-up of assets—inventory alone was increased by $46 million—but no more than $9 million of the purchase price was allocated to goodwill or other intangible assets that could not be amortized for tax purposes. Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 746 (1985).

73 Depreciation is charged against earnings. Writing up the book value of assets increases the amount of depreciation that may be taken, without reducing cash flow. Thus, by an accounting convention an acquirer can reduce the income taxes incurred by the acquired company. *See* Lowenstein, *supra* note 72, at 759-60.

74 G. FOSTER, FINANCIAL STATEMENT ANALYSIS (1978); P. GRIFFIN, USEFULNESS TO INVESTORS AND CREDITORS OF INFORMATION PROVIDED BY FINANCIAL REPORTING: A REVIEW OF EMPIRICAL ACCOUNTING RESEARCH (1982); *see infra* note 148.

75 To the extent that there still would be some impact on management's compensation, it often would be unfair because an acquisition giving rise to substantial goodwill is not necessarily bad for the purchaser. *See supra* text accompanying notes 69-71.

76 Note, *supra* note 20, at 1253.

managers try to reduce the risk to their compensation from fluctuating corporate earnings by making acquisitions that diversify their companies and thereby reduce earnings fluctuations.[77] Diversifying or conglomerate mergers, however, rarely produce synergies and are generally disadvantageous for the buyer.[78] Therefore, "all mergers that provide no benefit other than diversification" would be prohibited; only "synergistic combinations of unrelated businesses" would be permitted.[79] As to the latter, management would have to persuade a court that the benefits of the merger justify its cost.[80] The net effect "would be to make mergers very difficult to achieve."[81]

Although there is much to be said for this approach, it has two serious problems. First, it exaggerates the significance of diversification both as the motive for mergers and as the root evil of unprofitable acquisitions. Although reducing risk through diversification is one reason for mergers, it is not the only reason or even a very important one. To reduce risk substantially through diversification would require many more acquisitions than even large public companies generally could hope to make; one or two acquisitions produce little reduction in risk.[82] Further, the influence of earnings fluctuations in an industry on managers' compensation can be reduced by tying compensation to share price or other determinants, rather than to earnings.[83]

Moreover, countervailing factors favor acquiring a company in the same or related fields. The acquirer will better understand such companies and thus feel more confident of making an intelligent acquisition and running the acquired company. The opportunities for synergy may be

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77 *Id.* at 1241-44.

78 *Id.* at 1244-47.

79 *Id.* at 1253.

80 *Id.* at 1252-53.

81 *Id.* at 1253.

82 [I]nstitutional investors such as mutual funds often maintain over 100 different stocks in their portfolios, as well as a variety of corporate and government bonds. Some financial writers have estimated that diversification beyond 15 or 20 securities cannot reduce risk by a meaningful amount, and that the quality of the diversification, i.e., the degree of interrelatedness among the securities selected, is significantly more important than the quantity.

V. BRUDNEY & M. CHIRELSTEIN, *supra* note 17, at 1154. No company can hope to acquire 15 or 20 companies of its own size even over several years. Moreover, unlike the passive investor, who can select 15 or 20 stocks primarily to diversify his portfolio, an acquisitive company's management must consider many other factors, such as the availability of companies to be acquired and whether the nature of the acquired company's business is such that the acquiring company can manage it without disaster. Thus, it is most unlikely that even a conglomerate merger, however defined, *see infra* text accompanying note 88, will be optimal for diversification.

83 If the securities markets are truly efficient, *see infra* notes 109-17, fluctuations in corporate earnings due to unavoidable but temporary vicissitudes will be recognized as such and have little effect on the corporation's share price. It has become quite common to tie part of managers' compensation to share price. *See* W. CARY & M. EISENBERG, *supra* note 51, at 647-50 (discussion of stock appreciation rights and stock options). Compensation also could be tied to the corporation's performance as compared with other firms in the industry, and thereby further reduce the impact of industry fluctuations.

greater for companies in the same or related fields.[84] Thus, many mergers, if not most, are of companies in the same or related fields.[85] A more important reason for acquisitions than diversification is empire building, to increase prestige and perquisites and ward off raiders.[86] It is unnecessary for these purposes that a merger be conglomerate. Indeed, the very concept of a diversifying or conglomerate merger would be hard to define precisely enough to determine whether many mergers were within the definition.[87] Any reasonable definition of diversifying mergers would exclude many mergers that actually have occurred,[88] however, which further shows that diversification is not a primary motive for mergers.

Furthermore, not all conglomerate mergers (however defined) are unprofitable for buyers; nor are all nonconglomerate mergers profitable.[89] A conglomerate merger may produce better management and reduce the cost of capital and the risk of bankruptcy.[90] To winnow the

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84 Coffee, *supra* note 8, at 1213-14. Coffee suggests that another reason for acquiring a company in the same or related fields may be to acquire a company that can be subdivided among existing divisions of the acquirer, rather than operated as an independent division, so as to expand opportunities for promotion of incumbent executives of the acquirer. *Id.* at 1214.

85 *See id.* at 1213-15.

86 *See supra* text accompanying notes 20-25.

87 The article advancing this recommendation never attempts to define the concept except for the rather tautological statement that a conglomerate acquisition is one "in which two unrelated businesses are combined." Note, *supra* note 20, at 1245.

88 The article advancing this recommendation states that "[t]he antitrust laws substantially impede all horizontal and vertical mergers." *Id.* at 1253. This is false: the antitrust laws prohibit only mergers that threaten to reduce competition. *See* Clayton Act, § 7, 15 U.S.C. § 18 (Supp. 1984). Horizontal and vertical mergers have been facilitated by the relaxation of merger guidelines under the Reagan Administration. *See* 1982 *Department of Justice Merger Guidelines*, 47 Fed. Reg. 28,493 (1982). These guidelines afford "much greater tolerance of vertical and conglomerate mergers than was found in either the Justice Department's 1968 Merger Guidelines . . . or in the case law." Cohen & Sullivan, *The Herfindahl-Hirschman Index and the New Antitrust Merger Guidelines: Concentrating on Concentration*, 62 TEX. L. REV. 453, 456 (1983). Thus, not all mergers permitted by the antitrust laws are diversifying mergers.

Many major acquisitions are not conglomerate. Some nonconglomerate mergers are profitable. *See Do Mergers Really Work?*, BUS. WK., June 3, 1985, at 88 (successful mergers "usually involve companies in closely related businesses"). Some are not. *See infra* note 89 (Internorth-Houston Natural Gas and Rorer-Revlon).

89 Many if not most mergers are profitable for the purchaser. *See supra* note 8. Specifically, conglomerate mergers can work. *See Do Mergers Really Work?*, *supra* note 88, at 88, 90 (Sara Lee's acquisition of Hanes). Announcement of GE's agreement to acquire RCA was followed by a slight increase in GE's stock price. *See New York Stock Exchange Consolidated Trading Reports*, Dec. 11, 1985 (GE stock rose 1/4 to 67 7/8). Thus, an approach that would "make mergers very difficult to achieve," Note, *supra* note 20, at 1253, would thwart many profitable acquisitions. On the other hand, even the acquisition of a company in the same industry can be unprofitable. Disclosure of Internorth's plan to acquire Houston Natural Gas caused Internorth's stock to plummet by 10%, a loss of $250 million in Internorth's market value. Cole, *Gas Pipeline Giants Agree to a Merger*, *supra* note 7, at D1, col. 5. The stock of Rorer, a pharmaceuticals company, fell 8% on announcement of its acquisition of Revlon's prescription drug business. Crudele, *supra* note 7, at 29, 3, col. 1.

90 The last point is made by Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1060 n.161 (1981). They also note that use of retained earnings for a conglom-

good merger from the bad, some test more precise than the conglomerate/nonconglomerate dichotomy is necessary. Indeed, the proposal in question implicitly recognizes this by recommending that a court weigh the alleged benefits of a conglomerate acquisition against the costs.[91] The goal "would be to make mergers very difficult to achieve."[92] But courts could not easily weigh the arguments of managers and dissident shareholders about the benefits and detriments of a particular merger.[93] For example, how is a court to assess a claim that a merger will improve the management of the acquired company?[94] Moreover, the logistics of such an inquiry would clash with business procedures for consummating mergers. To weigh claims such as improved management would require lengthy pretrial discovery, a trial, and appeals. If mergers were routinely restrained pending final disposition, the resulting delay would itself thwart many mergers, regardless of their merits. If mergers were allowed to be consummated pending litigation, suits attacking them could seek only damages, and thereby raise all the problems that have made derivative suits for damages ineffective.[95]

Despite the criticisms of the three proposals—requiring approval of the buyer's shareholders, accounting changes, and prohibiting diversifying acquisitions—each has strengths, and any or all of them might ameliorate the current state of affairs. They might be supportable if no superior approach were available. There is, however, a superior approach.

III. A Market-Based Approach to Curbing Unprofitable Corporate Acquisitions

A. *The Proposed Approach*

A superior solution to the problem of unprofitable corporate acquisitions is surprisingly simple but not, I think, simplistic: a court should enjoin as corporate waste or a breach of fiduciary duty any acquisition the disclosure of which causes a material decline in the price of the proposed buyer's common stock.

Several details of this proposal require explication. First, what is a material decline? The answer depends in part on such factors as the price of the stock and the size of the purchaser.[96] Generally, a court

erate merger may produce tax treatment for shareholders that is preferable to the tax consequences of a distribution of earnings as dividends. *Id.*

91 Note, *supra* note 20, at 1253.

92 *Id.*

93 The author of the proposal concedes this. *See id.* at 1252.

94 The author of the proposal states that such a benefit is "unlikely to be realized in most situations." *Id.*

95 *See infra* text accompanying notes 103-04.

96 For example, a decline of half a point in the price of shares trading at $10 would be more significant than the same half-point decline in the price of shares trading at $50—5% versus 1%.

should disregard a minimal decline, not only because the decline may have been caused by factors other than disclosure of the merger, but also because such a small decline may not warrant judicial intervention. The plaintiff should bear the burden of proving a material decline in price.

Second, how can it be shown that disclosure of the proposed acquisition caused the drop in share price? Prices of actively traded stocks change constantly in response to many factors, and it is not always possible to isolate the reasons for a price change. Many extraneous factors ("noise," as economists call it) can be factored out, however, by comparing the performance of a stock to the performance of similar issues of stock during the same period.[97] The defendants should bear the burden of proving that the decline was not caused by disclosure of the acquisition both because they have better access to the relevant information and because it is reasonable to presume that the announcement of the merger caused the decline.[98]

Third, over what span of time should the change in price be measured? In most cases this will pose no problem because markets react very quickly to new information such as the announcement of a merger;[99] in such cases a few hours or at most a day will suffice. In some cases the market reaction may spread over a longer period because the market is alerted in steps, such as rumors or leaks, announcement of agreement in principle, rumors of competing offers, and final announcement. In a hostile tender offer in particular, the market's prediction of success or failure, and the corresponding reaction of share price, may evolve slowly.[100] Even in these cases, however, the final announcement of an agreement or a successful takeover usually is important news, so that courts generally should not intervene unless this announcement causes a material price drop.[101]

Also, a decline of, for example, one point would be more significant for a company with 100 million shares outstanding than for a company with one million shares outstanding; the latter would indicate a total loss in value of $1 million, while the former means a loss of $100 million. In general, courts could follow the standard of materiality adopted by the Supreme Court for disclosure under the federal securities laws: "there is a substantial likelihood that a reasonable shareholder would consider it important." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

97 *See* Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 627-30 (1985) (discussing techniques for factoring "noise" out of individual stock price movements).

98 "If all the critical information comes out at once, then the full change in price at the time of release (after taking out the market) may be attributed with reasonable assurance to the information." *Id.* at 627.

99 *See infra* text accompanying notes 109-12.

100 For example, rumors that Internorth would acquire Houston Natural Gas caused Internorth's stock to fall over 3%. Cole, *Houston Natural Bid Seen*, *supra* note 7, at Dl, col. 6.

101 One can imagine exceptions. For example, if announcement of an agreement in principle triggers a steep drop in the acquirer's share price, a court should enjoin the merger even if a final announcement did not further affect the stock price. Although the final public announcement gener-

The proposal contemplates that, with rare exceptions,[102] only injunctive relief will be granted. There are several reasons for this. First, although one usually can determine whether a merger announcement has materially reduced share price, a damage award requires the much more difficult task of measuring the decline. More important, damage awards would run headlong into some problems that have long plagued derivative suits: the possibility of indemnification and insurance reduces the deterrent threat of damages; it is difficult to prove that an individual officer or director caused, or could have prevented, the loss; liability in damages generally requires some culpability,[103] which is often hard to prove as to business decisions (for example, a defendant may claim reliance on others); and, because an award of full damages would be draconian, courts tend to nullify liability by finding ways to rule against the plaintiff.[104] Injunctions avoid all these problems.

Although only injunctive relief generally would be available under this proposal, disgruntled shareholders will have ample incentive to sue. The hope of avoiding a substantial loss in their investments may itself motivate large shareholders to sue.[105] Moreover, courts have long awarded plaintiffs attorneys' fees in successful derivative suits and share-

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ally will be a crucial event, courts may exercise their usual discretion in factfinding to consider other events.

Since this proposal provides for injunctive relief only, it is unnecessary to measure the magnitude of the decline except to determine that it is material. Could leaks provoke inside trading that would drive down the acquiring company's stock price to the point where the actual announcement of the deal would produce no further effect? Probably not. Although much inside trading is not detected, it remains illegal, and this probably is sufficient to deter most inside trading except when the gap between the current price and the expected price is quite large. Thus, inside trading probably will not eliminate that gap.

A problem also could arise if the defendants alleged that rumors and preliminary announcements about the merger caused the buyer's stock price to rise by, say, $5 per share, and that on final announcement the price fell $2 per share because the market viewed the merger as profitable, though less so than had been anticipated. In this case an injunction presumably would cause the share price to drop $3 more to the prerumor price. Defendants should be permitted to try to prove this claim, but should bear the burden of proving it.

102 In some cases it might be possible for a court to order rescission of a merger that already has occurred, but usually the affairs of the constituent companies quickly become so intertwined that rescission would be an administrative nightmare. Also, if the acquired company is publicly owned, it would be impossible to recover payments to its shareholders.

103 The standard of culpability in duty-of-care cases is a matter of some confusion. Many state statutes use "prudent man" language, suggesting an ordinary negligence standard. MODEL BUS. CORP. ACT § 35 (1979) ("with such care as an ordinarily prudent person in a like position would use under similar circumstances"). Some courts have enunciated or hinted at a much more lenient standard, such as recklessness or bad faith. *See* Dent, *supra* note 39, at 646. The Delaware Supreme Court recently has applied a gross negligence standard. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

104 *See* Dent, *supra* note 39, at 650, 652-54.

105 Bringing such a suit would be feasible because it would be much less expensive than waging a proxy fight, *but see supra* text accompanying notes 60-63, especially given the simple procedure contemplated by this proposal.

holder class actions, even if no damages are awarded.[106] Justifying a substantial award of fees should be easy when the action has averted a substantial loss.

This proposal has many advantages over the other proposals discussed above. Unlike the others, it is not a blunt instrument; it prohibits only acquisitions that are clearly unprofitable to the buyer and leaves others untouched.[107] Also unlike the others, it would be effective, since disfavored acquisitions would not merely be indirectly discouraged but enjoined. The proposal would be simple and inexpensive to implement. Since relief would be available only when the buyer's share price has dropped noticeably, frivolous suits should be rare and, if they are filed, should be easily dismissed. Because the factual issues will be few and relatively uncomplicated and relief will be limited to an injunction, trials should be brief. Indeed, in most cases a court should be able to decide quickly whether to grant a preliminary injunction, and as a practical matter this decision often will dispose of the entire case.[108]

B. Possible Objections to the Proposal

1. Undue Reliance on Short-Term Market Reactions.—Probably the most serious possible objection to my proposal is that it relies excessively on—one might claim it idolatrizes—the stock market's short-term reaction to a transaction. The market is not perfect at evaluating securities; if it were, including predicting all future events, stock prices would almost never change.[109] In a particular case when the purchaser's share price has dropped, the market might conclude after reflection and perhaps receipt of additional information that the acquisition was profitable for the buyer, and the buyer's share price would then rise above its preannouncement level. Indeed, the author admits to being haunted by a specter: For the first time a court is persuaded to adopt this proposal, and immediately after it enters an injunction against the merger under attack, the price of the buyer's shares drops several points.

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106 Courts have awarded attorneys' fees even when plaintiffs ultimately lost the case but along the way vindicated certain shareholder rights. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 389-90 (1970).

107 *See infra* text accompanying notes 109-28 (discussion of argument that the proposal would not accurately indentify profitable and unprofitable acquisitions).

108 If a preliminary injunction is granted, the deal often will collapse because of delay and the strong possibility that it eventually will be permanently enjoined. Another possibility is that the transaction could be renegotiated at a lower price that would be profitable to the buyer as well as to the acquired company, at which point the preliminary injunction could be lifted. If a preliminary injunction is denied, the merger may well be consummated before a trial can take place, so that equitable relief generally would be impossible. *See supra* note 102.

109 Levmore, *Efficient Markets and Puzzling Intermediaries*, 70 VA. L. REV. 645, 647-48 (1984) (stock market is "a reliable indicator of its own future," though "not necessarily 'correct' "). Stock prices still would change in a perfect market to reflect stock splits or payment of dividends, even though these had always been anticipated.

This nightmare could become real, but probably would not. The stock market is efficient—public information circulates rapidly and stock prices react quickly to it.[110] Indeed, "prices react so rapidly to new information that there is no consistent progression of prices as information circulates, but . . . prices follow a random walk; i.e., past movements of prices do not foretell the direction of future movements."[111] Some have criticized the efficient market and random walk hypotheses.[112] Professor Lowenstein, for example, argues that the market efficiently determines stock prices only for trading, not for takeovers.[113] None of the criticisms suggests any defect in the stock market's reaction to mergers, however, and there is no reason to suspect any such defect.[114] Nor is there any evidence that declines in buyers' stock prices after announcements are routinely followed by a rebound. Quite the contrary, following acquisitions acquiring companies may tend to underperform the market.[115] In

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110 Easterbrook & Fischel, *supra* note 97, at 628; Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293, 307 (1975).

111 *Id.* at 311.

112 Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978); *accord* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549-51, 555 n.26 (1984), and authorities cited therein.

113 Professor Lowenstein believes that the efficient market hypothesis is flawed generally and especially so in valuing targets in mergers and takeovers because the stock market prices stocks only for trading purposes; it does not even seek to reflect the "intrinsic" value of the entire firm. Lowenstein, *supra* note 23, at 274-309. He points out that many investors and corporate managers behave as if they do not believe the efficient market hypothesis. *Id.* at 288-89. In particular, he argues that institutional investors, who now dominate stock market trading, are preoccupied with short-term performance. *Id.* at 280 n.127, 300-04.

114 Even if Lowenstein is correct that the stock market determines prices only for trading, not for takeovers, *see supra* note 113, the market for the acquirer's stock is a trading market both before and after announcement of the merger. The defect, if it exists, casts doubt on the attractiveness of the merger to the acquired company—a large premium does not prove attractiveness because the preoffer stock market price did not reflect the "intrinsic" value of the target—but not for the acquiring company, and Lowenstein does not suggest otherwise. To prove the reliability of the stock market's reaction reflected in the acquirer's stock price, it is not essential that the stock market be in any cosmic sense right, but only that it be unbiased in that "it does not systematically overshoot or undershoot the change that ultimately will be deemed merited on the basis of more leisurely contemplation of the new information." Easterbrook & Fischel, *supra* note 97, at 628. Neither Lowenstein nor anyone else suggests that for this purpose it is not unbiased. Similarly, the alleged (and highly dubious) preoccupation of institutional investors with short-term performance would not rule out reliance on the share price movements of acquiring companies unless it were shown that mergers impaired acquiring companies' performance in the short term but not the long. Again there is no evidence of this; nor does Lowenstein claim any. Moreover, the evidence (admittedly sketchy) suggests that the long-term performance of acquisitive companies is weak. *See infra* note 115. This further suggests that defects in the efficient market hypothesis, if any, do not account for the frequent declines in the share price of acquiring companies.

115 *See* M. SALTER & W. WEINHOLD, DIVERSIFICATION THROUGH ACQUISITION: STRATEGIES FOR CREATING ECONOMIC VALUE 27-32 (1979); Gort & Hogarty, *New Evidence on Mergers*, 13 J. L. & ECON. 167, 177 (1970); Hogarty, *The Profitability of Corporate Mergers*, 43 J. BUS. 317, 325-26 (1970); Langtieg, *An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Mergers*, 6 J. FIN. ECON. 365 (1978); Lowenstein, *supra* note 23, at 289-90; Malatesta, *supra*

some cases the postmerger price will rebound, but in others it will fall—in short, random walks; "each day's market-clearing price is the best indicator of future prices."[116] Thus, any share appreciation following an initial decline should be presumed to be due to factors other than the merger.[117] The defendants might show that the price rebound resulted from the release of new information about the merger. Unless the new information concerns new terms for the merger, however, the rebound should be presumed the result of other forces, especially if the acquired company is publicly held.[118]

Reliance on market efficiency often is reflected in the securities laws already. For example, in computing damages courts often refer to the market price of a security as establishing its value, and most courts now accept the fraud-on-the-market theory.[119] This makes sense only if markets are believed to be efficient and unbiased.

Might one of the parties deceive the market? Might the acquirer, for example, withhold bullish information about its plans for the target so as not to be compelled (by negotiation or competing bid) to pay a higher price, and thereby trick the stock market into denigrating the merger? Even if the acquirer were willing and able to do this prior to reaching an agreement, the incentive to do so would mostly vanish once agreement was reached.[120] For many acquisitions the federal securities laws require full disclosure of the acquirer's plans for the target.[121] More

note 8, at 172-75; Mason & Goudzwaard, *Performance of Conglomerate Firms: A Portfolio Approach*, 31 J. FIN. 39, 45 (1976); *Do Mergers Really Work?*, *supra* note 88, at 88, 89 ("there is growing evidence that mergers and acquisitions for the most part do not work out"); Nordhaus, *The Vanity of the Takeover Game*, N.Y. Times, Oct. 3, 1982, §3, at 9, col. 1.

116 Levmore, *supra* note 109, at 647.

117 *See* Easterbrook & Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1742 (1981) (only valid basis for comparison is stock price "immediately after" an event; at any later date, "many events have influenced the price of the stock. . . . The number of possible causes of price changes is almost infinite."). The initial price drop should be presumed due to announcement of the merger. *See supra* text accompanying notes 97-98.

118 If the acquired company is publicly held, information about it is already publicly available, and any additional announcement about the company probably is already known and factored into market values.

119 For example, in computing damages some courts have excluded the part of the securities' price decline attributable to a decline in the market generally. Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 586-88 (E.D.N.Y. 1971). In inside trading cases, the "true" value of the stock is fixed at the time the inside information is published and absorbed; any price changes thereafter are borne by the inside trader for as long as he owns the stock, rather than being added to or deducted from his damages. SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983) (en banc); *see* Easterbrook & Fischel, *supra* note 97, at 646-48; Easterbrook & Fischel, *supra* note 10, at 708 n.28 (growing use of efficient market hypothesis in computation of damages and acceptance of fraud-on-the-market theory).

120 The announcement of a merger usually includes pronouncements of how attractive the deal is for both sides.

121 If the acquisition is made with stock or other securities, the securities would have to be registered under the 1933 Act. 15 U.S.C. § 77e (Supp. 1985). A tender offer must comply with the

important, it is unlikely that the acquirer would have material nonpublic information. When the target company is public (as is usually the case; we already assume that the acquiring company is public), the market should already know of any possible synergy between the merger partners. Moreover, if the acquirer has a history of successful acquisitions, the market may applaud the deal even if it does not perceive the synergy. If there is inside information, it often leaks out.[122]

Suppose the acquirer had managed to fool the market into overvaluing its securities, perhaps even concealing its impending bankruptcy. The market then might deprecate an announced merger even though that merger would benefit the acquirer, perhaps even offering its only hope of survival. Although one cannot categorically deny this possibility, it is unlikely. The acquirer would have to convince the market that it was not only solvent but so profitable that the merger would seriously damage it; this is major-league deception. The acquirer's management would have to hide its true financial condition not only from the investing public, but also from its suppliers, creditors, accountants, the SEC, and the acquired company. To maintain the charade would be not only difficult but also illegal as to the acquirer's shareholders[123] and, at least in a noncash acquisition, which this presumably would be,[124] to the shareholders of the acquired company, also.[125] Even if the acquiring company accomplished all this, one hardly could bewail an injunction against the merger. The injunction would deprive the acquirer of only a potential gain from deception and would, in a noncash deal, spare the acquired company's shareholders from unfair and illegal damage.

In a hostile takeover attempt the raider's share price could also fall

Williams Act, including filings with the SEC and disclosure to the target's shareholders. 15 U.S.C. §§ 78m(d), 78n(d) (Supp. 1985).

122 Studies repeatedly have shown that stock prices rise (fall) prior to the public announcement of good (bad) news. This suggests widespread inside trading. See W. CARY & M. EISENBERG, *supra* note 51, at 728 ("stock prices often move dramatically immediately *preceding* public announcement of important views"; leaks are common) (emphasis in original).

123 Any knowingly untrue public statement by management would violate rule 10b-5 and other federal securities laws. A public issuer is required to file public reports quarterly, *see* Securities Exchange Act of 1934, § 13(a)(2), 15 U.S.C. § 78m(a)(2) (Supp. 1984), so that deception cannot long be maintained by silence alone. In addition, the SEC believes that public companies have an affirmative duty to disclose material developments even when not filing a periodic report, and there is some support for this position in the cases. *See* Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979).

124 Although a company in good financial condition may make an acquisition to rid itself of cash that makes it a potential takeover candidate, *see supra* text accompanying note 24, a company in weak financial condition rarely would use earnings or borrowed funds. Therefore, the acquisition probably will be financed with securities of the acquirer.

125 An acquisition with securities would constitute a sale of securities to shareholders of the acquired company, T. HAZEN, *supra* note 40, at 164, and would bring into play state and federal securities laws against deception in connection with the sale of securities, including Securities Act of 1933, §§ 12(2) and 17(a), 15 U.S.C. §§ 77l and 77q (Supp. 1984), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1984).

through a "bear raid" by the target—that is, massive sales or short sales of the raider's stock by the target. Even if a bear raid were successful, defendants could prove this as a defense. More important, a bear raid is unlikely for two reasons. First, it would be illegal; several statutes and rules under the 1934 Act prohibit manipulation of securities markets, including transactions designed to depress a stock's price.[126] Second, a bear raid could be extremely costly but still fail. If the target's sales drive down the price of the bidder's stock, other investors have an incentive to snap up the newly undervalued stock, and thereby drive its price back up. The target would then have incurred substantial transaction costs and probably trading losses without ultimately depressing the bidder's stock price.

The market can err, but this is not an adequate reason to reject the proposal. A court would be ill-positioned to decide whether the market's disapproval of a merger is a mistake. Defendants can always hire experts to testify that it is a mistake, and the defendants' generally greater resources favor them in making an attractive case. But unlike expert witnesses at a trial, investors in the market must put their money where their mouths are, and their collective judgment is the best index of the profitability of a merger. "[V]aluation techniques that do not rely on market prices are notoriously arbitrary. Appraisers—be they judges, juries, arbitrators, or commentators—fare poorly in attempting to fix asset values, opportunity costs, or the values of earning streams, because these notions are themselves derivative of market prices."[127] In the attempt to second guess the market, the best would be the enemy of the good:[128] although the proposal advanced here may produce occasional mistakes, an attempt to avoid these mistakes by conducting a lengthy trial on the wisdom of a merger would not only make procedures cumbersome but also ultimately produce many more errors.

2. *Inconsistency with Current Law.*—It may be argued that the proposal advanced here is inconsistent with current law. To some extent that is clearly true: the proposal clashes with the few cases dealing with unprofitable acquisitions.[129] It is, however, consistent with fundamental

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[126] *E.g.*, 15 U.S.C. §§ 78i(a), 78j, 78n(e), 78o(c) (Supp. 1985); 17 C.F.R. §§ 240.10b-5, 240.14e-1 (1985); *see* R. JENNINGS & H. MARSH, CASES AND MATERIALS ON SECURITIES REGULATION 675 (5th ed. 1982).

[127] Levmore, *supra* note 109, at 656 (footnote omitted); *see* Easterbrook & Fischel, *supra* note 97, at 626-31 (discussing use of market price to measure damages).

[128] Thus, criticism of this approach may be another example of the "Nirvana Fallacy of asserting that if markets are 'imperfect' then regulation must be better." Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 700 (1984). More generally, the Nirvana Fallacy is "the belief that if a cost or flaw in existing affairs can be identified, it must follow that some other state of affairs (the 'remedy') is better." Easterbrook, *Breaking Up Is Hard To Do*, REGULATION 25, 26 (Nov.-Dec. 1981).

[129] *See supra* text accompanying notes 36-41.

principles of corporate law. Corporate officers and directors owe a duty to act loyally and with reasonable prudence.[130] A hostile market reaction to a corporate acquisition might itself be deemed strong evidence of imprudence, especially given the frequency of unprofitable acquisitions. Although suits alleging lack of due care generally succumb to the business judgment defense, recent cases show that the duty of care still has some life.[131] It is not unthinkable that a court could find that a proposed acquisition violates the duty of care, especially if only an injunction were sought.[132]

In reviewing alleged breaches of the duty of loyalty, courts are less deferential to corporate managers. Although the tests vary, a common version is the "entire fairness" standard, which requires the defendant managers to prove the entire fairness of the transaction under attack.[133] Applying this standard, a court easily could hold that an unprofitable acquisition was not entirely fair to the buyer, especially if only an injunction were sought.

Shareholder attacks against unprofitable acquisitions generally have been tested not under the duty of loyalty but under the duty of care, resulting in the application of the more lenient business judgment standard. The reason for this is that the acquisition, like other maneuvers to deter takeovers, is not a transaction to which the managers are parties or which directly and immediately affects their compensation.[134] This approach is not immutable, however. Only in the last fifteen years or so (approximately since the adoption of the Williams Act) have hostile takeovers flourished and, therefore, have defenses to takeovers evolved. To no surprise, courts initially reviewed these maneuvers under their usual doctrines of fiduciary duty and characterized these cases as involving only the duty of care.[135] But awareness has grown that managements have a strong personal interest in transactions affecting corporate control and that these transactions should not be treated as ordinary business activities entitled to the benefit of the business judgment rule. Some courts, for example, have held certain defensive maneuvers to violate fi-

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130 H. HENN & J. ALEXANDER, *supra* note 28, at § 231.

131 *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors held liable for grossly negligent approval of takeover bid).

132 *See supra* text accompanying notes 102-04; *cf.* Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch.), *aff'd per curiam*, 316 A.2d 619 (Del. Sup. 1974) (sale of subsidiary for grossly inadequate price preliminarily enjoined but for plaintiff's inability to post security of $25 million).

133 Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977) ("a majority stockholder standing on both sides of a merger transaction, has 'the burden of establishing its entire fairness' to the minority stockholders"); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (in transaction between parent and fiduciary, "the test of intrinsic fairness . . . is applied").

134 Growth to justify larger compensation may be a principal motive for acquisitions, *see supra* text accompanying note 20, but an acquisition does not give rise to any legal right to larger compensation.

135 *See, e.g.*, Cheff v. Mathes, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (1964) (directors can justify greenmail payments "by showing good faith and reasonable investigation").

duciary duties.[136] Because corporate acquisitions tend to entrench incumbent management, it would be consistent with the duty of loyalty if a court applied the entire fairness standard to a corporate acquisition. If management could not prove the fairness of a transaction that depressed the shareholders' investment, an injunction would be appropriate. This is precisely what this proposal contemplates. In sum, the proposal advanced by this Article does not stray far from the mainstream of current law.

3. *The Feedback Loop Problem.*—In theory, the proposal could be sabotaged by its own success. If the market confidently predicted that a court would enjoin an unwise merger, the acquirer's stock price would not fall and no injunction would issue.[137] Although this feedback loop problem is interesting theoretically, it should not be significant in practice. If the stock market were functioning perfectly it still would react to the unwise merger. Recognizing that a court would not enjoin the merger if the buyer's stock price did not fall, owners of the stock would sell. If the price fell to the point at which a court certainly would enjoin the merger, investors would bid the price up. Equilibrium would be the price at which the market could not predict either a grant or a denial of an injunction—that is, the borderline between a material and an immaterial decline in price. If we assume an unbiased market, approximately half of these unwise mergers would be enjoined.

Even enthusiasts of the efficient market hypothesis do not claim such perfect stock markets. More important, this scenario posits a perfectly functioning, frictionless judicial process, so that only the magnitude of the decline in share price would determine the outcome. But the judicial process is invariably imperfect; litigation always entails costs and uncertainties. These costs and uncertainties make it unlikely that the market would disregard an unwise merger in the confident expectation that it will be enjoined.

Even if the feedback loop problem did occur in a few cases, however, the principal benefits of the proposal would survive. Like most

136 *See, e.g.*, Norlin Corp. v. Rooney Pace, Inc., 744 F.2d 255 (2d Cir. 1984) (target enjoined from voting shares issued to its subsidiary and ESOP to thwart takeover); Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981) (crown jewel option enjoined); Joseph E. Seagram & Sons v. Abrams, 510 F. Supp. 860 (S.D.N.Y. 1981) (crown jewel asset sale); Revlon, Inc. v. MacAndrews & Forbes Holdings Inc., Corp. L. Guide (CCH) ¶ 11,738 (Del. Sup. 1986) ("asset lock-up" option and "no shop" clause enjoined); *see* Coffee, *supra* note 8, at 1252 n.320.

Positions between the business judgment rule and duty of loyalty are possible. The drafters of the American Law Institute's Corporate Governance Project would treat takeover defenses as involving an intermediate third category of fiduciary duty. For example, the reporters would permit many defenses against tender offers if approved by disinterested shareholders. ALI, *supra* note 45, at 34-35, 37, 42, 50, 52. This contrasts with the traditional approach, which permits ordinary business judgments even without shareholder approval, but forbids interested transactions (at least if unfair) even if approved by disinterested shareholders.

137 I thank my colleague, Jim Brook, for bringing this possibility to my attention.

rules of law, the proposal would operate primarily by deterring misdeeds rather than by remedying them after they occur. Deterrence will not be crippled simply because an unwise merger occasionally escapes judicial censure.[138]

4. *Improbability of Adoption.*—It can be argued that adoption of this Article's proposal is improbable. Professor Coffee says that "few prospects appear more utopian" than that state courts will curb defensive tactics against tender offers.[139] The scholar performs a useful function by pointing a better path for the law, however, even if the law is not ready to follow that path. Moreover, prospects for adoption of this proposal are not necessarily so farfetched. If a legislature acts, it can adopt this proposal as easily as other proposals that have been advanced. A preceding section shows, moreover, that the proposal is not so far from the current state of the law that its adoption is unthinkable.[140] Its adoption by the courts would be no more surprising than several recent decisions in the corporate area.[141]

5. *Discrimination Against Public Companies.*—It might be argued that this proposal discriminates against publicly held companies because

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138 The feedback loop problem could be avoided if courts enjoined any merger that did not cause the purchaser's stock price to rise. This would mean prohibiting some mergers that were not unprofitable in order to be sure of prohibiting those that were. It is not clear that the advantages of this approach would outweigh the detriments.

139 Coffee, *supra* note 8, at 1252. It is true that the courts, especially in Delaware, often have upheld defensive tactics that seriously reduce the possibility that shareholders will receive an unsolicited tender offer. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. Sup. 1985) (upholding issuance of "poison pill" preferred stock); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. Sup. 1985). Even Delaware, however, has not invariably upheld defenses against tender offers. *See supra* note 136 and cases cited therein. Professor Coffee fears that if some states curbed defenses against tender offers, corporations simply would migrate to more lenient states. Coffee, *supra* note 8, at 1252. Many commentators have doubted whether there is a race to the bottom among the states. They argue that the interest of both the states and managers is not to reduce shareholder rights to nothing (which would cause investor confidence and share prices to fall), but to apply the rules that investors and managers would agree upon if they could negotiate without transaction costs. *See* Lorie, *supra* note 53; Winter, *supra* note 53. But if the states knowingly have failed to protect shareholder interests, the problem probably rests more with state legislators, who are concerned with short-term politics and who have, for example, spawned a host of detrimental state antitakeover laws, than with state judges, who often have produced decisions surprisingly favorable to shareholders, *see supra* notes 131 & 136; *infra* note 141. Thus, to focus on state courts seems somewhat misguided.

140 *See supra* text accompanying notes 129-36.

141 For example, Delaware, long castigated for leading a supposed "race to the bottom" in state corporation laws, has produced several notable decisions favorable to shareholders in recent years. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors held to have breached duty of care); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (evaluation techniques for appraisal proceedings liberalized); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (limiting directors' power to terminate derivative suits); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) (shareholders may seek to enjoin unfair squeezeout).

it inherently excludes acquisitions by private companies from its prohibition. The criticism is groundless. First, the proposal benefits public companies by freeing them from unwise acquisitions. Thus, it is bizarre to say that the proposal discriminates *against* public companies; if anything, it discriminates in their favor. Moreover, it is most unlikely that a private company would make an unprofitable acquisition because it lacks the incentive to do so. In public companies the motive for acquisitions, even if unprofitable, lies largely in insulating the company from hostile takeovers.[142] Private companies are not subject to hostile takeovers, and therefore lack this motive. Most important, in the private company ownership is not separate from control; management is either subject to the controlling shareholders or owns a majority of the stock itself. If management's actions reduce the value of the firm, there are few minority shareholders to suffer and most of the loss is borne by management itself. Since these managers lack the conflicting motives of managers of public companies, the law need not worry here about the private company.

6. *Restriction of the Proposal to Unprofitable Acquisitions.*—If courts should enjoin acquisitions that depress a corporation's stock price, why not enjoin any corporate action that impairs share price? Several features distinguish mergers from most other corporate activity. Acquisitions are unusual, major events that often dramatically affect stock prices. Most other corporate activities do not influence stock prices to such an extent. Even serious mismanagement will only gradually influence share price over a long period of time. Acquisitions also deserve special treatment because they generate losses more often than other activities. Although other areas of corporate management, such as product development, marketing, and employee relations, may be mishandled, they are not unprofitable as frequently as acquisitions. This is not surprising because most other areas do not engender the same conflicts of interest as mergers.[143] Heavy reliance on market reactions is somewhat risky,[144] and therefore the approach recommended here should apply only when there are conflicts of interest and a strong likelihood of damage. Moreover, remedies would be more problematic in other areas. A merger is a specific transaction that can be enjoined; general mismanagement is not. Even if damages were a logical remedy for breach of fiduciary duty, measuring damages for mismanagement would be virtually impossible.

Nonetheless, there may be other areas of corporate law in which

[142] *See supra* text accompanying notes 22-25. The desire to grow in order to justify larger executive perquisites is also largely lacking since private companies do not receive the same scrutiny as public companies from the SEC and public shareholders and therefore need not publicly justify their executives' compensation.

[143] *See supra* text accompanying notes 20-30 (motives for mergers).

[144] *See supra* text accompanying notes 109-28.

courts could profitably pay more attention to the market's reaction to corporate acts. Most obvious is the area of defenses against tender offers. The stock prices of targets generally suffer losses, often staggering, when the targets defeat tender offers.[145] This has led many commentators to recommend that such defenses be prohibited.[146] Courts might also profitably tackle the continuing use of first-in-first-out (FIFO) rather than last-in-first-out (LIFO) inventory accounting. Many corporations stick with FIFO in order to report higher earnings, even though FIFO results in higher income taxes.[147] The higher reported earnings are only an accounting fiction, however; real indicia of economic performance, such as cash flow, are not affected. Shareholders do not benefit from this sleight of hand because the stock market is not fooled.[148] It would be entirely appropriate for a court to enjoin use of FIFO as corporate waste.[149]

IV. CONCLUSION

The corporate acquisition plays a crucial part in keeping corporate managements diligent, moving assets to their most efficient use, and maximizing shareholder wealth. The corporate acquisition can be twisted, however, to do precisely the opposite of what is intended—that is, it can be used to entrench an inefficient management and keep corporate assets under their control. This Article has focused on the latter case, the corporate acquisition that has gone astray and has imposed serious losses on investors. This Article proposes to remedy the problem by reinjecting the discipline of the market through the legal process. With this approach the corporate acquisition can regain its proper and salutary role.

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145 *See* Gilson, *supra* note 43, at 857-59, 857 n.135.

146 *See supra* note 43.

147 *See* Lowenstein, *supra* note 23, at 288-89.

148 *See* authorities cited *supra* note 74. Experts disagree on whether LIFO or FIFO presents a more accurate picture of financial condition and performance. T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 238-41 (2d ed. 1977). It is conceded, however, that the reason for choosing FIFO is rarely its accuracy but rather "a desire to obtain larger payments under management incentive compensation plans, avoid 'take-overs,' make stock options more valuable, pay larger dividends and keep shareholder confidence." *Id.* at 238. Moreover, not only is the market not fooled by FIFO, but "the market may tend to put a lower value on companies which seem to be unnecessarily disbursing cash by trying to show higher reported income through retention of FIFO." *Id.* at 238-39; *see* Sunder, *Relationships Between Accounting Changes and Stock Prices: Problems of Measurement and Some Empirical Evidence*, 11 J. ACCT. RES. 123 (Supp. 1973) (stock prices of firms changing from FIFO to LIFO rose 5%, while prices of firms making the opposite change dropped slightly). Thus, absent special circumstances (such as slow inflation or deflation in a particular industry), the argument for LIFO is compelling.

149 In a somewhat similar way, Professor Lowenstein has argued that when management proposes to buy out public shareholders there should be an auction for the company with outsiders free to bid. Lowenstein, *supra* note 72, at 731-32, 779-84. Although this approach relies on auction rather than stock market prices, the stock market is an ongoing auction, and an auction is a one-time market. *See id.* at 732 ("the marketplace will better protect shareholders than will bankers' opinions or judicially administered remedies").